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# First Business Financial Services, Inc.

Third Quarter 2024

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## CORPORATE SPEAKERS:

**Corey Chambas**
*First Business Financial Services; Chief Executive Officer*
**David Seiler**
*First Business Financial Services; President, Chief Operating Officer*
**Brian Spielmann**
*First Business Financial Services; Chief Financial Officer*

## PARTICIPANTS:

**Jeff Rulis**
*D.A. Davidson; Analyst*
**Daniel Tamayo**
*Raymond James; Analyst*
**Nathan Race**
*Piper Sandler; Analyst*
**Damon DelMonte**
*KBW; Analyst*
**Brian Martin**
*Janney Montgomery Scott; Analyst*

## PRESENTATION:

Operator^ Good afternoon. Welcome to the First Business Financial Services' third quarter 2024 earnings conference call. At this time all participants are in a listen only mode. After today's presentation there will be an opportunity to ask questions. Please note this event is being recorded. I would now like to turn the conference over to First Business Financial Services Inc. CEO Corey Chambas. Please go ahead.

Corey Chambas^ Good afternoon, everyone. Today marks our first quarterly earnings call and we appreciate your time and interest in First Business Bank. Joining me today is our President and Chief Operating Officer Dave Seiler and our CFO Brian Spielmann. Today we'll discuss our financial performance, operational highlights and strategic initiatives followed by a Q&A session.

I'd like to direct you to our third quarter earnings release and investor presentation which are available through our website at ir.firstbusiness.bank.

We encourage you to review these alongside our other investor materials. Before we begin, please note this call may include forward-looking statements and the company's actual results may differ materially from those indicated in any forward-looking statements.

Important factors that could cause actual results to differ materially from those indicated in the forward-looking statements are listed in the earnings release and on the company's most recent annual report Form 10-K, and as may be supplemented from time to time in the company's other filings with the SEC, all of which are expressly incorporated herein by reference. There you can also find information related to any non GAAP financial measures we discuss on today's call, including reconciliations of such measures.

We are pleased to report a very solid third quarter.

Our operating model did what we built it to do and produced strong loan and deposit growth, a stable net interest margin and outstanding asset quality, all of which contributed to healthy earnings on both a pre tax pre provision basis and at the bottom line. Most importantly, we saw continued growth in tangible book value per share. There are some moving parts in the financials that Brian will walk through in a moment.

Since this is our first earnings call, we wanted to take a few minutes to walk you through our model and our strategic plan which is the driving force behind the consistent results we've been able to produce. I'll review our plan at the end of our remarks before opening it up to questions. Now, I'll ask Dave Seiler to spend a few minutes on the activity we saw in our markets and products during the quarter. Dave?

David Seiler^  Thanks Corey.

One reason we wanted to host an earnings call is to offer commentary on our markets and businesses and the dynamics driving our performance from a day to day business perspective. You saw in our press release that our loan and deposit growth has been solid. Loan balances grew approximately 286 million over the same period last year, up more than 10%, which is our long term organic growth goal.

Deposits grew 313 million or nearly 12% from third quarter last year. This is a testament to our strong client relationships.

We operate four distinct markets: South Central Wisconsin, Southeast Wisconsin, Northeast Wisconsin and Kansas City.

Each market operates under the guidance of a regional president. Consistent with our trends over the past several years, our South Central Wisconsin and Southeast Wisconsin markets led

the way with strong loan growth during the quarter. In our Kansas City market, we are excited to have a new regional president in place.

Since he joined us in April this year, we have been able to hire two new bankers and we are already seeing loan growth in the market.

We are also pleased to have an internal successor as our new market president in our Northeast Wisconsin region which is headquartered in Appleton, Wisconsin.

You can see our C&I and CRE breakouts in the earnings release and investor presentation.

I want to take a minute to answer a question that I know we'll get.

As an active CRE lender, we are often asked about asset quality in our office portfolio.

We simply don't have any areas of concern there, primarily due to the location of the properties, loan structures, and strength of the sponsors.

On slide 36 of our investor presentation you can see our office portfolio breakdown and you'll see that we have no non performing loans in the portfolio and almost 90% of our office credits have recourse. The properties we lend against are predominantly in suburban locations in strong markets which have not experienced the vacancy issues that have plagued large downtown metropolitan areas.

As part of our C&I offerings we have niche lending areas that operate nationally. The product offerings that make up this part of our business contribute to our loan portfolio's diversification in terms of credit type and geography as well as to the diversification of our revenue streams. All these niched C&I lending areas have specialized bankers with deep expertise and they utilize specialized platforms to manage the portfolios.

I have a few comments on several niche areas that were notable this quarter.

Our small ticket vendor finance business continues to show nice growth at attractive spreads and we recently hired two more experienced business developers.

As previously disclosed, we continue to see weakness in the transportation sector of the equipment finance portfolio.

We currently have 46 million of transportation loans in this portfolio, down from 61 million at the start of the year. This business stopped lending to the transportation sector in the first quarter of 2023 and the remaining transportation loans in the portfolio have an average remaining life of 35 months.

Based on what we are seeing today with low spot rates for trucking and depressed equipment values, we expect the credit impact of this portfolio to be in line with the past several quarters for this foreseeable future.

The non transportation portion of the equipment finance portfolio has performed better than our expectations.

Our accounts receivable, financing or factoring business also showed nice growth in Q3.

We have been able to generate good activity through our business development officers, several referral channels, and pay per click marketing efforts.

Our floor plan financing business, which finances the purchase of automobiles for larger financially strong used car dealerships, has shown the strongest growth among our niche C&I lending areas year to date. The credit performance of this business has been outstanding since its inception in 2020.

Our SBA team generated gain on sale revenue of 460,000 during the quarter which although an increase over the two previous quarters is still below our expectations.

Although gain amounts can vary quarter over quarter, we expect gains to increase in future quarters. Reasons for our optimism include that we hired a new leader for this team in March of 2023 who has rebuilt our sales team which now stands at eight business development officers. With this expanded team, we are seeing our pipelines improve.

Additionally, our loan mix has changed and we are now closing more loans that have a construction component. These loans need to complete construction and fully fund before they are eligible for sale.

We currently have over 19 million of closed loans in this category.

One final note on our loan growth. The double digit growth we've been able to achieve is driven by our ability to maintain teams of quality bankers who outperform our competition by providing exceptional service and developing lasting relationships.

Having the best teams allows us to maintain our underwriting standards and continue to grow faster than our competitors. It's highly competitive in our markets, and we're winning clients who want the best partner to help them navigate the challenges and opportunities that lie ahead. This is also evident in our deposit activity.

Over the past two quarters, we have been successful in managing down some of the higher priced deposits that we had due to individualized pricing in recent quarters.

Despite that, we grew core deposits more than 193 million or 9% from a year ago.

Our pricing initiatives and commitment to high quality growth have supported our goal to maintain a stable net interest margin in the range of 360 to 365 basis points. We've accomplished this in a period of intense competition and we believe this speaks to the quality of our relationships.

One more area I'd like to quickly draw your attention to is private wealth management.

We grew private wealth assets under management and administration to 3.4 billion at the end of the quarter. This marked growth of 17% from the prior year, generating 3.3 million in fee income for the quarter, which was up 11% from the third quarter of last year.

This business tends to fly under the radar of investors and analysts, but its importance to our model is certainly noteworthy. Private wealth management is a natural area of growth for us given our business only banking model and the overlapping business and personal needs of our clients.

We believe this is a differentiated strength of our company for both clients and investors alike.

Currently, the majority of our private wealth relationships are in the south central market and we see meaningful opportunities to expand this business into our other geographic markets. I'll wrap up and reiterate Corey's message that our bankers are hard at work executing our strategic initiatives motivated by incentives that are linked to our goals. They are delivering a superior client experience, driving loan and deposit growth and upholding our asset quality. Now I'll hand it off to Brian.

Brian Spielmann^  Thanks Dave. I'll go a little deeper into our financial highlights for the third quarter.

As Dave mentioned, our ability to produce net interest margin that is strong and stable compared to peers contributed to our solid performance. In addition to successfully managing rates on both sides of the balance sheet before and after the Fed's 50 basis point rate cut, we believe our differentiated match funding strategy and relatively neutral balance sheet sensitivity continues to set us apart in the industry.

I want to provide a little more detail on our adjustment interest margin which we also refer to as core margin.

We distinguish between NIM and core margin because we recognize a significant and recurring but variable amount of interest income from items like prepayment fees and asset based loan fees which we refer to as fees in lieu of interest.

By stripping these out from reported NIM, we believe our core margin reflects a more accurate representation of our client facing loan and deposit rate changes. Adjusted NIM for the third quarter is 351 compared to 347 in the linked quarter. This compares to reported NIM of 364 in the third quarter and 365 in the linked quarter. The majority of the adjusted NIM benefit in the quarter came from the loan portfolio.

Additionally, our ability to start reducing deposit rates helped offset some temporary short term wholesale funding costs. I'll note that since we are generally interest rate neutral, we wouldn't expect to see a meaningful change in our margin due to the recent and anticipated rate cuts by the Fed.

Our long term target for NIM is 360 to 365.

So, we are comfortable operating where we currently are, but expect we will see some movement as we diligently work to fund our loan growth with core deposits in the current dynamic rate environment. For more insight into our approach to interest rate risk management, we've added slide 14 in our investor presentation.

You'll see that we've outlined our strategy and the components of our current balance sheet positioning. Looking at income and expense, I'd point out that our diversified sources of fee revenue have built in variability. I'll reiterate our long standing position that we manage to positive long term operating leverage so we also manage to long term growth and fee income. Quarter to quarter variances are generally smoothed over a longer horizon.

There are a few moving parts to review this quarter.

On non interest income, as Dave discussed, SBA loan sale gains experienced growth and benefited from new leadership in the business that is beginning to deliver on production goals.

We expect to see continued growth in these pipelines over time. Variability in swap fees and returns on SBIC mezzanine funds are expected and moved in opposite directions this quarter.

Our swap fee income will continue to vary quarterly based on CRE activity, the rate environment and client preference. SBIC mezzanine fee income is driven by interest income in the portfolio and unrealized and realized gains. While we experienced a stronger year in 2023 for realized gains, 2024 was slower and more reliant on interest income only as the funds continue to invest in new companies.

We believe realized gains will pick up again in 2025 as existing funds mature and reinvest in new funds.

Our overall decline in expenses during the quarter was mainly driven by two items. The first was our bonus and profit sharing accrual, which was adjusted down by approximately $400,000 to reflect updated full year performance expectations in relation to our internal targets.

In addition, we capitalized a higher level of cost related to an internal software development project. This amounted to approximately $300,000. At our current expected level of incentives and after adding back these two adjustments, we anticipate overall compensation costs will stay at this approximate level for the rest of the year. We're pleased to report that we produced positive operating leverage compared to the prior year period even after adjusting for these various compensation adjustments.

Next, taxes.

We utilize federal tax credit projects to improve the communities we serve and to lower our overall effective tax rate over time. The tax rate for the nine months ended September 30, 2024 was 16.8% and in line with our expected full year 2024 effective tax rate of 16% to 18%. This is of course subject to change based on the timing of tax credit projects.

The effective tax rate is down from 21.4% for the same period in 2023 due to the benefit of the Wisconsin Small Business Lending Law. Given our tax credit pipeline and continued expectation of no Wisconsin state income tax liability, we believe our effective tax rate of 16% to 18% will continue in 2025.

I'm happy to report our bottom line profitability metrics showed positive trends reflecting our strong execution and efficient use of capital.

Return on average tangible common equity expanded, and tangible book value per share grew by 9.7% annualized from the linked quarter and 12.5% from the prior year quarter in line with our 10% plus long term goals.

We also benefited from the issuance of $20 million in sub debt near the end of the quarter which boosted Tier 2 capital and increased our total capital ratio by 15 basis points all else equal.

This replaced $15 million of sub debt we redeemed during the quarter to maintain full Tier 2 capital treatment.

We feel good about our capital levels and our strong earnings are generating capital to facilitate our expected organic growth. Now I'll hand it back over to Corey.

Corey Chambas^  Thank you, Brian.

As promised, I want to report on our strategic plan for 2024 to 2028 which is well underway. If you're new to FBIZ, understanding our strategic plan and the process that shapes it provides important insight into our success.

We take strategic planning very seriously.

We operate a five year plan, and we spend a full year developing each plan.

We kicked off our current plan in January of this year.

You can see our strategies and the goals we use as a measure of success on slide seven and 8 of our investor presentation.

Our overriding objective is to foster innovative and engaged team members who develop deep client relationships and deliver exceptional results for all stakeholders. This isn't just lip service.

We have specific strategies and tactics in place to accomplish this. These include initiatives to protect and strengthen our culture.

While our culture has always been a strength and a differentiator, given the increasing geographic spread and remote nature of our team, we want to double down on our efforts.

Some things we are doing to promote a strong, inclusive and solutions oriented culture include sharing departmental best practices for leading remote and hybrid work teams and providing additional manager training on how to model and coach to our culture.

We measure our progress through anonymous third party surveys to determine employee engagement, manager effectiveness and belonging scores and we expect exceptional results. This goes hand in hand with our continued focus on future ready talent.

We need to retain and continuously invest in the development of our top notch team, and we want to attract the best talent around to enable our ambitious organic growth plans.

To do this, we are focused on the future, asking ourselves what does the workplace of the future require for success?

AI training is an example of something we're doing to improve our workplace preparedness for tomorrow. Employee education and training has always been a focus, but we believe the pace of change of technology advancement will make this even more critical and enabling our employees to effectively use AI tools can be a competitive advantage.

Of course we are in the business of banking, so a big focus for us is growing core deposits. Those of you familiar with FBIZ know we have a unique approach to funding.

We don't operate a consumer business or branches. Instead we develop deep business and private wealth relationships, drawing in deposits that are extremely sticky as was proven in 2023 with our success in deposit retention and growth following the bank failures of early 2023.

We aim to continue growing client sourced deposits through a company wide focus, adding treasury management talent and by utilizing incentive programs to reward deposit growth more than loan growth. Improving operational efficiency and excellence is another important goal for us. Digital transformation and technology utilization are priorities and we are leveraging our talent by using robotic process automation and AI to enhance our productivity and client experience.

As an example, we think robotic process automation is a game changer in terms of efficiently scaling for future growth. Recently we brought our RPA efforts in house by hiring our own team including a manager and two developers. In addition, we have recently implemented automated financial statement spreading software to improve credit analysis efficiency.

We believe these strategies will help us achieve our financial goals.

We aim to produce tangible book value growth of 10% or more per year along with return on average tangible common equity of 15% or more by 2028.

We believe this will deliver on our ultimate goal to generate total shareholder returns that exceed our peer group median, a target we overachieved for the five years ended 2023.

I want to note that our growth model works because of our deeply knowledgeable business experts who truly understand our clients' business needs. This allows us to form deep long term relationships with these clients, which is evidenced by our net promoter score of 78 which is over twice the industry average.

As a result of these relationships, the average tenure of our 50 largest depositors is approximately 15 years.

I'll offer a related anecdote. These banker client relationships are deep in more ways than you might realize. You probably saw our 8-K in late September announcing the completion of a $20 million sub debt placement with certain accredited investors.

These investors were our own private wealth clients who know us well and jumped at the opportunity to buy our debt, saving us considerable transaction costs by fully funding the

placement.

Our clients are our entrepreneurial partners.

Finally, I'll reiterate that our match funding strategy and growth model are doing the work they were designed to do. Bringing stability to the areas where it is needed like net interest margin, and bringing growth in key areas including loans, deposits and top line revenue.

We have long been a 10% per year grower and we intend to continue that trend. I want to thank you for taking time to join us today. We're happy to take your questions now.

Operator^ (Operator Instructions) We'll hear first from Jeff Rulis with D.A. Davidson. Please go ahead.

Jeff Rulis^ Thanks. Good afternoon, guys.

Corey Chambas^ Hi Jeff.

Jeff Rulis^ Nice work on the call so far. Question on the margin. Brian, do you have a September average for the margin?

Brian Spielmann^ No. We don't have that.

We don't disclose that.

Jeff Rulis^ OK. I guess the follow on is looking at the cost of funds, slide 45, still increasing but showed some deceleration. I guess any visibility on the peak there and the opportunity that you see on funding costs?

Brian Spielmann^ Yes. I think we've been proactive in our efforts to reduce deposit costs. Like I said, we did some before the 50 basis point rate cut and did more after and we'll continue to evaluate those rates as we get closer to presumably another rate cut.

And we think given our relationships we have opportunity to continue moving those down in line with the asset side of our balance sheet.

Then given the neutrality of our balance sheet, feel pretty comfortable continuing to operate in that 360 to 365 range.

Jeff Rulis^ The customers that you approached, was that more so the exception price, folks that sort of understood that, as you on the way up you adjusted and now re approaching them or was it pretty broad based in terms of lowering?

Brian Spielmann^ It was a combination of both. There was a broad based approach across the whole portfolio and then also a little bit more surgical approach on the exception rated, individually priced clients that we know we have strong relationships with and to have those conversations.

Jeff Rulis^ Got it, thanks. A quick one on the expense side, I think you talked about the comp line reverting.

In the other portion that is there any offset in that?

It looked like the SBA recourse provision. Any thought on that?

Maybe lowering going forward. Is that a pretty good run rate?

Brian Spielmann^ Yes. I think that's more of a non recurring one off that's just tied to some methodology that we have in place for our SBA lending, and we don't expect that to be recurring at that level.

Jeff Rulis^ OK.

Then just the last one, Corey, looking at slide 15, you talk about some of those strategic initiatives. I guess if you -- if you could, what -- what are -- which of those are maybe easier acquired?

If you -- If you handpick anyone that jump out to you?

Corey Chambas^ What slide you on Jeff?

15?

Jeff Rulis^ Slide 15.

Of the initiatives going forward in terms of what do you think it's --

Corey Chambas^ (Multiple Speakers) Yes, yes, I would say one that's well in motion is robotic process automation because we mentioned that we brought the team in house to do that, but we were already working on that prior with an outsourced consultant.

So, we've been playing in this space for about a year plus now.

So, we have, I think it's three bots in place and in two different areas.

So that one is, I don't want to say easier but it's already in motion.

So it's just a function of continuing to find the highest and best paybacks on those and tick them off. It's really been great internally. The staff has embraced it and I think I believe our Treasury Management team came to our technology folks and said we have like 12 use cases or something like that.

And we're like, well, we only have one team.

We've got to parse this out in an orderly fashion.

So, that one I feel really good about. The C&I lending that just continues to go, that's been a roll that we've been on and it's always a challenge with our model on deposits, but we keep doing it year after year.

So, that will be forever a focus of ours.

Jeff Rulis^ OK, thanks Corey. I'll step back.

Corey Chambas^ Thank you.

Operator^ Next we'll hear from Daniel Tamayo with Raymond James. Please go ahead.

Daniel Tamayo^ Hey guys. Good afternoon. Yes, maybe just one on the lending side, I know you guys reiterated your double digit loan growth guidance, but just curious if -- if you had any insight on kind of where you're seeing specific demand right now. And kind of how we're thinking about what the mix could look like as we go into the next few quarters.

Corey Chambas^ Yes. I'll probably kick that over to Dave, Danny, but I guess big picture, I would say mix probably more of the same, as what we've seen, but specific between different pieces of what we do. Dave, you want to touch on that?

David Seiler^ Sure. I think if you think about our niche C&I businesses, I think we've seen really nice demand and pipelines in our accounts receivable finance area, so I'd expect some nice growth there.

Our vendor finance area is also seeing some nice demand.

We had a fair amount of real estate growth, CRE growth this quarter. A lot of that I believe was from construction loans funding up.

We haven't added as many new CRE loans I'd say in the past six months due to interest rates.

So if I would guess I would say C&I might outpace CRE loans in the coming quarters.

In terms of markets, we still see really nice growth in our southeast Wisconsin market, which is headquartered in Milwaukee, and I'd expect that to continue.

Daniel Tamayo^ Great. Thanks for all that color, Dave and Corey.

Then maybe just a follow up on the credit side. You know, you guys did a good job of laying out the pressure on the over the road trucking, but the -- or the transportation.

But the -- Just curious kind of how you're thinking about overall net charge offs in the next few quarters. I think you said similar pressure from the transportation side.

But curious how you'd think that translates in terms of overall net charge offs near term?

Corey Chambas^ Yes. I think it probably stays the same. What we've been seeing -- As to what we've been seeing lately.

As we mentioned a few quarters ago, we knew as that transportation piece, our methodology is time based in terms of reserving for those.

So, we were building the reserve for a while and then it started to flow through to the charge offs eventually when it hit a certain point in time.

That's now we've been seeing that for the last couple quarters.

Daniel Tamayo^ OK, great.

I apologize if this was in the release or if you mentioned it, but the specific reserves that you called out, what were those related to?

Brian Spielmann^ Equipment finance, small ticket, transportation portfolio, and I think a little bit SBA, but it's primarily equipment finance small ticket.

Daniel Tamayo^ OK. All right, got it. All right, that's all I had. Thanks for taking my questions.

Corey Chambas^ Yes. Thanks Danny.

Operator^ Next we'll hear from Nathan Race with Piper Sandler. Please go ahead.

Nathan Race^  Hey guys. Good afternoon, and thanks for hosting the call.

Corey Chambas^  Yes. Thanks.

Nathan Race^  Question on the margin outlook going forward. You know, I appreciate that you guys are still expecting to maintain the margin within the provided range.

But just given you know the magnitude of the Fed rate cut last month and just you know the outlook for at least a couple more rate -- excuse me, rate cuts before year end. Just curious how you're thinking about the near term margin trajectory. Just going back to the earlier question around deposit cost reductions and what you have repricing on the in the loan portfolio?

Brian Spielmann^  Yes. I think I'll just reiterate. I think we -- we believe we're comfortable and confident in our ability to match the asset repricing side of the balance sheet on our existing book of business. The qualifier statement we've always been making is the competition and deposit growth.

We know we value deposit volume, I'll say more than we do the rate if it's competitive.

And so, we'll continue to grow the balance sheet on the deposit side.

So that's where I think we'll see the pressure if any that would cause us to come out of that 360 to 365 range temporarily.

Over the long term we think given the match funding we still have the ability to manage to that along with the specialty financed C&I, higher C&I lending percentage of our loan portfolio.

So.

Nathan Race^  OK, that's helpful. Thanks for that Brian.

Then just thinking about operating leverage for next year. You know, obviously you guys are on pace to post pretty strong growth in pre tax, pre provision earnings this year. Just curious how you're thinking about kind of the magnitude of the increase in pre tax, pre provision earnings next year with hopefully some moderation in upward deposit cost pressures if not relief?

Brian Spielmann^  Yes. We think about it in terms of our balance sheet growth. Again just kind of reiterating on the margin side of our ability to stabilize that and be stable there, we feel confident we can grow 10%.

Then so if we're growing balance sheet 10%, revenue 10% and driving some modest positive

operating leverage, we feel confident in our ability to continue to drive that PPNR at a similar rate.

Corey Chambas^ Yes. And Nate, as you know the biggest thing on the expense side is comp, and fortunately, a lot of the technology initiatives and that we've been putting in place for the last several years, across the company allow us to not have to add 10% headcount when we're growing 10% top line revenue.

I don't know what the exact numbers are, but they're well less than that. It's like 5% or so in terms of headcount, maybe up only like 10 from a year ago.

Yes.

So, being able to add, we'll still be adding people but not at a 10% clip.

So, if we can do that and wage increases aren't they've mitigated back down to reasonable numbers.

So that's really the key in generating that positive operating leverage, which we think is a real differentiator for us in terms of profitability and driving continued improvement in bottom line and in our efficiency ratio.

Brian Spielmann^ One thing Nate I would add on that in terms of the revenue side, we are seeing a little bit of a softer fee income year as we've spoken to.

So we have we're feeling very confident about our SBA pipelines like we said, as well as the what has typically been our recurring but variable items in SBIC, mezzanine fund income.

We're optimistic about that, as they start to realized gains in the portfolio.

That's a strategy of ours to expand some of that to expand some of that investment as well.

So, we feel like some of these recurring but historically variable fee income lines will begin to pick up and start to stabilize and show some more consistency, which we think really adds value to our PPNR story.

Nathan Race^ Yes, for sure, that's helpful.

Speaking of fee income I was surprised that wealth management fees came down a little bit versus 2Q despite AUM increasing quarter over quarter. Any color you can shed on that and just kind of how you're thinking about wealth management growth into next year, assuming relatively stable equity markets?

Brian Spielmann^ Yes, yes. Q2 had some, I'll say annual fees in there, some tax processing related fees that we'll typically see around that time of year.

So it wasn't unexpected to us, but that came down a little bit.

But to your point, strong asset under management growth in the quarter which we feel will be realized here with a pickup in fee income in the fourth quarter and going forward.

Corey Chambas^ Yes. And Nate, in there, that one obviously you think there's just a lockstep correlation between assets under management and fee levels.

It's -- it's not. And a little bit of that is if you smooth it out and you looked at a longer time period, it would be.

But quarter to quarter it's not because there's a little bit of lag in how we charge.

So quarter end asset levels are the basis for fee income for the next quarter.

So depending upon where you were the previous quarter can affect that current quarter being down compared to where you ended at the end of the quarter.

So, those two things can get off in a quarter, but they will smooth out over a couple quarter time period.

Nathan Race^ Got it. That makes sense. I appreciate all the color. Thanks guys.

Corey Chambas^ Yes.

Operator^ Our next question will come from the line of Damon DelMonte with KBW. Please go ahead.

Damon DelMonte^ Hi. Good afternoon guys. Hope you're all doing well today. A lot of good questions have been asked and answered.

But just kind of curious on the -- on the outlook for the reserve level. You know Corey, your comments, I believe it was Corey, about how you'd kind of build the reserves for the transportation sector in anticipation of them eventually being charged off down the road.

So as we look at the reserve at call it 116 this quarter, like how much padding do you have built in there?

Like what would be a more normalized reserve level once you've kind of worked through those problem loans?

Brian Spielmann^ Yes. Thanks Damon. You know our take on that is that we have some elevated small ticket equipment finance reserves like you said that we feel will taper and moderate over time along with then some credit normalization at some point. Right?

So we're really operating under an environment that are -- where we're reserved now is a good place to be and absent any -- any broader macro events that would flow through the quantitative components of the model, that'll kind of stay in that -- in that area for the foreseeable future.

Damon DelMonte^ OK, that's helpful. Thank you.

Then with regards to expenses, as it relates to the investments in the AI training and the robotic process optimization, is that kind of an ongoing expense that you guys deal with every quarter or is there kind of an upfront cost to get it going and then you don't really have to continue to invest in that?

Brian Spielmann^ So that's -- that's a good question. And part of what we were talking about and what happened this quarter is that that decrease in compensation was we have a much larger software development project going on related to a loan origination system.

So that's what's causing that increase in capitalized expense.

But going forward as we finish that project, because we have our software developers on staff, our RPA developers on staff, we'll continue to have modules that we'll add to maintenance that we'll do.

So, we'll continue to capitalize these compensation expenses through the software development.

And so, we'll have instead of outsourced software development licensing costs, we'll have just a slight moderate increase in computer software amortization over time as we continue to build out those systems and get the benefits of the operating efficiency.

Corey Chambas^ Just to put a finer point on that, Damon, besides a little bit of additional capitalization which was unique to this quarter, it's really a run rate thing. It's baked in. Those folks were on staff and will continue to be.

Damon DelMonte^ Got it.

OK, great. I appreciate that color. That's all that I had. Thank you very much.

Corey Chambas^ Thanks Damon.

Brian Spielmann^ Thanks Damon.

Operator^ (Operator Instructions) We'll hear now from Brian Martin with Janney. Please go ahead.

Brian Martin^ Hi. Good afternoon guys. Hey Brian, I guess just one back to the margin. I guess as you guys think about kind of right now you're kind of at the upper end of the range. Just kind of the the sub debt that was done this quarter and then as far as just kind of maybe what could take, I guess my thought was maybe you guys are looking to shift maybe to a little bit more of a liability sensitive balance sheet.

But I guess is that not something you guys are looking to do just kind of where we're at in the cycle or is just staying neutral and kind of what you've outlined in terms of kind of the range, how to best think about it?

Brian Spielmann^ Yes. I think your first point about being at the higher end of the range is accurate.

We got there a little faster than we thought we would. And again there's probably some basis points there from competitive pressures, still stay within that range.

But I would say we don't really try not to think about or bet on rates.

So we like the neutrality of that because who's to say right, that there could be a pause or a rate hike.

And so, we try to stay neutral, we try to stay in a position where we can maintain a stable margin.

So I think at the 930 because some various -- variable funding that came on.

We have a slight asset sensitive balance sheet that'll flip to liability sensitive here throughout the rest of the year as we get closer to what the markets think is another rate cut.

So we like the ability of staying really balanced so we can be nimble and we really just value the stability of the value of net interest stability.

Brian Martin^ Got you. And as far as what could actually take it above or below that range, I mean I think you said the competitive side on -- on the deposits could drift it a bit below the maybe the lower end of the range. And as far as on the flip side, I guess if you're going to get outside the range on the upside, what do you see the potential there?

If you move outside the band [ph]?

Brian Spielmann^ The upside would be our C&I lending mix.

So some of those niche areas such as asset based lending as a softer economy presents more opportunities for asset based lending and those are much higher yields opportunities for more prepayment fees, asset based loan fees.

So, we have more outsized opportunity there, I see that as an opportunity to increase margin.

That goes for some of the other niche areas in our C&I business as well.

Brian Martin^ OK.

Those niches today are what low 20s in terms of percentage wise, what they are of the total?

Is that kind of where you want to maintain them or is that something you're looking to kind of shift up or shift down from where we're at?

Corey Chambas^ Yes, Brian, we're about 25%, which was that had been our goal in our last strategic plan to move that from 16 at the beginning of that plan to 25 and we got there and we're kind of stabilized there right now. We'd like to see that inch up a little bit more. That would be great.

But it's a little bit of taking what the market gives you. We're not going to ever stretch on credit in any of the segments that we do.

As you know we like to play in the higher credit quality end of the spectrum for any of those business lines.

So, the, as I think we mentioned, ABL, asset based lending has been soft as banks have not been squeezing deals out over the last couple of years.

That's one of the places where we get a little bit more accounts receivable finance, the receivables factoring business. That -- That's a place that -- that we get a little higher yields to.

So, you know that would be where we could see a little bit more.

Brian Martin^  Got you.

OK. No, that's helpful.

Then maybe I just missed what you guys said on the compensation line.

But the compensation line, I heard the what had dropped to this quarter was is your expectation for 4Q that was stable towards that or it's going to return to where it was in terms of the fourth quarter outlook?

Brian Spielmann^  Yes.

So, we had the two adjustments in Q3, the total of $700,000.

So, you add those back and we feel like that's a good place, a good run rate for Q4 potentially to jump off of.

Brian Martin^  OK, so is that around 16, Brian?

Is that what that ballpark what that was?

Brian Spielmann^  Yes, ballpark. I think we're 15.2 plus 700,000. I think if you add back [ph].

Brian Martin^  OK.

Then just remind me kind of with your business model and the hiring and whatnot. I mean just a normal as you kind of look into '25 in terms of what to expect in terms of growth in that comp line what's kind of a normal as far as budgeting goes, how do you guys think about that given the model?

Corey Chambas^  Yes. I would say if we look back at recent history, I think Brian, you'd find that we've added maybe 5% in a headcount number.

Then our annual merit increases that we do at year end, they were inflated in the last couple of years with inflation.

But historically those have been in the 3%, 3.5% kind of range.

Then there's some other adjustments.

But if you think about something like that, if it is 5% and another 3%, 3.5% and another half a percent or something of adjustments that have to happen through the year, market adjustments, those kinds of things that puts you in the higher single digits, mid to high single digit range.

And I think that's where -- that's where we feel very confident in our ability to drive operating leverage. Because if we can deliver the 10% plus growth which we have pretty consistently as you know, that gives us that gap to the high single digits on the comp side, which is the biggest piece of expenses.

Brian Martin^ Got you. No.

OK, that makes sense.

Then just the last one for me was the you talked about some of the volatility on those fee income lines and just kind of the outlook near term and then a little bit longer term. You know, it sounds like the mezz funds, which is a pretty decent component and swings around a little bit.

Your expectation is that '23 was low, '24 was high.

Then 20 -- I guess '23 was low, '24 -- or '24 was low, '23 was high.

The outlook for next year is probably somewhere in between, if you get some recovery. Is that how to think about what '25 looks like in terms of those fees by quarter or bi [ph] annually [ph]?

Brian Spielmann^ Yes. We see '25 from the SBIC fee income being a lot similar to '23. We're just seeing a lot of opportunities for realizations in the portfolio based on where they are in their life cycle and feel good about where that's at.

Corey Chambas^ Yes, this quarter was probably one of the lowest points we've had ever.

So, no adjustments. They changed.

As you might remember, Brian, previous to this year, there was about revaluations on their portfolio, which would then flow through only twice a year.

This year that started to be monthly. Excuse me, quarterly. They would look at valuation, so that smooths that out a little bit, but there just really wasn't any of that. It was basically just the interest income on the coupon that they earned this quarter.

So, that was probably a low point.

Brian Martin^  Got you. Yes. I mean the outlook seems pretty positive with both SBA and the mezz coming back next year.

So at least the stage looks to be set for some pretty good momentum.

So, that's all I had, guys.

So thanks for hosting the call and congrats on putting it together.

Brian Spielmann^  Thanks, Brian. Appreciate it.

Operator^  As there are no further questions in queue at this time, I'd like to turn the floor back over to Corey Chambas for any additional or closing comments.

Corey Chambas^  That concludes our Q&A session.

We appreciate your time and interest in First Business Bank, and we look forward to sharing our progress next quarter. Thank you. And have a great weekend.

Operator^  Thank you.

Once again ladies and gentlemen. that will conclude today's call. Thank you for your participation. You may disconnect at this time.