

MICROFINANCIAL INC
Form 10-Q
May 14, 2008

Table of Contents

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q**

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES AND EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 2008

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES AND EXCHANGE ACT OF 1934

**Commission File No. 1-14771
MICROFINANCIAL INCORPORATED
(Exact name of registrant as specified in its charter)**

Massachusetts
(State or other jurisdiction of
incorporation or organization)

04-2962824
(I.R.S. Employer Identification No.)

10 M Commerce Way, Woburn, MA 01801
(Address of principal executive offices)

(781) 994-4800

(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(b) of the Securities and 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 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 and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company
(Do not check if a smaller reporting company)

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

As of April 30, 2008, 13,987,528 shares of the registrant's common stock were outstanding.

**MICROFINANCIAL INCORPORATED
TABLE OF CONTENTS**

	Page
Part I- FINANCIAL INFORMATION	
Item 1. Financial Statements (unaudited):	
<u>Condensed Consolidated Balance Sheets - December 31, 2007 and March 31, 2008</u>	3
<u>Condensed Consolidated Statements of Income - Three months ended March 31, 2007 and 2008</u>	4
<u>Condensed Consolidated Statements of Cash Flows - Three months ended March 31, 2007 and 2008</u>	5
<u>Notes to Condensed Consolidated Financial Statements</u>	6
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	11
<u>Item 3. Quantitative and Qualitative Disclosures about Market Risk</u>	18
<u>Item 4. Controls and Procedures</u>	18
Part II OTHER INFORMATION	
<u>Item 1. Legal Proceedings</u>	19
<u>Item 1A. Risk Factors</u>	19
<u>Item 6. Exhibits</u>	19
<u>Signatures</u>	20
<u>EX-10.1 COMPENSATORY ARRANGEMENTS WITH DIRECTORS</u>	
<u>EX-31.1 SECTION 302 CERTIFICATION OF THE CEO</u>	
<u>EX-31.2 SECTION 302 CERTIFICATION OF THE CFO</u>	
<u>EX-32.1 SECTION 906 CERTIFICATION OF THE CEO</u>	
<u>EX-32.2 SECTION 906 CERTIFICATION OF THE CFO</u>	

Table of Contents

MICROFINANCIAL INCORPORATED
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except share and per share data)

	March 31, 2008 Unaudited	December 31, 2007
ASSETS		
Cash and cash equivalents	\$ 5,835	\$ 7,080
Restricted cash	499	561
Net investment in leases:		
Receivables due in installments	108,864	92,314
Estimated residual value	11,567	9,814
Initial direct costs	864	729
Less:		
Advance lease payments and deposits	(381)	(219)
Unearned income	(40,834)	(35,369)
Allowance for credit losses	(7,771)	(5,722)
Net investment in leases	72,309	61,547
Investment in service contracts, net	141	203
Investment in rental contracts, net	96	106
Property and equipment, net	806	782
Other assets	645	703
Total assets	\$ 80,331	\$ 70,982
LIABILITIES AND STOCKHOLDERS EQUITY		
Notes payable	\$ 14,508	\$ 6,531
Accounts payable	872	1,350
Capital lease obligation	43	
Dividends payable		698
Other liabilities	1,010	801
Income taxes payable	172	228
Deferred income taxes	1,190	546
Total liabilities	17,795	10,154
Stockholders equity:		
Preferred stock, \$.01 par value; 5,000,000 shares authorized; no shares issued at March 31, 2008 and December 31, 2007		
Common stock, \$.01 par value; 25,000,000 shares authorized; 13,986,278 and 13,960,778 shares issued at March 31, 2008 and December 31, 2007, respectively	140	140
Additional paid-in capital	45,562	45,412
Retained earnings	16,834	15,276

Total stockholders' equity	62,536	60,828
Total liabilities and stockholders' equity	\$ 80,331	\$ 70,982

The accompanying notes are an integral part of the unaudited condensed consolidated financial statements.

Table of Contents

MICROFINANCIAL INCORPORATED
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(In thousands, except share and per share data)

	Three Months Ended March 31,	
	2008	2007
	Unaudited	
Revenues:		
Income on financing leases	\$ 4,940	\$ 2,033
Rental income	2,752	3,924
Income on service contracts	259	361
Loss and damage waiver fees	688	444
Service fees and other	549	386
Interest income	60	323
 Total revenues	 9,248	 7,471
 Expenses:		
Selling, general and administrative	3,239	3,568
Provision for credit losses	3,357	1,523
Depreciation and amortization	230	463
Interest	152	13
 Total expenses	 6,978	 5,567
 Income before provision for income taxes	 2,270	 1,904
Provision for income taxes	713	687
 Net income	 \$ 1,557	 \$ 1,217
 Net income per common share basic	 \$ 0.11	 \$ 0.09
Net income per common share diluted	\$ 0.11	\$ 0.09
 Weighted-average shares:		
Basic	13,974,904	13,860,534
Diluted	14,160,139	14,072,449

The accompanying notes are an integral part of the unaudited condensed consolidated financial statements.

Table of Contents

MICROFINANCIAL INCORPORATED
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Three Months Ended March 31,	
	2008	2007
	Unaudited	
Cash flows from operating activities:		
Cash received from customers	\$ 13,163	\$ 9,547
Cash paid to suppliers and employees	(4,022)	(3,537)
Income taxes paid	(125)	(90)
Interest paid	(151)	(1)
Interest received	60	323
Net cash provided by operating activities	8,925	6,242
Cash flows from investing activities:		
Investment in lease and rental contracts	(17,177)	(10,138)
Investment in direct costs	(265)	(142)
Investment in property and equipment	(111)	(57)
Net cash used in investing activities	(17,553)	(10,337)
Cash flows from financing activities:		
Proceeds from secured debt	18,648	19
Repayment of secured debt	(10,672)	
Decrease in restricted cash	62	
Proceeds from capital lease obligation	46	
Repayment of capital lease obligations	(3)	
Payment of dividends	(698)	(691)
Net cash provided by (used in) financing activities	7,383	(672)
Net change in cash and cash equivalents	(1,245)	(4,767)
Cash and cash equivalents, beginning of period	7,080	28,737
Cash and cash equivalents, end of period	\$ 5,835	\$ 23,970
Reconciliation of net income to net cash provided by operating activities:		
Net income	\$ 1,557	1,217
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of unearned income, net of initial direct costs	(4,939)	(2,033)
Depreciation and amortization	230	463

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

Provision for credit losses	3,357	1,523
Recovery of equipment cost and residual value	8,088	4,232
Stock-based compensation expense	22	392
Non-cash interest expense (amortization of debt discount)		12
Changes in assets and liabilities:		
Current taxes payable	(13)	597
Deferred income taxes	706	
Other assets	58	132
Accounts payable	(350)	(219)
Other liabilities	209	(74)
Net cash provided by operating activities	\$ 8,925	\$ 6,242

Supplemental disclosure of non-cash activities:

Fair market value of stock issued for compensation	\$ 128	\$ 307
--	--------	--------

The accompanying notes are an integral part of the unaudited condensed consolidated financial statements.

Table of Contents

MICROFINANCIAL INCORPORATED
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Tables in thousands, except share and per share data)

A. Nature of Business

MicroFinancial Incorporated (referred to as Microfinancial, we, us or our) operates primarily through its wholly-owned subsidiaries, TimePayment Corp. and Leasecomm Corporation. TimePayment is a specialized commercial finance company that leases and rents microticket equipment and provides other financing services. The average amount financed by TimePayment during 2007 was approximately \$6,500 while Leasecomm historically financed contracts of approximately \$1,900. We primarily source our originations through a nationwide network of independent equipment vendors, sales organizations and other dealer-based origination networks. We fund our operations through cash provided by operating activities and borrowings under our line of credit.

B. Summary of Significant Accounting Policies*Basis of Presentation*

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and the rules and regulations of the Securities and Exchange Commission for interim financial statements. Accordingly, our interim statements do not include all of the information and disclosures required for our annual financial statements. In the opinion of our management, the condensed consolidated financial statements contain all adjustments, consisting only of normal recurring adjustments, considered necessary for a fair presentation of these interim results. These financial statements should be read in conjunction with our consolidated financial statements and notes included in our Annual Report on Form 10-K for the year ended December 31, 2007. The results for the three months ended March 31, 2008 are not necessarily indicative of the results that may be expected for the full year ending December 31, 2008.

The balance sheet at December 31, 2007 has been derived from the audited financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2007.

Allowance for Credit Losses

We maintain an allowance for credit losses on our investment in leases, service contracts and rental contracts at an amount that we believe is sufficient to provide adequate protection against losses in our portfolio. Given the nature of the microticket market and the individual size of each transaction, we do not have a formal credit review committee to review individual transactions. Rather, we developed a sophisticated, risk-adjusted pricing model and have automated the credit scoring, approval and collection processes. We believe that with the proper risk-adjusted pricing model, we can grant credit to a wide range of applicants provided we have priced appropriately for the associated risk. As a result of approving a wide range of credits, we experience a relatively high level of delinquency and write-offs in our portfolio. We periodically review the credit scoring and approval process to ensure that the automated system is making appropriate credit decisions. Given the nature of the microticket market and the individual size of each transaction, we do not evaluate transactions individually for the purpose of developing and determining the adequacy of the allowance for credit losses. Contracts in our portfolio are not re-graded subsequent to the initial extension of credit and the allowance is not allocated to specific contracts. Rather, we view the contracts as having common characteristics and maintain a general allowance against our entire portfolio utilizing historical collection statistics and an assessment of current credit risk in the portfolio as the basis for the amount.

We have adopted a consistent, systematic procedure for establishing and maintaining an appropriate allowance for credit losses for our microticket transactions. We estimate the likelihood of credit losses net of recoveries in the portfolio at each reporting period based upon a combination of the lessee's bureau reported credit score at lease inception and the current delinquency status of the account. In addition to these elements, we also consider other relevant factors including general economic trends, trends in delinquencies and credit losses, static pool analysis of our portfolio, trends in recoveries made on charged off accounts, and other relevant factors which might affect the performance of our portfolio. This combination of historical experience, credit scores, delinquency levels, trends in credit losses, and the review of current factors provide the basis for our analysis of the adequacy of the allowance for credit losses. We take charge-offs against our receivables when such receivables are deemed uncollectible which is

Table of Contents

MICROFINANCIAL INCORPORATED
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Tables in thousands, except share and per share data)

generally at 360 days past due where no contact has been made with the lessee for 12 months. Historically, the typical monthly payment under our microticket leases has been small and as a result, our experience is that lessees will pay past due amounts later in the process because of the small amount necessary to bring an account current.

A summary of the activity in our allowance for credit losses for the three months ended March 31, 2008 is as follows:

Allowance for credit losses at December 31, 2007	\$ 5,722
Provision for credit losses	3,357
Charge-offs	(2,329)
Recoveries	1,021
Charge-offs, net of recoveries	(1,308)
Allowance for credit losses at March 31, 2008	\$ 7,771

Net Income Per Share

Basic net income per common share is computed based on the weighted-average number of common shares outstanding during the period. Diluted net income per common share gives effect to all potentially dilutive common shares outstanding during the period. The computation of diluted net income per share does not assume the issuance of common shares that have an antidilutive effect on net income per common share. At March 31, 2007, 1,115,188 options and 100,000 warrants were excluded from the computation of diluted net income per share because their effect was antidilutive. At March 31, 2008, 1,292,067 options were excluded from the computation of diluted net income per share because their effect was antidilutive.

	Three Months Ended March 31,	
	2008	2007
Net income	\$ 1,557	\$ 1,217
Weighted average common shares outstanding	13,974,904	13,860,534
Dilutive effect of common stock options, warrants and restricted stock	185,235	211,915
Shares used in computation of net income per common share diluted	14,160,139	14,072,449
Net income per common share basic	\$ 0.11	\$ 0.09
Net income per common share diluted	\$ 0.11	\$ 0.09

Stock-Based Employee Compensation

Under our 1998 Equity Incentive Plan, we reserved 4,120,380 shares of common stock for issuance. In February 2008, we granted 10 year options to our executive officers to purchase 176,879 shares of common stock at an exercise price of \$5.85 per share. The fair value of these awards was \$1.78 per share. The options were valued at the date of grant using the following assumptions: expected life in years of 6.25, annualized volatility of 41.30%,

expected dividend yield of 3.70% and a risk free interest rate of 2.66%. The options vest over five years beginning on the second anniversary of the grant date. In February 2007, we granted ten year options to our executive officers to purchase 40,188 shares of common stock at an exercise price of \$5.77 per share. The fair value of these awards

Table of Contents

MICROFINANCIAL INCORPORATED
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Tables in thousands, except share and per share data)

was \$2.08 per share. The options were valued at the date of grant using the following assumptions: expected life in years of 7, annualized volatility of 43.62%, expected dividend yield of 3.47%, and a risk-free interest rate of 4.62%. The options vest on the fifth anniversary of their grant date. No options were exercised or cancelled during the three months ended March 31, 2008.

On February 4, 2004, a new non-employee director was granted 25,000 shares of restricted stock with a fair value of \$3.17 per share. On August 15, 2006, a second new non-employee director was granted 25,000 shares of restricted stock with a fair value of \$3.35 per share. In each case, the restricted stock vested 20% upon grant and vests 5% on the first day of each quarter after the grant date. As vesting occurs, compensation expense is recognized. As of March 31, 2008, 37,500 shares were fully vested between these two directors.

Information relating to our outstanding stock options at March 31, 2008 is as follows:

Exercise Price	Outstanding		Intrinsic Value	Exercisable		
	Shares	Weighted-Average Life (Years)		Weighted-Average Exercise Price	Shares	Intrinsic Value
\$12.31	359,391	.91	\$	\$ 12.31	359,391	\$
13.54	40,609	.91		13.54	40,609	
9.78	350,000	1.9		9.78	350,000	
13.10	90,000	2.89		13.10	90,000	
6.70	235,000	3.91		6.70	235,000	
1.59	167,500	4.66	610,000	1.59	167,500	610,000
5.77	40,188	8.92		5.77		
5.85	176,879	9.83		5.85		
	1,459,567	3.48	\$ 610,000	9.19	1,242,500	\$ 610,000

During the three months ended March 31, 2008 and 2007, the total share based employee compensation cost recognized was \$22,000 and \$392,000, respectively.

For share-based liability awards, we recognize compensation cost equal to the greater of (a) the grant date fair value or (b) the fair value of the modified liability when it is settled. As a result of modifications to certain awards in 2005, some awards made under the plan had been classified as share-based liability awards. As of March 31, 2007, our share-based liability awards were fully vested. In April 2007, we modified certain exercise features of all our outstanding share-based liability awards by restricting the settlement methods available to the option holders and converted these awards to equity awards. As a result of our modifications, our cumulative share-based compensation liability of \$932,000 was reclassified in April 2007 to additional paid-in capital.

We estimate the fair value of our stock options using a Black-Scholes valuation model, consistent with the provisions of SFAS 123(R), SEC Staff Accounting Bulletin No. 107 and our prior period pro forma disclosures as prescribed by SFAS 123. Key input assumptions used to estimate the fair value of stock options include the expected option term, volatility of the stock, the risk-free interest rate and the dividend yield.

The fair values as of March 31, 2007, of the outstanding options classified as liability instruments under SFAS 123(R) were estimated using expected lives of one to three years, annualized volatility of 43%, an expected dividend yield of 3.86% and a risk free interest rate of 4.58%.

The expected life represents the average period of time that the options are expected to be outstanding given consideration to vesting schedules; annualized volatility is based on historical volatilities of our common stock;

dividend yield represents the current dividend yield expressed as a constant percentage of our stock price and the risk free rate is based on the U.S. Treasury yield curve in effect on the measurement date for periods corresponding

8

Table of Contents

MICROFINANCIAL INCORPORATED
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Tables in thousands, except share and per share data)

to the expected life of the option. At each subsequent reporting date, we are required to remeasure the fair value of our share-based liability awards.

C. Notes Payable

On August 2, 2007, we entered into a new three-year \$30 million line of credit with Sovereign Bank based on qualified TimePayment lease receivables. Outstanding borrowings bear interest at Prime or at a London Interbank Offered Rate (LIBOR) plus 2.75% and are collateralized by eligible lease contracts and a security interest in all of our other assets. Under the terms of the facility, loans are Prime Rate Loans, unless we elect LIBOR Loans. If a LIBOR Loan is not renewed at maturity it automatically converts to a Prime Rate Loan. At March 31, 2008 all of our loans were Prime Rate Loans. The prime rate at March 31, 2008 was 5.25%. The amount available on our line of credit at March 31, 2008 was \$15,492,000. The line of credit has financial covenants that we must comply with to obtain funding and avoid an event of default. As of March 31, 2008, we were in compliance with all covenants under the line of credit.

Prior to obtaining the Sovereign line of credit, on September 29, 2004, we entered into a three-year senior secured revolving line of credit with CIT Commercial Services, a unit of CIT Group (CIT), under which we could borrow a maximum of \$30 million based upon qualified lease receivables. Outstanding borrowings bore interest at prime plus 1.5% or at the 90-day LIBOR plus 4.0%. On July 20, 2007, by mutual agreement between CIT and us, we paid off and terminated the CIT line of credit without penalty.

D. Commitments and Contingencies*Legal Matters*

We are subject to claims and suits arising in the ordinary course of business. At this time, it is not possible to estimate the ultimate loss or gain, if any, related to these lawsuits, nor if any such loss will have a material adverse effect on our results of operation or financial position.

Lease Commitments

We accept lease applications on a daily basis and, as a result, we have a pipeline of applications that have been approved, where a lease has not been originated. Our commitment to lend does not become binding until all of the steps in the lease origination process have been completed, including the receipt of the lease, supporting documentation and verification with the lessee. Since we fund on the same day a lease is verified, we have no outstanding commitments to lend.

E. Recent Accounting Pronouncements

Effective January 1, 2008, we adopted the provisions of the Financial Accounting Standards Board (FASB) Statement of Financial Standards (SFAS) No. 157, *Fair Value Measurements*. This statement defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value. This statement establishes a fair value hierarchy about the assumptions used to measure fair value and clarifies assumptions about risk and the effect of a restriction on the sale or use of an asset. The adoption of SFAS No. 157 did not have a material effect on our consolidated financial position or results of operations.

In February 2007 the FASB issued SFAS 159, including an amendment of FASB statement No. 115, *The Fair Value Option for Financial Assets and Financial Liabilities*. This statement provides entities with an option to report selected financial assets and liabilities at fair value, with the objective to reduce both the complexity in accounting for financial instruments and the volatility in earnings caused by measuring related assets and liabilities differently. SFAS permits fair value to be used for both the initial and subsequent measurements on a contract-by-contract election, with changes in fair value to be recognized in earning as those changes occur. SFAS 159 also revises provisions of SFAS 115 that apply to available-for-sale and trading securities. Statement 159 is effective as of the beginning of fiscal years that begin after November 15, 2007. We have adopted the provisions under this statement but have chosen not to apply the provisions to any assets or liabilities.

Table of Contents

MICROFINANCIAL INCORPORATED
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Tables in thousands, except share and per share data)

In March 2008, The FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB statement No. 133. This statement applies to all derivative instruments and related hedge items accounted for under SFAS No. 133. Entities are required to provide enhanced disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedge items are accounted for under Statement 133 and its related interpretations, and (c) how derivative instruments and related hedge items affect an entity's financial position, financial performance, and cash flows. SFAS No. 161 is effective for fiscal years and interim periods beginning after November 15, 2008. Management is currently evaluating SFAS No. 161 to determine if it will have a material impact on the Company's future financial statements.

Table of Contents

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

Introduction

The following information should be read in conjunction with our condensed consolidated financial statements and notes thereto in Part I, Item 1 of this Quarterly Report and with Management's Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report on Form 10-K for the year ended December 31, 2007.

Forward-Looking Information

Statements in this document that are not historical facts are forward-looking statements made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. In addition, words such as "believes," "anticipates," "expects," and similar expressions are intended to identify forward-looking statements. We caution that a number of important factors could cause actual results to differ materially from those expressed in any forward-looking statements made by us or on our behalf. Such statements contain a number of risks and uncertainties, including but not limited to: our need for financing in order to originate leases and contracts; our dependence on point-of-sale authorization systems and expansion into new markets; our significant capital requirements; risks associated with economic downturns; higher interest rates; intense competition; changes in our regulatory environment; the availability of qualified personnel, and risks associated with acquisitions. Readers should not place undue reliance on forward-looking statements, which reflect our view only as of the date hereof. We undertake no obligation to publicly revise these forward-looking statements to reflect subsequent events or circumstances. We cannot assure that we will be able to anticipate or respond timely to changes which could adversely affect our operating results. Results of operations in any past period should not be considered indicative of results to be expected in future periods. Fluctuations in operating results may result in fluctuations in the price of our common stock. Statements relating to past dividend payments or our current dividend policy should not be construed as a guarantee that any future dividends will be paid. For a more complete description of the prominent risks and uncertainties inherent in our business, see the risk factors included in our most recent Annual Report on Form 10-K and other documents we file from time to time with the Securities and Exchange Commission.

Overview

We are a specialized commercial finance company that provides "microticket" equipment leasing and other financing services. The average amount financed by TimePayment during 2007 was approximately \$6,500 while Leasecomm historically financed contracts averaging approximately \$1,900. Our portfolio consists of point-of-sale (POS) authorization systems and other small business equipment leased or rented primarily to small commercial enterprises.

On August 2, 2007, we entered into a new three-year \$30 million line of credit with Sovereign Bank based on qualified TimePayment lease receivables. Outstanding borrowings bear interest at Prime or at LIBOR plus 2.75% and are collateralized by eligible lease contracts and a security interest in all of our other assets. Under the terms of the facility, loans are Prime Rate Loans, unless we elect LIBOR Loans. If a LIBOR Loan is not renewed at maturity it automatically converts to a Prime Rate Loan.

In a typical lease transaction, we originate a lease through our nationwide network of equipment vendors, independent sales organizations and brokers. Upon our approval of a lease application and verification that the lessee has received the equipment and signed the lease, we pay the dealer for the cost of the equipment, plus the dealer's profit margin. In a typical transaction for the acquisition of service contracts, a homeowner purchases a security system and simultaneously signs a contract with the dealer for the monitoring of that system for a monthly fee. Upon approval of the monitoring application and verification with the homeowner that the system is installed, we purchase the right to the payment stream under that monitoring contract at a negotiated multiple of the monthly payments from the dealer.

Substantially all leases originated or acquired by us are non-cancelable. During the term of the lease, we are scheduled to receive payments sufficient to cover our borrowing costs, the cost of the underlying equipment and

Table of Contents

provide us with an appropriate profit. We enhance the profitability of our leases and contracts by charging late fees, prepayment penalties, loss and damage waiver fees and other service fees, when applicable. Collection fees are imposed based on our estimate of the costs of collection. We only impose late fees on the first four months of late payments and are prohibited from imposing compound late fees or from assessing late fees as a percentage of the total outstanding late payments including outstanding late fees. The loss and damage waiver fees are charged if a customer fails to provide proof of insurance and are reasonably related to the cost of replacing the lost or damaged equipment or product. The initial non-cancelable term of the lease is equal to or less than the equipment's estimated economic life and often provides us with additional revenues based on the residual value of the equipment at the end of the lease. Initial terms of the leases in our portfolio generally range from 12 to 60 months, with an average initial term of 47 months as of December 31, 2007.

Critical Accounting Policies

Our significant accounting policies are more fully described in Note B to the condensed consolidated financial statements included in this Quarterly Report and in Note B to the consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2007 filed with the Securities and Exchange Commission. Certain accounting policies are particularly important to the portrayal of our consolidated financial position and results of operations. These policies require the application of significant judgment by us and as a result, are subject to an inherent degree of uncertainty. In applying these policies, we make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and the related disclosures. We base our estimates and judgments on historical experience, terms of existing contracts, observance of trends in the industry, information obtained from dealers and other sources, and on various other assumptions that we believe to be reasonable and appropriate under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

Our critical accounting policies, including revenue recognition, maintaining the allowance for credit losses, determining provisions for income taxes, and accounting for share-based compensation are each discussed in more detail in our Annual Report on Form 10-K. We have reviewed and determined that those policies remain our critical accounting policies and we did not make any changes in those policies during the three months ended March 31, 2008. Results of Operations – Three months ended March 31, 2008 compared to the three months ended March 31, 2007

Revenue

	Three Months Ended March 31,		
	2008	Change	2007
	(Dollars in thousands)		
Income on financing leases	\$ 4,940	143.0%	\$ 2,033
Rental income	2,752	(29.9)	3,924
Income on service contracts	259	(28.3)	361
Loss and damage waiver fees	688	55.0	444
Service fees and other income	549	42.2	386
Interest income	60	(81.4)	323
Total revenues	\$ 9,248	23.8%	\$ 7,471

Our lease contracts are accounted for as financing leases. At origination, we record the gross lease receivable, the estimated residual value of the leased equipment, initial direct costs incurred and the unearned lease income. Unearned lease income is the amount by which the gross lease receivable plus the estimated residual value exceeds the cost of the equipment. Unearned lease income and initial direct costs incurred are amortized over the related lease term using the interest method. Other revenues such as loss and damage waiver fees, service fees relating to the leases and contracts, and rental revenues are recognized as they are earned.

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

Total revenues for the three months ended March 31, 2008 were \$9.2 million, an increase of \$1.8 million, or 23.8%, from the three months ended March 31, 2007. The overall increase was due to an increase of \$2.9 million in income on financing leases and a \$407,000 increase in fees and other income partially offset by a decrease of \$1.1

Table of Contents

million in rental income, a decrease of \$263,000 in interest income and a decrease of \$102,000 in income on service contracts. The decline in rental income is primarily explained by attrition rates in the two sources of rental income. One source is rental agreements that are originated and cancellable on a monthly basis. The other is the rental income that is recognized at the end of the lease term when a lessee chooses to keep the equipment and rents it on a monthly basis. Since we resumed funding in 2004 following an interruption in our funding sources, we have not originated any new rental contracts, and few lease contracts have been eligible to convert to rental arrangements since they have not reached the end of term. The decrease in interest income is a direct result of the decrease in cash and cash equivalents on hand. In addition, we have not funded any new service contracts since we resumed funding in 2004; therefore this segment of revenue is expected to continually decline.

Selling, General and Administrative

	Three Months Ended March 31,		
	2008	Change	2007
	(Dollars in thousands)		
Selling, general and administrative	\$3,239	(9.2)%	\$3,568
As a percent of revenue	35.0%		47.8%

Our selling, general and administrative (SG&A) expenses include costs of maintaining corporate functions including accounting, finance, collections, legal, human resources, sales and underwriting, and information systems. SG&A expenses also include commissions, service fees and other marketing costs associated with our portfolio of leases and rental contracts. SG&A expenses decreased by \$329,000 for the three months ended March 31, 2008, as compared to the three months ended March 31, 2007. The decrease was primarily driven by reductions in compensation expense of \$218,000, amortization of debt closing costs of \$76,000 and legal and professional fees of \$69,000. The \$218,000 decrease of compensation expenses includes a \$370,000 decrease in stock-based compensation expense, which offset higher compensation costs resulting from headcount increases over the comparable quarter in 2007.

Provision for Credit Losses

	Three Months Ended March 31,		
	2008	Change	2007
	(Dollars in thousands)		
Provision for credit losses	\$3,357	120.4%	\$1,523
As a percent of revenue	36.3%		20.4%

We maintain an allowance for credit losses on our investment in leases, service contracts and rental contracts at an amount that we believe is sufficient to provide adequate protection against losses in our portfolio. Our provision for credit losses increased by \$1.8 million for the three months ended March 31, 2008, as compared to the three months ended March 31, 2007, while net charge-offs decreased by 32.4% to \$1.3 million. The provision was based on providing a general allowance on leases funded during the period and our analysis of actual and expected losses in our portfolio. The 90-day delinquent lease payments receivable on an exposure basis increased by 48.8% to \$13.4 million for the three months ended March 31, 2008 compared to \$9.0 million for the three months ended March 31, 2007 which required an incremental reserve of \$1.8 million. Dealer funding was \$17.4 million for the three months ended March 31, 2008 compared to \$10.1 million for the three months ended March 31, 2007.

Depreciation and Amortization

	Three Months Ended March 31,		
	2008	Change	2007
	(Dollars in thousands)		
Depreciation fixed assets	\$ 88	49.2%	\$ 59
Depreciation rental equipment	80	(70.6)	272
Amortization service contracts	62	(53.0)	132

Total depreciation and amortization	\$ 230	(50.3)%	\$ 463
As a percent of revenue	2.5%		6.2%

Depreciation and amortization expense consists of depreciation on fixed assets and rental equipment, and the amortization of service contracts. Fixed assets are recorded at cost and depreciated over their expected useful

Table of Contents

lives. Certain rental contracts are originated as a result of the renewal provisions of our lease agreements where at the end of lease term, the customer may elect to continue to rent the leased equipment on a month-to-month basis. The rental equipment is recorded at its residual value and depreciated over a term of 12 months. This term represents the estimated life of a previously leased piece of equipment and is based upon our historical experience. In the event the contract terminates prior to the end of the 12 month period, the remaining net book value is expensed.

We also offer a rental agreement, which allows the customer, assuming the contract is current and no event of default exists, to terminate the contract at any time by returning the equipment and providing us with 30 days notice. These assets are recorded at cost and depreciated over an estimated life of 36 months. This term is based upon our historical experience. In the event that the contract terminates prior to the end of the 36 month period, the remaining net book value is expensed.

Service contracts are recorded at cost and amortized over their estimated life of 84 months. In a typical service contract acquisition, a homeowner will purchase a home security system and simultaneously sign a contract with the security dealer for monthly monitoring of the system. The security dealer will then sell the rights to that monthly payment to us. We perform all of the processing, billing, collection and administrative work on the service contract. The estimated life is based upon the expected life of such contracts in the security monitoring industry and our historical experience. In the event the contract terminates prior to the end of the 84 month term, the remaining net book value is expensed.

Depreciation expense on rental contracts decreased by \$192,000 and amortization of service contracts decreased by \$70,000 for the three months ended March 31, 2008, as compared to the three months ended March 31, 2007. The decreases in depreciation and amortization are due to the decrease in the overall size of our portfolio of rental equipment and service contracts as well as the fact that a greater percentage of the assets are fully depreciated. Depreciation and amortization of property and equipment increased by \$29,000 for the three months ended March 31, 2008, as compared to the three months ended March 31, 2007.

Interest Expense

	Three Months Ended March 31,		
	2008	Change	2007
	(Dollars in thousands)		
Interest	\$ 152	1,069.2%	\$ 13
As a percent of revenue	1.6%		0.2%

We pay interest on borrowings under our senior credit facility. Interest expense increased by \$139,000 for the three months ended March 31, 2008, as compared to the three months ended March 31, 2007. This increase resulted primarily from our increased level of borrowings. At March 31, 2008, we had notes payable of \$14,508,000 compared to notes payable of \$24,000 at March 31, 2007.

Provision for Income Taxes

	Three Months Ended March 31,		
	2008	Change	2007
	(Dollars in thousands)		
Provision for income taxes	\$ 713	3.8%	\$ 687
As a percent of revenue	7.7%		9.2%
As a percent of income before taxes	31.4%		36.1%

The provision for income taxes, deferred tax assets and liabilities and any necessary valuation allowance recorded against net deferred tax assets, involves summarizing temporary differences resulting from the different treatment of items, such as leases, for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are recorded on the balance sheet. We must then assess the likelihood that deferred tax assets will be recovered from future taxable income or tax carry-back availability and to the extent we believe recovery is more likely than not, a valuation allowance is unnecessary. The provision for income taxes increased by \$26,000 for the three months ended March 31, 2008, as compared to the three months ended March 31, 2007. This increase resulted primarily from the

\$366,000 increase in pre-tax income partially offset by a decrease in the effective tax

Table of Contents

rate from 36.1% for the three months ended March 31, 2007 to 31.4% for the three months ended March 31, 2008. The decrease in the overall effective tax rate is primarily related to the release of certain state reserves related to the expiration of statutes of limitation.

As of December 31, 2007, we had a liability of \$450,000 for unrecognized tax benefits and a liability of \$170,000 for accrued interest and penalties related to various state income tax matters. As of March 31, 2008 we had a liability of \$345,000 for unrecognized tax benefits and a liability of \$145,000 for accrued interest and penalties. Of these amounts, approximately \$320,000 would impact our effective tax rate after a \$170,000 federal tax benefit for state income taxes. The decrease in the unrecognized tax benefits and interest is due to the release of \$140,000 of reserves related to expiration of state statutes of limitations offset by \$10,000 in additional accrued expense. It is reasonably possible that the total amount of unrecognized tax benefits may change significantly within the next 12 months; however at this time we are unable to estimate the change.

Our federal income tax returns are subject to examination for tax years ended on or after December 31, 2004 and our state income tax returns are subject to examination for tax years ended on or after December 31, 2002.

Other Operating Data

Dealer funding was \$17.4 million for the three months ended March 31, 2008, an increase of \$7.3 million or 72.3%, compared to the three months ended March 31, 2007. We continue to concentrate on our business development efforts, which include increasing the size of our vendor base and sourcing a larger number of applications from those vendors. Receivables due in installments, estimated residual values, net investment in service contracts and investment in rental contracts increased from \$107.5 million at December 31, 2007 to \$125.2 million at March 31, 2008. Net cash provided by operating activities increased by \$2.7 million, or 43.5%, to \$8.9 million during the three months ended March 31, 2008 as compared to the three months ended March 31, 2007.

Exposure to Credit Losses

The amounts in the table below represent the balance of delinquent receivables on an exposure basis for all leases, rental contracts, and service contracts in our portfolio. An exposure basis aging classifies the entire receivable based on the invoice that is the most delinquent. For example, in the case of a rental or service contract, if a receivable is 90 days past due, all amounts billed and unpaid are placed in the over 90 days past due category. In the case of lease receivables, where the minimum contractual obligation of the lessee is booked as a receivable at the inception of the lease, if a receivable is 90 days past due, the entire receivable, including all amounts billed and unpaid as well as the minimum contractual obligation yet to be billed, will be placed in the over 90 days past due category.

<i>(dollars in thousands)</i>	March 31, 2008		December 31, 2007	
Current	\$ 86,830	79.8%	\$75,528	81.8%
31-60 days past due	4,596	4.2	4,565	5.0
61-90 days past due	4,053	3.7	3,016	3.2
Over 90 days past due	13,385	12.3	9,205	10.0
Gross receivables due in installments	\$108,864	100.0%	\$92,314	100.0%

Liquidity and Capital Resources*General*

Our lease and finance business is capital-intensive and requires access to substantial short-term and long-term credit to fund lease originations. Since inception, we have funded our operations primarily through borrowings under our credit facilities, on-balance sheet securitizations, the issuance of subordinated debt, free cash flow and our initial public offering completed in February 1999. We will continue to require significant additional capital to maintain and expand our funding of leases and contracts, as well as to fund any future acquisitions of leasing companies or portfolios. In the near term, we expect to finance our business utilizing the cash on hand and our line

Table of Contents

of credit which matures in August 2010. Additionally, our uses of cash include the payment of interest and principal on borrowings, selling, general and administrative expenses, income taxes and capital expenditures.

For the three months ended March 31, 2008 and 2007, our primary sources of liquidity were cash provided by operating activities and borrowings on our line of credit. We generated cash flow from operations of \$8.9 million for the three months ended March 31, 2008 compared to \$6.2 million for the three months ended March 31, 2007. At March 31, 2008, we had approximately \$14,508,000 outstanding under our revolving credit facility and had available borrowing capacity of approximately \$15,492,000 as described below.

We used net cash in investing activities of \$17.6 million during the three months ended March 31, 2008 and \$10.3 million for the three months ended March 31, 2007. Investing activities primarily relate to the origination of leases and the increase in cash used is consistent with our focused and targeted sales and marketing effort.

Net cash provided by financing activities was \$7.4 million for the three months ended March 31, 2008 and net cash used in financing activities was \$672,000 for the three months ended March 31, 2007. Financing activities primarily consist of the borrowings and repayments of notes payable and dividend payments.

We believe that cash flows from our existing portfolio, cash on hand, available borrowings on our credit facility, and the completion of additional financing as required will be sufficient to support our operations and lease origination activity in the near term. Given the tight credit conditions in the current marketplace, it may be difficult for us to obtain additional low cost capital. Our inability to obtain additional financing would significantly impact our ability to grow the business.

Borrowings

We utilize our credit facilities to fund the origination and acquisition of leases that satisfy the eligibility requirements established pursuant to the facility. Borrowings outstanding consist of the following:

	March 31, 2008				December 31, 2007			
	Amounts Outstanding	Interest Rate	Unused Capacity	Maximum Facility Amount	Amounts Outstanding	Interest Rate	Unused Capacity	Maximum Facility Amount
<i>(dollars in 000)</i> Revolving credit facility ⁽¹⁾	\$ 14,508	5.25%	\$ 15,492	\$ 30,000	\$ 6,531	7.25%	\$ 23,469	\$ 30,000
	\$ 14,508		\$ 15,492	\$ 30,000	\$ 6,531		\$ 23,469	\$ 30,000

(1) The unused capacity is subject to the borrowing base formula.

On August 2, 2007, we entered into a new three-year \$30 million line of credit with Sovereign Bank based on qualified lease receivables. Outstanding borrowings bear interest at prime or at LIBOR plus 2.75% and are collateralized by eligible lease contracts and a security interest in all of our other assets. As of March 31, 2008 the qualified lease receivables eligible under the borrowing base exceeded the \$30 million line of credit. The line of credit has financial covenants that we must comply with to obtain funding and avoid an event of default. As of March 31, 2008, we were in compliance with all covenants under the line of credit. At March 31, 2008 all of our loans were Prime Rate Loans. The prime rate at March 31, 2008 was 5.25%.

Prior to entering into the Sovereign facility, we had a three-year senior secured revolving line of credit with CIT Commercial Services, a unit of CIT Group (CIT), where we could borrow a maximum of \$30 million based upon qualified lease receivables. Outstanding borrowings bore interest at prime plus 1.5% for prime rate loans or at the 90-day London Interbank Offered Rate (LIBOR) plus 4.0% for LIBOR loans. On July 20, 2007, by mutual agreement between CIT and us, we paid off and terminated the CIT line of credit without penalty, and CIT released its security

interests and liens.

Table of Contents

Dividends

During the three months ended March 31, 2008 we did not declare a dividend. During the three months ended March 31, 2007 we declared a dividend of \$0.05 payable to shareholders of record on March 30, 2007. During the three months ended December 31, 2007 we declared a dividend of \$0.05 payable on January 15, 2008 to shareholders of record on December 31, 2007.

On April 25, 2008 we declared a dividend of \$0.05 payable on May 15, 2008 to shareholders of record on May 5, 2008.

Future dividend payments are subject to ongoing review and evaluation by our Board of Directors. The decision as to the amount and timing of future dividends, if any, will be made in light of our financial condition, capital requirements and growth plans, as well as our external financing arrangements and any other factors our Board of Directors may deem relevant. We can give no assurance as to the amount and timing of future dividends.

Contractual Obligations and Lease Commitments

Contractual Obligations

We have entered into various agreements, such as debt and operating lease agreements that require future payments. For the three months ended March 31, 2008 we had borrowed \$18.6 million against our lines of credit and had repaid \$10.6 million. The \$14.5 million of outstanding borrowings as of March 31, 2008 will be repaid by the daily application of TimePayment receipts to our outstanding balance. Our future minimum lease payments under non-cancelable operating leases are \$237,000 annually for the years 2008 through 2010.

Lease Commitments

We accept lease applications on a daily basis and have a pipeline of applications that have been approved, where a lease has not been originated. Our commitment to lend does not become binding until all of the steps in the lease origination process have been completed, including but not limited to the receipt of a complete and accurate lease document, all required supporting information and successful verification with the lessee. Since we fund on the same day a lease is successfully verified, we have no firm outstanding commitments to lend.

Recent Accounting Pronouncements

See Note E of the notes to the unaudited condensed consolidated financial statements for a discussion of the impact of recent accounting pronouncements.

Table of Contents

ITEM 3. Quantitative and Qualitative Disclosures about Market Risk

The following discussion about our risk management activities includes forward-looking statements that involve risk and uncertainties. Actual results could differ materially from those projected in the forward-looking statements. In the normal course of operations, we also face risks that are either non-financial or non-quantifiable. Such risks principally include credit risk and legal risk, and are not represented in the analysis that follows.

The implicit yield on all of our leases and contracts is on a fixed interest rate basis due to the leases and contracts having scheduled payments that are fixed at the time of origination. When we originate or acquire leases or contracts, we base our pricing in part on the spread we expect to achieve between the implicit yield on each lease or contract and the effective interest rate we expect to incur in financing such lease or contract through our credit facility. Increases in interest rates during the term of each lease or contract could narrow or eliminate the spread, or result in a negative spread.

Given the relatively short average life of our leases and contracts, our goal is to maintain a blend of fixed and variable interest rate obligations which limits our interest rate risk. As of March 31, 2008, we have repaid all of our fixed-rate debt and have \$14.5 million of outstanding variable interest rate obligations under our Sovereign line of credit.

Our Sovereign line of credit bears interest at rates which fluctuate with changes in the prime rate or the LIBOR; therefore, our interest expense is sensitive to changes in market interest rates. The effect of a 10% adverse change in market interest rates, sustained for one year, on our interest expense would be immaterial.

We maintain an investment portfolio in accordance with our investment policy guidelines. The primary objectives of the investment guidelines are to preserve capital, maintain sufficient liquidity to meet our operating needs, and to maximize return. We minimize investment risk by limiting the amount invested in any single security and by focusing on conservative investment choices with short terms and high credit quality standards. We do not use derivative financial instruments or invest for speculative trading purposes

ITEM 4. Controls and Procedures

Disclosure controls and procedures: As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to the Exchange Act Rule 13a-15. Based upon the evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective. Disclosure controls and procedures are controls and procedures that are designed to ensure that information required to be disclosed in our reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.

Internal control over financial reporting: During the first quarter of our fiscal year ended December 31, 2008, no changes were made in our internal control over financial reporting that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

Part II Other Information

ITEM 1. Legal Proceedings

We are involved in certain legal proceedings arising in the ordinary course of business. While the outcome of these proceedings cannot be predicted, we do not believe the ultimate resolution of any existing matters will have a material effect on our results of operations or financial position.

ITEM 1A. Risk Factors

For a discussion of the material risks that we face relating to our business, financial performance and industry, as well as other risks that an investor in our common stock may face, see the factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2007. The risks described in our Annual Report on Form 10-K and elsewhere in this report are not the only risks we face. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial may also materially adversely affect our business, financial condition or operating results.

ITEM 6. Exhibits

(a) Exhibits index

- 10.1* Compensatory Arrangements with Directors

- 31.1* Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

- 31.2* Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

- 32.1* Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

- 32.2* Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

* Filed herewith

Table of Contents

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.

MicroFinancial Incorporated

By: /s/ Richard F. Latour

President and Chief Executive Officer

By: /s/ James R. Jackson Jr.

Vice President and Chief Financial Officer

Date: May 14, 2008