

MICROFINANCIAL INC  
Form 10-Q  
August 16, 2010

**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 June 30, 2010**

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definition 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 July 31, 2010, 14,266,345 shares of the registrant's common stock were outstanding.

**MICROFINANCIAL INCORPORATED  
TABLE OF CONTENTS**

	<u>Page</u>
<u>Part I- FINANCIAL INFORMATION</u>	
<u>Item 1. Financial Statements (unaudited):</u>	
<u>Condensed Consolidated Balance Sheets - June 30, 2010 and December 31, 2009</u>	3
<u>Condensed Consolidated Statements of Income - Three and six months ended June 30, 2010 and 2009</u>	4
<u>Condensed Consolidated Statements of Stockholders' Equity for the six months ended June 30, 2010 and the twelve months ended December 31, 2009</u>	5
<u>Condensed Consolidated Statements of Cash Flows - Six months ended June 30, 2010 and 2009</u>	6
<u>Notes to Condensed Consolidated Financial Statements</u>	7
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	13
<u>Item 3. Quantitative and Qualitative Disclosures about Market Risk</u>	23
<u>Item 4. Controls and Procedures</u>	23
<u>Part II OTHER INFORMATION</u>	
<u>Item 1. Legal Proceedings</u>	24
<u>Item 1A. Risk Factors</u>	24
<u>Item 6. Exhibits</u>	24
<u>Signatures</u>	25
<u>EX-31.1</u>	
<u>EX-31.2</u>	
<u>EX-32.1</u>	
<u>EX-32.2</u>	

---

**Table of Contents**

**MICROFINANCIAL INCORPORATED**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**

*(In thousands, except share and per share data)*

(Unaudited)

	June 30, 2010	December 31, 2009
<b>ASSETS</b>		
Cash and cash equivalents	\$ 1,510	\$ 391
Restricted cash	858	834
Net investment in leases:		
Receivables due in installments	184,584	175,615
Estimated residual value	20,464	19,014
Initial direct costs	1,521	1,509
Less:		
Advance lease payments and deposits	(3,075)	(2,411)
Unearned income	(58,008)	(55,821)
Allowance for credit losses	(13,431)	(13,856)
Net investment in leases	132,055	124,050
Investment in rental contracts, net	408	379
Property and equipment, net	534	699
Other assets	633	744
Total assets	\$ 135,998	\$ 127,097
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Revolving line of credit	\$ 59,016	\$ 51,906
Accounts payable	2,169	2,011
Capital lease obligation	60	93
Dividends payable	2	
Other liabilities	2,019	1,250
Income taxes payable	135	209
Deferred income taxes	5,156	4,863
Total liabilities	68,557	60,332
Stockholders equity:		
Preferred stock, \$.01 par value; 5,000,000 shares authorized; no shares issued at June 30, 2010 and December 31, 2009		
Common stock, \$.01 par value; 25,000,000 shares authorized; 14,230,670 and 14,174,326 shares issued at June 30, 2010 and December 31, 2009, respectively	142	142
Additional paid-in capital	46,428	46,197
Retained earnings	20,871	20,426
Total stockholders equity	67,441	66,765

Total liabilities and stockholders' equity	\$ 135,998	\$ 127,097
--	------------	------------

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)*

(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Revenues:				
Income on financing leases	\$ 8,509	\$ 7,098	\$ 16,631	\$ 13,887
Rental income	1,920	2,138	3,878	4,347
Income on service contracts	132	175	273	364
Loss and damage waiver fees	1,119	1,018	2,223	2,004
Service fees and other	940	699	1,933	1,370
Interest income	1	1	1	14
<b>Total revenues</b>	<b>12,621</b>	<b>11,129</b>	<b>24,939</b>	<b>21,986</b>
Expenses:				
Selling, general and administrative	3,581	3,492	6,811	7,064
Provision for credit losses	5,562	4,993	12,493	10,446
Depreciation and amortization	474	383	902	718
Interest	885	661	1,696	1,177
<b>Total expenses</b>	<b>10,502</b>	<b>9,529</b>	<b>21,902</b>	<b>19,405</b>
Income before provision for income taxes	2,119	1,600	3,037	2,581
Provision for income taxes	818	616	1,171	994
<b>Net income</b>	<b>\$ 1,301</b>	<b>\$ 984</b>	<b>\$ 1,866</b>	<b>\$ 1,587</b>
Net income per common share basic	\$ 0.09	\$ 0.07	\$ 0.13	\$ 0.11
Net income per common share diluted	\$ 0.09	\$ 0.07	\$ 0.13	\$ 0.11
Weighted-average shares:				
Basic	14,230,670	14,141,192	14,220,529	14,122,259
Diluted	14,452,575	14,239,391	14,432,535	14,214,308

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

**Table of Contents**

**MICROFINANCIAL INCORPORATED**  
**CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY**

*(In thousands, except share and per share data)*

(Unaudited)

	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Retained Earnings	Total Stockholders Equity
Balance at December 31, 2008	14,038,257	\$ 140	\$ 45,774	\$ 18,424	\$ 64,338
Stock issued for deferred compensation	131,069	2	336		338
Stock-based compensation			73		73
Amortization of unearned compensation	5,000		14		14
Common stock dividends (\$0.20 per share)				(2,125)	(2,125)
Net income				4,127	4,127
Balance at December 31, 2009	14,174,326	\$ 142	\$ 46,197	\$ 20,426	\$ 66,765
Stock issued for deferred compensation	53,844		169		169
Stock-based compensation			55		55
Amortization of unearned compensation	2,500		7		7
Common stock dividends (\$0.10 per share)				(1,421)	(1,421)
Net income				1,866	1,866
Balance at June 30, 2010	14,230,670	\$ 142	\$ 46,428	\$ 20,871	\$ 67,441

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

**Table of Contents**

**MICROFINANCIAL INCORPORATED**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOW**

*(In thousands)*

(Unaudited)

	Six Months Ended June 30,	
	2010	2009
Cash flows from operating activities:		
Cash received from customers	\$ 44,928	\$ 35,966
Cash paid to suppliers and employees	(7,824)	(7,768)
Income taxes paid	(951)	(164)
Interest paid	(1,173)	(952)
Interest received	1	13
Net cash provided by operating activities	34,981	27,095
Cash flows from investing activities:		
Investment in lease and rental contracts	(38,857)	(36,353)
Investment in direct costs	(575)	(631)
Investment in property and equipment	(62)	(102)
Net cash used in investing activities	(39,494)	(37,086)
Cash flows from financing activities:		
Proceeds from secured debt	50,933	41,384
Repayment of secured debt	(43,823)	(33,753)
Increase in restricted cash	(24)	(244)
Repayment of capital lease obligations	(33)	(31)
Payment of dividends	(1,421)	(1,409)
Net cash provided by financing activities	5,632	5,947
Net change in cash and cash equivalents	1,119	(4,044)
Cash and cash equivalents, beginning of period	391	5,047
Cash and cash equivalents, end of period	\$ 1,510	\$ 1,003
Reconciliation of net income to net cash provided by operating activities:		
Net income	\$ 1,866	\$ 1,587
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of unearned income, net of initial direct costs	(16,631)	(13,887)
Depreciation and amortization	902	718
Provision for credit losses	12,493	10,446
Recovery of equipment cost and residual value	34,862	26,636



Edgar Filing: MICROFINANCIAL INC - Form 10-Q

Stock-based compensation expense	62	34
Changes in assets and liabilities:		
Current taxes payable	(74)	491
Deferred income taxes	293	338
Other assets	111	(180)
Accounts payable	328	277
Other liabilities	769	635
Net cash provided by operating activities	\$ 34,981	\$ 27,095

Supplemental disclosure of non-cash activities:

Fair market value of stock issued for compensation	\$ 169	\$ 231
--	--------	--------

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

**Table of Contents****A. Nature of Business**

MicroFinancial Incorporated (referred to as MicroFinancial, we, us or our ) operates primarily through its wholly-owned subsidiaries, TimePayment Corp. ( TimePayment ) and Leasecomm Corporation ( LeaseComm ). 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 2009 was approximately \$5,500 compared to the 2010 year to date average of \$5,700. Leasecomm historically financed contracts of approximately \$1,900. We primarily source our originations through a nationwide network of independent equipment vendors, sales organizations, brokers and other dealer-based origination networks. We fund our operations through cash provided by operating activities and borrowings under our revolving 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, 2009. The results for the six months ended June 30, 2010 are not necessarily indicative of the results that may be expected for the full year ending December 31, 2010.

The balance sheet at December 31, 2009 has been derived from the audited financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2009.

*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, the business does not warrant the creation of a formal credit review committee to review individual transactions. 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 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 analyses 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 charge-off our receivables when such receivables are deemed uncollectible. In general, a receivable is deemed uncollectible when it is 360 days past due or earlier when other adverse events occur with respect to an account. 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.



**Table of Contents**

A summary of the activity in our allowance for credit losses is as follows:

	Six Months Ended June 30,	
	2010	2009
Allowance for credit losses, beginning	\$ 13,856	\$ 11,722
Provision for credit losses	12,493	10,446
Charge-offs	(14,946)	(10,675)
Recoveries	2,028	2,016
Allowance for credit losses, ending	\$ 13,431	\$ 13,509

*Fair Value of Financial Instruments*

For financial instruments including cash and cash equivalents, restricted cash, accounts payable, the revolving line of credit, and other liabilities, we believe that the carrying amount approximates fair value. The fair value of the revolving line of credit is calculated based on incremental borrowing rates currently available on loans with similar terms and maturities. Due to the short-term nature of our revolving line of credit, the fair value of our revolving line of credit at June 30, 2010 approximates its carrying value. The fair value of the revolving line of credit is calculated based on incremental borrowing rates currently available on loans with similar terms and maturities.

*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. For the three months ended June 30, 2010, 499,305 options were excluded from the computation of diluted net income per share because their effect was antidilutive. For the six months ended June 30, 2010, 849,305 options were excluded from the computation of diluted net income per share because their effect was antidilutive. For the three and six months ended June 30, 2009, 1,108,028 options were excluded from the computation of diluted net income per share because their effect was antidilutive.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Net income	\$ 1,301	\$ 984	\$ 1,866	\$ 1,587
Weighted average common shares outstanding	14,230,670	14,141,192	14,220,529	14,122,259
Dilutive effect of common stock options, warrants and restricted stock	221,905	98,199	212,006	92,049
Shares used in computation of net income per common share diluted	14,452,575	14,239,391	14,432,535	14,214,308
Net income per common share basic	\$ 0.09	\$ 0.07	\$ 0.13	\$ 0.11
Net income per common share diluted	\$ 0.09	\$ 0.07	\$ 0.13	\$ 0.11



**Table of Contents***Stock-Based Employee Compensation*

Under our 2008 Equity Incentive Plan, we reserved 1,000,000 shares of common stock for issuance. In February 2010, under our 2008 Equity Incentive Plan the Compensation and Benefits Committee of our Board of Directors granted 33,518 restricted stock units to our executive officers. The restricted stock units vest over five years at 25% annually beginning on the second anniversary of the grant date. The restricted stock units were valued on the date of grant and the fair value of these awards was \$3.15 per share.

In February 2009, under our 2008 Equity Incentive Plan, we granted 10 year options to our executive officers to purchase 321,058 shares of common stock at an exercise price of \$2.30 per share. The fair value of these awards was \$0.55 per share. The options were valued at the date of grant using the following assumptions: expected life in years of 6.50, annualized volatility of 55.54%, expected dividend yield of 8.70%, and a risk free interest rate of 2.28%. The options vest over five years beginning on the second anniversary of the grant date.

During the six months ended June 30, 2010, 350,000 options originally granted to members of the Board of Directors in February 2000 expired. During the six months ended June 30, 2009, 400,000 options originally granted to members of the Board of Directors in February of 1999 expired. In addition, 105,097 options granted to the former VP of Sales were forfeited upon his last date of employment in May 2009.

The following summarizes stock option activity for the six months ended June 30, 2010:

	Shares	Price Per Share	Weighted-Average Exercise Price
Outstanding at December 31, 2009	1,258,028	\$1.585 to \$13.10	\$ 6.38
Granted			
Expired	(350,000)	\$ 9.78	\$ 9.78
Forfeited			
Outstanding at June 30, 2010	908,028	\$ 1.585 to \$13.10	\$ 6.27

In February 2010, we granted our non-employee directors a total of 53,844 shares of stock with immediate vesting and a fair value of \$3.15 per share in accordance with our director compensation policy.

Director John Everets was appointed to the Board as a non employee director on August 15, 2006. In connection with his appointment he was granted 25,000 shares of restricted stock which vested 20% upon grant and 5% on the first day of each quarter subsequent to the grant date. The restricted share fair value was \$3.35 per share. The compensation expense associated with the grant is recognized as vesting occurs. As of June 30, 2010, 1,250 restricted shares remain unvested under Mr. Everets' grant.

The following table summarizes unvested restricted stock activity:

	Restricted Stock		Restricted Stock Units	
	Number of Shares	Amortized Compensation Expense	Number of Shares	Amortized Compensation Expense
Non-vested at December 31, 2009	3,750			
Granted	53,844		33,518	
Vested	(56,344)	\$ 6,800		\$ 9,000
Non-vested at June 30, 2010	1,250		33,518	

**Table of Contents**

Information relating to our outstanding stock options at June 30, 2010 is as follows:

Exercise Price	Shares	Outstanding	Intrinsic Value	Weighted-	Shares	Exercisable
		Weighted-Average Life (Years)		Average Exercise Price		Intrinsic Value
\$13.10	90,000	0.64	\$	13.10	90,000	\$
6.70	235,000	1.66		6.70	235,000	
1.59	150,000	2.41	285,000	1.59	150,000	285,000
5.77	31,923	6.67		5.77		
5.85	142,382	7.58		5.85	35,596	
2.30	258,723	8.67	308,000	2.30		
	908,028	4.78	\$ 593,000	6.27	510,596	\$ 285,000

During the three months ended June 30, 2010 and 2009, the total share based employee compensation cost recognized was \$32,000 and \$4,000, respectively. During the six months ended June 30, 2010 and 2009, the total share based compensation cost recognized was \$62,000 and \$34,000, respectively. For the period ended June 30, 2009, approximately \$23,000 of previously recognized employee compensation cost was reversed in connection with 105,097 options which were forfeited during the period. During the six months ended June 30, 2010, 350,000 options expired. There were no options granted or exercised during the six months ended June 30, 2010.

**Cash and Cash Equivalents**

We consider all highly liquid instruments purchased with original maturities of less than three months to be cash equivalents. Cash equivalents are stated at cost, which approximates fair value.

**Concentration of Credit Risk**

We deposit our cash and invest in short-term investments primarily through national commercial banks. Deposits in excess of amounts insured by the Federal Deposit Insurance Corporation (FDIC) are exposed to loss in the event of nonperformance by the institution. The Company maintains cash deposits in excess of the FDIC insurance coverage.

**C. Revolving line of credit**

On August 2, 2007, we entered into a three-year revolving line of credit with Sovereign Bank ( Sovereign ) based on qualified TimePayment lease receivables. The total commitment under the facility was originally \$30 million, and was subsequently increased to \$60 million in July 2008, to \$85 million in February 2009, and most recently to \$100 million in connection with a July 28, 2010 amendment. Outstanding borrowings are collateralized by eligible lease contracts and a security interest in all of our other assets and, as of June 30, 2010, bore interest at Prime plus 1.75% or at a London Interbank Offered Rate ( LIBOR ) plus 3.75%, in each case subject to a minimum rate of 5.00%. Following the July 28, 2010 amendment, outstanding borrowings bear interest at Prime plus 1.25% or LIBOR plus 3.25%, without being subject to any minimum rate. 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 June 30, 2010 and 2009 all of our loans were Prime Rate Loans. The interest rate on our revolving line of credit was 5.00% at June 30, 2010. The amount available on our revolving line of credit at June 30, 2010 (prior to the increase in the commitment under the July 28, 2010 amendment) was \$26.0 million. The revolving line of credit has financial covenants that we must comply with to obtain funding and avoid an event of default. As of June 30, 2010, we were in compliance with all covenants under the revolving line of credit.

As a part of the July 28, 2010 amendment, the maturity date of the facility was extended to August 2, 2013. At our option, upon maturity, the unpaid principal balance may be converted to a six-month term loan.

**Table of Contents****D. Commitments and Contingencies***Legal Matters*

We are involved from time to time in litigation incidental to the conduct of our business. Although we do not expect that the outcome of any of these matters, individually or collectively, will have a material adverse effect on our financial condition or results of operations, litigation is inherently unpredictable. Therefore, judgments could be rendered, or settlements entered, that could adversely affect our operating results or cash flows in a particular period. We routinely assess all of our litigation and threatened litigation as to the probability of ultimately incurring a liability, and record our best estimate of the ultimate loss in situations where we assess the likelihood of loss as probable.

*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 do not have any outstanding commitments to lend.

*Dividends*

On July 19, 2010, we declared a dividend of \$0.05 payable on August 13, 2010 to shareholders of record on July 29, 2010.

**E. Subsequent Events**

On August 10, 2010, the Board of Directors authorized the repurchase of up to 250,000 shares of our common stock. The timing and amount of any repurchase will be determined by management based on its evaluation of market conditions and other factors. Any repurchased share will be available for use in connection with future stock issuances. The repurchase program will be funded by our working capital and may be suspended or discontinued at anytime.

We have evaluated all events or transactions that occurred through the date on which we issued these financial statements. Other than the declaration of dividends, amendment of the revolving line of credit and stock repurchase program, as previously discussed, we did not have any material subsequent events that impacted our consolidated financial statements.

**F. Recent Accounting Pronouncements**

In June 2009, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards ( SFAS ) No. 166, Accounting for Transfers of Financial Assets an amendment of FASB Statement No. 140 ( SFAS 166 ), codified as FASB Accounting Standard Codification ( ASC ) 860 Transfers and Servicing. This topic requires entities to provide more information regarding sales of securitized financial assets and similar transactions, particularly if the entity has continuing exposure to the risks related to transferred financial assets. FASB ASC 860 eliminates the concept of a qualifying special-purpose entity, changes the requirements for derecognizing financial assets and requires additional disclosures. FASB ASC 860 is effective for fiscal years beginning after November 15, 2009. The adoption of the new content of FASB ASC 860 did not have an impact on our consolidated financial position or results of operations.

In June 2009, the FASB issued SFAS No. 167, Amendments to FASB Interpretation No. 46(R) ( SFAS 167 ), codified as FASB ASC 810-10 Consolidation. This topic modifies how a company determines when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. FASB ASC 810-10 clarifies that the determination of whether a company is required to consolidate an entity is based on, among other things, an entity's purpose and design and a company's ability to direct the activities of the entity that most significantly impact the entity's economic performance. FASB ASC 810-10 requires an ongoing



**Table of Contents**

reassessment of whether a company is the primary beneficiary of a variable interest entity. FASB ASC 810-10 also requires additional disclosures about a company's involvement in variable interest entities and any significant changes in risk exposure due to that involvement. FASB ASC 810-10 is effective for fiscal years beginning after November 15, 2009. The adoption of the new content of FASB ASC 810-10 did not have an impact on our consolidated financial position or results of operations.

In January 2010, the FASB issued Accounting Standard Update (ASU) No. 2010-06, Fair Value Measurements and Disclosures. This update provides amendments to FASB 820-10 Fair Value Measurements and Disclosures that require new disclosures as follows:

1. Transfers in and out of Levels 1 and 2. A reporting entity should disclose separately the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements and describe the reasons for the transfers.
2. Activity in level 3 fair value measurements
3. A reporting entity should provide fair value measurement disclosures for each class of assets and liabilities.

In the reconciliation for fair value measurements using significant unobservable inputs (Level 3), a reporting entity should present separately information about purchases, sales, issuances, and settlements (that is, on a gross basis rather than as one net number). The new disclosures and clarifications of existing disclosures are effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in the rollforward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. Management is currently evaluating this ASU to determine if it will have a material impact on our future financial statements.

In July 2010, the FASB issued ASU 2010-20 Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses. This guidance expands the disclosures pertaining to the credit quality of loans and should provide users of the financial statements with a better overall understanding of the credit risk in the loan portfolio. This guidance is effective for interim and annual periods ending after December 15, 2010. Management is currently evaluating the requirement of this ASU and will include the additional disclosures upon adoption.

**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, 2009.

**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 demand for the equipment types we offer, expansion into new markets and the development of a sizable dealer base; our significant capital requirements; risks associated with economic downturns; risks of defaults in our leases and the adequacy of our provision for credit losses; 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 2009 was approximately \$5,500 compared to the 2010 year to date average of \$5,700. Leasecomm historically financed contracts of approximately \$1,900. Our existing portfolio consists of business equipment leased or rented primarily to small commercial enterprises.

We finance the funding of our leases and contracts primarily through cash provided by operating activities and our revolving line of credit. On August 2, 2007, we entered into a three-year line of credit with Sovereign Bank based on qualified TimePayment lease receivables. The total commitment under the facility was originally \$30 million, and was subsequently increased to \$60 million in July 2008, to \$85 million in February 2009, and most recently to \$100 million in connection with a July 28, 2010 amendment. Outstanding borrowings are collateralized by eligible lease contracts and a security interest in all of our other assets. Prior to the July 2010 amendment, outstanding borrowings bore interest at Prime plus 1.75% or at LIBOR plus 3.75%, in each case subject to a minimum rate of 5%. Following the July 2010 amendment, outstanding borrowings bear interest at either Prime plus 1.25% or LIBOR plus 3.25%, without being subject to any minimum rate. 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. The July 2010 amendment extended the maturity date of the facility to August 2, 2013. At our option, upon maturity, the unpaid principal balance may be converted to a six-month term 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.

**Table of Contents**

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 and the cost of the underlying equipment and provide us with an appropriate profit. We pass along some of the costs 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. 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 44 months as of December 31, 2009.

**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, 2009 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 those policies and determined that they remain our critical accounting policies and that we did not make any changes in those policies during the six months ended June 30, 2010.

**Results of Operations** *Three months ended June 30, 2010 compared to the three months ended June 30, 2009*  
*Revenue*

	Three Months Ended June 30,		
	2010	Change	2009
	(Dollars in thousands)		
Income on financing leases	\$ 8,509	19.9%	\$ 7,098
Rental income	1,920	(10.2)	2,138
Income on service contracts	132	(24.6)	175
Loss and damage waiver fees	1,119	9.9	1,018
Service fees and other income	940	34.5	699
Interest income	1	0.0	1
<b>Total revenues</b>	<b>\$ 12,621</b>	<b>13.4%</b>	<b>\$ 11,129</b>

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 June 30, 2010 were \$12.6 million, an increase of \$1.5 million, or 13.4%, from the three months ended June 30, 2009. The overall increase was due to an increase of \$1.4 million in

14

---

**Table of Contents**

income on financing leases, an increase of \$0.3 million in fees and other income, partially offset by a decrease of \$0.2 million in rental income, and a decrease of \$43,000 in income on service contracts. The increase in income on financing leases is a result of the continued growth in new lease originations. The decline in rental income is the result of the attrition of Leasecomm rental contracts which is partially offset by TimePayment lease contracts coming to term and converting to rentals. Service contract revenue continues to decline since we have not funded any new service contracts since 2004.

*Selling, General and Administrative Expenses*

	Three Months Ended June 30,		
	2010	Change	2009
	(Dollars in thousands)		
Selling, general and administrative	\$3,581	2.5%	\$3,492
As a percent of revenue	28.3%		31.4%

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 service fees and other marketing costs associated with our portfolio of leases and rental contracts. SG&A expenses increased by \$89,000 for the three months ended June 30, 2010, as compared to the three months ended June 30, 2009. The increase was primarily driven by increases in compensation expense of \$51,000 and contracted labor of \$82,000, offset by a \$111,000 decrease in marketing expenses due to the elimination of certain programs. The increase in compensation related expenses is the result of an increase in the number of employees. The number of employees as of June 30, 2010 was 113 compared to 106 as of June 30, 2009.

*Provision for Credit Losses*

	Three Months Ended June 30,		
	2010	Change	2009
	(Dollars in thousands)		
Provision for credit losses	\$5,562	11.4%	\$4,993
As a percent of revenue	44.1%		44.9%

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 \$0.6 million for the three months ended June 30, 2010, as compared to the three months ended June 30, 2009, while net charge-offs increased by 40.9% to \$5.9 million. The provision is based on providing a general allowance on leases funded during the period and our analysis of actual and expected losses in our portfolio. The increase in the allowance reflects the growth in lease receivables associated with new lease originations, charge off levels, and the current economic conditions.

*Depreciation and Amortization*

	Three Months Ended June 30,		
	2010	Change	2009
	(Dollars in thousands)		
Depreciation fixed assets	\$ 111	5.7%	\$ 105
Depreciation rental equipment	363	34.9	269
Amortization service contracts	0	(100.0)	9
Total depreciation and amortization	\$ 474	23.8%	\$ 383
As a percent of revenue	3.8%		3.4%

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 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.

**Table of Contents**

Depreciation expense on rental contracts increased by \$94,000 and amortization of service contracts decreased by \$9,000 for the three months ended June 30, 2010, as compared to the three months ended June 30, 2009. The increase in depreciation is primarily due to the increase in the number of TimePayment lease contracts coming to maturity and converting to rentals. Depreciation and amortization of property and equipment increased by \$6,000 for the three months ended June 30, 2010, as compared to the three months ended June 30, 2009.

Service contracts are recorded at cost and amortized over their estimated life of 84 months. We have not originated any new service contracts since 2004 and the service portfolio is fully amortized.

*Interest Expense*

	Three Months Ended June 30,		
	2010	Change	2009
	(Dollars in thousands)		
Interest	\$ 885	33.9%	\$ 661
As a percent of revenue	7.0%		5.9%

We pay interest on borrowings under our senior credit facility. Interest expense increased by \$224,000 for the three months ended June 30, 2010, as compared to the three months ended June 30, 2009. This increase resulted primarily from our increased level of borrowings. At June 30, 2010, we had notes payable under our line of credit of \$59.0 million compared to notes payable of \$41.0 million at June 30, 2009.

*Provision for Income Taxes*

	Three Months Ended June 30,		
	2010	Change	2009
	(Dollars in thousands)		
Provision for income taxes	\$ 818	32.8%	\$ 616
As a percent of revenue	6.5%		5.5%
As a percent of income before taxes	38.6%		38.5%

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 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 \$202,000 for the three months ended June 30, 2010, as compared to the three months ended June 30, 2009. This increase resulted primarily from the \$519,000 increase in pre-tax income and a slight increase in the effective tax rate from 38.5% for the three months ended June 30, 2009 to 38.6% for the three months ended June 30, 2010.

As of March 31, 2010, we had a liability of \$35,000 for unrecognized tax benefits and a liability of \$12,000 for accrued interest and penalties related to various state income tax matters. As of June 30, 2010 we had a liability of \$25,000 for unrecognized tax benefits and a liability of \$10,000 for accrued interest and penalties. Of these amounts, approximately \$23,000 would impact our effective tax rate after a \$12,000 federal tax benefit for state income taxes. The decrease in the unrecognized tax benefits relates to a \$2,000 decrease in accrued interest expense and a \$10,000 decrease related to the completion of a state income tax audit. 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, 2006 and our state income tax returns are subject to examination for tax years ended on or after December 31, 2005.

*Other Operating Data*

Dealer funding was \$20.9 million for the three months ended June 30, 2010, an increase of \$1.3 million or 6.8%, compared to the three months ended June 30, 2009. 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





**Table of Contents**

vendors. Receivables due in installments, estimated residual values, net investment in service contracts and investment in rental contracts increased from \$200.9 million at March 31, 2010 to \$207.9 million at June 30, 2010. Net cash provided by operating activities increased by \$3.7 million, or 25.6%, to \$17.9 million during the three months ended June 30, 2010 as compared to the three months ended June 30, 2009.

**Table of Contents****Results of Operations** *Six months ended June 30, 2010 compared to the six months ended June 30, 2009*  
*Revenue*

	Six Months Ended June 30,		
	2010	Change	2009
	(Dollars in thousands)		
Income on financing leases	\$ 16,631	19.8%	\$ 13,887
Rental income	3,878	(10.8)	4,347
Income on service contracts	273	(25.0)	364
Loss and damage waiver fees	2,223	10.9	2,004
Service fees and other income	1,933	41.1	1,370
Interest income	1	(92.9)	14
Total revenues	\$ 24,939	13.4%	\$ 21,986

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.

Total revenues for the six months ended June 30, 2010 were \$24.9 million, an increase of \$3.0 million, or 13.4%, from the six months ended June 30, 2009. The overall increase was due to an increase of \$2.7 million in income on financing leases, and a \$0.8 million increase in fees and other income, partially offset by a decrease of \$0.5 million in rental income, a decrease of \$91,000 in service contracts and a decrease of \$13,000 in interest income. The increase in income on financing leases is a result of the continued growth in new lease originations. The decline in rental income is the result of the attrition of Leasecomm rental contracts which is partially offset by TimePayment lease contracts coming to term and converting to rentals. Service contract revenue continues to decline since we have not funded any new service contracts since 2004.

*Selling, General and Administrative Expenses*

	Six Months Ended June 30,		
	2010	Change	2009
	(Dollars in thousands)		
Selling, general and administrative	\$ 6,811	(3.6)%	\$ 7,064
As a percent of revenue	27.3%		32.1%

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 service fees and other marketing costs associated with our portfolio of leases and rental contracts. SG&A expenses decreased by \$253,000 for the six months ended June 30, 2010, as compared to the six months ended June 30, 2009. The decrease was primarily driven by decreases in marketing expenses of \$121,000, a decrease in professional services of \$83,000 and a decrease of \$55,000 in collection expenses.

*Provision for Credit Losses*

	Six Months Ended June 30,		
	2010	Change	2009
	(Dollars in thousands)		
Provision for credit losses	\$ 12,493	19.6%	\$ 10,446
As a percent of revenue	50.1%		47.5%

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 \$2.0 million for the six months ended June 30, 2010, as compared to the six months ended June 30, 2009, while net charge-offs increased by 49.2% to \$12.9 million. The provision is based on providing a general allowance on leases funded during the period and our analysis of actual and expected losses in

**Table of Contents**

our portfolio. The increase in the allowance reflects the growth in lease receivables associated with new lease originations, charge off levels, and the current economic conditions.

*Depreciation and Amortization*

	Six Months Ended June 30,		
	2010	Change	2009
	(Dollars in thousands)		
Depreciation fixed assets	\$ 227	8.1%	\$ 210
Depreciation rental equipment	675	39.8	483
Amortization service contracts	0	(100.0)	25
Total depreciation and amortization	\$ 902	25.6%	\$ 718
As a percent of revenue	3.6%		3.3%

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 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.

Depreciation expense on rental contracts increased by \$192,000 and amortization of service contracts decreased by \$25,000 for the six months ended June 30, 2010, as compared to the six months ended June 30, 2009. The increase in depreciation is due to the increase in the overall size of our portfolio of rental equipment. Depreciation and amortization of property and equipment increased by \$17,000 for the six months ended June 30, 2010, as compared to the six months ended June 30, 2009.

Service contracts are recorded at cost and amortized over their estimated life of 84 months. We have not originated any new service contracts since 2004 and the service portfolio is now fully amortized.

*Interest Expense*

	Six Months Ended June 30,		
	2010	Change	2009
	(Dollars in thousands)		
Interest	\$ 1,696	44.1%	\$ 1,177
As a percent of revenue	6.8%		5.4%

We pay interest on borrowings under our revolving line of credit. Interest expense increased by \$519,000 for the six months ended June 30, 2010, as compared to the six months ended June 30, 2009. This increase resulted primarily from our increased level of borrowings on our line of credit. At June 30, 2010, we had notes payable under our line of credit of \$59.0 million compared to notes payable of \$41.0 million at June 30, 2009.

*Provision for Income Taxes*

	Six Months Ended June 30,		
	2010	Change	2009
	(Dollars in thousands)		
Provision for income taxes	\$ 1,171	17.8%	\$ 994
As a percent of revenue	4.7%		4.5%
As a percent of income before taxes	38.6%		38.5%

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 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 \$177,000 for the

**Table of Contents**

six months ended June 30, 2010, as compared to the six months ended June 30, 2009. This increase resulted primarily from the \$456,000 increase in pre-tax income.

As of December 31, 2009, we had a liability of \$32,000 for unrecognized tax benefits and a liability of \$8,000 for accrued interest and penalties related to various state income tax matters. As of June 30, 2010 we had a liability of \$25,000 for unrecognized tax benefits and a liability of \$10,000 for accrued interest and penalties. Of these amounts, approximately \$23,000 would impact our effective tax rate after a \$12,000 federal tax benefit for state income taxes. The decrease in the unrecognized tax benefits relates to \$2,000 in additional accrued interest expense less \$10,000 related to the completion of a state income tax audit. 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, 2006 and our state income tax returns are subject to examination for tax years ended on or after December 31, 2005.

**Other Operating Data**

Dealer funding was \$39.1 million for the six months ended June 30, 2009, an increase of \$2.4 million or 6.5%, compared to the six months ended June 30, 2009. 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 \$197.9 million at December 31, 2009 to \$207.9 million at June 30, 2010. Net cash provided by operating activities increased by \$7.9 million, or 29.1%, to \$35.0 million during the six months ended June 30, 2010 as compared to the six months ended June 30, 2009.

**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>	June 30, 2010		December 31, 2009	
Current	\$ 154,206	83.5%	\$ 140,000	79.7%
31-60 days past due	4,967	2.7	6,233	3.6
61-90 days past due	4,226	2.3	5,336	3.0
Over 90 days past due	21,185	11.5	24,046	13.7
Gross receivables due in installments	\$ 184,584	100.0%	\$ 175,615	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, free cash flow, and our line of credit which matures in August 2013. Additionally, our uses of cash include the payment of

**Table of Contents**

interest and principal on borrowings, selling, general and administrative expenses, income taxes and capital expenditures.

For the six months ended June 30, 2010 and throughout 2009, our primary sources of liquidity were cash provided by operating activities and borrowings on our revolving line of credit. We generated cash flow from operations of \$35.0 million for the six months ended June 30, 2010 compared to \$27.1 million for the six months ended June 30, 2009. At June 30, 2010, we had approximately \$59.0 million outstanding under our revolving line of credit facility and had available borrowing capacity of approximately \$26.0 million as described below.

We used net cash in investing activities of \$39.5 million during the six months ended June 30, 2010 and \$37.1 million for the six months ended June 30, 2009. Investing activities primarily relate to the origination of leases.

Net cash provided by financing activities was \$5.6 million for the six months ended June 30, 2010 and \$6.0 million for the six months ended June 30, 2009. Financing activities primarily consist of the borrowings and repayments under our revolving line of credit facility and dividend payments.

*Borrowings*

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

	June 30, 2010				December 31, 2009			
	Amounts Outstanding	Interest Rate	Unused Capacity	Maximum Facility Amount	Amounts Outstanding	Interest Rate	Unused Capacity	Maximum Facility Amount
<i>(dollars in 000)</i> Revolving line of credit facility <sup>(1)</sup>	\$ 59,016	5.0%	\$ 25,984	\$ 85,000	\$ 51,906	5.00%	\$ 33,094	\$ 85,000

<sup>(1)</sup> The unused capacity is subject to the borrowing base formula and does not give effect to the increased capacity under the July 28, 2010 amendment described below.

On August 2, 2007, we entered into a three-year revolving line of credit with Sovereign based on qualified lease receivables. The total commitment under the facility was originally \$30 million, which was subsequently increased to \$60 million in July 2008, to \$85 million in February 2009, and most recently to \$100 million in connection with a July 28, 2010 amendment. Outstanding borrowings are collateralized by eligible lease contracts and a security interest in all of our other assets. Prior to the July 2010 amendment, outstanding borrowings bore interest at Prime plus 1.75% or the 90-day LIBOR plus 3.75%, in each case subject to a minimum rate of 5%. Following the July 2010 amendment, outstanding borrowings bear interest at Prime plus 1.25% or LIBOR plus 3.25%, without being subject to any minimum rate. At June 30, 2010 all of our loans were Prime Rate Loans. The interest rate on the revolving line of credit was 5.00% at June 30, 2010. As of June 30, 2010 the qualified lease receivables eligible under the borrowing base exceeded the \$85 million revolving line of credit. The revolving line of credit has financial covenants that we must comply with to obtain funding and avoid an event of default. As of June 30, 2010, we were in compliance with all covenants under the revolving line of credit. As part of the July 2010 amendment, the maturity date of the facility

was extended to August 2, 2013.

*Dividends*

On July 19, 2010, we declared a dividend of \$0.05 payable on August 13, 2010 to shareholders of record on July 29, 2010.

On January 22, 2010 we declared a dividend of \$0.05 payable on February 15, 2010 to shareholders of record on February 1, 2010. On April 20, 2010, we declared a dividend of \$0.05 payable on May 14, 2010 to shareholders of record on May 3, 2010.



**Table of Contents**

On July 14, 2009 we declared a dividend of \$0.05 payable on August 14, 2009 to shareholders of record on July 30, 2009. On April 16, 2009 we declared a dividend of \$0.05 payable on May 8, 2009 to shareholders of record on April 30, 2009.

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 six months ended June 30, 2010 we had borrowed \$50.9 million against our revolving line of credit and had repaid \$43.8 million. The \$59.0 million of outstanding borrowings as of June 30, 2010 will be repaid by the daily application of TimePayment receipts to our outstanding balance. Our future minimum lease payments under non-cancelable operating leases is \$119,000 through the year ended December 31, 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 F 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 June 30, 2010, we have repaid all of our fixed-rate debt and have \$59.0 million of outstanding variable interest rate obligations under our revolving line of credit.

Our revolving line of credit bears interest at rates which fluctuate with changes in the Prime Rate or 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 controls over financial reporting: During the fiscal quarter ended June 30, 2010, 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 from time to time in litigation incidental to the conduct of our business. Although we do not expect that the outcome of any of these matters, individually or collectively, will have a material adverse effect on our financial condition or results of operations, litigation is inherently unpredictable. Therefore, judgments could be rendered, or settlements entered, that could adversely affect our operating results or cash flows in a particular period. We routinely assess all of our litigation and threatened litigation as to the probability of ultimately incurring a liability, and record our best estimate of the ultimate loss in situations where we assess the likelihood of loss as probable.

**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, 2009. 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

- 3.1 Restated Articles of Organization, as amended (incorporated by reference to Exhibit 3.1 in the Registrant's Registration Statement on Form S-1, No. 333-56639, filed with the Securities and Exchange Commission on June 9, 1998).
- 3.2 Restated Bylaws, as amended (incorporated by reference to Exhibit 3.2 in the Registrant's Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 28, 2007).
- 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: August 16, 2010