

MICROFINANCIAL INC  
Form 10-Q  
May 15, 2013  
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**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, 2013

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)

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**Massachusetts**  
(State or other jurisdiction of  
incorporation or organization)

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

**16 New England Executive Park, Suite 200, Burlington, MA 01803**

(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  (Do not check if a smaller reporting company)

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, 2013, 14,493,156 shares of the registrant's common stock were outstanding.

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|   | March 31,<br>2013<br><i>(Unaudited)</i> | December 31,<br>2012 |
|---|---|----------------------|
| <b>ASSETS</b>   |   |                      |
| Cash and cash equivalents   | \$ 2,959                                | \$ 3,557             |
| Restricted cash   | 475                                     | 1,213                |
| Net investment in leases:   |   |                      |
| Receivables due in installments   | 212,526                                 | 213,466              |
| Estimated residual value  | 23,829                                  | 24,176               |
| Initial direct costs  | 1,730                                   | 1,751                |
| Less:   |   |                      |
| Advance lease payments and deposits   | (3,146)                                 | (3,278)              |
| Unearned income   | (60,937)                                | (62,244)             |
| Allowance for credit losses   | (14,747)                                | (14,038)             |
| Net investment in leases  | 159,255                                 | 159,833              |
| Investment in service contracts, net  | 1,179                                   | 797                  |
| Investment in rental contracts, net   | 1,120                                   | 1,037                |
| Property and equipment, net   | 1,619                                   | 1,534                |
| Other assets  | 1,541                                   | 1,658                |
| Total assets  | \$ 168,148                              | \$ 169,629           |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>  |   |                      |
| Revolving line of credit  | \$ 69,254                               | \$ 70,380            |
| Accounts payable  | 2,377                                   | 3,220                |
| Dividends payable   | 39                                      | 40                   |
| Other liabilities   | 2,624                                   | 2,545                |
| Income taxes payable  | 1,015                                   | 653                  |
| Deferred income taxes   | 8,889                                   | 10,399               |
| Total liabilities   | 84,198                                  | 87,237               |
| Stockholders' equity:   |   |                      |
| Preferred stock, \$.01 par value; 5,000,000 shares authorized; no shares issued at March 31, 2013, and December 31, 2012                                    |   |                      |
| Common stock, \$.01 par value; 25,000,000 shares authorized; 14,501,080 and 14,470,219 shares issued at March 31, 2013, and December 31, 2012, respectively | 145                                     | 145                  |
| Additional paid-in capital  | 47,670                                  | 47,500               |
| Retained earnings   | 36,135                                  | 34,747               |
| Total stockholders' equity  | 83,950                                  | 82,392               |
| Total liabilities and stockholders' equity  | \$ 168,148                              | \$ 169,629           |

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<br>March 31, |               |
|--|---------------------------------|---------------|
|  | 2013                            | 2012          |
| <b>Revenues:</b>                         |                                 |               |
| Income on financing leases               | \$ 10,204                       | \$ 9,635      |
| Rental income                            | 2,503                           | 2,317         |
| Income on service contracts              | 176                             | 85            |
| Loss and damage waiver fees              | 1,441                           | 1,287         |
| Service fees and other                   | 971                             | 920           |
| <b>Total revenues</b>                    | <b>15,295</b>                   | <b>14,244</b> |
| <b>Expenses:</b>                         |                                 |               |
| Selling, general and administrative      | 4,662                           | 4,356         |
| Provision for credit losses              | 4,881                           | 4,896         |
| Depreciation and amortization            | 1,305                           | 1,008         |
| Interest                                 | 670                             | 633           |
| <b>Total expenses</b>                    | <b>11,518</b>                   | <b>10,893</b> |
| Income before provision for income taxes | 3,777                           | 3,351         |
| Provision for income taxes               | 1,511                           | 1,340         |
| Net income                               | \$ 2,266                        | \$ 2,011      |
| Net income per common share basic        | \$ 0.16                         | \$ 0.14       |
| Net income per common share diluted      | \$ 0.15                         | \$ 0.14       |
| <b>Weighted-average shares:</b>          |                                 |               |
| Basic                                    | 14,495,411                      | 14,284,087    |
| Diluted                                  | 14,786,580                      | 14,600,775    |

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 |        | Additional | Retained  | Total        |
|--|--------------|--------|------------|-----------|--------------|
|  | Shares       | Amount | Paid-in    | Earnings  | Stockholders |
|  |              |        | Capital    |           | Equity       |
| Balance at December 31, 2011                         | 14,257,324   | \$ 143 | \$ 46,727  | \$ 28,853 | \$ 75,723    |
| Stock issued for deferred compensation               | 48,148       |        | 346        |           | 346          |
| Stock-based compensation                             |              |        | 191        |           | 191          |
| Shares issued upon vesting of restricted stock units | 8,380        |        |            |           |              |
| Warrants exercised                                   | 6,367        |        |            |           |              |
| Stock options exercised                              | 150,000      | 2      | 236        |           | 238          |
| Common stock dividends (\$0.24 per share)            |              |        |            | (3,457)   | (3,457)      |
| Net income   |              |        |            | 9,351     | 9,351        |
| Balance at December 31, 2012                         | 14,470,219   | 145    | 47,500     | 34,747    | 82,392       |
| Stock issued for deferred compensation               | 29,205       |        | 221        |           | 221          |
| Stock-based compensation                             |              |        | 61         |           | 61           |
| Stock repurchase program                             | (14,984)     |        | (112)      |           | (112)        |
| Shares issued upon vesting of restricted stock units | 16,640       |        |            |           |              |
| Common stock dividends (\$0.06 per share)            |              |        |            | (878)     | (878)        |
| Net income   |              |        |            | 2,266     | 2,266        |
| Balance at March 31, 2013                            | 14,501,080   | \$ 145 | \$ 47,670  | \$ 36,135 | \$ 83,950    |

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)*

(Unaudited)

|  | <b>Three Months Ended<br/>March 31,</b> |             |
|--|---|-------------|
|  | <b>2013</b>                             | <b>2012</b> |
| <b>Cash flows from operating activities:</b>   |   |             |
| Cash received from customers   | \$ 31,046                               | \$ 29,118   |
| Cash paid to suppliers and employees   | (6,406)                                 | (5,134)     |
| Cash paid for income taxes   | (2,659)                                 | (1,161)     |
| Interest paid  | (600)                                   | (556)       |
| Net cash provided by operating activities  | 21,381                                  | 22,267      |
| <b>Cash flows from investing activities:</b>   |   |             |
| Investment in lease and service contracts  | (20,064)                                | (21,181)    |
| Investment in direct costs   | (336)                                   | (348)       |
| Investment in property and equipment   | (198)                                   | (95)        |
| Net cash used in investing activities  | (20,598)                                | (21,624)    |
| <b>Cash flows from financing activities:</b>   |   |             |
| Proceeds from secured debt   | 31,600                                  | 29,555      |
| Repayment of secured debt  | (32,727)                                | (29,314)    |
| Decrease in restricted cash  | 738                                     | 13          |
| Repayment of capital lease obligation  |   | (1)         |
| Repurchase of common stock   | (112)                                   |             |
| Payment of dividends   | (880)                                   | (861)       |
| Net cash used in financing activities  | (1,381)                                 | (608)       |
| Net change in cash and cash equivalents  | (598)                                   | 35          |
| Cash and cash equivalents, beginning of period   | 3,557                                   | 2,452       |
| Cash and cash equivalents, end of period   | \$ 2,959                                | \$ 2,487    |
| <b>Reconciliation of net income to net cash provided by operating activities:</b>        |   |             |
| Net income   | \$ 2,266                                | \$ 2,011    |
| <b>Adjustments to reconcile net income to net cash provided by operating activities:</b> |   |             |
| Amortization of unearned income, net of initial direct costs                             | (10,204)                                | (9,635)     |
| Depreciation and amortization  | 1,305                                   | 1,008       |
| Provision for credit losses  | 4,881                                   | 4,896       |
| Recovery of equipment cost and residual value  | 24,686                                  | 23,095      |
| Stock-based compensation expense   | 61                                      | 45          |
| Increase (decrease) in deferred income tax liability                                     | (1,511)                                 | 268         |
| <b>Changes in assets and liabilities:</b>  |   |             |
| Increase (decrease) in income taxes payable  | 362                                     | (88)        |
| Decrease in other assets   | 117                                     | 150         |



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|   |           |           |
|---|-----------|-----------|
| Increase (decrease) in accounts payable   | (622)     | 89        |
| Increase in other liabilities             | 40        | 428       |
| Net cash provided by operating activities | \$ 21,381 | \$ 22,267 |

Supplemental disclosure of non-cash activities:

|  |        |        |
|--|--------|--------|
| Acquisition of property and equipment through lease incentives | \$ 39  | \$     |
| Fair market value of stock issued for compensation             | \$ 221 | \$ 210 |

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

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**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

*(Tables in thousands, except percentages, 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. LeaseComm originated leases from January 1986 through October 2002, and continues to service its remaining contract portfolio. TimePayment commenced originating leases in July 2004. The average lease amount financed by TimePayment during 2012 was approximately \$5,300. The average lease financed during the first quarter of 2013 was approximately \$4,900. 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 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, 2012. The results for the three months ended March 31, 2013, are not necessarily indicative of the results that may be expected for the full year ending December 31, 2013.

The balance sheet at December 31, 2012, has been derived from the audited financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2012.

*Segment Reporting*

We operate in one industry segment that leases and rents microticket equipment and provides other financing services. All of our operations are located in the United States. Accordingly, we believe we have a single reportable segment for disclosure purposes.

*Allowance for Credit Losses and Credit Quality*

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 have developed a sophisticated, multi-tiered pricing model and have automated the credit scoring, approval and collection processes. We believe that with the proper 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.

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Each period, the provision for credit losses in the income statement results from the combination of an estimate by management of credit losses that occurred during the current period and the ongoing adjustment of prior estimates of losses occurring in prior periods. To serve as a basis for making this provision, we have adopted a consistent,

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*(Tables in thousands, except percentages, share and per share data)*

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 an internally-developed proprietary scoring model that considers several factors including 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. In general, a receivable is uncollectable when it is 360 days past due or earlier if other adverse events occur with respect to an account. None of our receivables are placed on non-accrual status as accounts are charged off when deemed uncollectible. 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 relatively small amount necessary to bring an account current.

We segregate our lease portfolio between TimePayment and LeaseComm to perform the calculation and analysis of the allowance for loan losses. Each subsidiary consists of a single portfolio segment – microticket equipment. Leases of microticket equipment are made to businesses and individuals and are generally secured by assets of the business or a personal guarantee. Repayment is expected from the cash flows of the business or individual. A weakened economy, and resultant decreased consumer spending, may have a negative effect on the credit quality in this segment.

We assign internal risk ratings for all lessees and determine the creditworthiness of each lease based upon this internally developed proprietary scoring model. The LeaseComm portfolio is evaluated in total, with a reserve calculated based upon the aging of the portfolio and our collection experience. The TimePayment scoring model generates one of ten acceptable risk ratings based upon the creditworthiness of each lease or it rejects the lease application. The scores are assigned at lease inception, and these scores are maintained over the lease term regardless of payment performance. To facilitate review and reporting, management aggregates these nine scores into one of three categories with similar risk profiles and delinquency characteristics identified as Gold, Silver or Bronze.

Leases assigned a Gold rating represent those transactions which exhibit the best risk rating based on our internal credit scores. They are considered of sufficient quality to preclude an otherwise adverse rating. Gold rated leases are typically represented by lessees with high bureau-reported credit scores for personal guarantors at lease inception or are supported by established businesses for those transactions which are not personally guaranteed by the lessee.

Leases assigned a Silver rating fall in the middle range of the nine acceptable scores generated by the scoring model. These transactions possess a reasonable amount of risk based on their profile and may exhibit vulnerability to deterioration if adverse factors are encountered. These accounts typically demonstrate adequate coverage but warrant a higher level of monitoring by management to ensure that weaknesses do not advance.

A Bronze rating applies to leases at the lower end of the nine acceptable scores generated by the scoring model whereby the lessee may have difficulty meeting the lease obligation if adverse factors are encountered. Bronze rated transactions typically have lower reported credit scores at lease inception and will typically have other less desirable credit attributes.

See Note C for details of our allowance for credit losses and the aged analysis of past due financing receivables based upon our internally-developed proprietary lease scoring model.



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*Fair Value of Financial Instruments*

Accounting for fair value measurements involves a single definition of fair value, along with a conceptual framework to measure fair value, with fair value defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The fair value measurement hierarchy consists of three levels:

Level 1 - Quoted prices in active markets for identical assets or liabilities.

Level 2 - Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 - Unobservable inputs developed using estimates and assumptions which are developed by the reporting entity and reflect those assumptions that a market participant would use.

We apply valuation techniques that (1) place greater reliance on observable inputs and less reliance on unobservable inputs and (2) are consistent with the market approach, the income approach and/or the cost approach.

The carrying values of cash and cash equivalents, restricted cash, other assets, accounts payable and other liabilities approximate their fair values due to the short maturity of these instruments. The fair value of the amounts outstanding under our revolving line of credit, evaluated using Level 2 inputs as of March 31, 2013, and December 31, 2012, approximate the carrying value. We have elected not to mark the amount outstanding under this facility to market.

*Stock-based Employee Compensation*

We have adopted the fair value recognition provisions of FASB ASC Topic 718 *Compensation - Stock Compensation*. FASB ASC Topic 718 requires us to recognize the compensation cost related to share-based payment transactions with employees in the financial statements. The compensation cost is measured based upon the fair value of the instrument issued. Share-based compensation transactions with employees covered by FASB ASC Topic 718 include share options, restricted share plans and performance-based awards.

*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.

*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 has had cash deposits in excess of the FDIC insurance coverage. However, we have not experienced any losses in such accounts.



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The following table reconciles the activity in the allowance for credit losses by portfolio segment for the three months ended March 31, 2013 and 2012:

|   | Microticket equipment             |                  |           |                                   |                  |           |
|---|-----------------------------------|------------------|-----------|-----------------------------------|------------------|-----------|
|   | Three months ended March 31, 2013 |                  |           | Three months ended March 31, 2012 |                  |           |
|   | Lease-<br>Comm                    | Time-<br>Payment | Total     | Lease-<br>Comm                    | Time-<br>Payment | Total     |
| Allowance for credit losses:                |                                   |                  |           |                                   |                  |           |
| Beginning balance                           | \$ 103                            | \$ 13,935        | \$ 14,038 | \$ 162                            | \$ 13,018        | \$ 13,180 |
| Charge-offs                                 | (119)                             | (5,453)          | (5,572)   | (163)                             | (6,376)          | (6,539)   |
| Recoveries                                  | 52                                | 1,348            | 1,400     | 112                               | 1,208            | 1,320     |
| Provisions                                  | 62                                | 4,819            | 4,881     | 32                                | 4,864            | 4,896     |
| Ending balance, allowance for credit losses | \$ 98                             | \$ 14,649        | \$ 14,747 | \$ 143                            | \$ 12,714        | \$ 12,857 |

The following table presents the allowance for credit losses and financing receivables by portfolio segment as of March 31, 2013, and December 31, 2012, classified according to the impairment evaluation method:

|   | As of March 31, 2013 |                  |            | As of December 31, 2012 |                  |            |
|---|----------------------|------------------|------------|-------------------------|------------------|------------|
|   | Lease-<br>Comm       | Time-<br>Payment | Total      | Lease-<br>Comm          | Time-<br>Payment | Total      |
| Allowance for credit losses:                        |                      |                  |            |                         |                  |            |
| Individually evaluated for impairment               | \$                   | \$               | \$         | \$                      | \$               | \$         |
| Collectively evaluated for impairment               | 98                   | 14,649           | 14,747     | 103                     | 13,935           | 14,038     |
| Contracts acquired with deteriorated credit quality |                      |                  |            |                         |                  |            |
| Ending balance, allowance for credit losses         | \$ 98                | \$ 14,649        | \$ 14,747  | \$ 103                  | \$ 13,935        | \$ 14,038  |
| Financing receivables: <sup>(1)</sup>               |                      |                  |            |                         |                  |            |
| Individually evaluated for impairment               | \$                   | \$               | \$         | \$                      | \$               | \$         |
| Collectively evaluated for impairment               | 189                  | 173,813          | 174,002    | 174                     | 173,697          | 173,871    |
| Contracts acquired with deteriorated credit quality |                      |                  |            |                         |                  |            |
| Ending balance, financing receivables               | \$ 189               | \$ 173,813       | \$ 174,002 | \$ 174                  | \$ 173,697       | \$ 173,871 |

(1) Total financing receivables include net investment in leases. For purposes of asset quality and allowance calculations, the allowance for credit losses is excluded.



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The following table presents the aging status of the recorded investment in leases as of March 31, 2013, classified according to the original score granted by our internally-developed proprietary scoring model:

|                             | Current    | 31 to 60<br>days<br>Past Due | 61 to 90<br>days<br>Past Due | Over 90<br>Days<br>Past Due | Total      | Over 90<br>Days<br>Accruing |
|-----------------------------|------------|------------------------------|------------------------------|-----------------------------|------------|-----------------------------|
| LeaseComm                   | \$ 96      | \$ 3                         | \$ 4                         | \$ 86                       | \$ 189     | \$ 86                       |
| TimePayment                 |            |                              |                              |                             |            |                             |
| Gold                        | 53,654     | 2,978                        | 1,442                        | 2,632                       | 60,706     | 2,632                       |
| Silver                      | 83,874     | 2,470                        | 2,726                        | 14,171                      | 103,241    | 14,171                      |
| Bronze                      | 6,669      | 394                          | 425                          | 2,378                       | 9,866      | 2,378                       |
| TimePayment subtotal        | 144,197    | 5,842                        | 4,593                        | 19,181                      | 173,813    | 19,181                      |
| Total financing receivables | \$ 144,293 | \$ 5,845                     | \$ 4,597                     | \$ 19,267                   | \$ 174,002 | \$ 19,267                   |

Percent of total financing receivables 82.9% 3.4% 2.6% 11.1% 100%

The following table presents the aging status of the recorded investment in leases as of December 31, 2012, classified according to the original score granted by our internally-developed proprietary scoring model:

|                             | Current    | 31 to 60<br>days<br>Past Due | 61 to 90<br>days<br>Past Due | Over 90<br>Days<br>Past Due | Total      | Over 90<br>Days<br>Accruing |
|-----------------------------|------------|------------------------------|------------------------------|-----------------------------|------------|-----------------------------|
| LeaseComm                   | \$ 90      | \$ 5                         | \$ 5                         | \$ 74                       | \$ 174     | \$ 74                       |
| TimePayment                 |            |                              |                              |                             |            |                             |
| Gold                        | 54,446     | 2,763                        | 1,042                        | 2,309                       | 60,560     | 2,309                       |
| Silver                      | 84,268     | 2,883                        | 3,281                        | 13,312                      | 103,744    | 13,312                      |
| Bronze                      | 6,341      | 493                          | 441                          | 2,118                       | 9,393      | 2,118                       |
| TimePayment subtotal        | 145,055    | 6,139                        | 4,764                        | 17,739                      | 173,697    | 17,739                      |
| Total financing receivables | \$ 145,145 | \$ 6,144                     | \$ 4,769                     | \$ 17,813                   | \$ 173,871 | \$ 17,813                   |

Percent of total financing receivables 83.5% 3.5% 2.7% 10.3% 100%

**Table of Contents****MICROFINANCIAL INCORPORATED****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS***(Tables in thousands, except percentages, share and per share data)***D. Net Income per Share**

Net income per share for the three months ended March 31, 2013 and 2012 was as follows:

|  | Three Months Ended<br>March 31, |            |
|--|---------------------------------|------------|
|  | 2013                            | 2012       |
| Net income   | \$ 2,266                        | \$ 2,011   |
| Weighted average common shares outstanding                             | 14,495,411                      | 14,284,087 |
| Dilutive effect of common stock options, warrants and restricted stock | 291,169                         | 316,688    |
| Shares used in computation of net income per common share - diluted    | 14,786,580                      | 14,600,775 |
| Net income per common share - basic                                    | \$ 0.16                         | \$ 0.14    |
| Net income per common share - diluted                                  | \$ 0.15                         | \$ 0.14    |

For the three month periods ended March 31, 2013 and 2012, there were no options excluded from the computation of diluted net income per share because their effect would have been antidilutive.

**E. Dividends**

On January 29, 2013, we declared a dividend of \$0.06 per share payable on February 15, 2013, to stockholders of record on February 8, 2013.

On January 31, 2012, we declared a dividend of \$0.06 per share payable on February 15, 2012, to stockholders of record on February 10, 2012.

**F. Revolving line of credit**

On August 2, 2007, we entered into a revolving line of credit with a bank syndicate led by Sovereign Bank ( Sovereign ) based on qualified TimePayment lease receivables. The total commitment under the facility, originally \$30 million, has been increased at various times, most recently from \$100 million to \$150 million in December 2012. The December 2012 amendment would also permit further increases in the total commitment under an accordion feature, to \$175 million, with the agreement of the Agent and, as applicable, a new or existing Lender under certain conditions. Outstanding borrowings are collateralized by eligible lease contracts and a security interest in all of our other assets.

We had approximately \$69.3 million and \$70.4 million outstanding on our revolving line of credit facility at March 31, 2013, and December 31, 2012, respectively. At March 31, 2013, our available borrowing capacity was approximately \$80.7 million, subject to limitations based on lease eligibility and a borrowing base formula. The revolving line of credit has financial covenants that we must comply with to obtain funding and avoid an event of default. As of March 31, 2013, we were in compliance with all covenants under the revolving line of credit.

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The maturity date of our revolving line of credit is December 2016, at which time the outstanding loan balance plus interest becomes due and payable. At our option upon maturity, the unpaid principal balance may be converted to a six month term loan.

The following table demonstrates the total commitment under the revolving credit facility with the associated rate options in effect during the quarters ended March 31, 2013 and 2012. As of March 31, 2013, the total commitment under the facility was \$150 million.

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

| <b>Amendment Date</b> | <b>Total Commitment<br/>under Credit Facility<br/>(in millions)</b> | <b>Rate options<sup>(1)</sup></b> |    |                  |
|-----------------------|---|-----------------------------------|----|------------------|
| October 2011          | \$ 100  | Prime plus 0.75%                  | or | LIBOR plus 2.75% |
| December 2012         | \$ 150  | Base <sup>(2)</sup> plus 0.75%    | or | LIBOR plus 2.50% |

- (1) Under the terms of the facility, loans are Base Rate Loans (or, prior to December 2012, Prime Rate Loans), unless we elect LIBOR Loans. If a LIBOR Loan is not renewed at maturity it automatically converts to a Base Rate Loan.
- (2) The base rate is the highest of the prime rate established by the Agent, or one-month LIBOR plus 1%, or the federal funds effective rate plus 0.5%.

At March 31, 2013, \$65.0 million of our loans were LIBOR loans and \$4.3 million of our loans were Base Rate Loans. The interest rate on our loans at March 31, 2013, was between 2.75% and 4.0%. At the same date, the qualified lease receivables eligible under the borrowing base computation was approximately \$128.4 million.

**G. Stock-Based Employee Compensation**

Under our 2008 Equity Incentive Plan, we reserved 1,000,000 shares of common stock for issuance, of which 15,718 shares are unissued as of March 31, 2013. In May 2012, our stockholders approved our 2012 Equity Incentive Plan, for which we have 750,000 shares of common stock reserved, of which 614,052 shares are unissued as of March 31, 2013. The total potential future grants under the combined 2008 and 2012 plans are 629,770 shares at March 31, 2013.

*Non-employee director stock grants*

The following details the stock granted to our non-employee directors under the 2008 Plan during the three month periods ended March 31, 2013 and 2012. These shares were issued as part of our annual director compensation arrangements and were fully vested on the date of issuance.

| <b>Date of Grant</b> | <b>Number of<br/>Shares</b> | <b>Fair Value<br/>per Share</b> | <b>Fair Value of<br/>Grant</b> |
|----------------------|-----------------------------|---------------------------------|--------------------------------|
| February 2012        | 31,820                      | \$ 6.60                         | \$ 210                         |
| January 2013         | 29,205                      | \$ 7.55                         | \$ 221                         |

*Restricted Stock Unit Grants (RSUs)*

The following provides details of our vested and unvested RSUs as of March 31, 2013:

| <b>Date of Grant</b> | <b>Number of<br/>RSUs</b> | <b>Fair Value<br/>per Share</b> | <b>Fair Value<br/>of Grant</b> | <b>As of March 31, 2013</b> |                        |
|----------------------|---------------------------|---------------------------------|--------------------------------|-----------------------------|------------------------|
|                      |                           |                                 |                                | <b>Vested</b>               | <b>Non-<br/>Vested</b> |
| February 2010        | 33,518                    | \$ 3.15                         | \$ 106                         | 16,759                      | 16,759                 |
| February 2011        | 33,044                    | \$ 4.11                         | 136                            | 8,261                       | 24,783                 |
| February 2012        | 40,393                    | \$ 6.60                         | 266                            |                             | 40,393                 |
| January 2013         | 45,316                    | \$ 7.55                         | 342                            |                             | 45,316                 |

|         |    |     |        |         |
|---------|----|-----|--------|---------|
| 152,271 | \$ | 850 | 25,020 | 127,251 |
|---------|----|-----|--------|---------|

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

In January 2013, the Compensation and Benefits Committee of our Board of Directors granted 45,316 RSUs to our executive officers. The RSUs were valued on the date of grant and the fair value of these awards was \$7.55 per share. The issuance consists of three separate tranches. The first tranche is for 28,643 RSUs which vest over five years at 25% annually beginning on the second anniversary of the grant date. The second tranche is for 15,548 RSUs which cliff vest after three years only if management achieves specific performance measures. The third tranche is for 1,125 RSUs which vest over five years at 25% annually, beginning on the second anniversary of the grant date, and represent payment related to 2012 incentive bonus compensation.

During the three months ended March 31, 2013, and March 31, 2012, amortized compensation expense related to RSUs was \$50,000 and \$23,000, respectively.

Information relating to our outstanding stock options at March 31, 2013, is as follows:

| Exercise Price | Outstanding |                               |                 | Exercisable |                                 |                 |
|----------------|-------------|-------------------------------|-----------------|-------------|---------------------------------|-----------------|
|                | Shares      | Weighted-Average Life (Years) | Intrinsic Value | Shares      | Weighted-Average Exercise Price | Intrinsic Value |
| \$ 2.30        | 258,723     | 5.92                          | \$ 1,586        | 194,042     | \$ 2.30                         | \$ 1,189        |
| \$ 5.77        | 31,923      | 3.92                          | 85              | 31,923      | \$ 5.77                         | 85              |
| \$ 5.85        | 142,382     | 4.83                          | 367             | 142,382     | \$ 5.85                         | 367             |
|                | 433,028     | 5.41                          | \$ 2,038        | 368,347     | \$ 3.72                         | \$ 1,641        |

During the three months ended March 31, 2013, there were no options granted, exercised, forfeited, or expired.

For the three months ended March 31, 2013 and 2012, the total share-based compensation cost recognized was \$61,000 and \$45,000, respectively. The unrecognized compensation cost was \$649,000 at March 31, 2013.

**H. 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.

*Stock Repurchases*

On August 10, 2010, our Board of Directors approved a common stock repurchase program under which we are authorized to purchase up to 250,000 of our outstanding shares from time to time. The repurchases may take place in either the open market or through block trades. The repurchase program will be funded by our working capital and may be suspended or discontinued at any time.

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**MICROFINANCIAL INCORPORATED**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

*(Tables in thousands, except percentages, share and per share data)*

During the first quarter of fiscal year 2013 we repurchased and retired 14,984 shares of our common stock under our stock buyback program, at an average price per share of \$7.45. The total cost of the shares purchased was approximately \$112,000. There were no share repurchases made during the first quarter of 2012.

**I. Subsequent Events**

We have evaluated all events and transactions that occurred through the date on which we issued these financial statements. Other than the declaration of dividends, we did not have any material subsequent events that impacted our consolidated financial statement.

On April 23, 2013, we declared a dividend of \$0.06 payable on May 15, 2013, to shareholders of record on May 3, 2013.

**J. Recent Accounting Pronouncements**

None.



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**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, 2012.

**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, intends 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 those associated with: the demand for the equipment types we finance; our significant capital requirements; our ability or inability to obtain the financing we need, or to use internally generated funds, in order to continue originating contracts; the risks of defaults on our leases; our provision for credit losses; our residual interests in underlying equipment; possible adverse consequences associated with our collection policy; the effect of higher interest rates on our portfolio; increasing competition; increased governmental regulation of the rates and methods we use in financing and collecting on our leases and contracts; acquiring other portfolios or companies; dependence on key personnel; changes to accounting standards for equipment leases; adverse results in litigation and regulatory matters, or promulgation of new or enhanced legislation or regulations; information technology systems disruptions; and general economic and business conditions. 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/consumer finance company that provides microticket equipment leasing and other financing services. The average amount financed by TimePayment during 2012 was approximately \$5,100. Our portfolio generally consists of business equipment leased or rented primarily to small commercial enterprises.

We finance the origination of our leases and contracts primarily through cash provided by operating activities and borrowings under our revolving line of credit. On August 2, 2007, we entered into a revolving line of credit with a bank syndicate led by Sovereign Bank (Sovereign) based on qualified TimePayment lease receivables. The total commitment under the facility, originally \$30 million, has been increased at various times, most recently in December 2012, when it was increased from \$100 million to \$150 million. The December 2012 amendment would permit further increases in the total commitment under an accordion feature, to \$175 million, with the agreement of the Agent and, as applicable, a new or existing Lender under certain conditions. Outstanding borrowings are collateralized by eligible lease contracts and a security interest in all of our other assets.

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.

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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 42 months as of December 31, 2012.

We have also from time to time acquired service contracts under which 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 the monitoring contract from the dealer at a negotiated multiple of the monthly payments. In prior years, most of our service contract revenue was derived from our LeaseComm portfolio, for which we have not purchased any new security service contracts since 2002. Consequently, our service contract revenue from LeaseComm represents a less significant portion of our revenue stream over time. However, beginning in the second quarter of 2012, TimePayment began acquiring service contracts. During the first quarter of 2013, revenue from TimePayment monitoring contracts exceeded for the first time that earned from LeaseComm service contracts during the same period. TimePayment's revenue from monitoring contracts is expected to continue to grow.

*Operating Data*

Dealer fundings were \$20.1 million for the three months ended March 31, 2013; a decrease of \$1.5 million or 7.2%, compared to the three months ended March 31, 2012. The decrease in origination dollars resulted from a decline in the average funded amount from approximately \$5,400 in the first quarter of 2012 to \$4,600 in the first quarter of 2013. 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, and gross investment in rental equipment and service contracts decreased from \$242.3 million at December 31, 2012, to \$241.5 million at March 31, 2013. Net cash provided by operating activities decreased by \$0.9 million, or 4.0%, to \$21.4 million during the three months ended March 31, 2013, as compared to the three months ended March 31, 2012.

**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, 2012, 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, 2013.

**Table of Contents**Results of Operations - Three months ended March 31, 2013, compared to the three months ended March 31, 2012Revenues

|                             | <b>Three months ended March 31,</b> |               |                  |
|-----------------------------|-------------------------------------|---------------|------------------|
|                             | <b>2013</b>                         | <b>Change</b> | <b>2012</b>      |
|                             | <i>(Dollars in thousands)</i>       |               |                  |
| <b>Revenues:</b>            |                                     |               |                  |
| Income on financing leases  | \$ 10,204                           | 5.9%          | \$ 9,635         |
| Rental income               | 2,503                               | 8.0%          | 2,317            |
| Income on service contracts | 176                                 | 107.1%        | 85               |
| Loss and damage waiver fees | 1,441                               | 12.0%         | 1,287            |
| Service fees and other      | 971                                 | 5.5%          | 920              |
| <b>Total revenues</b>       | <b>\$ 15,295</b>                    | <b>7.4%</b>   | <b>\$ 14,244</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.

Total revenues for the three months ended March 31, 2013, were \$15.3 million, an increase of \$1.1 million, or 7.4%, from the three months ended March 31, 2012. The overall increase was due to an increase of \$0.6 million in income on financing leases, a \$0.2 million increase in rental income, \$0.2 million increase in fees and other income and a \$0.1 million increase in service contract revenue. The increase in income on financing leases is a result of the continued growth in new lease originations. The increase in rental income is the result of TimePayment lease contracts coming to term and converting to rentals, partially offset by the attrition of LeaseComm and TimePayment rental contracts. Historically, our service contract revenue was derived from our LeaseComm portfolio, for which we have not purchased any new security service contracts since 2002. Consequently, our service contract revenue from LeaseComm represents a less significant portion of our revenue stream over time. However, beginning in the first second quarter of 2012, TimePayment began acquiring service contracts. During the first quarter of 2013, TimePayment's service contract revenue exceeded that earned by LeaseComm. We expect TimePayment's service contract revenue to continue to increase in 2013.

Selling, General and Administrative Expenses

|                                     | <b>Three months ended March 31,</b> |               |             |
|-------------------------------------|-------------------------------------|---------------|-------------|
|                                     | <b>2013</b>                         | <b>Change</b> | <b>2012</b> |
|                                     | <i>(Dollars in thousands)</i>       |               |             |
| Selling, general and administrative | \$ 4,662                            | 7.0%          | \$ 4,356    |
| As a percent of revenue             | 30.5%                               |               | 30.6%       |

Our selling, general and administrative (SG&A) expenses include costs of maintaining corporate functions such as 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 increased by \$0.3 million for the three months ended March 31, 2013, as compared to the three months ended March 31, 2012. The increase was primarily driven by increases in compensation-related expenses, partially offset by a reduction in legal fees. The number of employees as of March 31, 2013, was 151 compared to 141 as of March 31, 2012.

**Table of Contents***Provision for Credit Losses*

|                             | <b>Three months ended March 31,</b> |               |             |
|-----------------------------|-------------------------------------|---------------|-------------|
|                             | <b>2013</b>                         | <b>Change</b> | <b>2012</b> |
|                             | <i>(Dollars in thousands)</i>       |               |             |
| Provision for credit losses | \$ 4,881                            | (0.3)%        | \$ 4,896    |
| As a percent of revenue     | 31.9%                               |               | 34.4%       |

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 decreased by \$15,000 for the three months ended March 31, 2013, as compared to the three months ended March 31, 2012, while net charge-offs decreased by 20.1% to \$4.2 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 decrease in the allowance reflects improvements in delinquency levels of the lease portfolio.

*Depreciation and Amortization*

|                                       | <b>Three months ended March 31,</b> |               |             |
|---------------------------------------|-------------------------------------|---------------|-------------|
|                                       | <b>2013</b>                         | <b>Change</b> | <b>2012</b> |
|                                       | <i>(Dollars in thousands)</i>       |               |             |
| Depreciation - property and equipment | \$ 154                              | 2.0%          | \$ 151      |
| Depreciation - rental equipment       | 1,048                               | 22.3%         | 857         |
| Amortization - service contracts      | 103                                 | 100%          |             |
| Total depreciation and amortization   | \$ 1,305                            | 29.5%         | \$ 1,008    |
| As a percent of revenue               | 8.5%                                |               | 7.1%        |

Depreciation and amortization expense consists of depreciation on property and equipment and rental equipment, and the amortization of service contracts. Property and equipment 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.

Investments in service contracts are amortized over the expected life of the contract. In a typical service contract acquisition, a homeowner purchases a home security system and simultaneously signs a contract with the security dealer for monthly monitoring of the system. The security dealer then sells the rights to that monthly payment to us. We perform all of the processing, billing, collection and administrative work on the service contract. In the event the contract terminates prior to its estimated life, the remaining net book value is expensed. Beginning in the second quarter of 2012, TimePayment began acquiring service contracts.

Depreciation expense on rentals increased by \$0.2 million for the three months ended March 31, 2013, as compared to the three months ended March 31, 2012. The increase in depreciation is due to the increase in the number of TimePayment lease contracts reaching maturity and converting to rentals. Depreciation expense on service contracts increased by \$0.1 million for the three months ended March 31, 2013, as compared to the three months ended March 31, 2012. Depreciation and amortization of property and equipment increased by \$3,000 for the three months ended March 31, 2013, as compared to the three months ended March 31, 2012.

**Table of Contents***Interest Expense*

|   | <b>Three months ended March 31,</b> |               |             |
|---|-------------------------------------|---------------|-------------|
|   | <b>2013</b>                         | <b>Change</b> | <b>2012</b> |
|   | <i>(Dollars in thousands)</i>       |               |             |
| Interest                                | \$ 670                              | 5.8%          | \$ 633      |
| As a percent of revenue                 | 4.4%                                |               | 4.4%        |
| Line of credit balance (end of period): | \$ 69,254                           |               | \$ 62,981   |

We pay interest on borrowings under our revolving line of credit. Interest expense increased by \$37,000 for the three months ended March 31, 2013, as compared to the three months ended March 31, 2012. This increase resulted primarily from our increased level of borrowing on our revolving line of credit partially offset by lower interest rates.

*Provision for Income Taxes*

|                                     | <b>Three months ended March 31,</b> |               |             |
|-------------------------------------|-------------------------------------|---------------|-------------|
|                                     | <b>2013</b>                         | <b>Change</b> | <b>2012</b> |
|                                     | <i>(Dollars in thousands)</i>       |               |             |
| Provision for income taxes          | \$ 1,511                            | 12.8%         | \$ 1,340    |
| As a percent of revenue             | 9.9%                                |               | 9.4%        |
| As a percent of income before taxes | 40.0%                               |               | 40.0%       |

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 \$171,000 for the three months ended March 31, 2013, as compared to the three months ended March 31, 2012. This increase resulted from the \$0.4 million increase in income before taxes for the three months ended March 31, 2013, as compared to the three months ended March 31, 2012.

As of March 31, 2013, we had a liability of \$32,000 for accrued interest and penalties related to various state income tax matters. 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, 2010, and our state income tax returns are subject to examination for tax years ended on or after December 31, 2009.

*Fair Value of Financial Instruments*

For financial instruments including cash and cash equivalents, restricted cash, accounts payable, and other liabilities, we believe that the carrying amount approximates fair value due to their short-term nature. The fair value of the revolving line of credit is calculated based on the incremental borrowing rates currently available on loans with similar terms and maturities. In December 2012, we amended our revolving line of credit which reduced our interest rate to a more current rate. We have determined that the fair value of our revolving line of credit at March 31, 2013, approximates its carrying value.

**Table of Contents****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.

|                                       | March 31, 2013                |        | December 31, 2012 |        |
|---------------------------------------|-------------------------------|--------|-------------------|--------|
|                                       | <i>(dollars in thousands)</i> |        |                   |        |
| Current                               | \$ 177,927                    | 83.7%  | \$ 179,887        | 84.3%  |
| 31-60 days past due                   | 7,184                         | 3.4    | 7,601             | 3.6    |
| 61-90 days past due                   | 5,633                         | 2.7    | 5,825             | 2.7    |
| Over 90 days past due                 | 21,782                        | 10.2   | 20,153            | 9.4    |
| Gross receivables due in installments | \$ 212,526                    | 100.0% | \$ 213,466        | 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, cash provided by operating activities and the proceeds from 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, cash provided from operating activities and borrowings on our revolving line of credit which matures in December 2016. Additionally, our uses of cash include the payment of interest and principal on borrowings, selling, general and administrative expenses, income taxes, payment of dividends and capital expenditures.

For the three months ended March 31, 2013 and 2012, 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 \$21.4 million for the three months ended March 31, 2013, compared to \$22.3 million for the three months ended March 31, 2012. At March 31, 2013, we had approximately \$69.3 million outstanding under our revolving credit facility and had available borrowing capacity of approximately \$80.7 million, subject to the borrowing base formula.

We used net cash in investing activities of \$20.6 million for the three months ended March 31, 2013, and \$21.6 million for the three months ended March 31, 2012. Investing activities primarily relate to the origination of leases with investments in lease and service contracts, direct costs, property and equipment.

Net cash used in financing activities was \$1.4 million for the three months ended March 31, 2013, and \$0.6 million for the three months ended March 31, 2012. Financing activities primarily consist of the borrowings and repayments on our revolving line of credit and dividend payments. During the first quarter of 2013, we borrowed \$31.6 million and repaid \$32.7 million on our line of credit. During the same period in 2012, we borrowed \$29.6 million and repaid \$29.3 million on our line of credit.

The maturity date of our revolving line of credit is December 2016, at which time the outstanding loan balance plus interest becomes due and payable. At our option upon maturity, the unpaid principal balance may be converted to a six-month term loan.

**Table of Contents***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:

| <i>(dollars in 000)</i>                  | March 31, 2013         |                  |                    | Maximum<br>Facility<br>Amount | December 31, 2012      |                  |                    | Maximum<br>Facility<br>Amount |
|--|------------------------|------------------|--------------------|-------------------------------|------------------------|------------------|--------------------|-------------------------------|
|  | Amounts<br>Outstanding | Interest<br>Rate | Unused<br>Capacity |                               | Amounts<br>Outstanding | Interest<br>Rate | Unused<br>Capacity |                               |
| Revolving credit facility <sup>(1)</sup> | \$ 69,254              | 2.75-4.00%       | \$ 80,746          | \$ 150,000                    | \$ 70,380              | 2.96-4.00%       | \$ 79,620          | \$ 150,000                    |

<sup>(1)</sup> The unused capacity is subject to the borrowing base formula.

On August 2, 2007, we entered into a revolving line of credit with a bank syndicate led by Sovereign Bank ( Sovereign ) based on qualified TimePayment lease receivables. The total commitment under the facility, originally \$30 million, has been increased at various times, most recently in December 2012, from \$100 million to \$150 million. In addition, the December 2012 amendment would permit further increases in the total commitment under an accordion feature, to \$175 million, with the agreement of the Agent and, as applicable, a new or existing Lender under certain conditions. Outstanding borrowings are collateralized by eligible lease contracts and a security interest in all of our other assets.

The following table demonstrates the total commitment under the revolving credit facility with the associated rate options in effect during the quarters ended March 31, 2013 and 2012. As of March 31, 2013, the total commitment under the facility was \$150 million.

| Amendment Date | Total Commitment<br>under Credit Facility<br><i>(in millions)</i> |                                | Rate options <sup>(1)</sup> |                  |
|----------------|---|--------------------------------|-----------------------------|------------------|
|                | October 2011  | \$ 100                         | Prime plus 0.75%            | or               |
| December 2012  | \$ 150  | Base <sup>(2)</sup> plus 0.75% | or                          | LIBOR plus 2.50% |

<sup>(1)</sup> Under the terms of the facility, loans are Base Rate Loans (or prior to December 2012, Prime Rate Loans), unless we elect LIBOR Loans. If a LIBOR Loan is not renewed at maturity it automatically converts to a Base Rate Loan.

<sup>(2)</sup> The base rate is the highest of the prime rate established by the Agent, or one-month LIBOR plus 1%, or the federal funds effective rate plus 0.5%.

At March 31, 2013, \$65.0 million of our loans were LIBOR loans and \$4.3 million of our loans were Base Rate Loans. At March 31, 2012, the qualified lease receivables eligible under the borrowing base computation was approximately \$128.4 million.

*Dividends*

During the three months ended March 31, 2013, we declared a dividend of \$0.06 per share payable on February 15, 2013, to shareholders of record on February 8, 2013. During the three months ended March 31, 2012, we declared a dividend of \$0.06 per share payable on February 15, 2012, to shareholders of record on February 10, 2012.

On April 23, 2013, we declared a dividend of \$0.06 per share payable on May 15, 2013, to stockholders of record on May 3, 2013.

## **Table of Contents**

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.

### *Share repurchases*

On August 10, 2010, our Board of Directors approved a common stock repurchase program under which we are authorized to purchase up to 250,000 of our outstanding shares from time to time. The repurchases may take place in either the open market or through block trades. The repurchase program will be funded by our working capital and may be suspended or discontinued at any time.

During the quarter ended March 31, 2013, we repurchased a total of 14,984 shares of our common stock under the common stock repurchase program approved in 2010, at an average price per share of \$7.45. The total cost of the shares purchased was approximately \$112,000. See Part II, Item 2 of this Quarterly Report on Form 10-Q for more information.

Since the program's inception, we have repurchased a total of 101,279 shares of our common stock at a total cost of approximately \$491,000.

### **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 do not have any firm outstanding commitments to lend.

### **Recent Accounting Pronouncements**

None.



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### **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, 2013, we have repaid all of our fixed-rate debt and have \$69.3 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 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. Investment activity during 2012 and 2013 was very limited given the lack of cash available to invest and the relatively low investment rates being offered.

### **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 ending December 31, 2013, 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, 2012. 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 2. Unregistered Sales of Equity Securities and Use of Proceeds**

On August 10, 2010, our Board of Directors approved a common stock repurchase program under which we are authorized to purchase up to 250,000 of our outstanding shares from time to time. The repurchases may take place in either the open market or through block trades. The repurchase program will be funded by our working capital and may be suspended or discontinued at any time.

During the quarter ended March 31, 2013, we repurchased and retired shares of our common stock under our stock buyback program. The following table shows details of these repurchases:

| Period                                | Total Number of Shares Purchased | Average Price Paid Per Share | Total Number of Shares Purchased as Part of Publicly Announced Program <sup>(1)</sup> | Maximum Number of Shares That May Yet Be Purchased Under the Program |
|---------------------------------------|----------------------------------|------------------------------|---|--|
| August 10, 2010, to December 31, 2012 | 86,295                           | \$ 4.40                      | 86,295  | 163,705  |
| January 1 to January 31, 2013         |                                  |                              |   | 163,705  |
| February 1 to February 28, 2013       | 13,775                           | \$ 7.45                      | 13,775  | 149,930  |
| March 1 to March 31, 2013             | 1,209                            | \$ 7.50                      | 1,209   | 148,721  |
| January 1 to March 31, 2013 Total     | 14,984                           | \$ 7.45                      | 14,984  |  |

(1) All repurchases were made pursuant to the repurchase program described above, which was publicly announced on August 11, 2010.

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**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).
- 10.1 Amended and Restated Employment Agreement between the Registrant and James R. Jackson, Jr., dated February 1, 2013 (incorporated by reference to Exhibit 10.1 in the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on February 4, 2013).
- 10.2 Amended and Restated Employment Agreement between the Registrant and Steven LaCreta, dated February 1, 2013 (incorporated by reference to Exhibit 10.2 in the Registrant's Current Report on Form 8-K filed with the Securities and Exchange Commission on February 4, 2013).
- 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.
- 101\*\* The following materials from the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 2013, formatted in XBRL (eXtensible Business Reporting Language): (i) Consolidated Balance Sheets as of March 31, 2013 and December 31, 2012, (ii) Condensed Consolidated Statements of Income for the three months ended March 31, 2013 and 2012, (iii) Condensed Consolidated Statements of Stockholders' Equity for the three months ended March 31, 2013 and the twelve months ended December 31, 2012, (iv) Condensed Consolidated Statements of Cash Flows for the three months ended March 31, 2013 and 2012, and (v) Notes to Consolidated Financial Statements.

\* Filed herewith

\*\* Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

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**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 15, 2013