

MICROFINANCIAL INC  
Form 10-Q  
November 14, 2008

**Table of Contents**

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

(Mark One)

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

**For the quarterly period ended September 30, 2008**

**or**

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

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

Massachusetts  
(State or other jurisdiction of  
incorporation or organization)

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

10 M Commerce Way, Woburn, MA 01801  
(Address of principal executive offices)  
(781) 994-4800

(Registrant's telephone number, including area code)

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

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

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

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

As of October 31, 2008, 14,020,757 shares of the registrant's common stock were outstanding.

---

**MICROFINANCIAL INCORPORATED  
TABLE OF CONTENTS**

	Page
Part I FINANCIAL INFORMATION	
Item 1. Financial Statements (unaudited):	
<u>Condensed Consolidated Balance Sheets - September 30, 2008 and December 31, 2007</u>	3
<u>Condensed Consolidated Statements of Income - Three and nine months ended September 30, 2008 and 2007</u>	4
<u>Condensed Consolidated Statements of Stockholders' Equity for the nine months ended September 30, 2008 and the twelve months ended December 31, 2007</u>	5
<u>Condensed Consolidated Statements of Cash Flows - Nine months ended September 30, 2008 and 2007</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>	12
<u>Item 3. Quantitative and Qualitative Disclosures about Market Risk</u>	22
<u>Item 4. Controls and Procedures</u>	22
Part II OTHER INFORMATION	
<u>Item 1. Legal Proceedings</u>	23
<u>Item 1A. Risk Factors</u>	23
<u>Item 6. Exhibits</u>	23
<u>Signatures</u>	24
<u>EX-31.1 SECTION 302 CERTIFICATION OF CEO</u>	
<u>EX-31.2 SECTION 302 CERTIFICATION OF CFO</u>	
<u>EX-32.1 SECTION 906 CERTIFICATION OF CEO</u>	
<u>EX-32.2 SECTION 906 CERTIFICATION OF CFO</u>	

---

**Table of Contents**

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

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

(Unaudited)

	September 30, 2008	December 31, 2007
<b>ASSETS</b>		
Cash and cash equivalents	\$ 19,691	\$ 7,080
Restricted cash	222	561
Net investment in leases:		
Receivables due in installments	132,673	92,314
Estimated residual value	14,049	9,814
Initial direct costs	1,092	729
Less:		
Advance lease payments and deposits	(707)	(219)
Unearned income	(46,909)	(35,369)
Allowance for credit losses	(10,402)	(5,722)
Net investment in leases	89,796	61,547
Investment in service contracts, net	52	203
Investment in rental contracts, net	175	106
Property and equipment, net	816	782
Other assets	1,133	703
Total assets	\$ 111,885	\$ 70,982
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Notes payable	\$ 41,065	\$ 6,531
Accounts payable	1,395	1,350
Capital lease obligation	137	
Dividends payable		698
Other liabilities	1,341	801
Income taxes payable	189	228
Deferred income taxes	3,007	546
Total liabilities	47,134	10,154
Stockholders' equity:		
Preferred stock, \$.01 par value; 5,000,000 shares authorized; no shares issued at September 30, 2008 and December 31, 2007	140	140

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

Common stock, \$.01 par value; 25,000,000 shares authorized; 14,019,507 and 13,960,778 shares issued at September 30, 2008 and December 31, 2007, respectively

Additional paid-in capital	45,723	45,412
Retained earnings	18,888	15,276
Total stockholders' equity	64,751	60,828
Total liabilities and stockholders' equity	\$ 111,885	\$ 70,982

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

**Table of Contents**

**MICROFINANCIAL INCORPORATED**  
**CONDENSED CONSOLIDATED STATEMENTS OF INCOME**

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

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Revenues:				
Income on financing leases	\$ 6,030	\$ 3,406	\$ 16,566	\$ 8,092
Rental income	2,330	3,268	7,566	10,706
Income on service contracts	221	303	720	993
Loss and damage waiver fees	849	524	2,305	1,442
Service fees and other	632	415	1,712	1,131
Interest income	23	182	110	752
<b>Total revenues</b>	<b>10,085</b>	<b>8,098</b>	<b>28,979</b>	<b>23,116</b>
Expenses:				
Selling, general and administrative	3,260	3,134	9,697	9,861
Provision for credit losses	3,782	1,919	10,199	5,119
Depreciation and amortization	245	288	705	1,098
Interest	310	13	696	39
<b>Total expenses</b>	<b>7,597</b>	<b>5,354</b>	<b>21,297</b>	<b>16,117</b>
Income before provision for income taxes	2,488	2,744	7,682	6,999
Provision for income taxes	905	941	2,670	2,530
<b>Net income</b>	<b>\$ 1,583</b>	<b>\$ 1,803</b>	<b>\$ 5,012</b>	<b>\$ 4,469</b>
Net income per common share basic	\$ 0.11	\$ 0.13	\$ 0.36	\$ 0.32
Net income per common share diluted	\$ 0.11	\$ 0.13	\$ 0.35	\$ 0.32
Weighted-average shares:				
Basic	14,016,167	13,956,881	13,992,951	13,910,234
Diluted	14,179,080	14,180,213	14,174,576	14,146,696

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 Capital	Earnings	Stockholders Equity
Balance at December 31, 2006	13,811,442	\$ 138	\$44,136	\$ 11,862	\$56,136
Warrant exercises	125,000	1	319		320
Purchase and retirement of shares	(75,000)	(1)	(398)		(399)
Stock issued for deferred compensation	77,654	2	307		309
Restricted stock granted	11,682		72		72
Stock-based compensation			12		12
Conversion of share-based liability awards to equity awards			932		932
Amortization of unearned compensation	10,000		32		32
Common stock dividends (\$0.20 per share)				(2,788)	(2,788)
Net income				6,202	6,202
Balance at December 31, 2007	13,960,778	\$ 140	\$45,412	\$ 15,276	\$60,828
Stock issued for deferred compensation	53,729		241		241
Stock-based compensation			55		55
Amortization of unearned compensation	5,000		15		15
Common stock dividends (\$0.10 per share)				(1,400)	(1,400)
Net income				5,012	5,012
Balance at September 30, 2008	14,019,507	\$ 140	\$45,723	\$ 18,888	\$64,751

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)

	Nine Months Ended September 30,	
	2008	2007
Cash flows from operating activities:		
Cash received from customers	\$ 43,185	\$ 30,143
Cash paid to suppliers and employees	(10,928)	(9,892)
Income taxes paid	(249)	(212)
Interest paid	(696)	(3)
Interest received	110	752
Net cash provided by operating activities	31,422	20,788
Cash flows from investing activities:		
Investment in lease and rental contracts	(50,569)	(37,219)
Investment in direct costs	(836)	(527)
Investment in property and equipment	(318)	(297)
Net cash used in investing activities	(51,723)	(38,043)
Cash flows from financing activities:		
Proceeds from notes payable	71,176	46
Repayment of notes payable	(36,642)	(50)
Decrease in restricted cash	339	
Proceeds from capital lease obligation	163	
Repayment of capital lease obligations	(26)	
Proceeds from exercise of common stock warrants		41
Payment of dividends	(2,098)	(2,083)
Net cash provided by (used in) financing activities	32,912	(2,046)
Net change in cash and cash equivalents	12,611	(19,301)
Cash and cash equivalents, beginning of period	7,080	28,738
Cash and cash equivalents, end of period	\$ 19,691	\$ 9,437
Reconciliation of net income to net cash provided by operating activities:		
Net income	\$ 5,012	\$ 4,469
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of unearned income, net of initial direct costs	(16,566)	(8,092)



Edgar Filing: MICROFINANCIAL INC - Form 10-Q

Depreciation and amortization	705	1,098
Provision for credit losses	10,199	5,119
Recovery of equipment cost and residual value	29,297	15,187
Stock-based compensation expense	70	537
Non-cash interest expense (amortization of debt discount)		37
Changes in assets and liabilities:		
Current taxes payable	(39)	(123)
Deferred income taxes	2,461	2,440
Other assets	(430)	(223)
Accounts payable	173	287
Other liabilities	540	52
Net cash provided by operating activities	\$ 31,422	\$ 20,788
Supplemental disclosure of non-cash activities:		
Fair market value of stock issued for compensation	\$ 241	\$ 381
Conversion of share-based liability awards to equity awards		932

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

**Table of Contents**

**MICROFINANCIAL INCORPORATED**  
**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

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

**A. Nature of Business**

MicroFinancial Incorporated (referred to as MicroFinancial, we, us or our ) operates primarily through its wholly-owned subsidiaries, TimePayment Corp. and Leasecomm Corporation. TimePayment is a specialized commercial finance company that leases and rents microticket equipment and provides other financing services. The average amount financed by TimePayment during 2007 was approximately \$6,500 compared to the 2008 year to date average of \$5,400. 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 line of credit.

**B. Summary of Significant Accounting Policies**

*Basis of Presentation*

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and the rules and regulations of the Securities and Exchange Commission for interim financial statements. Accordingly, our interim statements do not include all of the information and disclosures required for our annual financial statements. In the opinion of our management, the condensed consolidated financial statements contain all adjustments, consisting only of normal recurring adjustments, considered necessary for a fair presentation of these interim results. These financial statements should be read in conjunction with our consolidated financial statements and notes included in our Annual Report on Form 10-K for the year ended December 31, 2007. The results for the nine months ended September 30, 2008 are not necessarily indicative of the results that may be expected for the full year ending December 31, 2008.

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

*Allowance for Credit Losses*

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

We have adopted a consistent, systematic procedure for establishing and maintaining an appropriate allowance for credit losses for our microticket transactions. We estimate the likelihood of credit losses net of recoveries in the portfolio at each reporting period based upon a combination of the lessee's bureau reported credit score at lease inception and the current delinquency status of the account. In addition to these elements, we also consider other relevant factors including general economic trends, trends in delinquencies and credit losses, static pool 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

Table of Contents

**MICROFINANCIAL INCORPORATED**  
**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

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

credit losses, and the review of current factors provide the basis for our analysis of the adequacy of the allowance for credit losses. We take charge-offs against our receivables when such receivables are deemed uncollectible. In general a receivable is deemed uncollectible when it is 360 days past due where no contact has been made with the lessee for 12 months or, if 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.

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

	Nine Months Ended September 30,	
	2008	2007
Allowance for credit losses, beginning	\$ 5,722	\$ 5,223
Provision for credit losses	10,199	5,119
Charge-offs	(8,869)	(8,733)
Recoveries	3,350	3,697
Allowance for credit losses, ending	\$ 10,402	\$ 5,306

*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 and nine months ended September 30, 2008, 1,292,067 options were excluded from the computation of diluted net income per share because their effect was antidilutive. For the three and nine months ended September 30, 2007, 1,115,188 options were excluded from the computation of diluted net income per share because their effect was antidilutive.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Net income	\$ 1,583	\$ 1,803	\$ 5,012	\$ 4,469
Weighted average common shares outstanding	14,016,167	13,956,881	13,992,951	13,910,234
Dilutive effect of common stock options, warrants and restricted stock	162,913	223,332	181,625	236,462
Shares used in computation of net income per common share diluted	14,179,080	14,180,213	14,174,576	14,146,696
Net income per common share basic	\$ 0.11	\$ 0.13	\$ 0.36	\$ 0.32

Net income per common share	diluted	\$	0.11	\$	0.13	\$	0.35	\$	0.32
-----------------------------	---------	----	------	----	------	----	------	----	------

*Stock-Based Employee Compensation*

In February 2008, we granted 10 year options under our 1998 Equity Incentive Plan to our executive officers to purchase 176,879 shares of common stock at an exercise price of \$5.85 per share. The fair value of these awards was \$1.78 per share. The options were valued at the date of grant using the following assumptions: expected life in years of 6.25, annualized volatility of 41.30%, expected dividend yield of 3.70% and a risk free interest rate of 2.66%. The options vest over five years beginning on the second anniversary of the grant date. In February 2007,

**Table of Contents**

**MICROFINANCIAL INCORPORATED**  
**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

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

we granted ten year options to our executive officers to purchase 40,188 shares of common stock at an exercise price of \$5.77 per share. The fair value of these awards was \$2.08 per share. The options were valued at the date of grant using the following assumptions: expected life in years of 7, annualized volatility of 43.62%, expected dividend yield of 3.47%, and a risk-free interest rate of 4.62%. The options vest on the fifth anniversary of their grant date. No options were exercised or cancelled during the nine months ended September 30, 2008.

On February 4, 2004, a new non-employee director was granted 25,000 shares of restricted stock with a fair value of \$3.17 per share. On August 15, 2006, a second new non-employee director was granted 25,000 shares of restricted stock with a fair value of \$3.35 per share. In each case, the restricted stock vested 20% upon grant and vests 5% on the first day of each quarter after the grant date. As vesting occurs, compensation expense is recognized. As of September 30, 2008, 40,000 shares were fully vested between these two directors.

Information relating to our outstanding stock options at September 30, 2008 is as follows:

Exercise Price	Outstanding			Exercisable		
	Shares	Weighted-Average Life (Years)	Intrinsic Value	Shares	Weighted-Average Exercise Price	Intrinsic Value
\$12.31	359,391	.41	\$	359,391	\$ 12.31	\$
13.54	40,609	.41		40,609	13.54	
9.78	350,000	1.40		350,000	9.78	
13.10	90,000	2.39		90,000	13.10	
6.70	235,000	3.41		235,000	6.70	
1.59	167,500	4.16	404,000	167,500	1.59	404,000
5.77	40,188	8.42		40,188	5.77	
5.85	176,879	9.33		176,879	5.85	
	1,459,567	2.98	\$ 404,000	1,242,500	9.19	\$ 404,000

During the three months ended September 30, 2008 and 2007, the total share based employee compensation cost recognized was \$24,000 and \$12,000, respectively. During the nine months ended September 30, 2008 and 2007, the total share based employee compensation cost recognized was \$70,000 and \$537,000, respectively.

For share-based liability awards, we recognize compensation cost equal to the greater of (a) the grant date fair value or (b) the fair value of the modified liability when it is settled. As a result of modifications to certain awards in 2005, some awards made under our 1998 Equity Incentive Plan had been classified as share-based liability awards. As of March 31, 2007, our share-based liability awards were fully vested. In April 2007, we modified certain exercise features of all our outstanding share-based liability awards by restricting the settlement methods available to the option holders and converted these awards to equity awards. As a result of these modifications, our cumulative share-based compensation liability of \$932,000 was reclassified in April 2007 to additional paid-in capital.

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

The fair values as of April 2007, of the outstanding options classified as liability instruments under SFAS 123(R) were estimated using expected lives of one to three years, annualized volatility of 43.43%, an expected dividend yield of 3.64% and a risk free interest rate of 4.58%.



**Table of Contents**

**MICROFINANCIAL INCORPORATED**  
**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

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

The expected life represents the average period of time that the options are expected to be outstanding given consideration to vesting schedules; annualized volatility is based on historical volatilities of our common stock; dividend yield represents the current dividend yield expressed as a constant percentage of our stock price and the risk free rate is based on the U.S. Treasury yield curve in effect on the measurement date for periods corresponding to the expected life of the option. At each subsequent reporting date, we are required to remeasure the fair value of our share-based liability awards.

***Cash and Cash Equivalents***

Cash and cash equivalents include demand deposits with various commercial banks and highly liquid investments with maturities of three months or less when acquired. Cash equivalents are stated at cost, which approximates market value.

***Concentration of Credit Risk***

Financial instruments that subject us to concentrations of credit risk principally consist of cash equivalents and deposits in bank accounts. We deposit our cash and invest in short-term investments primarily through 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 cash deposits in excess of the FDIC insurance coverage.

**C. Notes Payable**

On August 2, 2007, we entered into a new three-year \$30 million line of credit with Sovereign Bank based on qualified TimePayment lease receivables. On July 9, 2008 we entered into an amended agreement to increase our line of credit with Sovereign Bank from \$30 million to \$60 million. The maturity date of the amended agreement is August 2, 2010. Outstanding borrowings bear interest at Prime Rate or at a London Interbank Offered Rate ( LIBOR ) plus 2.75% and are collateralized by eligible lease contracts and a security interest in all of our other assets. Under the terms of the facility, loans are Prime Rate Loans, unless we elect LIBOR Loans. If a LIBOR Loan is not renewed at maturity it automatically converts to a Prime Rate Loan. At September 30, 2008 all of our loans were Prime Rate Loans. The Prime Rate at September 30, 2008 was 5.0%. The amount available on our line of credit at September 30, 2008 was \$18,935,000. The line of credit has financial covenants that we must comply with to obtain funding and avoid an event of default. As of September 30, 2008, we were in compliance with all covenants under the line of credit.

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

**D. Commitments and Contingencies*****Legal Matters***

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

***Lease Commitments***

We accept lease applications on a daily basis and, as a result, we have a pipeline of applications that have been approved, where a lease has not been originated. Our commitment to lend does not become binding until all of the steps in the lease origination process have been completed, including the receipt of the lease, supporting

**Table of Contents**

**MICROFINANCIAL INCORPORATED**  
**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

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

documentation and verification with the lessee. Since we fund on the same day a lease is verified, we have no outstanding commitments to lend.

*Dividends*

On October 24, 2008 we declared a dividend of \$.05 payable on November 14, 2008 to the shareholders of record on November 5, 2008.

**E. Recent Accounting Pronouncements**

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

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

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

In May 2008, the FASB issued SFAS No. 162, *The Hierarchy of General Accepted Accounting Principles*. This statement identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparations of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (GAAP) in the United States (the GAAP hierarchy). SFAS No. 162 is effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board amendments to AU Section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*. The FASB Board does not expect this statement will result in a change in current practice.



**Table of Contents**

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

**Introduction**

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

**Forward-Looking Information**

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

**Overview**

We are a specialized commercial finance company that provides "microticket" equipment leasing and other financing services. The average amount financed by TimePayment during 2007 was approximately \$6,500 per contract compared to the 2008 year to date average of \$5,400. 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 on hand and our bank credit facility. On August 2, 2007, we entered into a new three-year \$30 million line of credit with Sovereign Bank based on qualified TimePayment lease receivables. On July 9, 2008 we entered into an amended agreement to increase this line of credit from \$30 million to \$60 million. The maturity date of the amended agreement is August 2, 2010. Outstanding borrowings bear interest at Prime Rate or at the London Interbank Offered Rate ( "LIBOR" ) plus 2.75% and are collateralized by eligible lease contracts and a security interest in all of our other assets. Under the terms of the facility, loans are Prime Rate Loans, unless we elect LIBOR Loans. If a LIBOR Loan is not renewed at maturity it automatically converts to a Prime Rate Loan.

In a typical lease transaction, we originate a lease through a 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.

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

**Table of Contents**

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 47 months as of December 31, 2007.

In the past 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 would purchase the right to the payment stream under the monitoring contract from the dealer at a negotiated multiple of the monthly payments. We have not purchased any new security service contracts since 2004 and our service contract portfolio represents a less significant portion of our revenue stream over time.

**Critical Accounting Policies**

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

Our critical accounting policies, including revenue recognition, maintaining the allowance for credit losses, determining provisions for income taxes, and accounting for share-based compensation are each discussed in more detail in our Annual Report on Form 10-K. We have reviewed and determined that those policies remain our critical accounting policies and we did not make any changes in those policies during the nine months ended September 30, 2008.

***Results of Operations Three months ended September 30, 2008 compared to the three months ended September 30, 2007****Revenue*

	2008	Three Months Ended September 30, Change	2007
	(Dollars in thousands)		
Income on financing leases	\$ 6,030	77.0%	\$ 3,406
Rental income	2,330	(28.7)	3,268
Income on service contracts	221	(27.1)	303
Loss and damage waiver fees	849	62.0	524
Service fees and other income	632	52.3	415
Interest income	23	(87.4)	182
<b>Total revenues</b>	<b>\$ 10,085</b>	<b>24.5%</b>	<b>\$ 8,098</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 September 30, 2008 were \$10.1 million, an increase of \$2.0 million, or 24.5%, from the three months ended September 30, 2007. The overall increase was due to an increase of \$2.6 million in income on financing leases, an increase of \$542,000 in fees and other income, partially offset by a decrease of \$0.9 million in rental income, a decrease of \$160,000 in interest income, and a decrease of \$82,000 in income on service contracts. The increase in income on financing leases is a result of the continued growth in new

**Table of Contents**

lease originations. The decline in rental income is primarily explained by attrition rates in the two sources of rental income. One source is rental agreements that are originated and cancellable on a monthly basis. The other is the rental income that is recognized at the end of the lease term when a lessee chooses to keep the equipment and rents it on a monthly basis. Since we resumed funding in 2004 following an interruption in our funding sources, we have not originated any new rental contracts and few lease contracts have been eligible to convert to rental agreements since they have not reached the end of term. The decrease in interest income is a result of the decrease in cash and cash equivalents on hand as well as lower rates of investment. In addition we have not funded any new service contracts, in which we purchase the right to the payment stream under a home security monitoring contract for a negotiated multiple of the monthly payments, since we resumed funding in 2004; therefore this segment of revenue is expected to continually decline.

*Selling, General and Administrative*

	2008	Three Months Ended September 30, Change	2007
		(Dollars in thousands)	
Selling, general and administrative	\$3,260	4.0%	\$3,134
As a percent of revenue	32.3%		38.7%

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 \$126,000 for the three months ended September 30, 2008, as compared to the three months ended September 30, 2007. The increase was primarily driven by a \$145,000 increase in payroll, a \$124,000 increase in collection expense, and a \$78,000 increase in cost of equipment sold; offset in part by a \$98,000 decrease in professional fees, a \$58,000 decrease in legal services, and a \$57,000 decrease in other taxes as well as a net decrease of \$8,000 in all other categories of SG&A.

*Provision for Credit Losses*

	2008	Three Months Ended September 30, Change	2007
		(Dollars in thousands)	
Provision for credit losses	\$3,782	97.1%	\$1,919
As a percent of revenue	37.5%		23.7%

We maintain an allowance for credit losses on our investment in leases, service contracts and rental contracts at an amount that we believe is sufficient to provide adequate protection against losses in our portfolio. Our provision for credit losses increased by \$1.9 million, or 97.1%, for the three months ended September 30, 2008, as compared to the three months ended September 30, 2007, while net charge-offs increased by 92.2% to \$2.9 million. The provision was based on our analysis of actual and expected losses in our portfolio. The 90-day delinquent lease payments receivable on an exposure basis increased by 98.9% to \$17.9 million at September 30, 2008 compared to \$9.0 million at September 30, 2007. The increase in the allowance for credit losses reflects both the increased size of our lease portfolio and increased delinquency levels.

*Depreciation and Amortization*

	2008	Three Months Ended September 30, Change	2007
		(Dollars in thousands)	
Depreciation fixed assets	\$ 100	31.6%	\$ 76

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

Depreciation	rental equipment	107	(10.8)	120
Amortization	service contracts	38	(58.7)	92
Total depreciation and amortization		\$ 245	(14.9)%	\$ 288
As a percent of revenue		2.4%		3.6%

**Table of Contents**

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 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 lease contracts that have converted to rental contracts decreased by \$13,000 and amortization of service contracts decreased by \$54,000 for the three months ended September 30, 2008, as compared to the three months ended September 30, 2007. The decreases in depreciation and amortization are due to the decrease in the overall size of our portfolio of rental equipment and service contracts as well as the fact that a greater percentage of the assets are fully depreciated. Depreciation and amortization of property and equipment increased by \$24,000 for the three months ended September 30, 2008, as compared to the three months ended September 30, 2007. The increase in depreciation on property and equipment is a result of office and computer equipment additions.

We have in the past offered a rental agreement, which allowed the customer, assuming the contract was current and no event of default existed, to terminate the contract at any time by returning the equipment and providing us with 30 days notice. These assets were recorded at cost and depreciated over an estimated life of 36 months. This term was based upon our historical experience. In the event that the contract terminated prior to the end of the 36 month period, the remaining net book value was expensed. We have not originated any new rental contracts since 2004.

Service contracts were recorded at cost and amortized over their estimated life of 84 months. In a typical service contract acquisition, a homeowner will purchase a home security system and simultaneously sign a contract with the security dealer for monthly monitoring of the system. The security dealer would then sell the rights to that monthly payment to us. We perform all of the processing, billing, collection and administrative work on the service contract. The estimated life is based upon the expected life of such contracts in the security monitoring industry and our historical experience. In the event the contract terminates prior to the end of the 84 month term, the remaining net book value is expensed. We have not originated any new service contracts since 2004.

*Interest Expense*

	2008	Three Months Ended September 30, Change	2007
Interest	\$ 310	2,284.6%	\$ 13
As a percent of revenue	3.1%		0.2%

We pay interest on borrowings under our senior credit facility. Interest expense increased by \$297,000 for the three months ended September 30, 2008, as compared to the three months ended September 30, 2007. This increase resulted primarily from our increased level of borrowings. At September 30, 2008, we had notes payable of \$41.1 million compared to notes payable of \$0 at September 30, 2007.

*Provision for Income Taxes*

	2008	Three Months Ended September 30, Change	2007
Provision for income taxes	\$ 905	(3.8)%	\$ 941
As a percent of revenue	9.0%		11.6%
As a percent of income before taxes	36.4%		34.3%

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



**Table of Contents**

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 decreased by \$36,000 for the three months ended September 30, 2008, as compared to the three months ended September 30, 2007. This decrease resulted primarily from the \$256,000 decrease in pre-tax income and was partially offset by an increase in the effective tax rate from 34.3% for the three months ended September 30, 2007 to 36.4% for the three months ended September 30, 2008. The increase in the overall effective tax rate relates to the release of \$325,000 of state tax reserves during the three months ended September 30, 2007. The Commonwealth of Massachusetts has enacted legislation that provides for a reduction in the corporate income rate as well as requiring mandatory unitary combined filing. We are currently evaluating the impact of this legislation, we do not believe that it will have a material effect on our provision for income taxes.

As of June 30, 2008, we had a liability of \$328,000 for potential tax obligations and a liability of \$147,000 for accrued interest and penalties related to various state income tax matters. As of September 30, 2008 we had a liability of \$290,000 for potential tax obligations and a liability of \$145,000 for accrued interest and penalties. Of these amounts, approximately \$282,000 would impact our effective tax rate after a \$153,000 federal tax benefit for state income taxes. The decrease in the unrecognized tax benefits and interest is due to the conclusion of various state audits and the payment of assessments. It is reasonably possible that the total amount of unrecognized tax benefits may change significantly within the next 12 months; however at this time we are unable to estimate the change.

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

*Other Operating Data*

Dealer funding was \$16.1 million for the three months ended September 30, 2008, an increase of \$1.1 million or 7.7%, compared to the three months ended September 30, 2007. Throughout the year, the Company has adopted more restrictive credit standards which, on a dollar basis, have resulted in a decrease in our application approval ratios. 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. The aggregate amount of receivables due in installments, estimated residual values, net investment in service contracts and net investment in rental contracts increased from \$141.2 million at June 30, 2008 to \$150.9 million at September 30, 2008. Net cash provided by operating activities increased by \$4.1 million, or 56.7%, to \$11.3 million during the three months ended September 30, 2008 as compared to the three months ended September 30, 2007.

**Results of Operations** *Nine months ended September 30, 2008 compared to the nine months ended September 30, 2007**Revenue*

	2008	Nine Months Ended September 30, Change	2007
	(Dollars in thousands)		
Income on financing leases	\$ 16,566	104.7%	\$ 8,092
Rental income	7,566	(29.3)	10,706
Income on service contracts	720	(27.5)	993
Loss and damage waiver fees	2,305	59.8	1,442
Service fees and other income	1,712	51.4	1,131
Interest income	110	(85.4)	752
Total revenues	\$ 28,979	25.4%	\$ 23,116





**Table of Contents**

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 nine months ended September 30, 2008 were \$29.0 million, an increase of \$5.9 million, or 25.4%, from the nine months ended September 30, 2007. The overall increase was due to an increase of \$8.5 million in income on financing leases, and a \$1.4 million increase in fees and other income partially offset by a decrease of \$3.1 million in rental income, a decrease of \$0.6 million in interest income and a decrease of \$0.3 million 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 primarily explained by attrition rates in the two sources of rental income. One source is rental agreements that are originated and cancellable on a monthly basis. The other is the rental income that is recognized at the end of the lease term when a lessee chooses to keep the equipment and rents it on a monthly basis. Since we resumed funding in 2004 following an interruption in our funding sources, we have not originated any new rental contracts, and few lease contracts have been eligible to convert to rental agreements since they have not reached the end of term. The decrease in interest income is a direct result of the decrease in cash and cash equivalents on hand as well as a reduction in the rates of return on invested cash. In addition, we have not funded any new service contracts since we resumed funding in 2004; therefore this segment of revenue is expected to continually decline.

*Selling, General and Administrative*

	2008	Nine Months Ended September 30, Change	2007
		(Dollars in thousands)	
Selling, general and administrative	\$9,697	(1.7)%	\$9,861
As a percent of revenue	33.5%		42.7%

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 \$164,000 for the nine months ended September 30, 2008, as compared to the nine months ended September 30, 2007. The decrease was primarily driven by reductions in legal expense of \$124,000, and amortization of debt closing cost of \$196,000 offset by an increase of \$172,000 in cost of equipment sold.

*Provision for Credit Losses*

	2008	Nine Months Ended September 30, Change	2007
		(Dollars in thousands)	
Provision for credit losses	\$10,199	99.2%	\$5,119
As a percent of revenue	35.2%		22.1%

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 \$5.1 million, or 99.2%, for the nine months ended September 30, 2008, as compared to the nine months ended September 30, 2007, while net charge-offs increased by 9.6% to \$5.5 million. The provision was based on providing a general allowance on leases funded during the period and our analysis of actual and expected losses in our portfolio. The 90-day delinquent lease payments receivable on an exposure basis increased by 98.9% to \$17.9 million at September 30, 2008 compared to \$9.0 million at September 30, 2007. The increase in the allowance

for credit losses reflects both the increased size of our lease portfolio and increased delinquency levels.

**Table of Contents***Depreciation and Amortization*

	2008	Nine Months Ended September 30, Change	2007
		(Dollars in thousands)	
Depreciation fixed assets	\$ 284	39.9%	\$ 203
Depreciation rental equipment	270	(52.0)	563
Amortization service contracts	151	(54.5)	332
Total depreciation and amortization	\$ 705	(35.8)%	\$ 1,098
As a percent of revenue	2.4%		4.8%

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 lease contracts that have converted to rental contracts decreased by \$293,000 and amortization of service contracts decreased by \$181,000 for the nine months ended September 30, 2008, as compared to the nine months ended September 30, 2007. The decreases in depreciation and amortization are due to the decrease in the overall size of our portfolio of rental equipment and service contracts as well as the fact that a greater percentage of the assets are fully depreciated. Depreciation and amortization of property and equipment increased by \$81,000 for the nine months ended September 30, 2008, as compared to the nine months ended September 30, 2007.

We have in the past offered a rental agreement, which allowed the customer, assuming the contract was current and no event of default existed, to terminate the contract at any time by returning the equipment and providing us with 30 days notice. These assets were recorded at cost and depreciated over an estimated life of 36 months. This term was based upon our historical experience. In the event that the contract terminated prior to the end of the 36 month period, the remaining net book value was expensed. We have not originated any new rental contracts since 2004.

Service contracts were recorded at cost and amortized over their estimated life of 84 months. In a typical service contract acquisition, a homeowner will purchase a home security system and simultaneously sign a contract with the security dealer for monthly monitoring of the system. The security dealer would then sell the rights to that monthly payment to us. We perform all of the processing, billing, collection and administrative work on the service contract. The estimated life is based upon the expected life of such contracts in the security monitoring industry and our historical experience. In the event the contract terminates prior to the end of the 84 month term, the remaining net book value is expensed. We have not originated any new service contracts since 2004.

*Interest Expense*

	2008	Nine Months Ended September 30, Change	2007
		(Dollars in thousands)	
Interest	\$ 696	1,684.6%	\$ 39
As a percent of revenue	2.4%		0.2%

We pay interest on borrowings under our senior credit facility and subordinated notes payable. Interest expense increased by \$657,000 for the nine months ended September 30, 2008, as compared to the nine months ended September 30, 2007. This increase resulted primarily from our increased level of borrowings. At September 30, 2008,

we had notes payable of \$41.1 million compared to notes payable of \$0, at September 30, 2007.

**Table of Contents***Provision for Income Taxes*

	2008	Nine Months Ended September 30, Change	2007
		(Dollars in thousands)	
Provision for income taxes	\$2,670	5.5%	\$2,530
As a percent of revenue	9.2%		10.9%
As a percent of income before taxes	34.8%		36.1%

The provision for income taxes, deferred tax assets and liabilities and any necessary valuation allowance recorded against net deferred tax assets, involves summarizing temporary differences resulting from the different treatment of items, such as leases, for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are recorded on the balance sheet. We 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 \$140,000 for the nine months ended September 30, 2008, as compared to the nine months ended September 30, 2007. This increase resulted primarily from the \$683,000 increase in pre-tax income partially offset by a decrease in the effective tax rate from 36.1% for the nine months ended September 30, 2007 to 34.8% for the nine months ended September 30, 2008. The decrease in the overall effective tax rate is primarily related to the reduction of nondeductible expenses offset in part by the utilization of state net operating losses. The Commonwealth of Massachusetts has enacted legislation that provides for a reduction in the corporate income rate as well as requiring mandatory unitary combined filing. We are currently evaluating the impact of this legislation, we do not believe that it will have a material effect on our provision for income taxes.

*Other Operating Data*

Dealer funding was \$51.4 million for the nine months ended September 30, 2008, an increase of \$14.0 million or 37.3%, compared to the nine months ended September 30, 2007. Throughout the year, the Company has adopted more restrictive credit standards which, on a dollar basis, have resulted in a decrease in our application approval ratios. 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. The aggregate amount of receivables due in installments, estimated residual values, net investment in service contracts and investment in rental contracts increased from \$107.5 million at December 31, 2007 to \$150.9 million at September 30, 2008. Net cash provided by operating activities increased by \$10.6 million, or 33.8%, compared to \$31.4 million during the nine months ended September 30, 2008 as compared to the nine months ended September 30, 2007.

Exposure to Credit Losses

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

<i>(dollars in thousands)</i>	September 30, 2008		December 31, 2007	
Current	\$104,183	78.5%	\$75,528	81.8%
31-60 days past due	6,235	4.7	4,565	5.0
61-90 days past due	4,335	3.3	3,016	3.2
Over 90 days past due	17,920	13.5	9,205	10.0
Gross receivables due in installments	\$132,673	100.0%	\$92,314	100.0%



**Table of Contents****Liquidity and Capital Resources***General*

Our lease and finance business is capital-intensive and requires access to substantial short-term and long-term credit to fund lease originations. Since inception, we have funded our operations primarily through borrowings under our credit facilities, on-balance sheet securitizations, the issuance of subordinated debt, free cash flow and our initial public offering completed in February 1999. We will continue to require significant additional capital to maintain and expand our funding of leases and contracts, as well as to fund any future acquisitions of leasing companies or portfolios. In the near term, we expect to finance our business utilizing the cash on hand and our line of credit which matures in August 2010. Additionally, our uses of cash include the payment of interest and principal on borrowings, selling, general and administrative expenses, income taxes and capital expenditures.

For the nine months ended September 30, 2008 and 2007, our primary sources of liquidity were cash provided by operating activities and borrowings on our line of credit. We generated cash flow from operations of \$31.4 million for the nine months ended September 30, 2008 compared to \$20.8 million for the nine months ended September 30, 2007. At September 30, 2008, we had approximately \$41.1 million outstanding under our revolving credit facility and had available borrowing capacity of approximately \$18.9 million as described below. During the quarter ended September 30, 2008, we drew down additional cash against our line of credit as a precautionary measure. Cash on hand was \$20.0 million at September 30, 2008 compared to a cash balance of \$9.0 million at September 30, 2007.

We used net cash in investing activities of \$51.7 million during the nine months ended September 30, 2008 and \$38.0 million for the six months ended September 30, 2007. Investing activities primarily relate to the origination of leases and the increase in cash used is consistent with our focused and targeted sales and marketing effort.

Net cash provided by financing activities was \$32.9 million for the nine months ended September 30, 2008 and net cash used in financing activities was \$2.0 million for the nine months ended September 30, 2007. Financing activities primarily consist of the borrowings and repayments of notes payable and dividend payments.

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

*Borrowings*

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

	September 30, 2008				December 31, 2007			
	Amounts Outstanding	Interest Rate	Unused Capacity	Maximum Facility Amount	Amounts Outstanding	Interest Rate	Unused Capacity	Maximum Facility Amount
<i>(dollars in 000)</i> Revolving credit facility <sup>(1)</sup>	\$ 41,065	5.0%	\$ 18,935	\$ 60,000	\$ 6,531	7.25%	\$ 23,469	\$ 30,000
	\$ 41,065		\$ 18,935	\$ 60,000	\$ 6,531		\$ 23,469	\$ 30,000

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

On August 2, 2007, we entered into a new three-year \$30 million line of credit with Sovereign Bank based on qualified lease receivables. On July 9, 2008 we entered into an amended agreement to increase this line of credit from \$30 million to \$60 million. Outstanding borrowings bear interest at Prime Rate or at the London Interbank Offered



Rate ( LIBOR ) plus 2.75% and are collateralized by eligible lease contracts and a security interest in all of  
20

---

**Table of Contents**

our other assets. The line of credit has financial covenants that we must comply with to obtain funding and avoid an event of default. As of September 30, 2008, we were in compliance with all covenants under the line of credit. At September 30, 2008 all of our loans were Prime Rate Loans. The Prime Rate at September 30, 2008 was 5.0%.

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

*Dividends*

On October 24, 2008 we declared a dividend of \$.05 payable on November 14, 2008 to the shareholders of record on November 5, 2008. On July 25, 2008 we declared a dividend of \$.05 payable on August 15, 2008 to the shareholders of record on August 5, 2008. On April 25, 2008 we declared a dividend of \$0.05 payable on May 15, 2008 to shareholders of record on May 5, 2008. During the three months ended March 31, 2008 we did not declare a dividend.

During the nine months ended September 30, 2007, we declared dividends of \$0.05 payable to shareholders of record on each of March 30, 2007, June 29, 2007 and September 28, 2007.

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 nine months ended September 30, 2008 we had borrowed \$71.2 million against our lines of credit and had repaid \$36.6 million. The \$41.1 million of outstanding borrowings as of September 30, 2008 will be repaid by the application of TimePayment receipts and other payments when required to our outstanding balance. Our future minimum lease payments under non-cancelable operating leases are \$237,000 annually for the years 2008 through 2010.

*Lease Commitments*

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

**Recent Accounting Pronouncements**

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

**Table of Contents**

**ITEM 3. Quantitative and Qualitative Disclosures about Market Risk**

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

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

Given the relatively short average life of our leases and contracts, our goal is to maintain a blend of fixed and variable interest rate obligations which limits our interest rate risk. As of September 30, 2008, we had repaid all of our fixed-rate debt and had \$41.1 million of outstanding variable interest rate obligations under our Sovereign line of credit.

Our Sovereign line of credit bears interest at rates which fluctuate with changes in the Prime Rate or 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 September 30, 2008, no changes were made in our internal control over financial reporting that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Table of Contents**

**Part II Other Information**

**ITEM 1. Legal Proceedings**

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

**ITEM 1A. Risk Factors**

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

**ITEM 6. Exhibits**

(a) Exhibits index

- 10.1 Amended and Restated Credit Agreement dated July 9, 2008 (incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K filed on July 15, 2008).
- 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: November 14, 2008