MICROFINANCIAL INC
Form 10-Q
August 14, 2008

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

(Mark One)

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

For the quarterly period ended June 30, 2008

or

o **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	04-2962824
(State or other jurisdiction of incorporation or organization)	(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. þ Yes o 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 o	Accelerated filer o	Non-accelerated filer o	Smaller reporting company þ
		(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). o Yes þ No

As of July 31, 2008, 14,019,507 shares of the registrant s common stock were outstanding.

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

	June 30, 2008	December 31, 2007
ASSETS		
Cash and cash equivalents	$ 5,387	$ 7,080
Restricted cash	570	561
Net investment in leases:		
Receivables due in installments	123,618	92,314
Estimated residual value	13,117	9,814
Initial direct costs	997	729
Less:		
Advance lease payments and deposits	(572)	(219)
Unearned income	(45,234)	(35,369)
Allowance for credit losses	(9,499)	(5,722)
Net investment in leases	82,427	61,547
Investment in service contracts, net	90	203
Investment in rental contracts, net	117	106
Property and equipment, net	850	782
Other assets	842	703
Total assets	$ 90,283	$ 70,982
LIABILITIES AND STOCKHOLDERS EQUITY		
Notes payable	$ 21,377	$ 6,531
Accounts payable	1,247	1,350
Capital lease obligation	150	
Dividends payable		698
Other liabilities	1,419	801
Income taxes payable	378	228
Deferred income taxes	1,980	546
Total liabilities	26,551	10,154
Stockholders equity:		
Preferred stock, $.01 par value; 5,000,000 shares authorized; no shares issued at June 30, 2008 and December 31, 2007		
Common stock, $.01 par value; 25,000,000 shares authorized; 13,987,528 and 13,960,778 shares issued at June 30, 2008 and December 31, 2007, respectively	140	140
Additional paid-in capital	45,586	45,412
Retained earnings	18,006	15,276

Total stockholders equity	63,732	60,828
Total liabilities and stockholders equity	$ 90,283	$ 70,982

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

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

	Three Months Ended June 30, 2008	Three Months Ended June 30, 2007	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
Revenues:				
Income on financing leases	$ 5,596	$ 2,653	$ 10,536	$ 4,686
Rental income	2,484	3,514	5,236	7,438
Income on service contracts	240	329	499	690
Loss and damage waiver fees	768	473	1,456	917
Service fees and other	532	330	1,080	716
Interest income	27	247	87	570
Total revenues	9,647	7,546	18,894	15,017
Expenses:				
Selling, general and administrative	3,198	3,158	6,437	6,726
Provision for credit losses	3,060	1,677	6,417	3,200
Depreciation and amortization	230	347	460	810
Interest	234	13	386	26
Total expenses	6,722	5,195	13,700	10,762
Income before provision for income taxes	2,925	2,351	5,194	4,255
Provision for income taxes	1,053	902	1,765	1,589
Net income	$ 1,872	$ 1,449	$ 3,429	$ 2,666
Net income per common share basic	$ 0.13	$ 0.10	$ 0.25	$ 0.19
Net income per common share diluted	$ 0.13	$ 0.10	$ 0.24	$ 0.19
Weighted-average shares:				
Basic	13,987,528	13,912,228	13,981,216	13,886,524
Diluted	14,137,300	14,129,399	14,151,034	14,101,436

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

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

	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Retained Earnings	Total Stockholders Equity
Balance at December 31, 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 accrued 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 accrued compensation	23,000		127		127
Stock-based compensation			35		35
Amortization of unearned compensation	3,750		12		12
Common stock dividends ($0.05 per share)				(699)	(699)
Net income				3,429	3,429
Balance at June 30, 2008	13,987,528	$ 140	$ 45,586	$ 18,006	$ 63,732

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

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MICROFINANCIAL INCORPORATED
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOW
(In thousands)
(Unaudited)

	Six Months Ended June 30, 2008	Six Months Ended June 30, 2007
Cash flows from operating activities:		
Cash received from customers	$ 27,866	$ 19,621
Cash paid to suppliers and employees	(7,215)	(6,453)
Income taxes paid	(182)	(129)
Interest paid	(386)	(1)
Interest received	87	570
Net cash provided by operating activities	20,170	13,608
Cash flows from investing activities:		
Investment in lease and rental contracts	(34,644)	(22,431)
Investment in direct costs	(557)	(317)
Investment in property and equipment	(252)	(183)
Net cash used in investing activities	(35,453)	(22,931)
Cash flows from financing activities:		
Proceeds from notes payable	37,860	39
Repayment of notes payable	(23,014)	
Increase in restricted cash	(9)	
Proceeds from capital lease obligation	163	
Repayment of capital lease obligations	(13)	
Proceeds from exercise of common stock warrants		41
Payment of dividends	(1,397)	(1,385)
Net cash provided by (used in) financing activities	13,590	(1,305)
Net change in cash and cash equivalents	(1,693)	(10,628)
Cash and cash equivalents, beginning of period	7,080	28,737
Cash and cash equivalents, end of period	$ 5,387	$ 18,109
Reconciliation of net income to net cash provided by operating activities:		
Net income	$ 3,429	2,666
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of unearned income, net of initial direct costs	(10,536)	(4,686)
Depreciation and amortization	460	810

Provision for credit losses	6,417	3,200
Recovery of equipment cost and residual value	18,265	9,405
Stock-based compensation expense	47	525
Non-cash interest expense (amortization of debt discount)	0	24
Changes in assets and liabilities:		
Current taxes payable	150	(94)
Deferred income taxes	1,434	1,554
Other assets	(139)	(14)
Accounts payable	25	98
Other liabilities	618	120
Net cash provided by operating activities	$ 20,170	$ 13,608
Supplemental disclosure of non-cash activities:		
Fair market value of stock issued for compensation	$ 127	$ 308
Conversion of share-based liability awards to equity awards		932

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

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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 $5,600. 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 six months ended June 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

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(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:

	Six Months Ended June 30,	
	2008	2007
Allowance for credit losses, beginning	$ 5,722	$ 5,223
Provision for credit losses	6,417	3,200
Charge-offs	(4,801)	(5,986)
Recoveries	2,161	2,447
Allowance for credit losses, ending	$ 9,499	$ 4,884

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 six months ended June 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 months ended June 30, 2007, 1,075,000 options and 100,000 warrants were excluded from the computation of diluted net income per share because their effect was antidilutive. For the six months ended June 30, 2007, 1,115,188 options and 100,000 warrants were excluded from the computation of diluted net income per share because their effect was antidilutive.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
Net income	$ 1,872	$ 1,449	$ 3,429	$ 2,666
Weighted average common shares outstanding	13,987,528	13,912,228	13,981,216	13,886,524
Dilutive effect of common stock options, warrants and restricted stock	149,772	217,171	169,818	214,912
Shares used in computation of net income per common share diluted	14,137,300	14,129,399	14,151,034	14,101,436
Net income per common share basic	$ 0.13	$ 0.10	$ 0.25	$ 0.19

Net income per common share diluted	$	0.13	$	0.10	$	0.24	$	0.19

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

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years of 6.25, annualized volatility of 41.30%, expected dividend yield of 3.70% and a risk free interest rate of 2.66%. The options vest over five years beginning on the second anniversary of the grant date. In February 2007, we granted ten year options to our executive officers to purchase 40,188 shares of common stock at an exercise price of $5.77 per share. The fair value of these awards 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 six months ended June 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 June 30, 2008, 38,750 shares were fully vested between these two directors.

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

	Outstanding				Exercisable	
Exercise Price	Shares	Weighted-Average Life (Years)	Intrinsic Value	Weighted-Average Exercise Price	Shares	Intrinsic Value
$ 12.31	359,391	.66	$	$ 12.31	359,391	$
13.54	40,609	.66		13.54	40,609	
9.78	350,000	1.65		9.78	350,000	
13.10	90,000	2.64		13.10	90,000	
6.70	235,000	3.66		6.70	235,000	
1.59	167,500	4.41	348,000	1.59	167,500	348,000
5.77						