

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

MICROFINANCIAL INC
Form 10-Q
August 14, 2003

FORM 10-Q
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES AND EXCHANGE ACT OF 1934
For the Quarterly Period Ended June 30, 2003

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 04-2962824
(State or other jurisdiction of (I.R.S. Employer Identification No.)
Incorporation or Organization)

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 an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes No

As of August 4, 2003, 13,461,018 shares of the registrant's common stock were outstanding.

MICROFINANCIAL INCORPORATED
TABLE OF CONTENTS

Part I

FINANCIAL INFORMATION

Item 1 Financial Statements (unaudited):
Condensed Consolidated Balance Sheets
December 31, 2002 and June 30, 2003
Condensed Consolidated Statements of Operations

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

Three months ended June 30, 2002 and 2003
 Condensed Consolidated Statements of Cash Flows
 Six months ended June 30, 2002 and 2003
 Notes to Condensed Consolidated Financial Statements

Item 2	Management's Discussion and Analysis of Financial Condition and Results of Operations
Item 3	Quantitative and Qualitative Disclosures about Market Risk
Item 4	Controls and Procedures
Part II	OTHER INFORMATION
Item 1	Legal Proceedings
Item 3	Recent Sales of Unregistered Securities
Item 5	Other Information
Item 6	Exhibits and Reports on Form 8-K
Signatures	

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

	December 31, ----- 2002 -----
ASSETS	
Net investment in leases and loans:	
Receivables due in installments	\$ 334,623
Estimated residual value	30,754
Initial direct costs	4,891
Loans receivable	1,796
Less:	
Advance lease payments and deposits	(96)
Unearned income	(67,574)
Allowance for credit losses	(69,294)
Net investment in leases and loans	\$ 235,100
Investment in service contracts	14,463
Cash and cash equivalents	5,494
Restricted cash	18,516
Property and equipment, net	9,026
Income taxes receivable	8,652
Other assets	3,834
Total assets	\$ 295,085 =====
LIABILITIES AND STOCKHOLDERS' EQUITY	
Notes payable	\$ 168,927

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

Subordinated notes payable	3,262
Capitalized lease obligations	471
Accounts payable	3,840
Other liabilities	6,776
Income taxes payable	1,400
Deferred income taxes payable	23,806

Total liabilities	208,482

Stockholders' equity:	
Preferred stock, \$.01 par value; 5,000,000 shares authorized; no shares issued at 12/31/02 and 6/30/03	-
Common stock, \$.01 par value; 25,000,000 shares authorized; 13,410,646 and 13,765,116 shares issued at 12/31/02 and 6/30/03, respectively	134
Additional paid-in capital	47,723
Retained earnings	45,089
Treasury stock (588,700 and 426,366 shares of common stock at 12/31/02 and 6/30/03), at cost	(6,343)
Unearned compensation	0

Total stockholders' equity	86,603

Total liabilities and stockholders' equity	\$ 295,085
	=====

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

3

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

	For the three months end June 30,	
	2002	2003
	-----	-----
Revenues:		
Income on financing leases and loans	\$ 13,790	\$ 8,
Income on service contracts	2,458	2,
Rental income	9,220	8,
Loss and damage waiver fees	1,532	1,
Service fees and other	5,961	3,
	-----	-----
Total revenues	32,961	23,
	-----	-----
Expenses:		
Selling general and administrative	11,409	8,
Provision for credit losses	10,824	15,
Depreciation and amortization	4,851	4,
Interest	2,618	2,
	-----	-----
Total expenses	29,702	30,

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

Income/(loss) before provision for income taxes	3,259	(6,
Provision/(benefit) for income taxes	1,304	(2,
Net income/(loss)	\$ 1,955	(\$ 3,
Net income/(loss) per common share - basic	\$ 0.15	(\$ 0
Net income/(loss) per common share - diluted	\$ 0.15	(\$ 0
Weighted-average shares used to compute:		
Basic net income (loss) per share	12,821,946	12,917,
Fully diluted net income (loss) per share	12,901,149	12,917,

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

4

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

	For the three months end June 30,	
	2002	2003
Cash flows from operating activities:		
Cash received from customers	\$ 45,004	\$ 35,
Cash paid to suppliers and employees	(10,149)	(12,
Cash (paid) received for income taxes	(2,271)	11,
Interest paid	(2,579)	(2,
Interest received	87	
Net cash provided by operating activities	30,092	31,
Cash flows from investing activities:		
Investment in lease contracts	(23,358)	(
Investment in inventory	(1,057)	
Investment in direct costs	(1,417)	
Investment in service contracts	(2,081)	
Investment in fixed assets	19	
Repayment of notes from officers	23	
Net cash used in investing activities	(27,871)	(
Cash flows from financing activities:		

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

Proceeds from secured debt	11,929	
Repayment of secured debt	(13,733)	(35,
Repayment of short term demand notes payable	(200)	
Decrease in restricted cash	1,015	2,
Repayment of capital leases	(105)	
Payment of dividends	(642)	
	-----	-----
Net cash used in financing activities	(1,736)	(32,
	-----	-----
Net increase (decrease) in cash and cash equivalents:	485	(1,
Cash and cash equivalents, beginning of period	1,646	9,
	-----	-----
Cash and cash equivalents, end of period	\$ 2,131	\$ 8,
	=====	=====

(continued on following page)

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

5

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

	For the three months end June 30,	
	2002	2003
	-----	-----
Reconciliation of net income to net cash provided by operating activities:		
Net income (loss)	\$ 1,955	(\$ 3,
Adjustments to reconcile net income (loss) to cash provided by operating activities		
Depreciation and amortization	4,851	4,
Provision for credit losses	10,824	15,
Recovery of equipment cost and residual value, net of revenue recognized	13,367	27,
Change in assets and liabilities:		
Decrease (increase) in current taxes payable	(1,523)	2,
Increase (decrease) in current taxes receivable	0	(8,
Decrease (increase) in deferred income taxes	557	(2,
Increase (decrease) in other assets	502	(1,
Increase (decrease) in accounts payable	39	(
Increase in accrued liabilities	(480)	(
	-----	-----
Net cash provided by operating activities	\$ 30,092	\$ 31,
	=====	=====
Supplemental disclosure of noncash activities:		
Property acquired under capital leases	\$ 68	\$

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

Accrual of common stock dividends \$ 641 \$

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

6

MICROFINANCIAL INCORPORATED NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(A) Nature of Business:

MicroFinancial Incorporated (the "Company") which operates primarily through its wholly-owned subsidiary, Leasecomm Corporation, is a specialized commercial finance company that primarily leases and rents "microticket" equipment and provides other financing services in amounts generally ranging from \$400 to \$15,000 with an average amount financed of approximately \$1,700 and an average lease term of 44 months. The Company does not market its services directly to lessees but sources leasing transactions through a network of independent sales organizations and other dealer-based origination networks nationwide. The Company has funded its operations primarily through borrowings under its credit facilities, the issuance of subordinated debt and on balance sheet securitizations.

MicroFinancial incurred net losses of \$22.1 million for the year ended December 31, 2002. The net losses incurred by the Company during the third and fourth quarters caused the Company to be in default of certain debt covenants in its credit facility and securitization agreements. In addition, as of September 30, 2002, the Company's credit facility failed to renew and consequently, the Company was forced to suspend new origination activity as of October 11, 2002. On April 14, 2003, the Company entered into a long-term agreement with its lenders. This long-term agreement waives the defaults described above, and in consideration for this waiver, requires the outstanding balance of the loan to be repaid over a term of 22 months beginning in April 2003 at an interest rate of prime plus 2.0%. The Company received a waiver, which was set to expire on April 15, 2003, for the covenant violations in connection with the securitization agreement. Subsequently, the Company received a permanent waiver of the covenant defaults and the securitization agreement was amended so that going forward, the covenants are the same as those contained in the long-term agreement entered into on April 14, 2003, for the senior credit facility. The Company remains in full compliance with the terms and conditions of its securitizations and senior credit facility. The Company operates within all delinquency and charge-off covenants and has continued to make or exceed all scheduled payments on these debt instruments in a timely manner.

In an effort to improve its financial position, MicroFinancial has taken certain steps including the engagement of a financial and strategic advisory firm, Triax Capital Advisors, LLC. Management and its advisors are actively considering various financing, restructuring and strategic alternatives. In addition, Management has taken steps to reduce overhead, including a reduction in headcount from 380 at December 31, 2001 to 203 at December 31, 2002. During the six months ended June 30, 2003, the employee headcount was further reduced to 159 in a continued effort to maintain an appropriate cost structure.

Leasecomm Corporation periodically finances its lease and service contracts, together with unguaranteed residuals, through securitizations using special purpose vehicles. MFI Finance Corporation I and MFI Finance Corporation II, LLC are special purpose companies. The assets of such special purpose

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

vehicles and cash collateral or other accounts created in connection with the financings in which they participate are not available to pay creditors of Leasecomm Corporation, MicroFinancial Incorporated, or other affiliates. While Leasecomm Corporation generally does not sell its interests in leases, service contracts or loans to third parties after origination, the Company does, from time to time, contribute certain leases, service contracts, or loans to special-purpose entities for purposes of obtaining financing in connection with the related receivables. The contribution of such assets under the terms of such financings are intended to constitute "true sales" of such assets for bankruptcy purposes (meaning that such assets are legally isolated from Leasecomm Corporation). However, the special purpose entities to which such assets are contributed are not "qualifying special purpose entities" within the meaning Statement of Financial Accounting Standards ("SFAS") SFAS No. 140, and are required under generally accepted accounting principles to be consolidated in the financial statements of the Company. As a result, such assets and the related liability remain on the balance sheet and do not receive gain on sale treatment.

7

MICROFINANCIAL INCORPORATED NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(B) Summary of Significant Accounting Policies:

Basis of Presentation:

The accompanying unaudited 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, the interim statements do not include all of the information and disclosures required for the annual financial statements. In the opinion of the Company's 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 the consolidated financial statements and notes included in the Company's Annual Report and Form 10-K for the year ended December 31, 2002. The results for the six-month period ended June 30, 2003 are not necessarily indicative of the results that may be expected for the full year ended December 31, 2003.

The balance sheet at December 31, 2002 has been derived from the audited financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2002.

Allowance for Credit Losses:

The Company maintains an allowance for credit losses on its investment in leases, service contracts and loans at an amount that it believes is sufficient to provide adequate protection against losses in its portfolio. The allowance is determined principally on the basis of the historical loss experience of the Company and the level of recourse provided by such lease, service contract or loan, if any, and reflects management's judgment of additional loss potential considering current economic conditions and the nature and characteristics of the underlying lease portfolio. The Company determines the necessary periodic provision for credit losses, taking into account actual and expected losses in the portfolio, as a whole, and the relationship of the allowance to the net investment in leases, service contracts and loans.

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

The following table sets forth the Company's allowance for credit losses as of December 31, 2002 and June 30, 2003 and the related provision, charge-offs and recoveries for the six months ended June 30, 2003.

Balance of allowance for credit losses at December 31, 2002		\$ 69,294	=====
Provision for credit losses	26,048		
Total provisions for credit losses		26,048	
Charge-offs	(40,362)		
Recoveries	4,200		

Charge-offs, net of recoveries		(36,162)	-----
Balance of allowance for credit losses at June 30, 2003		\$ 59,180	=====

Earnings (Loss) Per Share:

Basic net income (loss) per common share is computed based on the weighted-average number of common shares outstanding during the period. Dilutive net income (loss) per common share gives effect to all dilutive potential common shares outstanding during the period. The computation of diluted earnings (loss) per share does not assume the issuance of common shares that have an antidilutive effect on net income per common share. Options to purchase 1,770,000 shares of common stock were not included in the computation of diluted earnings per share for the three months and six months ended June 30, 2002 because their effects were antidilutive. All stock options, common stock warrants, and unvested restricted stock were excluded from the computation of dilutive

8

MICROFINANCIAL INCORPORATED NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

earnings (loss) per share for the three and six months ended June 30, 2003, because their inclusion would have had an antidilutive effect on earnings (loss) per share.

	For three months ended June 30,		For six months ended June 30,	
	2002 ----	2003 ----	2002 ----	2003 ----
Net income (loss)	\$ 1,955	(\$ 3,736)	\$ 5,172	(\$
Shares used in computation:				
Weighted average common shares outstanding used in computation of net income (loss) per common share	12,821,946	12,917,752	12,821,946	12,9
Dilutive effect of common stock options	79,203	-	55,893	
	-----	-----	-----	-----

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

Shares used in computation of net income (loss) per common share - assuming dilution	12,901,149	12,917,752	12,877,839	12,9
	-----	-----	-----	-----
Net income (loss) per common share	\$ 0.15	(\$ 0.29)	\$ 0.40	(\$
Net income (loss) per common share assuming dilution	\$ 0.15	(\$ 0.29)	\$ 0.40	(\$

Stock Options

Under the 1998 Equity Incentive Plan (the "1998 Plan") which was adopted on July 9, 1998 the Company had reserved 4,120,380 shares of the Company's common stock for issuance pursuant to the 1998 Plan. The Company granted a total of 200,000 options during the six months ended June 30, 2003. A total of 195,000 options were surrendered during the six months ended June 30, 2003. A total of 1,675,000 options were outstanding at June 30, 2003 of which 783,000 were vested.

On February 7, 2003, the Company offered non-director employees and executives who had been granted stock options in the past the opportunity to cancel any of the original option agreements in exchange for a grant of restricted stock. All option awards subject to the offer were converted to restricted stock. In connection with this offer, on February 12, 2003, 1,325,000 options converted to 319,854 shares of restricted common stock. In addition, on March 17, 2003 one non-employee director was granted 50,000 shares of restricted stock. The restricted stock vested 20% upon grant, and vests 5% on the first day of each quarter after the grant date, with accelerated vesting if the price of the Company's common stock exceeds certain thresholds during the vesting period. As of June 30, 2003, 15,384 shares had been cancelled, 232,201 shares were fully vested, and \$178,000 had been amortized from unearned compensation to compensation expense.

Stock-based Employee Compensation

All stock options issued to directors and employees have an exercise price not less than the fair market value of the Company's common stock on the date of grant. In accordance with accounting for such options utilizing the intrinsic-value method, there is no related compensation expense recorded in the Company's financial statements. The Company follows the disclosure requirements of SFAS No. 123, Accounting for Stock-Based Compensation. SFAS No. 123 requires that compensation under a fair value method be determined using the Black-Scholes option-pricing model and disclosed in a pro forma effect on earnings and earnings per share. The Company accounts for stock-based employee compensation plans under the recognition and measurement principles of APB Opinion No.

MICROFINANCIAL INCORPORATED NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

25, Accounting for Stock Issued to Employees, and related Interpretations. The current period amortization of unearned compensation expense relating to the restricted stock awards is reflected in net income (loss). No other stock-based employee compensation cost is reflected in net income (loss), as either all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant or options granted that result in variable compensation costs had an exercise price greater than

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

the fair market value of the underlying common stock on June 30, 2003. The following table illustrates the effect on net income (loss) and earnings per share if the Company had applied the fair value recognition provisions of SFAS No. 123, Accounting for Stock-Based Compensation, to stock-based employee compensation.

	For the six months ended June 30,	
	2002	2003
	-----	-----
Net income (loss), as reported	\$5,172	(\$ 4,491)
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(676)	(403)
	-----	-----
Pro forma net income (loss)	\$4,496	(\$ 4,894)
	=====	=====
Earnings (loss) per share:		
Basic - as reported	\$ 0.40	(\$ 0.35)
	=====	=====
Basic - pro forma	\$ 0.35	(\$ 0.38)
	=====	=====
Diluted - as reported	\$ 0.40	(\$ 0.35)
	=====	=====
Diluted - pro forma	\$ 0.35	(\$ 0.38)
	=====	=====

The fair value of option grants for options granted during the six months ended June 30, 2003 was estimated on the date of grant utilizing the Black-Scholes option-pricing model with the following weighted-average assumptions.

Risk-free interest rate	3.34%
Expected dividend yield	0.00%
Expected life	7 years
Volatility	76.00%

The weighted-average fair value at the date of grant for options granted during the six months ended June 30, 2003 approximated \$0.62 per option. The Company granted 200,000 options during the six months ended June 30, 2003. There were no options granted during the three months ended June 30, 2002.

Notes Payable:

On August 22, 2000, the Company entered into a revolving line of credit and term loan facility with a group of financial institutions whereby it may borrow a maximum of \$192,000,000 based upon qualified lease receivables, loans, rentals and service contracts. According to the agreement, outstanding borrowings with respect to the revolving line of credit bear interest based either at Prime minus 0.25% for Prime Rate Loans or the prevailing rate per annum as offered in the London Interbank Offered Rate (LIBOR) plus 1.75% for LIBOR Loans or the seven-day Money Market rate plus 2.00% for Swing Line Advances. If the LIBOR loans are not renewed upon their maturity they automatically convert into prime rate loans. The Swing Line Advances have a

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

seven-day maturity, and upon their maturity they automatically convert into prime rate loans. In addition, the Company's aggregate outstanding principal amount of Swing Line Advances shall not exceed \$10 million. The prime rate at December 31, 2002, and June 30, 2003 was 4.25% and 4.00%. The 90-day LIBOR rate at December 31, 2002 and June 30, 2003 was 1.40% and 1.12% respectively.

10

MICROFINANCIAL INCORPORATED NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

As of September 30, 2002 the revolving credit line failed to renew and the Company began paying down the balance on the basis of a 36-month amortization plus interest. Based on the terms of the agreement, interest rates increased from Prime minus 0.25% to Prime plus 0.50% for prime based loans and from LIBOR plus 1.75% to LIBOR plus 2.50% for existing LIBOR based loans. In addition, based on the covenant defaults described below, the outstanding borrowings on all loans bear an additional 2.00% default interest. On January 3, 2003, the Company entered into a Forbearance and Modification Agreement for the senior credit facility which expired on February 7, 2003. Based on the terms of the Forbearance and Modification Agreement, interest rates increased again on the prime based loans to prime plus 1.00%.

At December 31, 2002, the Company was in default of certain of its debt covenants in its senior credit facility. The covenants that were in default with respect to the senior credit facility require that the Company maintain a fixed charge ratio in an amount not less than 130% of consolidated earnings, a consolidated tangible net worth minimum of \$77.5 million plus 50% of net income quarterly beginning with September 30, 2000 and compliance with the borrowing base. On April 14, 2003, the Company entered into a long-term agreement with its lenders. This long-term agreement waives the defaults described above, and in consideration for this waiver, requires the outstanding balance of the loan to be repaid over a term of 22 months beginning in April 2003 at an interest rate of prime plus 2.0%. Based on the amortization schedule in the new agreement, as subsequently amended on June 30, 2003, the Company is obligated to repay a minimum of \$56.1 million, plus applicable interest, over the next twelve months.

The Company had borrowings outstanding under the senior credit facility with the following terms:

Type -----	December 31, 2002		June 30, 2003	
	Rate	Amount	Rate	Amount
	(in thousands)		(in thousands)	
Prime	4.7500%	\$ 31,556	6.0000%	\$88,906
LIBOR	4.1875%	50,000		
LIBOR	4.1875%	45,000		
		-----		-----
Total Outstanding		\$126,556		\$88,906
		=====		=====

On April 14, 2003, the Company issued warrants to purchase an aggregate of 268,199 shares of the Company's common stock at an exercise price of \$.825 per share. The warrants were issued to the nine lenders in the Company's lending

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

syndicate in connection with the waiver of defaults and an extension of the Company's term loan. The warrants will be automatically terminated if all of the obligations owed by the Company to the lenders pursuant to the loan agreement have been paid in full prior to June 30, 2004. If all of the Company's obligations to the Lenders have not been paid in full prior to June 30, 2004, the warrants will become 50% exercisable as of that date. If all of the Company's obligations to the Lenders have not been paid in full prior to September 30, 2004, the warrants will then become 100% exercisable as of that date. Unless the warrants are automatically terminated or exercised pursuant to the above criteria, they will expire on September 30, 2014. The fair market value of the warrants, as determined using the Black-Scholes option-pricing model, was accounted for as additional paid in capital. The resulting cost of the warrants was \$77,000, which is being amortized to interest expense under the interest method. As of June 30, 2003, \$20,000 had been accreted to interest expense and the resulting effective interest rate on the senior credit facility was prime plus 2.09%.

MFI I issued three series of notes, the 2000-1 Notes, the 2000-2 Notes, and the 2001-3 Notes. In March 2000, MFI I issued the 2000-1 Notes in aggregate principal amount of \$50,056,686. In December 2000, MFI I issued the 2000-2 Notes in aggregate principal amount of \$50,561,633. In September 2001, MFI I issued the 2001-3 Notes in aggregate principal amount of \$39,397,354. Outstanding borrowings are collateralized by specific pools of lease receivables. In September 2001, MFI II, LLC was formed and issued one series of notes, the 2001-1 Notes in aggregate principal amount of \$10,000,000. Outstanding borrowings are collateralized by a specific pool of lease

MICROFINANCIAL INCORPORATED
 NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

receivables as well as the excess cash flow from the MFI I collateral. These notes are subordinate to the three series of notes issued by MFI I.

At December 31, 2002, the Company was in default on two of its debt covenants in its securitization agreements. The covenants that were in default with respect to the securitization agreements require that the Company maintain a fixed charge ratio in an amount not less than 125% of consolidated earnings and a consolidated tangible net worth greater than \$90 million plus 50% of net income for each fiscal quarter after June 30, 2001. Additionally per the terms of the securitization agreement, any default with respect to the senior credit facility is considered a default under the terms of the agreement. The Company received a waiver, which was set to expire on April 15, 2003, for the covenant violations in connection with the securitization agreement. Subsequently, the Company received a permanent waiver of the covenant defaults and the securitization agreement was amended so that going forward, the covenants are the same as those contained in the long-term agreement entered into on April 14, 2003, for the senior credit facility.

At December 31, 2002 and June 30, 2003, MFI I and MFI II had borrowings outstanding under the series of notes with the following terms:

Series	December 31, 2002		June 30, 2003	
	Rate	Amount	Rate	Amount
-----	-----	-----	-----	-----
		(in thousands)		(in thousands)

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

MFI I				
2000-1 Notes	7.3750%	3,464	7.3750%	-
2000-2 Notes	6.9390%	17,983	6.9390%	9,444
2001-3 Notes	5.5800%	17,019	5.5800%	10,477
MFI II LLC				
2001-1 Notes	8.0000%	3,625	8.0000%	1,075
		-----		-----
Total Outstanding		\$ 42,091		\$20,996
		=====		=====

On February 18, 2003, the Company repaid \$2.4 million in principal plus accrued interest for the MFI Finance I series 2000-1 notes utilizing the clean up call provision under its securitizations. The re-payment was made using cash previously classified as restricted.

At December 31, 2002 and June 30, 2003, the Company also had other notes payable which totaled \$280,000 and \$250,000 respectively. Of these notes, at December 31, 2002 and June 30, 2003, \$250,000 were term notes that carry an interest rate of 7.5% and are due on February 1, 2005. As of December 2002, there was also a demand note in the amount of \$30,000, bearing an interest rate of prime less 1.0%, outstanding. The Company had repaid the \$30,000 demand note as of June 30, 2003.

Dividends:

During the fourth quarter of 2002, the Board of Directors suspended the future payment of dividends to comply with the Company's banking agreements. Provisions in certain of the Company's credit facilities and agreements governing its subordinated debt contain, and the terms of any indebtedness issued by the Company in the future are likely to contain, certain restrictions on the payment of dividends on the Common Stock. The decision as to the amount and timing of future dividends paid by the Company, if any, will be made at the discretion of the Company's Board of Directors in light of the financial condition, capital requirements, earnings and prospects of the Company and any restrictions under the Company's credit facilities or subordinated debt agreements, as well as other factors the Board of Directors may deem relevant, and there can be no assurance as to the amount and timing of payment of future dividends.

MICROFINANCIAL INCORPORATED
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

New Accounting Pronouncements:

The FASB issued SFAS No. 149, "Amendments of Statement 133 on Derivative Instruments and Hedging Activities." This Statement amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities under FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities. The Company has determined that the adoption SFAS No. 149 does not have a material impact on its results of operations or consolidated financial position.

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

The FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity." The statement establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). Many of those instruments were previously classified as equity. Some of the provisions of this Statement are consistent with the current definition of liabilities in FASB Concepts Statement No. 6, Elements of Financial Statements. The Company has not completed its evaluation of SFAS No. 150 and has not yet determined the effect on its consolidated financial statements.

Reclassification of Prior Year Balances:

Certain reclassifications have been made to prior years' Consolidated Financial Statements to conform to the current presentation.

Commitments and Contingencies:

Please refer to Part II Other Information, Item 1 Legal Proceedings for information about pending litigation of the Company.

13

ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Three months ended June 30, 2003 as compared to the three months ended June 30, 2002.

Net income for the three months ended June 30, 2003 was a loss of approximately \$3.7 million, a decrease of \$5.7 million or 291% from the three months ended June 30, 2002. This represents diluted earnings per share for the three months ended June 30, 2003 of (\$0.29) per share on weighted-average outstanding shares of 12,917,752 as compared to \$0.15 per share on weighted-average outstanding shares of 12,821,946 for the three months ended June 30, 2002.

Total revenues for the three months ended June 30, 2003 were \$24.0 million, a decrease of \$9.0 million, or 27%, from the three months ended June 30, 2002. The decrease was primarily due to a decrease of \$5.4 million, or 39%, in financing leases and loans, \$2.9 million or 38% in fee and other income, and \$592,000 or 6% in rental income. The decrease in income on financing leases and loans was due to the decreased number of leases originated primarily resulting from the Company's decision during the third quarter of 2002 to suspend the funding of new contracts. The decrease in fee income and other income is the result of decreased fees from the lessees related to the collection and legal process employed by the Company. The decrease in rental income is the result of a decrease in the origination of rental contracts.

Selling, general and administrative expenses decreased by \$2.7 million, or 24%, for the three months ended June 30, 2003, as compared to the three months ended June 30, 2002. Compensation expenses decreased by \$1.2 million or 27% primarily due to staff reductions. Cost of goods sold expenses decreased \$1.0 million or 82%. Collections expense decreased by \$383,000 or 32%.

Depreciation and amortization decreased by \$764,000 or 16%, due to a decrease in the number of early terminations and new originations of monthly rental and service contracts.

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

The Company's provision for credit losses increased by \$4.4 million or 41%, for the three months ended June 30, 2003 as compared to the three months ended June 30, 2002, while net charge-offs increased 39% to \$36.2 million. This provision was based on the Company's historical policy, based on experience, of providing a provision for credit losses based upon the dealer fundings and revenue recognized in any period and reflects management's judgement of loss potential considering current economic conditions and the nature of the underlying receivables.

Interest expense decreased by \$473,000, or 18%, for the three months ended June 30, 2003 as compared to the three months ended June 30, 2002. This decrease resulted primarily from an overall decrease in the level of borrowings.

Dealer fundings were \$232,000 for the three months ended June 30, 2003, down \$25.4 million, or 99% as compared to the three months ended June 30, 2002. This decrease is a result of the Company's decision during the third quarter of 2002 to suspend new contract originations until a new line of credit is obtained. Total cash from customers decreased by \$9.5 million or 21% to a total of \$35.5 million. This decrease is primarily the result of a decrease in the size of the overall portfolio. Investment in lease and loan receivables due in installments, estimated residuals, rental and service contracts were down from \$396.5 million in December of 2002 to \$311.3 million in June of 2003.

14

Six months ended June 30, 2003 as compared to the six months ended June 30, 2002.

Net income for the six months ended June 30, 2003 was a loss of approximately \$4.5 million, a decrease of \$9.7 million or 187% from the six months ended June 30, 2002. This represents diluted earnings per share for the six months ended June 30, 2003 of (\$0.35) per share on weighted-average outstanding shares of 12,917,752 as compared to \$0.40 per share on weighted-average outstanding shares of 12,821,946 for the six months ended June 30, 2002.

Total revenues for the six months ended June 30, 2003 were \$49.5 million, a decrease of \$18.7 million, or 27%, from the six months ended June 30, 2002. The decrease was primarily due to a decrease of \$10.8 million, or 37%, in financing leases and loans, \$5.7 million or 37% in fee and other income, and \$2.2 million or 9% in rental and service contract income. The decrease in income on financing leases and loans was due to the decreased number of leases originated primarily resulting from the Company's change in its credit approval process. The decrease in fee income and other income is the result of decreased fees from the lessees related to the collection and legal process employed by the Company. The decrease in rental and service contract income is a result of the decreased number of lessees that have continued to rent their equipment beyond their original lease term and a decrease in originations in rental and service contracts.

Selling, general and administrative expenses decreased by \$6.1 million, or 26%, for the six months ended June 30, 2003, as compared to the six months ended June 30, 2002. Compensation expenses decreased by \$2.9 million or 31% primarily due to staff reductions. Headcount decreased to 159 as of June 30, 2003 from 356 as of June 30, 2002. Cost of goods sold expenses decreased \$1.6 million or 78%. Collection expense decreased by \$1.3 million or 42%.

Depreciation and amortization increased by \$133,000, or 2% due to an increase in the number of early terminations of monthly cancelable contracts.

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

The Company's provision for credit losses increased by \$4.3 million, or 20%, for the six months ended June 30, 2003 as compared to the six months ended June 30, 2002. This increase is a result of the Company's historical policy, based on experience, of providing a provision for credit losses based upon the dealer fundings and revenue recognized in any period and reflects management's judgement of loss potential considering current economic conditions and the nature of the underlying receivables.

Interest expense decreased by \$591,000, or 11%, for the six months ended June 30, 2003 as compared to the six months ended June 30, 2002. This decrease resulted primarily from an overall decrease in the level of borrowings.

Dealer fundings were \$1.4 million for the six months ended June 30, 2003, down \$46.9 million, or 97% as compared to the six months ended June 30, 2002. This decrease is a result of the Company's decision during the third quarter of 2002 to suspend new contract originations until a new line of credit is obtained. Total cash from customers decreased by \$16.6 million or 18% to a total of \$75.1 million. This decrease is primarily the result of a decrease in the size of the overall portfolio. Investment in lease and loan receivables due in installments, estimated residuals, rental and service contracts were down from \$396.5 million in December of 2002 to \$311.3 million in June of 2003.

15

Critical Accounting Policies

In response to the SEC's release No. 33-8040, "Cautionary Advice regarding Disclosure About Critical Accounting Policies," Management identified the most critical accounting principles upon which our financial status depends. The Company determined the critical principles by considering accounting policies that involve the most complex or subjective decisions or assessments. We identified our most critical accounting policies to be those related to revenue recognition and maintaining the allowance for credit losses. These accounting policies are discussed below as well as within the notes to the consolidated financial statements.

The Company's investments in cancelable service contracts are recorded at cost and amortized over the expected life of the service period. Income on service contracts from monthly billings is recognized as the related services are provided. The Company periodically evaluates whether events or circumstances have occurred that may affect the estimated useful life or recoverability of the investment in service contracts. Rental equipment is either recorded at estimated residual value and depreciated using the straight-line method over a period of 12 months or at the acquisition cost and depreciated using the straight line method over a period of 36 months. Loans are reported at their outstanding principal balance. Interest income on loans is recognized as it is earned.

The Company's lease contracts are accounted for as financing leases. At origination, the Company records 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. Amortization of unearned lease income and initial direct costs is suspended if, in the opinion of management, full payment of the contractual amount due under the lease agreement is doubtful. In conjunction with the origination of leases, the Company may retain a residual interest in the underlying equipment upon termination of the lease. The value of such interests is estimated at inception of the lease and

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

evaluated periodically for impairment. Other revenues such as loss and damage waiver fees, service fees relating to the leases, contracts and loans, and rental revenues are recognized as they are earned.

The Company maintains an allowance for credit losses on its investment in leases, service contracts, rental contracts and loans at an amount that it believes is sufficient to provide adequate protection against losses in its portfolio. The allowance is determined principally on the basis of the historical loss experience of the Company and the level of recourse provided by such lease, service contract, rental contract or loan, if any, and reflects management's judgment of additional loss potential considering current economic conditions and the nature and characteristics of the underlying lease portfolio. The Company determines the necessary periodic provision for credit losses taking into account actual and expected losses in the portfolio as a whole and the relationship of the allowance to the net investment in leases, service contracts, rental contracts and loans. Such provisions generally represent a percentage of funded amounts of leases, contracts and loans. The resulting charge is included in the provision for credit losses.

Leases, service contracts, rental contracts and loans are charged against the allowance for credit losses and are put on non-accrual when they are deemed to be uncollectable. Generally, the Company deems leases, service contracts, rental contracts and loans to be uncollectable when one of the following occurs: (I) the obligor files for bankruptcy; (ii) the obligor dies, and the equipment is returned; or (iii) when an account has become 360 days delinquent without contact with the lessee. The typical monthly payment under the Company's leases is between \$30 and \$50 per month. As a result of these small monthly payments, the Company's experience is that lessees will pay past due amounts later in the process because of the small amount necessary to bring an account current (at 360 days past due, a lessee will typically only owe lease payments of between \$360 and \$600).

The Company has developed and regularly updates proprietary credit scoring systems designed to improve its risk-based pricing. The Company uses credit scoring in most, but not all, of its extensions of credit. In addition, the Company monitors delinquent accounts using its automated collection process. The Company's collection efforts include one or more of the following: sending collection letters, making collection calls, reporting delinquent accounts to credit reporting agencies, and litigating delinquent accounts when necessary. The Company also uses a collectability scoring model to determine if the benefits from further collection efforts will out weigh the costs associated with those efforts.

16

Exposure to Credit Losses

The following table sets forth certain information as of December 31, 2001 and 2002 and June 30, 2003 with respect to delinquent leases, service contracts and loans. The percentages in the table below represent the aggregate on such date of the actual amounts not paid on each invoice by the number of days past due, rather than the entire balance of a delinquent receivable, over the cumulative amount billed at such date from the date of origination on all leases, service contracts, and loans in the Company's portfolio. For example, if a receivable is 90 days past due, the portion of the receivable that is over 30 days past due will be placed in the 31-60 days past due category, the portion of the receivable which is over 60 days past due will be placed in the 61-90 days past due category and the portion of the receivable which is over 90 days past due will be placed in the over 90 days past due category. The Company historically used this methodology of calculating its delinquencies because of

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

its experience that lessees who miss a payment do not necessarily default on the entire lease. Accordingly, the Company includes only the amount past due rather than the entire lease receivable in each category.

	As of December 31,		As of June 30,
	2001	2002	2003
	----	----	----
Cumulative amounts billed (in thousands)	\$ 602,649	\$ 600,637	\$ 553,900
31-60 days past due	1.8%	1.0%	0.8%
61-90 days past due	1.7%	1.0%	0.8%
Over 90 days past due	13.4%	22.9%	21.4%
	-----	-----	-----
Total past due	16.9%	24.9%	23.0%
	=====	=====	=====

Liquidity and Capital Resources

General

The Company's lease and finance business is capital-intensive and requires access to substantial short-term and long-term credit to fund new leases, contracts and loans. Since inception, the Company has funded its operations primarily through borrowings under its credit facilities, on-balance sheet securitizations, subordinated debt and an initial public offering completed in February of 1999. The Company will continue to require significant additional capital to maintain and expand its volume of leases, contracts and loans funded, as well as to fund any future acquisitions of leasing companies or portfolios.

As of September 30, 2002 the Company's senior credit facility failed to renew. While cash flows from its portfolio and other fees have been sufficient to repay amounts borrowed under the senior credit facility, securitizations and subordinated debt, in October 2002, the Company was forced to suspend new contract originations until a new source of liquidity is obtained.

The Company's uses of cash include, repayment of borrowings under its senior credit facility, securitizations, and subordinated debt, payment of interest expenses, payment of selling, general and administrative expenses, income taxes, capital expenditures and the origination and acquisition of leases, contracts and loans.

The Company utilizes its credit facilities to fund the origination and acquisition of leases that satisfy the eligibility requirements established pursuant to each facility. On August 22, 2000, the Company entered into a \$192 million credit facility with nine banks, expiring on September 30, 2002. As of September 30, 2002 the credit facility failed to renew and the Company began paying down the balance on the basis of a 36-month amortization plus interest. Based on the terms of the agreement, interest rates increased from Prime minus 0.25% to Prime plus 0.50% for prime based loans and from LIBOR plus 1.75% to LIBOR plus 2.50% for LIBOR based loans. In addition, based on the covenant defaults described below, the outstanding borrowings on all loans bear an additional 2.00% default interest. On January 3, 2003, the Company entered into a Forbearance and Modification Agreement from the senior credit facility, which expired on February 7, 2003. Based on the terms of the Forbearance and Modification Agreement, interest rates increased again on the prime based loans to prime plus 1.00%. At June 30,

2003, the Company had approximately \$88.9 million outstanding under the facility. The Company also may use its subordinated debt program as a source of funding for potential acquisitions of portfolios and leases which otherwise are not eligible for funding under the credit facilities.

At December 31, 2002, the Company was in default of certain of its debt covenants in its senior credit facility and securitization agreements. The covenants that were in default with respect to the senior credit facility, require that the Company maintain a fixed charge ratio in an amount not less than 130% of consolidated earnings, a consolidated tangible net worth minimum of \$77.5 million plus 50% of net income quarterly beginning with September 30, 2000, and compliance with the borrowing base. On April 14, 2003, the Company entered into a long-term agreement with its lenders. This long-term agreement waives the defaults described above, and in consideration for this waiver, requires the outstanding balance of the loan to be repaid over a term of 22 months beginning in April 2003 at an interest rate of prime plus 2.0%. Based on the amortization schedule in the new agreement, as subsequently amended on June 30, 2003, the Company is obligated to repay a minimum of \$56.1 million, plus applicable interest, over the next twelve months. The covenants that were in default with respect to the securitization agreements, require that the Company maintain a fixed charge ratio in an amount not less than 125% of consolidated earnings and a consolidated tangible net worth greater than \$90 million plus 50% of net income for each fiscal quarter after June 30, 2001. The Company received a waiver, which was set to expire on April 15, 2003, for the covenant violations in connection with the securitization agreement. Subsequently, the Company received a permanent waiver of the covenant defaults and the securitization agreement was amended so that going forward, the covenants are the same as those contained in the long-term agreement entered into on April 14, 2003, for the senior credit facility.

The Company believes that cash flows from its portfolio will be sufficient to fund the Company's operations for the foreseeable future, given the satisfactory resolution of the Company's discussions with the lenders involved in the senior credit facility and the securitized notes.

Contractual Obligations and Commercial Commitments

The Company has entered into various agreements, such as long term debt agreements, capital lease agreements and operating lease agreements that require future payments be made. Long term debt agreements include all debt outstanding under the senior credit facility, securitizations, subordinated notes, demand notes and other notes payable.

At June 30, 2003 the repayment schedules for outstanding long term debt, minimum lease payments under non-cancelable operating leases and future minimum lease payments under capital leases were as follows:

For the year ended December 31, -----	Long-Term Debt ----	Operating Leases -----	Capital Leases -----	Total -----
2003	\$ 44,219	\$ 670	\$ 74	\$ 44,963
2004	60,827	291	169	61,287
2005	5,767	174	54	5,995
2006	2,600	-	-	2,600

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

Thereafter	-	-	-	-
	-----	-----	-----	-----
Total	\$113,413	\$ 1,135	\$ 297	\$114,845
	=====	=====	=====	=====

Note on 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. The Company cautions that a number of important factors could cause actual results to differ materially from those expressed in any forward-looking statements made by or on behalf of the Company. Such statements contain a number of risks and uncertainties, including but not limited to: the Company's dependence on point-of-sale

18

authorization systems and expansion into new markets; the Company's significant capital requirements; risks associated with economic downturns; higher interest rates; intense competition; change in regulatory environment and risks associated with acquisitions. Readers should not place undue reliance on forward-looking statements, which reflect the management's view only as of the date hereof. The Company undertakes no obligation to publicly revise these forward-looking statements to reflect subsequent events or circumstances. The Company cannot assure that it will be able to anticipate or respond timely to changes which could adversely affect its operating results in one or more fiscal quarters. 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 the Company's common stock. For a more complete description of the prominent risks and uncertainties inherent in the Company's business, see the risks factors described in the Company's Form S-1 Registration Statement and other documents filed from time to time with the Securities and Exchange Commission.

19

ITEM 3 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market-Rate-Sensitive Instruments and Risk Management

The following discussion about the Company's 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, the Company also faces risks that are either nonfinancial or nonquantifiable. Such risks principally include country risk, credit risk, and legal risk, and are not represented in the analysis that follows.

Interest Rate Risk Management

The implicit yield to the Company on all of its leases, contracts and loans is on a fixed interest rate basis due to the leases, contracts and loans having scheduled payments that are fixed at the time of origination of the

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

lease. When the Company originates or acquires leases, contracts, and loans it bases its pricing in part on the spread it expects to achieve between the implicit yield rate to the Company on each lease and the effective interest cost it will pay when it finances such leases, contracts and loans through its credit facility. Increases in interest rates during the term of each lease, contract or loan could narrow or eliminate the spread, or result in a negative spread. The Company has adopted a policy designed to protect itself against interest rate volatility during the term of each lease, contract or loan.

Given the relatively short average life of the Company's leases, contracts and loans, the Company's goal is to maintain a blend of fixed and variable interest rate obligations. As of June 30, 2003, the Company's outstanding fixed-rate indebtedness outstanding under the Company's securitizations and subordinated debt represented 19.1% of the Company's total outstanding indebtedness.

ITEM 4 CONTROLS AND PROCEDURES

(a) Disclosure controls and procedures. Within 90 days before filing this report, we evaluated the effectiveness of the design and operation of our disclosure controls and procedures. Our disclosure controls and procedures are the controls and other procedures that we designed to ensure that we record, process, summarize and report in a timely manner the information we must disclose in reports that we file with or submit to the SEC. Richard F. Latour, our President and Chief Executive Officer, and James R. Jackson Jr., our Vice President and Chief Financial Officer, reviewed and participated in this evaluation. Based on this evaluation, Messrs. Richard F. Latour and James R. Jackson Jr. concluded that, as of the date of their evaluation, our disclosure controls were effective.

(b) Internal controls. Since the date of the evaluation described above, there have not been any significant changes in our internal accounting controls or in other factors that could significantly affect those controls.

20

PART II. OTHER INFORMATION

ITEM 1 LEGAL PROCEEDINGS

Management believes, after consultation with counsel, that the allegations against the Company included in the lawsuits described below are subject to substantial legal defenses, and the Company is vigorously defending each of the allegations. The Company also is 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 the Company's results of operations or financial position.

Leasecomm had been served with Civil Investigative Demands and subpoenas by the Offices of the Attorney General for the states of Kansas, Illinois, Florida, and Texas, and for the Commonwealth of Massachusetts. Those Offices of the Attorney General, in conjunction with the Northwest Region Office of the Federal Trade Commission, the Offices of the Attorney General for North Carolina and North Dakota, and the Ventura County, California, District Attorney's Office, had informed Leasecomm that they were seeking to coordinate their investigations. All of these investigations have been concluded by the entry of consent judgements in each of the applicable jurisdictions. The consent judgments resolve all matters alleged by the government agencies in their court filings without any admission of liability or of wrongful conduct by Leasecomm

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

or MicroFinancial. Under the terms of the settlement, Leasecomm has agreed to the following: (1) Not to collect upon certain court judgments where the financing included virtual terminals or the predominant purpose of the financing was for business opportunities. (2) Not to finance any product in conjunction with a business opportunity solicitation, and not to finance the virtual terminal product for four years. (3) Include in its lease forms, and in its lease processing and collection activities, certain provisions and practices, including filing collection actions in the customer's home forum. (Existing actions pending in Massachusetts may be transferred or dismissed and then re-filed in the lessee's home forum.) Neither MicroFinancial nor Leasecomm were required to pay any fines or penalties; however, the Company agreed to pay \$1.0 million in twelve equal monthly installments, as recovery in the investigations. In addition Leasecomm has agreed to take steps to monitor its vendors, and to file periodic reports concerning its vendors for two years. The financial impact directly related to the terms of the settlement, have been accounted for in current and or past periods as appropriate.

A. The Company filed an action in the United States District Court for the District of Massachusetts against Sentinel Insurance Company, Ltd., ("Sentinel"), Premier Holidays International, Inc., ("Premier") and Daniel DelPiano ("DelPiano") arising from Premier's October, 1999, default on its repayment obligations to the Company under a Twelve Million Dollar (\$12,000,000) loan. Judgment has been entered in this case against Sentinel, which had issued a business performance insurance policy guaranteeing repayment of the loan, in the amount of Fourteen Million Dollars (\$14,000,000). This judgment has not been satisfied. Sentinel is currently undergoing liquidation proceedings, and a claim in this amount has been filed with the bankruptcy court. Premier has asserted a counterclaim against the Company for Seven Hundred Sixty Nine Million Three Hundred Fifty Thousand dollars (\$769,350,000) in actual and consequential damages, and for Five Hundred Million Dollars (\$500,000,000) in punitive damages, plus interest, cost and attorney's fees. The counterclaim is based upon an alleged representation by the Company that it would lend Premier an additional Forty-Five Million Dollars (\$45,000,000), when all documents evidencing the Premier loan refer only to the Twelve Million (\$12,000,000) amount actually loaned and not repaid. The Company denies any liability on the counterclaim, which the Company is vigorously contesting. The Company's motion for summary judgment seeking dismissal of the counterclaim and the award of full damages on the Company's claims was denied by Court Order, without a written decision. The Company's motion for the appointment of a special master was also denied without a written decision. The case is currently scheduled to be tried in November, 2003. Because of the uncertainties inherent in litigation, we cannot predict whether the outcome will have a material adverse effect.

B. On January 29, 2002, Leasecomm was served with an Amended Complaint ("Complaint") in an action entitled People v. Roma Computer Solutions, Inc., et al., Ventura County Superior Court Case No. CIV207490. The Complaint asserts two claims, one for violation of the California Business Professions Code Section 17500 (false advertising), and the other for violation of the California Business and Professions Code Section 17200 (unfair or unlawful acts or practices). The claims arise from the marketing and selling activities of other defendants, including Roma Computer Solutions, Inc., and/or Maro Securities, Inc. The Complaint seeks to have Leasecomm held liable for the acts of other defendants, alleging that Leasecomm directly participated in those acts and received proceeds

21

and the assignment of lease contracts as a result of those acts. The case has been concluded through the filing of stipulated consent judgement.

C. In October, 2002, the Company was served with a Complaint in an

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

action in the United States District Court for the Southern District of New York filed by approximately 170 present and former lessees asserting individual claims. The Complaint contains claims for violation of RICO (18 U.S.C. Section 1964), fraud, unfair and deceptive acts and practices, unlawful franchise offerings, and intentional infliction of mental anguish. The claims purportedly arise from Leasecomm's dealer relationships with Themeware, E-Commerce Exchange, Cardservice International, Inc., and Online Exchange for the leasing of websites and virtual terminals. The Complaint asserts that the Company is responsible for the conduct of its dealers in trade shows, infomercials and web page advertisements, seminars, direct mail, telemarketing, all which are alleged to constitute unfair and deceptive acts and practices. Further, the Complaint asserts that Leasecomm's lease contracts as well as its collection practices and late fees are unconscionable. The Complaint seeks restitution, compensatory and treble damages, and injunctive relief. The Company filed a Motion to Dismiss the Complaint on January 31, 2003. Briefing has been completed, but the Motion to Dismiss has not been decided. Because of the uncertainties inherent in litigation, we cannot predict whether the outcome will have a material adverse effect.

D. On August 22, 2002 plaintiff Aaron Cobb filed a Complaint against Leasecomm Corporation and MicroFinacial, Inc. and another Entity known as Galaxy Mall, Inc. alleging breach of contract; Fraud, Suppression and Deceit; Unjust Enrichment; Conspiracy; Conversion; Theft by Deception; and violation of Alabama Usury Laws. The Complaint was filed on behalf of Aaron Cobb individually, and on behalf of a class of persons and entities similarly situated in the State of Alabama. More specifically, the Plaintiff purports to represent a class of persons and small business in the State of Alabama who allegedly were induced to purchase services and/or goods from any of the Defendants named in the Complaint. The case is venued in Bullock County, Alabama. On March 31, 2003 the trial court entered an Order denying the Company's Motion to Dismiss. An appeal of the Order was filed with the Alabama Supreme Court on May 12, 2003. The Company continues to deny any wrongdoing and plans to vigorously defend this claim. Because of the uncertainties inherent in litigation, the company cannot predict whether the outcome will have a material adverse affect.

E. In March, 2003, an action was filed by a shareholder against the Company in United States District Court asserting a single count of common law fraud and constructive fraud. The complaint alleges that the shareholder was defrauded by untrue statements made to him by management, upon which he relied in the purchase of Company stock for himself and for others. The complaint seeks damages in an unspecified amount. The Company has filed an answer denying the allegations. Because of the uncertainties inherent in litigation, we cannot predict whether the outcome will have a material adverse effect.

F. In March, 2003, a purported class action was filed in Superior Court in Massachusetts against Leasecomm and one of its dealers. The class sought to be certified is a nationwide class (excluding certain residents of the State of Texas) who signed identical or substantially similar lease agreements with Leasecomm covering the same product. The complaint asserts claims for declaratory relief, rescission, civil conspiracy, usury, breach of fiduciary duty, and violation of Massachusetts General Laws Chapter 93A, Section 11 ("Chapter 93A"). The claims concern the validity, enforceability, and alleged unconscionability of agreements provided through the dealer, including a Leasecomm lease, to acquire on line credit card processing services. The complaint seeks rescission of the lease agreements with Leasecomm, restitution, multiple damages and attorneys fees under Chapter 93A, and injunctive relief. The Company has filed a motion to dismiss the complaint, which is scheduled to be heard by the Court in September, 2003. Because of the uncertainties inherent in litigation we cannot predict whether the outcome will have a material adverse effect.

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

G. On April 28, 2003 plaintiff Wallace Dickey filed a purported class action against Leasecomm Corporation, Cardservice International, Linkpoint International and Clear Commerce Corporation alleging that he lease-financed through Leasecomm the right to use certain computer software manufactured, distributed and sold by the other defendants. The plaintiff does not allege that Leasecomm failed to provide the lease financing contemplated by the Leasecomm Lease, rather the Plaintiff alleges that the software failed to operate as he believed it would, and he has sued for a declaration that would allow him to rescind his contract, to recover money paid in the course of the transaction and to recover damages allegedly caused by unspecified deceptive trade practices. The plaintiff asserts his claims "on behalf of himself and all others similarly situated." Leasecomm denies all of the Plaintiff's

22

allegations and intends to vigorously defend this suit. It is expected that the Court will soon hold a hearing on Leasecomm's motion to dismiss. The court has not yet addressed the Plaintiff's class certification allegations. Because of the uncertainties inherent in litigation, the company cannot predict whether the outcome will have a material adverse affect.

H. On April 29, 2003, Leasecomm was served with a Complaint filed in the Orange County Superior Court for the State of California. In that Complaint, Maria J. Smith purports to bring a claim against Leasecomm and two other defendants (Galaxy Mall, Inc. and Electronic Commerce International, Inc.) for unfair business practices and competition under California Business and Professions Code section 17200 et seq. The essence of the claim is that Smith and others who are similarly situated were defrauded in connection with their acquisition of certain licenses that were financed by Leasecomm. In May 2003, Leasecomm filed a motion to stay the action in favor of a Massachusetts forum based on a forum selection clause contained in plaintiff's lease agreement with Leasecomm. After filing the motion, Leasecomm entered into settlement negotiations with plaintiff's counsel to explore the possibility of resolving the matter on a class wide basis without the need for further litigation (meaning the settlement would, if accepted, apply not only to the named plaintiff but to others similarly situated). The parties have agreed to postpone the hearing on Leasecomm's stay motion until August 22, 2003 in order to allow the parties time to explore possible settlement. Because of the uncertainties inherent in litigation we cannot predict whether the outcome will have a material adverse effect.

In February 2003, Leasecomm received a CID from the Office of the Attorney General, State of Washington, to which it has responded. The CID concerns an investigation of monitoring agreements between Priority One, Inc. and various State of Washington consumers, as to which Leasecomm appears to be the assignee of the right to receive monthly payments. Since the investigation has not been concluded, and no legal action has been commenced against Leasecomm, there can be no assurance as to the eventual outcome.

ITEM 3 RECENT SALES OF UNREGISTERED SECURITIES

On April 14, 2003, the Company issued warrants to purchase an aggregate of 268,199 shares of the Company's common stock at an exercise price of \$.825 per share. The warrants were issued to the nine lenders in the Company's lending syndicate in connection with a waiver of defaults and an extension of the Company's term loan, and are only exercisable if the debt remains outstanding as of June 30, 2004. The exemption from registration relied on by the Company was Section 4(2) of the Securities Act of 1933. All investors were accredited investors and the offering otherwise met the requirements of Regulation D under the Securities Act.

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

ITEM 5 OTHER INFORMATION

The Company's Chief Executive Officer and Chief Financial Officer have furnished to the SEC the certification with respect to this Form 10-Q that is required by Section 906 of the Sarbanes-Oxley Act of 2002.

23

ITEM 6 EXHIBITS AND REPORTS ON FORM 8-K

- (a) The following exhibits are filed herewith:
- 10.1 Third Amendment to Fourth Amended and Restated Revolving Credit Agreement dated June 30, 2003 among Leasecomm Corporation, Fleet National Bank, as agent, and the other Lenders named therein.
 - 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
- (b) A form 8-K was filed on April 16, 2003, to announce that the Company has secured an amendment to its Credit Agreement and received permanent waivers under its securitization facility. A second report on Form 8-K was filed on April 16, 2003 to announce fourth quarter results for the year ended December 31, 2002. A third report on Form 8-K was filed on May 7, 2003 to announce first quarter 2003 results. A fourth report on Form 8-K was filed on May 22, 2003 to disclose that the New York Stock Exchange has accepted the Company's proposed compliance plan for continued listing on the Exchange. On May 29, 2003, a fifth report on Form 8-K was filed announcing the settlement of several pending investigations concerning the Company's wholly owned subsidiary, Leasecomm Corporation.

24

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

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

By: /s/ James R. Jackson Jr.

Vice President and Chief Financial Officer

Date: August 14, 2003