

MICROFINANCIAL INC  
Form 10-Q  
November 14, 2014  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

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FORM 10-Q

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(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, 2014

or

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

Commission File No. 1-14771

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MICROFINANCIAL INCORPORATED  
(Exact name of registrant as specified in its charter)

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Massachusetts	04-2962824
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
16 New England Executive Park, Suite 200, Burlington, MA 01803	
(Address of principal executive offices)	
(781) 994-4800	
(Registrant's telephone number, including area code)	

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

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

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

Large accelerated filer	<input type="checkbox"/>	Accelerated filer	<input type="checkbox"/>
Non-accelerated filer	<input type="checkbox"/> (Do not check if a smaller reporting company)	Smaller reporting company	<input checked="" type="checkbox"/>

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 November 7, 2014, 14,433,154 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)

	September 30, 2014	December 31, 2013
<b>ASSETS</b>		
Cash and cash equivalents	\$1,271	\$2,246
Restricted cash	1,604	1,107
Net investment in leases:		
Receivables due in installments	224,844	214,628
Estimated residual value	22,821	23,070
Initial direct costs	2,415	1,732
Less:		
Advance lease payments and deposits	(2,974	) (3,010
Unearned income	(60,536	) (58,772
Allowance for credit losses	(14,857	) (15,379
Net investment in leases	171,713	162,269
Investment in service contracts, net	2,862	2,058
Investment in rental contracts, net	961	1,059
Property and equipment, net	1,698	1,333
Other assets	2,207	2,980
Deferred income taxes, net	1,604	—
Total assets	\$183,920	\$173,052
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Revolving line of credit	\$85,526	\$72,566
Accounts payable	3,629	2,993
Dividends payable	77	63
Other liabilities	1,684	2,272
Deferred income taxes	—	6,678
Total liabilities	90,916	84,572
Commitments and contingencies (Note H)		
Stockholders' equity:		
Preferred stock, \$.01 par value; 5,000,000 shares authorized; no shares issued at September 30, 2014, and December 31, 2013	—	—
Common stock, \$.01 par value; 25,000,000 shares authorized; 14,433,154 and 14,435,498 shares issued and outstanding at September 30, 2014, and December 31, 2013	144	144
Additional paid-in capital	47,576	47,475
Retained earnings	45,284	40,861
Total stockholders' equity	93,004	88,480
Total liabilities and stockholders' equity	\$183,920	\$173,052

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



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CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except share and per share data)

(Unaudited)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2014	2013	2014	2013
Revenues:				
Income on financing leases	\$10,463	\$10,303	\$30,750	\$30,866
Rental income	2,741	2,660	8,226	7,845
Income on service contracts	413	250	1,108	640
Loss and damage waiver fees	1,616	1,474	4,699	4,361
Service fees and other	1,002	1,056	2,948	3,000
Total revenues	16,235	15,743	47,731	46,712
Expenses:				
Selling, general and administrative	4,862	4,618	14,730	14,121
Provision for credit losses	4,318	4,790	13,743	14,414
Depreciation and amortization	1,454	1,355	4,319	3,970
Interest	750	679	2,111	2,009
Total expenses	11,384	11,442	34,903	34,514
Income before provision for income taxes	4,851	4,301	12,828	12,198
Provision for income taxes	1,964	1,721	5,341	4,886
Net income	\$2,887	\$2,580	\$7,487	\$7,312
Net income per common share – basic	\$0.20	\$0.18	\$0.52	\$0.51
Net income per common share – diluted	\$0.20	\$0.18	\$0.51	\$0.49
Weighted-average shares:				
Basic	14,431,592	14,433,695	14,427,695	14,469,077
Diluted	14,735,988	14,744,158	14,738,190	14,773,263

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		Additional	Retained	Total
	Shares	Amount	Paid-in Capital	Earnings	Stockholders' Equity
Balance at December 31, 2012	14,470,219	\$145	\$47,500	\$34,747	\$82,392
Stock issued for director compensation	45,792	—	361	—	361
Stock-based compensation	—	—	232	—	232
Shares issued upon vesting of restricted stock units	16,640	—	—	—	—
Repurchase of common stock	(97,153 )	(1 )	(707 )	—	(708 )
Excess tax benefits from share-based compensation	—	—	89	—	89
Common stock dividends (\$0.25 per share)	—	—	—	(3,649 )	(3,649 )
Net income	—	—	—	9,763	9,763
Balance at December 31, 2013	14,435,498	144	47,475	40,861	88,480
Stock issued for director compensation	41,279	—	348	—	348
Stock-based compensation	—	—	215	—	215
Shares issued upon vesting of restricted stock units	22,929	—	—	—	—
Repurchase of common stock	(66,552 )	—	(536 )	—	(536 )
Excess tax benefits from share-based compensation	—	—	74	—	74
Common stock dividends (\$0.21 per share)	—	—	—	(3,064 )	(3,064 )
Net income	—	—	—	7,487	7,487
Balance at September 30, 2014	14,433,154	\$144	\$47,576	\$45,284	\$93,004

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

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CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Nine Months Ended	
	September 30,	
	2014	2013
Cash flows from operating activities:		
Cash received from customers	\$105,835	\$97,886
Cash paid to suppliers and employees	(18,876	) (18,212
Cash paid for income taxes	(13,020	) (8,660
Excess tax benefits from share-based compensation	(74	) —
Interest paid	(1,870	) (1,803
Net cash provided by operating activities	71,995	69,211
Cash flows from investing activities:		
Investment in lease and service contracts	(79,101	) (66,672
Investment in direct costs	(2,015	) (1,091
Investment in property and equipment	(805	) (252
Net cash used in investing activities	(81,921	) (68,015
Cash flows from financing activities:		
Proceeds from revolving line of credit	119,866	99,838
Repayment of revolving line of credit	(106,906	) (99,452
Increase in restricted cash	(497	) (428
Repurchase of common stock	(536	) (708
Excess tax benefits from share-based compensation	74	—
Payment of dividends	(3,050	) (2,614
Net cash provided by (used in) financing activities	8,951	(3,364
Net change in cash and cash equivalents	(975	) (2,168
Cash and cash equivalents, beginning of period	2,246	3,557
Cash and cash equivalents, end of period	\$1,271	\$1,389
Reconciliation of net income to net cash provided by operating activities:		
Net income	\$7,487	\$7,312
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of unearned income, net of initial direct costs	(30,750	) (30,866
Depreciation and amortization	4,319	3,970
Provision for credit losses	13,743	14,414
Recovery of equipment cost and residual value	84,096	77,651
Stock-based compensation expense	215	175
Excess tax benefits from share-based compensation	(74	) —
Decrease in deferred income taxes	(8,282	) (3,408
Changes in assets and liabilities:		
Decrease (increase) in other assets	846	(63
Increase in accounts payable	983	395
Decrease in other liabilities	(588	) (3
Decrease in income taxes payable	—	(366
Net cash provided by operating activities	\$71,995	\$69,211



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Supplemental disclosure of non-cash activities:

Fair value of stock issued for compensation	\$348	\$361
Acquisition of property and equipment through lease incentives	\$—	\$39
Non-cash transfer of leases to rental contracts	\$2,975	\$3,268

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

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

A. Nature of Business

MicroFinancial Incorporated (referred to as “MicroFinancial,” “we,” “us” or “our”) operates primarily through its wholly-owned subsidiaries, TimePayment Corp. and LeaseComm Corporation. TimePayment is a specialized commercial/consumer finance company that leases and rents equipment and provides other financing services, with a primary focus on the “microticket” market. LeaseComm originated leases from January 1986 through October 2002, and continues to service its remaining contract portfolio. TimePayment commenced originating leases in July 2004, and began acquiring security monitoring service contracts in the second quarter of 2012. We primarily source our originations through a nationwide network of independent equipment vendors, sales organizations and other dealer-based origination networks. We fund our operations through cash provided by operating activities and borrowings under our revolving line of credit.

B. 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, including our critical accounting policies, included in our Annual Report on Form 10-K for the year ended December 31, 2013. The results for the nine months ended September 30, 2014, are not necessarily indicative of the results that may be expected for the full year ending December 31, 2014.

The balance sheet at December 31, 2013, has been derived from the audited financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2013.

We have no elements of comprehensive income, and therefore a statement of comprehensive income is not necessary for the three and nine months ended September 30, 2014 and 2013.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amount of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reported period. Significant areas requiring the use of management estimates are revenue recognition, the allowance for credit losses, share-based payments and income taxes. Actual results could differ from those estimates.

Segment Reporting

We operate in one industry segment that leases and rents microticket equipment and provides other financing services. We typically fund contracts that range from \$500 to \$25,000, with an average transaction of approximately \$4,000 to \$6,000. All of our operations are located in the United States. Accordingly, we believe we have a single reportable segment for disclosure purposes.

Concentration of Credit Risk

Our financial instruments that are exposed to concentration of credit risk consist primarily of lease and rental receivables and cash and cash equivalent balances. To reduce our risk, credit policies are in place for approving leases and the lease pools are monitored by us. In addition, cash and cash equivalents are maintained at high-quality financial institutions.

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 national commercial banks. Deposits in excess of amounts insured by the Federal Deposit Insurance Corporation (“FDIC”) are exposed to loss in the event of nonperformance by the institution. The Company regularly maintains cash deposits in excess of the FDIC insurance coverage. However, we have not experienced any losses in such accounts.

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## MICROFINANCIAL INCORPORATED

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

## C. Allowance for Credit Losses and Credit Quality

The following table reconciles the activity in the allowance for credit losses by subsidiary for the three months ended September 30, 2014 and 2013:

	Microticket equipment			Three Months Ended		
	September 30, 2014			September 30, 2013		
	Lease- Comm	Time- Payment	Total	Lease- Comm	Time- Payment	Total
Allowance for credit losses:						
Beginning balance	\$71	\$14,412	\$14,483	\$108	\$15,468	\$15,576
Charge-offs	(57 )	(5,402 )	(5,459 )	(84 )	(6,042 )	(6,126 )
Recoveries	31	1,484	1,515	37	1,257	1,294
Provisions	18	4,300	4,318	37	4,753	4,790
Ending balance, allowance for credit losses	\$63	\$14,794	\$14,857	\$98	\$15,436	\$15,534

The following table reconciles the activity in the allowance for credit losses by subsidiary for the nine months ended September 30, 2014 and 2013:

	Microticket equipment			Nine Months Ended		
	September 30, 2014			September 30, 2013		
	Lease- Comm	Time- Payment	Total	Lease- Comm	Time- Payment	Total
Allowance for credit losses:						
Beginning balance	\$91	\$15,288	\$15,379	\$103	\$13,935	\$14,038
Charge-offs	(207 )	(18,756 )	(18,963 )	(254 )	(17,050 )	(17,304 )
Recoveries	151	4,547	4,698	126	4,260	4,386
Provisions	28	13,715	13,743	123	14,291	14,414
Ending balance, allowance for credit losses	\$63	\$14,794	\$14,857	\$98	\$15,436	\$15,534

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## MICROFINANCIAL INCORPORATED

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

The following table presents the allowance for credit losses and financing receivables by subsidiary as of September 30, 2014, and December 31, 2013, classified according to the impairment evaluation method:

	As of September 30, 2014			As of December 31, 2013		
	Lease-Comm	Time-Payment	Total	Lease-Comm	Time-Payment	Total
Allowance for credit losses:						
Individually evaluated for impairment	\$—	\$—	\$—	\$—	\$—	\$—
Collectively evaluated for impairment	63	14,794	14,857	91	15,288	15,379
Contracts acquired with deteriorated credit quality	—	—	—	—	—	—
Ending balance, allowance for credit losses	\$63	\$14,794	\$14,857	\$91	\$15,288	\$15,379
Financing receivables: <sup>(1)</sup>						
Individually evaluated for impairment	\$—	\$—	\$—	\$—	\$—	\$—
Collectively evaluated for impairment	146	186,424	186,570	185	177,463	177,648
Contracts acquired with deteriorated credit quality	—	—	—	—	—	—
Ending balance, financing receivables	\$146	\$186,424	\$186,570	\$185	\$177,463	\$177,648

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

The following table presents the aging status of the recorded investment in leases as of September 30, 2014, classified according to the original score granted by our internally-developed proprietary scoring model:

	Current	31 to 60 Days Past Due	61 to 90 Days Past Due	Over 90 Days Past Due	Total	Over 90 Days Accruing
LeaseComm	\$80	\$4	\$4	\$58	\$146	\$58
TimePayment						
Gold	69,719	2,465	889	2,040	75,113	2,040
Silver	79,308	2,553	2,837	12,122	96,820	12,122
Bronze	9,916	681	636	3,258	14,491	3,258
TimePayment subtotal	158,943	5,699	4,362	17,420	186,424	17,420
Total financing receivables	\$159,023	\$5,703	\$4,366	\$17,478	\$186,570	\$17,478
Percent of total financing receivables	85.2	% 3.1	% 2.3	% 9.4	% 100.0	%

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

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## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

	Current	31 to 60 Days Past Due	61 to 90 Days Past Due	Over 90 Days Past Due	Total	Over 90 Days Accruing
LeaseComm	\$93	\$5	\$4	\$83	\$185	\$83
TimePayment						
Gold	58,769	2,501	902	3,391	65,563	3,391
Silver	81,152	2,933	2,754	13,437	100,276	13,437
Bronze	7,788	493	502	2,841	11,624	2,841
TimePayment subtotal	147,709	5,927	4,158	19,669	177,463	19,669
Total financing receivables	\$147,802	\$5,932	\$4,162	\$19,752	\$177,648	\$19,752
Percent of total financing receivables	83.2	% 3.3	% 2.4	% 11.1	% 100.0	%

## D. Net Income per Common Share

Net income per common share for the three and nine months ended September 30, 2014 and 2013, was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Net income	\$2,887	\$2,580	\$7,487	\$7,312
Weighted average common shares outstanding	14,431,592	14,433,695	14,427,695	14,469,077
Dilutive effect of common stock options, warrants and restricted stock	304,396	310,463	310,495	304,186
Shares used in computation of net income per common share - diluted	14,735,988	14,744,158	14,738,190	14,773,263
Net income per common share - basic	\$0.20	\$0.18	\$0.52	\$0.51
Net income per common share - diluted	\$0.20	\$0.18	\$0.51	\$0.49

For the three and nine month periods ended September 30, 2014, there were 24,811 options excluded from the computation of diluted net income per share because their effect would have been antidilutive. There were no options excluded from the computation of diluted net income per share for the three and nine month periods ended September 30, 2013.

## E. Dividends

## 2014

Date Declared	Record Date	Payment Date	Dividend per Share
January 14, 2014	January 30, 2014	February 14, 2014	\$0.07
April 23, 2014	May 5, 2014	May 15, 2014	0.07
July 23, 2014	August 4, 2014	August 14, 2014	0.07
Total			\$0.21

## 2013

Date Declared	Record Date	Payment Date	Dividend per Share
January 29, 2013	February 8, 2013	February 15, 2013	\$0.06
April 23, 2013	May 3, 2013	May 15, 2013	0.06

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July 17, 2013	July 30, 2013	August 15, 2013	0.06
Total			\$0.18

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## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

**F. Revolving line of credit**

We entered into the revolving line of credit in August 2007 with a bank syndicate led by Santander Bank (Santander) based on qualified TimePayment lease receivables. The total commitment under the facility, originally \$30 million, has been increased at various times, most recently from \$100 million to \$150 million in December 2012. The December 2012 amendment also permits further increases in the total commitment under an accordion feature, to \$175 million, with the agreement of the Agent and, as applicable, a new or existing Lender under certain conditions. Outstanding borrowings are collateralized by eligible lease contracts and a security interest in all of our other assets. We had approximately \$85.5 million and \$72.6 million outstanding on our revolving line of credit facility at September 30, 2014, and December 31, 2013, respectively. At September 30, 2014, the total commitment under the facility was \$150 million, and our available borrowing capacity was approximately \$64.5 million, subject to limitations based on lease eligibility and a borrowing base formula. The revolving line of credit has financial covenants that we must comply with to obtain funding and avoid an event of default. As of September 30, 2014, we were in compliance with all covenants under the revolving line of credit.

The maturity date of our revolving line of credit is December 31, 2016, at which time the outstanding loan balance plus interest becomes due and payable. At our option upon maturity, the unpaid principal balance may be converted to a six month term loan.

At September 30, 2014, \$76.0 million of our loans were LIBOR loans and \$9.5 million of our loans were Base Rate Loans. The interest rate on our loans at September 30, 2014, was between 2.82% and 4.00%. At the same date, the qualified lease receivables eligible under the borrowing base computation were approximately \$137.7 million.

**G. Stock-Based Compensation**

Under our 2008 Equity Incentive Plan, we reserved 1,000,000 shares of common stock for issuance, all of which had been issued as of December 31, 2013. In May 2012, our stockholders approved our 2012 Equity Incentive Plan, for which we have 750,000 shares of common stock reserved, of which 457,070 shares are unissued as of September 30, 2014.

**Non-employee director stock grants**

The following table details the stock granted to our non-employee directors under the 2008 and 2012 Plans during the nine months ended September 30, 2014 and 2013. These shares were issued as part of our annual director compensation arrangements related to the prior years' service, and were fully vested on the date of issuance.

Date of Grant	Number of Shares	Fair Value per Share <sup>(1)</sup>	Fair Value of Grant
January 2014	25,310	\$8.89	\$225
July 2014	15,969	\$7.69	123
Total 2014 grants	41,279		\$348
January 2013	29,205	\$7.55	\$221
July 2013	16,587	\$8.44	140
Total 2013 grants	45,792		\$361

(1) The fair value per share is equal to the closing price of our stock on the date of grant.



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## MICROFINANCIAL INCORPORATED

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

## Restricted Stock Unit Grants (RSUs)

The following table summarizes our RSU activity for the year ended December 31, 2013, and the nine months ended September 30, 2014:

	Number of RSUs	Grant Date Fair Value per Share <sup>(1)</sup>	Grant Date Fair Value	Fair Value of RSUs at Vesting Date <sup>(2)</sup>
Unvested RSUs at December 31, 2012	98,575			
Granted	45,316	\$7.55	\$342	
Vested	(16,640)	)		\$125
Unvested RSUs at December 31, 2013	127,251			
Granted	38,278	\$8.89	\$340	
Vested	(22,929)	)		\$178
Unvested RSUs at September 30, 2014	142,600			

(1) The grant date fair value per share is equal to the closing price of our stock on the date of grant.

(2) The fair value of vested RSUs is calculated based on the closing stock price on the vesting date. The fair value of unvested RSUs at September 30, 2014, based on the closing price on that date, was \$1.1 million.

In January 2014, the Compensation and Benefits Committee of our Board of Directors granted 38,278 RSUs to our executive officers. The RSUs were valued on the date of grant and the fair value of these awards was \$8.89 per share. The issuance consisted of two separate tranches. The first tranche was for 24,811 RSUs which vest over 5 years at 25% annually beginning on the second anniversary of the grant date. The second tranche was for 13,467 RSUs which cliff vest after 3 years only if management achieves specific performance measures.

In January 2013, the Compensation and Benefits Committee of our Board of Directors granted 45,316 RSUs to our executive officers. The RSUs were valued on the date of grant and the fair value of these awards was \$7.55 per share. The issuance consisted of three separate tranches. The first tranche was for 28,643 RSUs which vest over 5 years at 25% annually beginning on the second anniversary of the grant date. The second tranche was for 15,548 RSUs which cliff vest after 3 years only if management achieves specific performance measures. The third tranche was for 1,125 RSUs which vest over 5 years at 25% annually, beginning on the second anniversary of the grant date, and represented 2012 incentive bonus compensation for exceeding performance targets.

## Stock Options

Information relating to our outstanding stock options at September 30, 2014, is as follows:

## Outstanding and Exercisable Options

Exercise Price	Shares	Weighted- Average Life (Years)	Intrinsic Value
\$2.30	258,723	4.34 years	\$1,490
\$5.77	31,923	2.40 years	73
\$5.85	142,382	3.35 years	315
	433,028	3.87 years	\$1,878

As of September 30, 2014, all outstanding options were fully vested and exercisable. There were no options granted, exercised, forfeited, or expired during the year ended December 31, 2013, or the nine months ended September 30, 2014.



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## MICROFINANCIAL INCORPORATED

## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

## Warrants

In 2003 we issued warrants to purchase common stock to our lenders in connection with a waiver of certain covenant defaults and the extension of our loan. As of December 31, 2013, there were 86,221 warrants outstanding with an exercise price of \$0.815. All of these warrants expired on September 30, 2014. There were no warrants exercised during the nine months ended September 30, 2014 or 2013.

## Compensation Expense

Stock compensation expense recognized during the three and nine months ended September 30, 2014 and 2013, and unrecognized compensation expense as of September 30, 2014, were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,		Unrecognized Compensation Cost as of September 30, 2014
	2014	2013	2014	2013	
Compensation expense					
RSUs	\$71	\$50	\$213	\$149	\$604
Options	—	7	2	26	—
Total	\$71	\$57	\$215	\$175	\$604

We expect to recognize the remaining compensation expense over each grant's vesting period. The remaining weighted average vesting period of these RSUs as of September 30, 2014, is 2.33 years.

## H. Commitments and Contingencies

## Legal Matters

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

## Contract Commitments

We accept contract applications on a daily basis and, as a result, we have a pipeline of applications that have been approved, where a contract has not been originated. Our commitment to lend does not become binding until all of the steps in the contract origination process have been completed, including the receipt of the contract, supporting documentation and verification with the lessee. Since we fund on the same day a contract is verified, we do not have any outstanding commitments to lend.

## Stock Repurchases

On August 10, 2010, our Board of Directors approved a common stock repurchase program (2010 Repurchase Program) under which we were authorized to purchase up to 250,000 of our outstanding shares from time to time. The repurchases were permitted to take place in either the open market or through block trades. The repurchase program was funded by our working capital.

During the first quarter of 2014, we repurchased and retired 66,552 shares of our common stock under the 2010 Repurchase Program at an average price per share of \$8.07, at a total cost of approximately \$536,000. Including these purchases, we have repurchased a total of 250,000 shares of our common stock since the 2010 Repurchase Program's inception, which represented the total shares authorized to be repurchased under the program, at a total cost of

approximately \$1.6 million.

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MICROFINANCIAL INCORPORATED

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

On July 23, 2014, the Board of Directors authorized a new common stock repurchase program (2014 Repurchase Program) under which we are authorized to repurchase up to an additional 250,000 shares of our common stock from time to time. We may repurchase our common stock in open market purchases or in privately negotiated transactions. We will determine the timing and amount of any shares repurchased based on our evaluation of market conditions and other factors. The 2014 Repurchase Program may be suspended or discontinued at any time. Any repurchased shares will be available for use in connection with our stock plans and for other corporate purposes. The 2014 Repurchase Program will be funded by our working capital.

During the three months ended September 30, 2014, we did not repurchase and retire any shares of our common stock under the 2014 Repurchase Program.

**Income Tax Audits**

We were recently notified by the Internal Revenue Service that the Company has been selected for an audit of its 2012 federal income tax return. Furthermore, the Florida Department of Revenue has also notified the Company that it has been selected for an audit of its 2011 to 2013 Florida income tax returns. While we do not anticipate any material adjustments resulting from these audits at this time, we are unable to fully assess the risks and exposure at these early stages of the audits.

**I. Subsequent Events**

We have evaluated all events and transactions that occurred through the date on which we issued these financial statements. Other than as noted below, we did not have any material subsequent events that impacted our condensed consolidated financial statements.

On October 22, 2014, we declared a dividend of \$0.08 payable on November 10, 2014, to shareholders of record on November 3, 2014.

**J. Recent Accounting Pronouncements**

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standard Update Number 2014-09, Revenue from Contracts with Customers (Topic 606). The amendments in this Update create Topic 606, Revenue from Contracts with Customers, and supersede the revenue recognition requirements in Topic 605, Revenue Recognition, including most industry-specific revenue recognition guidance throughout the Industry Topics of the Codification. In addition, the amendments supersede the cost guidance in Subtopic 605-35, Revenue Recognition-Construction-Type and Production-Type Contracts, and create new Subtopic 340-40, Other Assets and Deferred Costs-Contracts with Customers. In summary, the core principle of Topic 606 is that an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance in this Update affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts of nonfinancial assets unless those contracts are within the scope of other standards (for example, insurance contracts or lease contracts). The amendments in Topic 606 are effective for annual reporting periods beginning after December 15, 2016. We are still evaluating the potential impact of this Update on our results of operations.

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

Introduction

The following information should be read in conjunction with our condensed consolidated financial statements and notes thereto in Part I, Item 1 of this Quarterly Report and with Management's Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report on Form 10-K for the year ended December 31, 2013.

Forward-Looking Information

Statements in this document that are not historical facts are forward-looking statements made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. In addition, words such as "believes" "anticipates" "expects," "intends" and similar expressions are intended to identify forward-looking statements. We caution that a number of important factors could cause actual results to differ materially from those expressed in any forward-looking statements made by us or on our behalf. Such statements contain a number of risks and uncertainties, including but not limited to those associated with: the demand for the equipment types we finance; our significant capital requirements; our ability or inability to obtain the financing we need, or to use internally generated funds, in order to continue originating contracts; the risks of defaults on our leases; our provision for credit losses; our residual interests in underlying equipment; possible adverse consequences associated with our collection policy; the effect of higher interest rates on our portfolio; increasing competition; increased governmental regulation of the rates and methods we use in financing and collecting on our leases and contracts; acquiring other portfolios or companies; dependence on key personnel; changes to accounting standards for equipment leases; adverse results in litigation and regulatory matters, or promulgation of new or enhanced legislation or regulations; information technology systems disruptions; and general economic and business conditions. Readers should not place undue reliance on forward-looking statements, which reflect our view only as of the date hereof. We undertake no obligation to publicly revise these forward-looking statements to reflect subsequent events or circumstances. We cannot assure that we will be able to anticipate or respond timely to changes which could adversely affect our operating results. Results of operations in any past period should not be considered indicative of results to be expected in future periods. Fluctuations in operating results may result in fluctuations in the price of our common stock. Statements relating to past dividend payments or our current dividend policy should not be construed as a guarantee that any future dividends will be paid. For a more complete description of the prominent risks and uncertainties inherent in our business, see the risk factors included in our most recent Annual Report on Form 10-K and other documents we file from time to time with the Securities and Exchange Commission.

Overview

We are a specialized commercial/consumer finance company that provides equipment leasing and other financing services, with a primary focus on the "microticket market". Our portfolio generally consists of business equipment leased or rented primarily to small commercial enterprises. We typically fund contracts that range from \$500 to \$25,000, with an average transaction amount of approximately \$4,000 to \$6,000. Initial terms of the leases in our portfolio generally range from 18 to 60 months, with an average initial term of approximately 45 months.

We derive the majority of our revenues from leases originated and held by us, payments on service and rental contracts and fee income.

In a typical lease transaction, we originate a lease through our nationwide network of equipment vendors, independent sales organizations and brokers. Upon our approval of a lease application and verification that the lessee has received the equipment and signed the lease, we pay the dealer for the cost of the equipment, plus the dealer's profit margin. 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 to provide us with an appropriate profit. We pass along some of the costs of our leases and contracts by charging late fees, prepayment penalties, loss and damage waiver fees and other service fees, when applicable. Collection fees are imposed based on our estimate of the costs of collection. The loss and damage waiver fees are charged if a customer fails to provide proof of insurance and are reasonably related to the cost of replacing the lost or damaged equipment or

product. The initial non-cancelable term of the lease is equal to or less than the equipment's estimated economic life and often provides us with additional revenues based on the residual value of the equipment at the end of the lease. We also acquire service contracts under which a homeowner purchases a security system and simultaneously signs a contract with the dealer for the monitoring of that system for a monthly fee. Upon approval of the monitoring application and verification with the homeowner that the system is installed, we purchase the right to the payment stream under the monitoring service contract from the dealer at a negotiated multiple of the monthly payments. In years prior to 2012, our service contract

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revenue was derived from our LeaseComm portfolio, for which we have not purchased any new security service contracts since 2002. Beginning in the second quarter of 2012, TimePayment began purchasing service contracts. We finance the origination of our leases and contracts primarily through cash provided by operating activities and borrowings under our revolving line of credit. The total commitment under the facility, originally \$30 million, has been increased at various times, most recently from \$100 million to \$150 million in December 2012. The December 2012 amendment also permits further increases in the total commitment under an accordion feature, to \$175 million, with the agreement of the Agent and, as applicable, a new or existing Lender under certain conditions. Our borrowing capacity under the facility is subject to a borrowing base calculated by reference to qualified TimePayment lease receivables. Outstanding borrowings are collateralized by eligible lease contracts and a security interest in all of our other assets.

Operating Data

Dealer funding was \$29.7 million and \$80.5 million for the three and nine months ended September 30, 2014, respectively; compared to \$23.6 million and \$67.6 million for the comparable periods in 2013. This represents an increase of \$12.9 million, or 19.2%, over the comparable nine month period. The increase in origination dollars resulted primarily from a 17.3% increase in the number of contracts funded during the first nine months of 2014 compared to the same period in 2013. The average contract amount funded was approximately \$4,800 during both periods.

We continue to concentrate on our business development efforts, which include increasing the size of our vendor base and sourcing a larger number of applications from those vendors. Receivables due in installments, estimated residual values and investment in rental equipment and service contracts increased from \$243.8 million at December 31, 2013, to \$254.9 million at September 30, 2014. Net cash provided by operating activities increased by \$2.8 million, or 4.0% to \$72.0 million during the nine months ended September 30, 2014, as compared to the equivalent period in 2013.

Critical Accounting Policies

Our significant accounting policies are described in Note B to the consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2013, 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 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, 2014.



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Results of Operations - Three months ended September 30, 2014, compared to the three months ended September 30, 2013

## Revenues

	Three months ended September 30,		
	2014	Change	2013
	(Dollars in thousands)		
Revenues:			
Income on financing leases	\$10,463	1.6%	\$10,303
Rental income	2,741	3.0%	2,660
Income on service contracts	413	65.2%	250
Loss and damage waiver fees	1,616	9.6%	1,474
Service fees and other	1,002	(5.1)%	1,056
Total revenues	\$16,235	3.1%	\$15,743

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, 2014, were \$16.2 million, an increase of \$492,000, or 3.1%, from the three months ended September 30, 2013. The overall increase was due to a \$160,000 increase in revenue from leases, a \$163,000 increase in service contract revenue, an \$81,000 increase in rental income and an \$88,000 increase in fees and other income. The increases in lease revenue, service contract income and fees and other income are due to growth in lease and service contract originations.

## Selling, General and Administrative Expenses

	Three months ended September 30,		
	2014	Change	2013
	(Dollars in thousands)		
Selling, general and administrative	\$4,862	5.3%	\$4,618
As a percent of revenue	29.9	%	29.3

Our selling, general and administrative (SG&A) expenses include costs of maintaining corporate functions such as accounting, finance, collections, legal, human resources, sales and underwriting and information systems. SG&A expenses also include commissions, service fees and other marketing costs associated with our portfolio of leases and rental contracts. SG&A expenses increased by \$244,000 for the three months ended September 30, 2014, as compared to the three months ended September 30, 2013. The increase was primarily driven by increases in compensation-related expenses of \$181,000 and increases in bank service charges of \$51,000. The number of employees as of September 30, 2014, was 166 compared to 145 as of September 30, 2013.

## Provision for Credit Losses

	Three months ended September 30,		
	2014	Change	2013
	(Dollars in thousands)		
Provision for credit losses	\$4,318	(9.9)%	\$4,790
As a percent of revenue	26.6	%	30.4

We maintain an allowance for credit losses on our investment in leases, service contracts and rental contracts at an amount that we believe is sufficient to provide adequate protection against losses in our portfolio. 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. Our provision for credit losses decreased by \$472,000 for the three months ended September 30, 2014, as compared to the three months ended September 30, 2013. The decrease in the provision during the third quarter of 2014 was due to an improvement in

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the delinquency levels of the lease portfolio. As of September 30, 2013, 11.4% of our investment in leases was over 90 days past due. As of September 30, 2014, 9.4% of our investment in leases was over 90 days past due. See Note C to our Unaudited Condensed Consolidated Financial Statements for further information regarding the provision for credit losses.

## Depreciation and Amortization

	Three months ended September 30,		
	2014	Change	2013
	(Dollars in thousands)		
Depreciation - property and equipment	\$153	1.3%	\$151
Depreciation - rental equipment	1,029	(4.1)%	1,073
Amortization - service contracts	272	107.6%	131
Total depreciation and amortization	\$1,454	7.3%	\$1,355
As a percent of revenue	9.0	%	8.6

Depreciation and amortization expense consists of depreciation on property and equipment and rental equipment, and the amortization of service contracts. Property and equipment are recorded at cost and depreciated over their expected useful lives. Most of our rental contracts are originated as a result of the renewal provisions of our lease agreements where at the end of lease term, the customer has elected 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. Terminated contracts include buyouts, returns, and write-offs.

Investments in service contracts are amortized over the expected life of the contract. In the event the contract terminates prior to its expected life, the remaining net book value is expensed.

Depreciation and amortization of property and equipment increased by \$2,000 for the three months ended September 30, 2014, as compared to the three months ended September 30, 2013. Depreciation expense on rentals decreased by \$44,000 for the three months ended September 30, 2014, compared to the three months ended September 30, 2013. Additions to the rental portfolio resulting from completed leases converting to rental were offset by the acceleration of depreciation on rental contracts that were terminated during the period. There were fewer rental contracts terminated during the third quarter of 2014 compared to the third quarter of 2013, resulting in the decrease in rental equipment depreciation for the period. Amortization expense on service contracts increased by \$141,000 for the three months ended September 30, 2014, as compared to the three months ended September 30, 2013, due to an increased level of new service contract originations during the previous twelve months. The net investment in service contracts increased from \$1.7 million at September 30, 2013, to \$2.9 million at September 30, 2014.

## Interest Expense

	Three months ended September 30,		
	2014	Change	2013
	(Dollars in thousands)		
Interest	\$750	10.5%	\$679
As a percent of revenue	4.6	%	4.3
Line of credit balance (end of period):	\$85,526		\$70,766

We pay interest on borrowings under our revolving line of credit. Interest expense increased by \$71,000 for the three months ended September 30, 2014, as compared to the three months ended September 30, 2013. This increase resulted primarily from the increased level of borrowing on our revolving line of credit, partially offset by lower interest rates.



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## Provision for Income Taxes

	Three Months Ended September 30,		2013	
	2014	Change		
	(Dollars in thousands)			
Provision for income taxes	\$1,964	14.1%	\$1,721	
As a percent of revenue	12.1	%	10.9	%
As a percent of income before taxes	40.5	%	40.0	%

The provision for income taxes, deferred tax assets and liabilities and any necessary valuation allowance recorded against net deferred tax assets, involves summarizing temporary differences resulting from the different treatment of items, such as leases, for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are recorded on the balance sheet. We must then assess the likelihood that deferred tax assets will be recovered from future taxable income or tax carry-back availability and to the extent we believe recovery is more likely than not, a valuation allowance is unnecessary.

The provision for income taxes increased by \$243,000 for the three months ended September 30, 2014, as compared to the three months ended September 30, 2013. This increase resulted from an increase in our 2014 estimated effective tax rate, along with the \$550,000 increase in income before taxes for the three months ended September 30, 2014, as compared to the three months ended September 30, 2013. The effective tax rate increased to 40.5% for the three months ended September 30, 2014, compared to 40.0% for the three months ended September 30, 2013, primarily due to an increase in the effective state tax rate resulting from the expiration of the federal bonus tax depreciation regulations at the end of 2013.

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, 2011, and our state income tax returns are subject to examination for tax years ended on or after December 31, 2010. The Company has been selected for an Internal Revenue Service audit of its 2012 federal income tax return. Additionally, the Florida Department of Revenue has notified the Company that it has been selected for an audit of its 2011 to 2013 Florida income tax returns. While we do not anticipate any material adjustments resulting from these audits at this time, we are unable to fully assess the risks and exposure at these early stages of the audits.

Results of Operations - Nine months ended September 30, 2014, compared to the nine months ended September 30, 2013

## Revenues

	Nine months ended September 30,		2013
	2014	Change	
	(Dollars in thousands)		
Revenues:			
Income on financing leases	\$30,750	(0.4)%	\$30,866
Rental income	8,226	4.9%	7,845
Income on service contracts	1,108	73.1%	640
Loss and damage waiver fees	4,699	7.8%	4,361
Service fees and other	2,948	(1.7)%	3,000
Total revenues	\$47,731	2.2%	\$46,712

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, 2014, were \$47.7 million, an increase of \$1.0 million, or 2.2%, from the nine months ended September 30, 2013. The overall increase was due to a \$381,000 increase in rental income, a \$468,000 increase in service contract revenue, and a \$286,000 increase in fees and other income, partially offset by a \$116,000

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decrease in income on financing leases. The increase in rental income is the result of TimePayment lease contracts coming to term and converting to rentals, partially offset by the attrition of LeaseComm and TimePayment rental contracts. Beginning in the second quarter of 2012, TimePayment began acquiring service contracts resulting in an increase in service contract revenue. The decrease in lease revenue is attributed to slightly lower yields, combined with higher direct origination costs. Our risk-based scoring model results in higher yields as risk increases. Yields decrease as the initial credit scores for lease originations improve. (See the comparison of our recorded investment in leases shown below.) Our direct origination costs have increased due to commission programs and other marketing costs associated with growing our lease portfolio. The following table reflects the change in the mix by comparing our recorded investment in leases as of September 30, 2014, to the investment in leases as of September 30, 2013, classified according to the original score granted by our internally-developed proprietary scoring model:

	Investment in Leases as of September 30,					
	2014		Change		2013	
	Amount	%	Amount	%	Amount	%
TimePayment						
Gold	\$75,113	40.2	% \$11,940	4.6	% \$63,173	35.6
Silver	96,820	51.9	% (6,140	) (6.1	)% 102,960	58.0
Bronze	14,491	7.8	% 3,388	1.5	% 11,103	6.3
TimePayment subtotal	186,424	99.9	% 9,188	—	% 177,236	99.9
LeaseComm	146	0.1	% (42	) —	% 188	0.1
Total financing	\$186,570	100.0	% \$9,146	—	% \$177,424	100.0
Receivables						

## Selling, General and Administrative Expenses

	Nine months ended September 30,		
	2014	Change	2013
	(Dollars in thousands)		
Selling, general and administrative	\$14,730	4.3%	\$14,121
As a percent of revenue	30.9	%	30.2

Our selling, general and administrative (SG&A) expenses include costs of maintaining corporate functions such as accounting, finance, collections, legal, human resources, sales and underwriting and information systems. SG&A expenses also include commissions, service fees and other marketing costs associated with our portfolio of leases and rental contracts. SG&A expenses increased by \$609,000 for the nine months ended September 30, 2014, as compared to the nine months ended September 30, 2013. The increase was primarily driven by increases in compensation-related expenses of \$394,000, third-party security monitoring services of \$84,000 and bank servicing fees of \$128,000. The number of employees as of September 30, 2014, was 166 compared to 145 as of September 30, 2013.

## Provision for Credit Losses

	Nine months ended September 30,		
	2014	Change	2013
	(Dollars in thousands)		
Provision for credit losses	\$13,743	(4.7)%	\$14,414
As a percent of revenue	28.8	%	30.9

We maintain an allowance for credit losses on our investment in leases, service contracts and rental contracts at an amount that we believe is sufficient to provide adequate protection against losses in our portfolio. The provision was based on providing a general allowance on contracts funded during the period and our analysis of actual and expected losses in our portfolio. Our provision for credit losses decreased by \$671,000 for the nine months ended September 30, 2014, as compared to the nine months ended September 30, 2013. The decrease in the provision for the nine

months ended September 30, 2014, was due to an improvement in the delinquency levels of the lease portfolio. As of September 30, 2013, 11.4% of our investment in leases was over 90 days past due. As of September 30, 2014, 9.4% of our investment in leases was over 90 days past due. See Note C to our Unaudited Condensed Consolidated Financial Statements for further information regarding the provision for credit losses.



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## Depreciation and Amortization

	Nine months ended September 30,		2013	
	2014	Change		
	(Dollars in thousands)			
Depreciation - property and equipment	\$440	(4.8)%	\$462	
Depreciation - rental equipment	3,074	(2.9)%	3,167	
Amortization - service contracts	805	136.1%	341	
Total depreciation and amortization	\$4,319	8.8%	\$3,970	
As a percent of revenue	9.0	%	8.5	%

Depreciation and amortization expense consists of depreciation on property and equipment and rental equipment, and the amortization of service contracts. Property and equipment are recorded at cost and depreciated over their expected useful lives. Most of our rental contracts are originated as a result of the renewal provisions of our lease agreements where at the end of lease term, the customer has elected 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. Terminated contracts include buyouts, returns, and write-offs.

Investments in service contracts are amortized over the expected life of the contract. In the event the contract terminates prior to its expected life, the remaining net book value is expensed.

Depreciation and amortization of property and equipment decreased by \$22,000 for the nine months ended September 30, 2014, as compared to the nine months ended September 30, 2013, as certain assets became fully depreciated.

Depreciation expense on rentals decreased by \$93,000 for the nine months ended September 30, 2014, compared to the nine months ended September 30, 2013. Additions to the rental portfolio resulting from completed leases converting to rental were offset by the acceleration of depreciation on rental contracts that were terminated during the period. There were fewer rental contracts terminated during the first nine months of 2014 compared to the first nine months of 2013, resulting in the decrease in rental equipment depreciation for the period. Amortization expense on service contracts increased by \$464,000 for the nine months ended September 30, 2014, as compared to the nine months ended September 30, 2013, due to an increased level of new service contract originations during the last quarter of 2013 and the first nine months of 2014. The net investment in service contracts increased from \$1.7 million at September 30, 2013, to \$2.9 million at September 30, 2014.

## Interest Expense

	Nine months ended September 30,		2013	
	2014	Change		
	(Dollars in thousands)			
Interest	2,111	5.1%	\$2,009	
As a percent of revenue	4.4	%	4.3	%
Line of credit balance (end of period):	\$85,526		\$70,766	

We pay interest on borrowings under our revolving line of credit. Interest expense increased by \$102,000 for the nine months ended September 30, 2014, as compared to the nine months ended September 30, 2013. This increase resulted primarily from our increased level of borrowing on our revolving line of credit, partially offset by lower interest rates.

## Provision for Income Taxes

	Nine months ended September 30,		2013	
	2014	Change		
	(Dollars in thousands)			
Provision for income taxes	\$5,341	9.3%	\$4,886	
As a percent of revenue	11.2	%	10.5	%

As a percent of income before taxes	41.6	%	40.1	%
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The provision for income taxes, deferred tax assets and liabilities and any necessary valuation allowance recorded against net deferred tax assets, involves summarizing temporary differences resulting from the different treatment of items, such as leases, for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are recorded on the balance sheet. We must then assess the likelihood that deferred tax assets will be recovered from future taxable income or tax carry-back availability and, to the extent we believe recovery is more likely than not, a valuation allowance is unnecessary.

The provision for income taxes increased by \$455,000 for the nine months ended September 30, 2014, as compared to the nine months ended September 30, 2013. This increase resulted from an increase in our 2014 estimated effective tax rate along with the \$630,000 increase in income before taxes for the nine months ended September 30, 2014, as compared to the nine months ended September 30, 2013. The effective tax rate increased to 41.6% for the nine months ended September 30, 2014, compared to 40.1% for the nine months ended September 30, 2013, primarily due to an increase in the effective state tax rate resulting from the expiration of the federal bonus tax depreciation regulations at the end of 2013.

**Fair Value of Financial Instruments**

For financial instruments including cash and cash equivalents, restricted cash, accounts payable, and other liabilities, we believe that the carrying amount approximates fair value due to their short-term nature. The fair value of the revolving line of credit is calculated based on the incremental borrowing rates currently available on loans with similar terms and maturities. In December 2012, we amended our revolving line of credit which resulted in a reduction of the interest rates being charged on the outstanding balance. We have determined that the fair value of our revolving line of credit at September 30, 2014, and at December 31, 2013, approximates its carrying value.

**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 as of September 30, 2014, and December 31, 2013. 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.

	September 30, 2014		December 31, 2013		
	(dollars in thousands)				
Current	\$193,536	86.0	% \$180,419	84.1	%
31-60 days past due	6,872	3.1	% 7,171	3.3	%
61-90 days past due	5,199	2.3	% 4,932	2.3	%
Over 90 days past due	19,237	8.6	% 22,106	10.3	%
Gross receivables due in installments	\$224,844	100.0	% \$214,628	100.0	%

**Liquidity and Capital Resources****General**

Our lease and finance business is capital-intensive and requires access to substantial short-term and long-term credit to fund lease originations. Since inception, we have funded our operations primarily through borrowings under our credit facilities, on-balance sheet securitizations, the issuance of subordinated debt, cash provided by operating activities and the proceeds from our initial public offering completed in February 1999. We will continue to require significant additional capital to maintain and expand our funding of leases and contracts, as well as to fund any future acquisitions of leasing companies or portfolios. In the near term, we expect to finance our business utilizing cash on hand, cash provided from operating activities and borrowings on our revolving line of credit which matures in

December 2016. Additionally, our uses of cash include the payment of interest and principal on borrowings, selling, general and administrative expenses, income taxes, payment of dividends and capital expenditures. For the nine months ended September 30, 2014 and 2013, our primary sources of liquidity were cash provided by operating activities and borrowings on our revolving line of credit. We generated cash flow from operations of \$72.0 million for the nine months ended September 30, 2014, compared to \$69.2 million for the nine months ended September 30, 2013. The \$2.8 million increase in cash from operations related primarily to a \$7.9 million increase in cash received from customers. This increase was

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partially offset by an increase of \$4.4 million in cash paid for taxes and an increase of \$0.7 million paid to suppliers and employees.

We used net cash in investing activities of \$81.9 million for the nine months ended September 30, 2014, and \$68.0 million for the nine months ended September 30, 2013. Investing activities primarily related to the origination of leases with investments in lease and service contracts, direct costs and purchases of property and equipment. Net cash provided by financing activities was \$9.0 million for the nine months ended September 30, 2014, and net cash used in financing activities was \$3.4 million for the nine months ended September 30, 2013. Financing activities primarily consist of the borrowings and repayments on our revolving line of credit and dividend payments. During the first nine months of 2014, we borrowed \$119.9 million and repaid \$106.9 million our line of credit. During the same period in 2013, we borrowed \$99.8 million and repaid \$99.5 million our line of credit. During the first nine months of 2014, we paid dividends of \$3.1 million compared to \$2.6 million during the same period in 2013. In addition, we used \$0.5 million and \$0.7 million during the first nine months of 2014 and 2013, respectively, to repurchase our common stock.

At September 30, 2014, we had approximately \$85.5 million outstanding under our \$150 million revolving credit facility. Our ability to borrow under the line of credit is subject to limitations based on lease eligibility and a borrowing base formula. At September 30, 2014, the qualified lease receivables eligible under the borrowing base computation were approximately \$137.7 million, compared to actual borrowings of \$85.5 million. As of September 30, 2014, an additional \$52.2 million was available to borrow based on eligible lease receivables. The maturity date of our revolving line of credit is December 2016, at which time the outstanding loan balance plus interest becomes due and payable. At our option upon maturity, the unpaid principal balance may be converted to a six-month term loan.

We believe that cash flows from our existing portfolio, cash on hand, available borrowings to the existing credit facility, and additional financing as required will be sufficient to support our operations and lease origination activity in the near term.

**Borrowings**

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

	September 30, 2014				December 31, 2013			
	Amounts Outstanding	Interest Rate	Unused Capacity <sup>(1)</sup>	Maximum Facility Amount	Amounts Outstanding	Interest Rate	Unused Capacity <sup>(1)</sup>	Maximum Facility Amount
	(Dollars in Thousands)							
Revolving credit facility	\$ 85,526	2.82-4.00%	\$ 64,474	\$ 150,000	\$ 72,566	2.74-4.00%	\$ 77,434	\$ 150,000

(1) The unused capacity is subject to the borrowing base formula, as described above.

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

At September 30, 2014, \$76.0 million of our loans were LIBOR loans and \$9.5 million of our loans were Base Rate Loans. The Base Rate is the highest of the prime rate established by the Agent, or one-month LIBOR plus 1%, or the federal funds effective rate plus 0.5%.



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## Dividends

Dividends declared and paid or payable were as follows:

## 2014

Date Declared	Record Date	Payment Date	Dividend per Share
January 14, 2014	January 30, 2014	February 14, 2014	\$0.07
April 23, 2014	May 5, 2014	May 15, 2014	0.07
July 23, 2014	August 4, 2014	August 14, 2014	0.07
October 22, 2014	November 3, 2014	November 10, 2014	0.08
Total			\$0.29

## 2013

Date Declared	Record Date	Payment Date	Dividend per Share
January 29, 2013	February 8, 2013	February 15, 2013	\$0.06
April 23, 2013	May 3, 2013	May 15, 2013	0.06
July 17, 2013	July 30, 2013	August 15, 2013	0.06
October 24, 2013	November 4, 2013	November 15, 2013	0.07
Total			\$0.25

Future dividend payments are subject to ongoing review and evaluation by our Board of Directors. The decision as to the amount and timing of future dividends, if any, will be made in light of our financial condition, capital requirements and growth plans, as well as our external financing arrangements and any other factors our Board of Directors may deem relevant. We can give no assurance as to the amount and timing of future dividends.

## Share repurchases

On August 10, 2010, our Board of Directors approved a common stock repurchase program (2010 Repurchase Program) under which we were authorized to purchase up to 250,000 of our outstanding shares from time to time, in the open market or through block trades. The 2010 Repurchase Program was funded by our working capital. During the first quarter of 2014, we repurchased and retired 66,552 shares of our common stock under this program at an average price per share of \$8.07, at a total cost of approximately \$536,000. Including these purchases, we have repurchased a total of 250,000 shares of our common stock since the 2010 Repurchase Program's inception, which represented the total shares authorized to be repurchased under the program, at a total cost of approximately \$1.6 million.

On July 23, 2014, the Board of Directors authorized a new common stock repurchase program (2014 Repurchase Program) under which we are authorized to repurchase up to an additional 250,000 shares of our common stock from time to time. We may repurchase our common stock in open market purchases or in privately negotiated transactions. We will determine the timing and amount of any shares repurchased based on our evaluation of market conditions and other factors. The repurchase program may be suspended or discontinued at any time. Any repurchased shares will be available for use in connection with our stock plans and for other corporate purposes. The 2014 Repurchase Program will be funded by our working capital.

During the third quarter of 2014 we did not repurchase any shares of our common stock. Lease Commitments We accept lease applications on a daily basis and have a pipeline of applications that have been approved, where a lease has not been originated. Our commitment to lend does not become binding until all of the steps in the lease origination process have been completed, including but not limited to the receipt of a complete and accurate lease document, all required supporting information and successful verification with the lessee. Since we fund on the same day a lease is successfully verified, we do not have any firm outstanding commitments to lend.





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Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standard Update Number 2014-09, Revenue from Contracts with Customers (Topic 606). The amendments in this Update create Topic 606, Revenue from Contracts with Customers, and supersede the revenue recognition requirements in Topic 605, Revenue Recognition, including most industry-specific revenue recognition guidance throughout the Industry Topics of the Codification. In addition, the amendments supersede the cost guidance in Subtopic 605-35, Revenue Recognition-Construction-Type and Production-Type Contracts, and create new Subtopic 340-40, Other Assets and Deferred Costs-Contracts with Customers. In summary, the core principle of Topic 606 is that an entity recognizes revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance in this Update affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts of nonfinancial assets unless those contracts are within the scope of other standards (for example, insurance contracts or lease contracts). The amendments in Topic 606 are effective for annual reporting periods beginning after December 15, 2016. We are still evaluating the potential impact of this Update on our results of operations.

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 philosophy is to maintain a blend of fixed and variable interest rate obligations, whenever feasible, in order to limit our interest rate risk. Based on our assessment of current market conditions, we have determined that the cost associated with obtaining fixed rate debt would exceed the benefits associated with mitigating the current interest rate risk. Accordingly, we currently have no fixed-rate obligations; however our variable interest rate obligations under our revolving line of credit are tied to several LIBOR contracts with varying maturity dates ranging from 30 days to 180 days in duration. As of September 30, 2014, we have \$85.5 million of outstanding variable interest rate obligations under our revolving line of credit.

Our revolving line of credit bears interest at rates which fluctuate with changes in the Prime Rate or the LIBOR; therefore, our interest expense is sensitive to changes in market interest rates. The effect of a 10% adverse change in market interest rates, sustained for one year, on our interest expense would be immaterial.

We maintain an investment portfolio in accordance with our investment policy guidelines. The primary objectives of the investment guidelines are to preserve capital, maintain sufficient liquidity to meet our operating needs, and to maximize return. We minimize investment risk by limiting the amount invested in any single security and by focusing on conservative investment choices with short terms and high credit quality standards. We do not use derivative financial instruments or invest for speculative trading purposes. There was no investment activity during 2013 or the first nine months of 2014.



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ITEM 4. Controls and Procedures

Disclosure controls and procedures

As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to the Exchange Act Rule 13a-15. Based upon the evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective. Disclosure controls and procedures are controls and procedures that are designed to ensure that information required to be disclosed in our reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.

Internal control over financial reporting

During the third quarter of our fiscal year ending December 31, 2014, 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.

Part II - Other Information

ITEM 1. Legal Proceedings

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

ITEM 1A. Risk Factors

For a discussion of the material risks that we face relating to our business, financial performance and industry, as well as other risks that an investor in our common stock may face, see the factors discussed in Part I, "Item 1A. Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2013. 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

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- 3.1 Restated Articles of Organization, as amended (incorporated by reference to Exhibit 3.1 in the Registrant's Registration Statement on Form S-1, No. 333-56639, filed with the Securities and Exchange Commission on June 9, 1998).
- 3.2 Restated Bylaws, as amended (incorporated by reference to Exhibit 3.2 in the Registrant's Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 28, 2007).
- 31.1\* Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2\* Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1\* Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2\* Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

101\* The following materials from the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2014, formatted in XBRL (eXtensible Business Reporting Language): (i) Condensed Consolidated Balance Sheets as of September 30, 2014 and December 31, 2013, (ii) Condensed Consolidated Statements of Income for the three and nine months ended September 30, 2014 and 2013, (iii) Condensed Consolidated Statements of Stockholders' Equity for the nine months ended September 30, 2014, and the twelve months ended December 31, 2013, (iv) Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2014 and 2013, and (v) Notes to Unaudited Condensed Consolidated Financial Statements.

\* Filed herewith

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

MicroFinancial Incorporated

By: /s/ Richard F. Latour  
President and Chief Executive Officer

By: /s/ James R. Jackson Jr.  
Senior Vice President and Chief Financial Officer

Date: November 14, 2014