

NEWTEK BUSINESS SERVICES, INC.

Form 10-Q

May 12, 2014

[Table of Contents](#)

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**

**FORM 10-Q**

(Mark One)

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

**For the quarterly period ended March 31, 2014**

**OR**

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission File Number: 001-16123**

**NEWTEK BUSINESS SERVICES, INC.**

(Exact name of registrant as specified in its charter)

New York  
(State or other jurisdiction of  
incorporation or organization)

11-3504638  
(I.R.S. Employer  
Identification No.)

212 West 35<sup>th</sup> Street, 2<sup>nd</sup> Floor, New York, NY  
(Address of principal executive offices)

10001  
(Zip Code)

Registrant's telephone number, including area code: (212) 356-9500

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the past 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 website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 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 (as defined in Rule 12b-2 of the Exchange Act).

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

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

As of May 7, 2014, there were 36,966,672 of the Company's Common Shares outstanding.

**Table of Contents**

**CONTENTS**

	<b>PAGE</b>
<b>PART I - FINANCIAL INFORMATION</b>	
<b><u>Item 1. Financial Statements:</u></b>	
<u>Condensed Consolidated Statements of Income (Unaudited) for the Three Months Ended March 31, 2014 and 2013</u>	3
<u>Condensed Consolidated Balance Sheets as of March 31, 2014 (Unaudited) and December 31, 2013</u>	4
<u>Condensed Consolidated Statements of Cash Flows (Unaudited) for the Three Months Ended March 31, 2014 and 2013</u>	5
<u>Notes to Condensed Consolidated Financial Statements (Unaudited)</u>	7
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	28
<u>Item 3. Quantitative and Qualitative Disclosures about Market Risk</u>	41
<u>Item 4. Controls and Procedures</u>	42
<b><u>PART II - OTHER INFORMATION</u></b>	
<u>Item 1. Legal Proceedings</u>	43
<u>Item 6. Exhibits</u>	43
<u>Signatures</u>	44

**Table of Contents****Item 1. Financial Statements.****NEWTEK BUSINESS SERVICES, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)****FOR THE THREE MONTHS ENDED MARCH 31, 2014 AND 2013****(In Thousands, except for Per Share Data)**

	<b>Three Months Ended March 31,</b>	
	<b>2014</b>	<b>2013</b>
Operating revenues		
Electronic payment processing	\$ 21,527	\$ 21,677
Web hosting and design	3,987	4,380
Premium income	5,137	4,259
Interest income	1,561	1,030
Servicing fee income NSBF portfolio	832	614
Servicing fee income external portfolios	1,793	847
Income from tax credits	13	26
Insurance commissions	385	444
Other income	852	867
<b>Total operating revenues</b>	<b>\$ 36,087</b>	<b>\$ 34,144</b>
Net change in fair value of:		
SBA loans	(1,266)	(376)
Credits in lieu of cash and notes payable in credits in lieu of cash	1	19
<b>Total net change in fair value</b>	<b>(1,265)</b>	<b>(357)</b>
Operating expenses:		
Electronic payment processing costs	18,362	18,284
Salaries and benefits	6,478	6,056
Interest	1,636	1,303
Depreciation and amortization	855	807
Provision for loan losses	(205)	118
Other general and administrative costs	5,480	5,017
<b>Total operating expenses</b>	<b>32,606</b>	<b>31,585</b>
Income before income taxes	2,216	2,202
Provision for income taxes	(849)	(897)

Edgar Filing: NEWTEK BUSINESS SERVICES, INC. - Form 10-Q

Net income	1,367	1,305
Net loss attributable to non-controlling interests	24	147
Net income attributable to Newtek Business Services, Inc.	\$ 1,391	\$ 1,452
Weighted average common shares outstanding - basic	35,432	35,218
Weighted average common shares outstanding - diluted	38,386	37,736
Earnings per share basic and diluted	\$ 0.04	\$ 0.04

See accompanying notes to these unaudited condensed consolidated financial statements.

Table of Contents**NEWTEK BUSINESS SERVICES, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS****MARCH 31, 2014 AND DECEMBER 31, 2013****(In Thousands, except for Per Share Data)**

	<b>March 31, 2014</b>	<b>December 31, 2013</b>
	Unaudited	(Note 1)
<b><u>ASSETS</u></b>		
Cash and cash equivalents	\$ 10,234	\$ 12,508
Restricted cash	10,569	16,877
Broker receivable	12,907	13,606
SBA loans held for investment, net (includes \$10,311 and \$10,894, respectively, related to securitization trust VIE; net of reserve for loan losses of \$1,553 and \$1,811, respectively)	10,237	10,689
SBA loans held for investment, at fair value (includes \$82,368 and \$74,387, respectively, related to securitization trust VIE)	87,670	78,951
Accounts receivable (net of allowance of \$1,161 and \$871, respectively)	11,638	11,602
SBA loans held for sale, at fair value	3,924	4,734
Prepaid expenses and other assets, net (includes \$2,095 and \$2,187, respectively, related to securitization trust VIE)	13,671	18,549
Servicing asset (net of accumulated amortization and allowances of \$8,257 and \$7,909, respectively)	7,287	6,776
Fixed assets (net of accumulated depreciation and amortization of \$10,995 and \$10,547, respectively)	3,844	3,741
Intangible assets (net of accumulated amortization of \$2,198 and \$2,243, respectively)	1,219	1,240
Credits in lieu of cash	3,231	3,641
Deferred tax asset, net	3,925	3,606
Goodwill	12,092	12,092
Total assets	\$ 192,448	\$ 198,612
<b><u>LIABILITIES AND EQUITY</u></b>		
Liabilities:		
Accounts payable, accrued expenses and other liabilities	\$ 13,808	\$ 14,688
Notes payable	37,227	41,218
Note payable securitization trust VIE	57,786	60,140
Capital lease obligation	585	642
Deferred revenue	1,312	1,274
Notes payable in credits in lieu of cash	3,231	3,641

Total liabilities	113,949	121,603
Commitments and contingencies		
Equity:		
Newtek Business Services, Inc. shareholders' equity:		
Preferred shares (par value \$0.02 per share; authorized 1,000 shares, no shares issued and outstanding)		
Common shares (par value \$0.02 per share; authorized 54,000 shares, 36,913 issued; 35,451 and 35,385 outstanding, respectively, not including 83 shares held in escrow)	738	738
Additional paid-in capital	61,469	61,349
Retained earnings	15,927	14,536
Treasury shares, at cost (1,461 and 1,528, respectively)	(1,242)	(1,279)
Total Newtek Business Services, Inc. shareholders' equity	76,892	75,344
Non-controlling interests	1,607	1,665
Total equity	78,499	77,009
Total liabilities and equity	\$ 192,448	\$ 198,612

See accompanying notes to these unaudited condensed consolidated financial statements.

**Table of Contents****NEWTEK BUSINESS SERVICES, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)****FOR THE THREE MONTHS ENDED MARCH 31, 2014 AND 2013****(In Thousands)**

	<b>2014</b>	<b>2013</b>
Cash flows from operating activities:		
Condensed consolidated net income	\$ 1,367	\$ 1,305
Adjustments to reconcile condensed consolidated net income to net cash (used in) provided by operating activities:		
Income from tax credits	(13)	(26)
Accretion of interest expense	14	46
Fair value adjustments on SBA loans	1,266	376
Fair value adjustment of credits in lieu of cash and notes payable in credits in lieu of cash	(1)	(19)
Deferred income taxes	(319)	(311)
Depreciation and amortization	855	807
Accretion of discount	70	(34)
Provision for loan losses	(205)	118
Other, net	643	309
Changes in operating assets and liabilities:		
Originations of SBA loans held for sale	(34,224)	(27,238)
Proceeds from sale of SBA loans held for sale	34,955	25,111
Broker receivable	700	(791)
Accounts receivable	(263)	(2,784)
Prepaid expenses, accrued interest receivable and other assets	4,636	(240)
Accounts payable, accrued expenses and deferred revenue	(778)	2,052
Other, net	(875)	(1,208)
<b>Net cash provided by (used in) operating activities</b>	<b>7,828</b>	<b>(2,527)</b>
Cash flows from investing activities:		
(Investment in) return of investments in qualified businesses	(72)	970
Purchase of fixed assets	(588)	(564)
SBA loans originated for investment, net	(11,385)	(7,640)
Payments received on SBA loans	2,159	1,201
Change in restricted cash		(1,290)
Other, net		15
<b>Net cash used in investing activities</b>	<b>(9,886)</b>	<b>(7,308)</b>

See accompanying notes to these unaudited condensed consolidated financial statements.





**Table of Contents****NEWTEK BUSINESS SERVICES, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)****FOR THE THREE MONTHS ENDED MARCH 31, 2014 AND 2013 (CONTINUED)****(In Thousands)**

	<b>2014</b>	<b>2013</b>
<b>Cash flows from financing activities:</b>		
Net repayments on bank lines of credit	\$ (3,977)	\$ (6,530)
Repayments on bank term note payable	(104)	(104)
Issuance of senior notes, net of issuance costs		20,962
Repayments of senior notes	(2,355)	(1,215)
Additions to deferred financing costs	(11)	(808)
Change in restricted cash related to securitization	6,323	(4,898)
Other	(92)	197
<b>Net cash (used in) provided by financing activities</b>	<b>(216)</b>	<b>7,604</b>
Net decrease in cash and cash equivalents	(2,274)	(2,231)
Cash and cash equivalents - beginning of period	12,508	14,229
Cash and cash equivalents - end of period	\$ 10,234	\$ 11,998
 <b>Supplemental disclosure of cash flow activities:</b>		
Reduction of credits in lieu of cash and notes payable in credits in lieu of cash balances	\$ 417	\$ 2,819

See accompanying notes to these unaudited condensed consolidated financial statements.

---

Table of Contents

NEWTEK BUSINESS SERVICES, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

**NOTE 1 DESCRIPTION OF BUSINESS AND BASIS OF PRESENTATION:**

Newtek Business Services, Inc. ( Newtek ) is a holding company for several wholly- and majority-owned subsidiaries, including twelve certified capital companies which are referred to as Capcos, and several portfolio companies in which the Capcos own non-controlling or minority interests. The Company provides a one-stop-shop for business services to the small- and medium-sized business market and uses state of the art web-based proprietary technology to be a low cost acquirer and provider of products and services. The Company partners with companies, credit unions, and associations to offer its services.

The Company's principal business segments are:

**Electronic Payment Processing:** Marketing third party credit card processing and check approval services to the small- and medium-sized business market under the name of Newtek Merchant Solutions.

**Managed Technology Solutions:** CrystalTech Web Hosting, Inc., d/b/a Newtek Technology Services ( NTS ), offers shared and dedicated web hosting, data storage and backup services, cloud computing plans and related services to the small- and medium-sized business market.

**Small Business Finance:** The segment is comprised of Newtek Small Business Finance, Inc. ( NSBF ), a nationally licensed, U.S. Small Business Administration ( SBA ) lender that originates, sells and services loans to qualifying small businesses, which are partially guaranteed by the SBA and CDS Business Services, Inc. d/b/a Newtek Business Credit ( NBC ) which provides receivable financing and management services.

**All Other:** Businesses formed from investments made through Capco programs and others which cannot be aggregated with other operating segments, including insurance and payroll processing.

**Corporate Activities:** Corporate implements business strategy, directs marketing, provides technology oversight and guidance, coordinates and integrates activities of the segments, contracts with alliance partners, acquires customer opportunities, and owns our proprietary NewTracker® referral system. This segment includes revenue and expenses not allocated to other segments, including interest income, Capco management fee income and corporate operations expenses.

**Capco:** Twelve certified capital companies which invest in small- and medium-sized businesses. They generate non-cash income from tax credits and non-cash interest expense and insurance expenses in addition to cash management fees.

The condensed consolidated financial statements of Newtek, its subsidiaries and consolidated entities included herein have been prepared by the Company in accordance with accounting principles generally accepted in the United States of America and include all wholly- and majority-owned subsidiaries, and several portfolio companies in which the Capcos own non-controlling minority interest in, or those variable interest entities of which Newtek is considered to be the primary beneficiary. All inter-company balances and transactions have been eliminated in consolidation. Non-controlling interests are reported below net income (loss) under the heading Net (income) loss attributable to non-controlling interests in the condensed consolidated statements of income (unaudited) and shown as a component of equity in the condensed consolidated balance sheets.

The accompanying notes to unaudited condensed consolidated financial statements should be read in conjunction with Newtek's 2013 Annual Report on Form 10-K. These financial statements have been prepared in accordance with instructions to Form 10-Q and Article 10 of Regulation S-X and, therefore, omit or condense certain footnotes and other information normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States. In the opinion of management, all adjustments, consisting of normal recurring items, considered necessary for a fair presentation have been included. The results of operations for an interim period may not give a true indication of the results for the entire year. The December 31, 2013 condensed consolidated balance sheet has been derived from the audited financial statements of that date but does not include all disclosures required by accounting principles generally accepted in the United States of America.

All financial information included in the tables in the following footnotes is stated in thousands, except per share data.

---

**Table of Contents****NOTE 2 SIGNIFICANT ACCOUNTING POLICIES:*****Use of Estimates***

The preparation of consolidated 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 amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the consolidated financial statements, and the reported amounts of revenue and expense during the reporting period. The level of uncertainty in estimates and assumptions increases with the length of time until the underlying transactions are complete. The most significant estimates are with respect to valuation of investments in qualified businesses, asset impairment valuation, allowance for loan losses, valuation of servicing assets, charge-back reserves, tax valuation allowances and the fair value measurements used to value certain financial assets and financial liabilities. Actual results could differ from those estimates.

***Revenue Recognition***

The Company operates in a number of different segments. Revenues are recognized as services are rendered and are summarized as follows:

*Electronic payment processing revenue:* Electronic payment processing and fee income is derived from the electronic processing of credit and debit card transactions that are authorized and captured through third-party networks. Typically, merchants are charged for these processing services on a percentage of the dollar amount of each transaction plus a flat fee per transaction. Certain merchant customers are charged miscellaneous fees, including fees for handling charge-backs or returns, monthly minimum fees, statement fees and fees for other miscellaneous services. Revenues derived from the electronic processing of MasterCard® and Visa® sourced credit and debit card transactions are reported gross of amounts paid to sponsor banks.

*Web hosting revenue:* Managed technology solutions revenue is primarily derived from monthly recurring service fees for the use of its web hosting, web design and software support services. Customer set-up fees are billed upon service initiation and are recognized as revenue over the estimated customer relationship period of 2.5 years. Payment for web hosting and related services, excluding cloud plans, is generally received one month to one year in advance. Deferred revenues represent customer payments for web hosting, web design and related services in advance of the reporting period date. Revenue for cloud related services is based on actual consumption used by a cloud customer.

*Sales and Servicing of SBA Loans:* NSBF originates loans to customers under the SBA program that generally provides for SBA guarantees of 75% to 90% of each loan, subject to a maximum guarantee amount. This guaranteed portion is generally sold to a third party via an SBA regulated secondary market transaction utilizing SBA Form 1086 for a price equal to the guaranteed loan amount plus a premium. NSBF recognizes premium on loan sales as equal to the cash premium plus the fair value of the initial servicing asset. Revenue is recognized on the trade date of the guaranteed portion.

Upon recognition of each loan sale, the Company retains servicing responsibilities and receives servicing fees of a minimum of 1% of the guaranteed loan portion sold. The Company is required to estimate its adequate servicing compensation in the calculation of its servicing asset. The purchasers of the loans sold have no recourse to the Company for failure of customers to pay amounts contractually due.

Subsequent measurements of each class of servicing assets and liabilities may use either the amortization method or the fair value measurement method. NSBF has chosen to apply the amortization method to its servicing asset,

amortizing the asset in proportion to, and over the period of, the estimated future net servicing income on the underlying sold guaranteed portion of the loans and assessing the servicing asset for impairment based on fair value if and when a triggering event occurs. In the event future prepayments are significant or impairments are incurred and future expected cash flows are inadequate to cover the unamortized servicing assets, additional amortization or impairment charges would be recognized. In evaluating and measuring impairment of servicing assets, NSBF stratifies its servicing assets based on year of loan and loan term which are the key risk characteristics of the underlying loan pools. The Company uses an independent valuation specialist to estimate the fair value of the servicing asset by calculating the present value of estimated future net servicing cash flows, using assumptions of prepayments, defaults, servicing costs and discount rates that NSBF believes market participants would use for similar assets. If NSBF determines that the impairment for a stratum is temporary, a valuation allowance is recognized through a charge to current earnings for the amount the amortized balance exceeds the current fair value. If the fair value of the stratum were to later increase, the valuation allowance may be reduced as a recovery. However, if NSBF determines that impairment for a stratum is other than temporary, the value of the servicing asset and any related valuation allowance is written-down.

*SBA Loan Interest and Fees:* Interest income on loans is recognized as earned. A loan is placed on non-accrual status if it exceeds 90 days past due with respect to principal or interest and, in the opinion of management, interest or principal on the loan is not

---

**Table of Contents**

collectible, or at such earlier time as management determines that the collectability of such principal or interest is unlikely. Such loans are designated as impaired non-accrual loans. All other loans are defined as performing loans. When a loan is designated as impaired, the accrual of interest is discontinued, and any accrued but uncollected interest income is reversed and charged against current operations. While a loan is classified as impaired and the future collectability of the recorded loan balance is doubtful, collections of interest and principal are generally applied as a reduction to principal outstanding. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

The Company passes certain expenditures it incurs to the borrower, such as force placed insurance, insufficient funds fees, or fees it assesses, such as late fees, with respect to managing the loan. These expenditures are recorded when incurred. Due to the uncertainty with respect to collection of these passed through expenditures or assessed fees, any funds received to reimburse the Company are recorded on a cash basis as other income.

*Income from tax credits:* Following an application process, a state will notify a company that it has been certified as a Capco. The state or jurisdiction then allocates an aggregate dollar amount of tax credits to the Capco. However, such amount is neither recognized as income nor otherwise recorded in the financial statements since it has yet to be earned by the Capco. The Capco is entitled to earn tax credits upon satisfying defined investment percentage thresholds within specified time requirements. Newtek has Capcos operating in five states and the District of Columbia. Each statute requires that the Capco invest a threshold percentage of certified capital (the funds provided by the insurance company investors) in businesses defined as qualified within the time frames specified. As the Capco meets these requirements, it avoids grounds under the statute for its disqualification for continued participation in the Capco program. Such a disqualification, or decertification as a Capco results in a permanent recapture of all or a portion of the allocated tax credits. The proportion of the possible recapture is reduced over time as the Capco remains in general compliance with the program rules and meets the progressively increasing investment benchmarks. As the Capco progresses in its investments in Qualified Businesses and, accordingly, places an increasing proportion of the tax credits beyond recapture, it earns an amount equal to the non-recapturable tax credits and records such amount as income, with a corresponding asset called credits in lieu of cash in the balance sheet.

The amount earned and recorded as income is determined by multiplying the total amount of tax credits allocated to the Capco by the percentage of tax credits immune from recapture (the earned income percentage) at that point. To the extent that the investment requirements are met ahead of schedule, and the percentage of non-recapturable tax credits is accelerated, the present value of the tax credit earned is recognized currently and the asset, credits in lieu of cash, is accreted up to the amount of tax credits deliverable to the certified investors. The obligation to deliver tax credits to the certified investors is recorded as notes payable in credits in lieu of cash. On the date the tax credits are utilizable by the certified investors, the Capco decreases credits in lieu of cash with a corresponding decrease to notes payable in credits in lieu of cash.

*Insurance commissions:* Revenues are comprised of commissions earned on premiums paid for insurance policies and are recognized at the time the commission is earned. At that date, the earnings process has been completed and the Company can estimate the impact of policy cancellations for refunds and establish reserves. The reserve for policy cancellations is based on historical cancellation experience adjusted by known circumstances.

*Other income:* Other income represents revenues derived from operating units that cannot be aggregated with other business segments. In addition, other income represents one time recoveries or gains on investments. Revenue is recorded when there is strong evidence of an agreement, the related fees are fixed, the service or product has been delivered, and the collection of the related receivable is assured.

Receivable fees: Receivable fees are derived from the funding (purchase) of receivables from finance clients. NBC recognizes the revenue on the date the receivables are purchased at a percentage of face value as agreed to by the client. The Company also has arrangements with certain of its clients whereby it purchases the client's receivables and charges a fee at a specified rate based on the amount of funds advanced against such receivables. The funds provided are collateralized and the income is recognized as earned.

Late fees: Late fees are derived from receivables NBC has purchased that have gone over a certain period (usually over 30 days) without payment. The client or the client's customer is charged a late fee according to the agreement with the client and NBC records the fees as income in the month in which such receivable becomes past due.

Billing fees: Billing fees are derived from billing-only (non-finance) clients. These fees are recorded when earned, which occurs when the service is rendered.

Other fees: These fees include re-underwriting fees, due diligence fees, termination fees, under minimum fees, and other fees including finance charges, supplies sold to clients, NSF fees, wire fees and administration fees. These fees are charged upon funding, takeovers or liquidation of finance clients. The Company also receives commission revenue from various sources.



**Table of Contents*****Electronic Payment Processing Costs***

Electronic payment processing costs consist principally of costs directly related to the processing of merchant sales volume, including interchange fees, VISA® and MasterCard® dues and assessments, bank processing fees and costs paid to third-party processing networks. Such costs are recognized at the time the merchant transactions are processed or when the services are performed. Two of the most significant components of electronic processing expenses include interchange and assessment costs, which are set by the credit card associations. Interchange costs are passed on to the entity issuing the credit card used in the transaction and assessment costs are retained by the credit card associations. Interchange and assessment fees are billed primarily as a percent of dollar volume processed or, to a lesser extent, as a per transaction fee. In addition to costs directly related to the processing of merchant sales volume, electronic payment processing costs also include residual expenses, which represent fees paid to third-party sales referral sources. Residual expenses are paid under various formulae as contracted. These are generally linked to revenues derived from merchants successfully referred to the Company and that begin using the Company for merchant processing services.

***Restricted Cash***

Restricted cash includes cash collateral relating to a letter of credit; monies due on SBA loan-related remittances and insurance premiums received by the Company and due to third parties; cash held by the Capcos restricted for use in managing and operating the Capco, making qualified investments and for the payment of income taxes; cash reserves associated with the securitization, cash set aside to purchase unguaranteed portions originated subsequent to the securitization transaction, cash held in blocked accounts used to pay down bank note payables, cash held for our payroll clients waiting to be remitted to their employees or taxing authority and a cash account maintained as a reserve against electronic payment processing chargeback losses. Following is a summary of restricted cash by segment:

(In thousands):	<b>March 31, 2014</b>	<b>December 31, 2013</b>
Electronic payment processing	\$ 571	\$ 573
Small business finance	6,810	12,829
All other	2,187	2,475
Corporate activities	990	989
Capcos	11	11
Totals	\$ 10,569	\$ 16,877

***Broker Receivable***

Broker receivable represents amounts due from third parties for loans which have been traded at period end but have not yet settled.

***SBA Loans Held for Investment***

For loans that completed funding before October 1, 2010, SBA loans held for investment are reported at their outstanding unpaid principal balances adjusted for charge-offs, net deferred loan origination costs and the allowance for loan losses. For loans that completed funding on or after October 1, 2010, management elected to fair value SBA loans held for investment within the fair value hierarchy that prioritizes observable and unobservable inputs utilizing

Level 3 unobservable inputs which reflect the Company's own expectations about the assumptions that market participants would use in pricing the asset (including assumptions about risk). Prior to 2013, the Company determined fair value based on its securitization pricing, as well as internal quantitative data on the portfolio with respect to historical default rates and future expected losses, and now uses a discounted cash flow method, which includes assumptions for cumulative default rates, prepayment speeds, servicing cost and a market yield.

If a loan measured at fair value is subsequently impaired, then the fair value of the loan is measured based on the present value of expected future cash flows discounted at the loan's market interest rate, or the fair value of the collateral less estimated costs to sell, if the loan is collateral dependent. The significant unobservable inputs used in the fair value measurement of the impaired loans involve management's judgment in the use of market data and third party estimates regarding collateral values. Such estimates are further discounted by 20% - 80% to reflect the cost of liquidating the various assets under collateral. Any subsequent increases or decreases in any of the inputs would result in a corresponding decrease or increase in the reserve for loan loss or fair value of SBA loans, depending on whether the loan was originated prior or subsequent to October 1, 2010. Because the loans bear interest at a variable rate, NSBF does not have to factor in interest rate risk.

**Table of Contents**

***Allowance for SBA Loan Losses***

For loans funded before October 1, 2010, the allowance for loan losses for performing loans is established by management through provisions for loan losses charged against income. The amount of the allowance for loan losses is inherently subjective, as it requires making material estimates which may vary from actual results. Management's ongoing estimates of the allowance for loan losses are particularly affected by the changing composition of the loan portfolio over the last few years as well as other portfolio characteristics, such as industry concentrations and loan collateral. The adequacy of the allowance for loan losses is reviewed by management on a monthly basis at a minimum, and as adjustments become necessary, are reflected in operations during the periods in which they become known. Considerations in this evaluation include past and anticipated loss experience, risks inherent in the current portfolio and evaluation of real estate collateral as well as current economic conditions. In the opinion of management, the allowance, when taken as a whole, is adequate to absorb estimated loan losses inherent in the Company's entire loan portfolio. The allowance consists of specific and general reserves. The specific reserves relate to loans that are classified as either loss, doubtful, substandard or special mention that are considered impaired. An allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical loss experience adjusted for qualitative factors.

Loans funded on or after October 1, 2010 are recorded at fair value. Changes in the value of such loans, whether performing or impaired, are reported as a net change in the fair value of SBA loans held for investment in the consolidated statement of operations.

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement, and includes troubled debt restructured loans. Other factors considered by management in determining impairment include payment status and collateral value. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed.

Impairment of a loan is measured based on the present value of expected future cash flows discounted at the loan's market interest rate, or the fair value of the collateral less estimated costs to sell, if the loan is collateral dependent. Impaired loans for which the carrying amount is based on fair value of the underlying collateral are included in assets and reported at estimated fair value on a non-recurring basis, both at initial recognition of impairment and on an on-going basis until recovery or charge-off of the loan amount. The determination of impairment involves management's judgment in the use of market data and third party estimates regarding collateral values. For loans funded before October 1, 2010, the impairment of a loan resulted in management establishing an allowance for loan losses through provisions for loan losses charged against income; for subsequent loans at fair value, impairment results in a net change in the fair value of SBA loans held for investment. Amounts deemed to be uncollectible are charged against the allowance for loan losses or reduces the fair value and subsequent recoveries, if any, are credited to the allowance or increases the fair value.

The Company's charge-off policy is based on a loan-by-loan review for which the estimated uncollectible portion of nonperforming loans is charged off against the corresponding loan receivable and the allowance for possible loan losses or against the reduction in fair value.

***Troubled Debt Restructured Loans***

A loan is considered a troubled debt restructuring, ( TDR ) when a borrower is experiencing financial difficulties that lead to a restructuring that the Company would not otherwise consider. Concessions per Accounting Standards Codification, ( ASC ) Topic 310, Receivables, may include rate reductions, principal forgiveness, extension of the maturity date and other actions to minimize potential losses. All TDRs are modified loans; however, not all modified loans are TDRs.

The Company reviews its modified loans for TDR classification. When a borrower is granted extended time to pay and there are no other concessions as to rate reductions or principal, the loan remains an accrual loan. Certain time extensions based on the time value of money require reserves to be established despite no interruption on payments being made. In the case of a default, the loan becomes non-accrual and reviewed by committee for adequate specific reserves to that loan.

### ***SBA Loans Held For Sale***

For guaranteed portions funded, but not yet traded at each measurement date, management elected to fair value SBA loans held for sale within the fair value hierarchy that prioritizes observable and unobservable inputs used to measure fair value utilizing

---

**Table of Contents**

Level 2 assets. These inputs include debt securities with quoted prices that are traded less frequently than exchange-traded instruments or have values determined using a pricing model with inputs that are observable in the market. The secondary market for the guaranteed portions is extremely robust with broker dealers acting as primary dealers. NSBF sells regularly into the market and can quickly price its loans held for sale. The Company values the guaranteed portion based on observable market prices for similar assets.

Loans receivable held for sale are sold with the servicing rights retained by the Company. For loans funded prior to October 1, 2010, gains on sales of loans are recognized based on the difference between the selling price and the carrying value of the related loans sold. Unamortized net deferred loan origination costs are recognized as a component of gain on sale of loans. For loans funded on or after October 1, 2010, premium on loan sales is equal to the cash premium plus the fair value of the servicing asset while reversing the fair value gain previously recorded.

***Purchased Receivables***

For clients that are assessed fees based on a discount as well as for clients that are on a prime plus fee schedule, purchased receivables are recorded at the point in time when cash is released to the client. A majority of the receivables purchased with respect to prime plus arrangements are recourse and are sold back to the client if aged over 90 days, depending on contractual agreements. Purchased receivables are included in accounts receivable on the consolidated balance sheets.

***Investments in Qualified Businesses***

The various interests that the Company acquires in its qualified investments are accounted for under three methods: consolidation, equity method and cost method. The applicable accounting method is generally determined based on the Company's voting interest or the economics of the transaction if the investee is determined to be a variable interest entity.

*Consolidation Method.* Investments in which the Company directly or indirectly owns more than 50% of the outstanding voting securities, those the Company has effective control over, or those deemed to be a variable interest entity in which the Company is the primary beneficiary are generally accounted for under the consolidation method of accounting. Under this method, an investment's financial position and results of operations are reflected within the Company's condensed consolidated financial statements. All significant inter-company accounts and transactions are eliminated, including returns of principal, dividends, interest received and investment redemptions. The results of operations and cash flows of a consolidated operating entity are included through the latest interim period in which the Company owned a greater than 50% direct or indirect voting interest, exercised control over the entity for the entire interim period or was otherwise designated as the primary beneficiary. Upon dilution of control below 50%, or upon occurrence of a triggering event requiring reconsideration as to the primary beneficiary of a variable interest entity, the accounting method is adjusted to the equity or cost method of accounting, as appropriate, for subsequent periods.

*Equity Method.* Investments that are not consolidated, but over which the Company exercises significant influence, are accounted for under the equity method of accounting. Whether or not the Company exercises significant influence with respect to an investee depends on an evaluation of several factors including, among others, representation on the investee's Board of Directors and ownership level, which is generally a 20% to 50% interest in the voting securities of the investee, including voting rights associated with the Company's holdings in common, preferred and other convertible instruments in the investee. Under the equity method of accounting, an investee's accounts are not reflected within the Company's condensed consolidated financial statements; however, the Company's share of the earnings or losses of the investee is reflected in the Company's condensed consolidated financial statements.

*Cost Method.* Investments not accounted for under the consolidation or the equity method of accounting are accounted for under the cost method of accounting. Under this method, the Company's share of the net earnings or losses of such investments is not included in the Company's condensed consolidated financial statements. However, cost method impairment charges are recognized, as necessary, in the Company's condensed consolidated financial statements. If circumstances suggest that the value of the investee has subsequently recovered, such recovery is not recorded until ultimately liquidated or realized.

The Company's debt and equity investments have substantially been made with funds available to Newtek through the Capco programs. These programs generally require that each Capco meet a minimum investment benchmark within five years of initial funding. In addition, any funds received by a Capco as a result of a debt repayment or equity return may, under the terms of the Capco programs, be reinvested and counted towards the Capcos' minimum investment benchmarks.

### ***Securitization Activities***

NSBF engaged in securitization transactions of the unguaranteed portions of its SBA 7(a) loans in 2010, 2011 and 2013. Because the transfer of these assets did not meet the criteria of a sale for accounting purposes, it was treated as a secured borrowing. NSBF continues to recognize the assets of the secured borrowing in Loans held for investment and the associated financing in Notes payable on the consolidated balance sheets.

---

**Table of Contents*****Share - Based Compensation***

All share-based payments to employees are recognized in the financial statements based on their fair values using an option-pricing model at the date of grant. The Company recognizes compensation on a straight-line basis over the requisite service period for the entire award. The Company has elected to adopt the alternative transition method for calculating the tax effects of share-based compensation. The alternative transition method includes a simplified method to establish the beginning balance of the additional paid-in capital pool related to the tax effects of employee share-based compensation, which is available to absorb tax deficiencies.

***Fair Value***

ASC Topic 820 stipulates a fair value hierarchy based on whether the inputs to valuation techniques utilized to measure fair value are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect Company-based assumptions. The Company adopted the methods of fair value to value its financial assets and liabilities. The Company carries its credits in lieu of cash, prepaid insurance and notes payable in credits in lieu of cash at fair value, as well as its SBA loans held for investment and SBA loans held for sale. Fair value is based on the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In accordance with ASC Topic 820 and in order to increase consistency and comparability in fair value measurements, the Company utilized a fair value hierarchy that prioritizes observable and unobservable inputs used to measure fair value into three broad levels, which are described below:

- Level 1** Quoted prices in active markets for identical assets or liabilities. Level 1 assets and liabilities include debt and equity securities and derivative contracts that are traded in an active exchange market, as well as certain U.S. Treasury, other U.S. Government and agency mortgage-backed debt securities that are highly liquid and are actively traded in over-the-counter markets.
- Level 2** Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. Level 2 assets and liabilities include debt securities with quoted prices that are traded less frequently than exchange-traded instruments and derivative contracts whose value is determined using a pricing model with inputs that are observable in the market or can be derived principally from or corroborated by observable market data. This category generally includes certain U.S. Government and agency mortgage-backed debt securities, corporate debt securities, derivative contracts and residential mortgage loans held-for-sale.
- Level 3** Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation. This category generally includes certain private equity investments, retained residual interests in securitizations, residential mortgage servicing rights, and highly structured or long-term derivative contracts.

***Income Taxes***

Deferred tax assets and liabilities are computed based upon the differences between the financial statement and income tax basis of assets and liabilities using the enacted tax rates in effect for the year in which those temporary

differences are expected to be realized or settled. If available evidence suggests that it is more likely than not that some portion or all of the deferred tax assets will not be realized, a valuation allowance is required to reduce the deferred tax assets to the amount that is more likely than not to be realized.

The Company's U.S. Federal and state income tax returns prior to fiscal year 2010 are closed and management continually evaluates expiring statutes of limitations, audits, proposed settlements, changes in tax law and new authoritative rulings.

***Accounting for Uncertainty in Income Taxes***

The ultimate deductibility of positions taken or expected to be taken on tax returns is often uncertain. In order to recognize the benefits associated with a tax position taken (i.e., generally a deduction on a corporation's tax return), the entity must conclude that the ultimate allowability of the deduction is more likely than not. If the ultimate allowability of the tax position exceeds 50%



## **Table of Contents**

(i.e., it is more likely than not), the benefit associated with the position is recognized at the largest dollar amount that has more than a 50% likelihood of being realized upon ultimate settlement. Differences between tax positions taken in a tax return and recognized will generally result in (1) an increase in income taxes currently payable or a reduction in an income tax refund receivable or (2) an increase in a deferred tax liability or a decrease in a deferred tax asset, or both (1) and (2).

### ***Fair Value of Financial Instruments***

As required by the Financial Instruments Topic of the Financial Accounting Standards Board ( FASB ) ASC Topic 820, the estimated fair values of financial instruments must be disclosed. Excluding fixed assets, intangible assets, goodwill, and prepaid expenses and other assets (noted below), substantially all of the Company s assets and liabilities are considered financial instruments as defined under this standard. Fair value estimates are subjective in nature and are dependent on a number of significant assumptions associated with each instrument or group of similar instruments, including estimates of discount rates, risks associated with specific financial instruments, estimates of future cash flows and relevant available market information.

The carrying values of the following balance sheet items approximate their fair values primarily due to their liquidity and short-term or adjustable-yield nature:

Cash and cash equivalents

Restricted cash

Broker receivable

Accounts receivable

Notes payable

Accrued interest receivable (included in Prepaid expenses and other assets)

Accrued interest payable (included in Accounts payable, accrued expenses and other liabilities)

Accounts payable and accrued expenses

The carrying value of investments in Qualified Businesses (included in Prepaid expenses and other assets), Credits in lieu of cash and Notes payable in credits in lieu of cash as well as its SBA loans held for investment and SBA loans held for sale approximate fair value based on management s estimates.

### ***New Accounting Standards***

In January 2014, the FASB issued ASU 2014-04, *Receivables Troubled Debt Restructurings by Creditors: Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure* (a consensus of the FASB Emerging Issues Task Force). The update clarifies that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. The ASU is effective for fiscal years and interim periods beginning after December 15, 2014. The adoption of this ASU is not expected to have a significant impact on the Company's Consolidated Financial Statements or disclosures.

### **NOTE 3 FAIR VALUE MEASUREMENTS:**

#### **Fair Value Option Elections**

Effective January 1, 2008, the Company adopted fair value accounting concurrent with the election of the fair value option. The accounting standard relating to the fair value measurements clarifies the definition of fair value and describes methods available to appropriately measure fair value in accordance with GAAP. The accounting standard applies whenever other accounting standards require or permit fair value measurements. The accounting standard relating to the fair value option for financial assets and financial liabilities allows entities to irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and financial liabilities that are not otherwise required to be measured at fair value, with changes in fair value recognized in earnings as they occur. It also establishes presentation and disclosure requirements designed to improve comparability between entities that elect different measurement attributes for similar assets and liabilities.

On January 1, 2008, the Company elected the fair value option for valuing its Capcos credits in lieu of cash, notes payable in credits in lieu of cash and prepaid insurance.

**Table of Contents**

On October 1, 2010, the Company elected the fair value option for valuing its SBA 7(a) loans funded on or after that date which are included in SBA loans held for investment and SBA loans held for sale.

The Company elected the fair value option in order to reflect in its financial statements the assumptions that market participants use in evaluating these financial instruments.

**Assets and Liabilities Measured at Fair Value on a Recurring Basis:**

(In thousands):	Fair Value Measurements at March 31, 2014 Using:				Total Unrealized Gains and (Losses)
	Total	Level 1	Level 2	Level 3	
<b>Assets</b>					
Credits in lieu of cash	\$ 3,231	\$	\$ 3,231	\$	\$
SBA loans held for investment	87,670			87,670	(1,187)
SBA loans held for sale	3,924		3,924		(79)
<b>Total assets</b>	<b>\$ 94,825</b>	<b>\$</b>	<b>\$ 7,155</b>	<b>\$ 87,670</b>	<b>\$ (1,266)</b>
<b>Liabilities</b>					
Notes payable in credits in lieu of cash	\$ 3,231	\$	\$ 3,231	\$	\$ 1

**Assets and Liabilities Measured at Fair Value on a Recurring Basis:**

(In thousands):	Fair Value Measurements at December 31, 2013 Using:				Total Unrealized Gains and (Losses)
	Total	Level 1	Level 2	Level 3	
<b>Assets</b>					
Credits in lieu of cash	\$ 3,641	\$	\$ 3,641	\$	\$
SBA loans held for investment	78,951			78,951	(1,629)
SBA loans held for sale	4,734		4,734		403

Edgar Filing: NEWTEK BUSINESS SERVICES, INC. - Form 10-Q

Total assets	\$ 87,326	\$	\$ 8,375	\$ 78,951	\$ (1,226)
--------------	-----------	----	----------	-----------	------------

**Liabilities**

Notes payable in credits in lieu of cash	\$ 3,641	\$	\$ 3,641	\$	\$ 21
--	----------	----	----------	----	-------

Total liabilities	\$ 3,641	\$	\$ 3,641	\$	\$ 21
-------------------	----------	----	----------	----	-------

---

**Table of Contents**

***Fair value measurements:***

**Credits in lieu of cash and Notes payable in credits in lieu of cash**

The Company elected to account for both credits in lieu of cash and notes payable in credits in lieu of cash at fair value in order to reflect in its condensed consolidated financial statements the assumptions that market participants use in evaluating these financial instruments.

The Company's Capcos debt, enhanced by Chartis insurance, effectively bears the nonperformance risk of Chartis. The closest trading comparators are the debt of Chartis' parent, AIG. Therefore the Company calculates the fair value of both the credits in lieu of cash and notes payable in credits in lieu of cash using the yields of various AIG notes with similar maturities to each of the Company's respective Capcos debt (the Chartis Note Basket). The Company elected to discontinue utilizing AIG's 7.70% Series A-5 Junior Subordinated Debentures because those long maturity notes began to trade with characteristics of a preferred stock after AIG received financing from the United States Government. The Company considers the Chartis Note Basket a Level 2 input under fair value accounting, since it is a quoted yield for a similar liability that is traded in an active exchange market. The Company selected the Chartis Note Basket as the most representative of the nonperformance risk associated with the Capco notes because they are Chartis issued notes, are actively traded and because maturities match credits in lieu of cash and notes payable in credits in lieu of cash.

After calculating the fair value of both the credits in lieu of cash and notes payable in credits in lieu of cash, the Company compares their values. This calculation is done on a quarterly basis. Calculation differences primarily due to tax credit receipt versus delivery timing may cause the value of the credits in lieu of cash to differ from that of the notes payable in credits in lieu of cash. Because the credits in lieu of cash asset has the single purpose of paying the notes payable in credits in lieu of cash and has no other value to the Company, Newtek determined that the credits in lieu of cash should equal the notes payable in credits in lieu of cash.

On December 31, 2013, the yield on the Chartis Note Basket was 1.49%. As of March 31, 2014, the date the Company revalued the asset and liability, the yields on the Chartis notes averaged 1.63% reflecting changes in interest rates in the marketplace. This increase in yield increased both the fair value of the credits in lieu of cash and the fair value of the notes payable in credits in lieu of cash. The Company increased the value of the credits in lieu of cash to equal the value of the notes payable in credits in lieu of cash because the credits in lieu of cash can only be used to satisfy the liability and must equal the value of the notes payable in credits in lieu of cash at all times. For the three months ended March 31, 2014, the Company reported a gain of \$1,000.

On December 31, 2012, the yield on the Chartis Note Basket was 1.72%. As of March 31, 2013, the date the Company revalued the asset and liability, the yields on the Chartis notes averaged 1.80% reflecting changes in interest rates in the marketplace. This increase in yield increased both the fair value of the credits in lieu of cash and the fair value of the notes payable in credits in lieu of cash. The Company decreased the value of the credits in lieu of cash to equal the value of the notes payable in credits in lieu of cash because the credits in lieu of cash can only be used to satisfy the liability and must equal the value of the notes payable in credits in lieu of cash at all times. The net change in fair value reported in the Company's condensed consolidated statements of income for the three months ended March 31, 2013 was a gain of \$19,000.

Changes in the future yield of the Chartis Note Basket will result in changes to the fair values of the credits in lieu of cash and notes payable in credits in lieu of cash when calculated for future periods; these changes will be reported through the Company's condensed consolidated statements of income.

**SBA 7(a) Loans**

On October 1, 2010, the Company elected to utilize the fair value option for SBA 7(a) loans funded on or after that date. Management believed that doing so would promote its effort to both simplify and make more transparent its financial statements by better portraying the true economic value of this asset on its balance sheet and statement of income. NSBF originates, funds, and services government guaranteed loans under section 7(a) of the Small Business Act. The SBA does not fully guarantee the SBA 7(a) Loans: An SBA 7(a) Loan is bifurcated into a guaranteed portion and an unguaranteed portion, each accruing interest on the principal balance of such portion at a per annum rate in effect from time to time. NSBF originates variable interest loans, usually set at a fixed index to the Prime rate that resets quarterly. Primarily, NSBF has made SBA 7(a) loans carrying guarantees of 75% and 85%; from 2009 through early 2011 under a special program, most of the loans NSBF originated carried a guarantee of 90%. NSBF, both historically and as a matter of its business plan, sells the guaranteed portions via SBA Form 1086 into the secondary market when the guaranteed portion becomes available for sale upon the closing and fully funding of the SBA 7(a)

---

**Table of Contents**

loan and retains the unguaranteed portions. Management recognized that the economic value in the guaranteed portion did not inure to NSBF at the time of their sale but rather when the guaranty attached at origination; amortization accounting by its nature does not recognize this increase in value at the true time when it occurred. Under fair value, the value of the guarantee is recorded when it economically occurs at the point of the creation and funding of the loan, and is not delayed until the sale occurs. Contemporaneously, the value of the unguaranteed portion will also be determined to reflect the full, fair value of the loan.

Although the fair value election is for the entire SBA 7(a) loan, the Company primarily sells the guaranteed portions at the completion of funding. The need to record the fair value for the guaranteed portion of the loan will primarily occur when a guaranteed portion is not traded at period end ( SBA loans held for sale ). The unguaranteed portion retained is recorded under SBA loans held for investment.

***SBA Loans Held for Investment***

For loans that completed funding before October 1, 2010, SBA loans held for investment are reported at their outstanding unpaid principal balances adjusted for charge-offs, net deferred loan origination costs and the allowance for loan losses. For loans that completed funding on or after October 1, 2010, management elected to fair value SBA loans held for investment within the fair value hierarchy that prioritizes observable and unobservable inputs utilizing Level 3 unobservable inputs which reflect the Company's own expectations about the assumptions that market participants would use in pricing the asset (including assumptions about risk).

In determining the net change in fair value of loans held for investment for the three months ended March 31, 2014, the Company used a discounted cash flow model which incorporated a series of expected future cash flows for the performing SBA 7(a) loan portfolio, and discounts those cash flows at a market clearing yield of 5.38%. The key assumptions used in the model are considered unobservable inputs and include anticipated prepayment speeds, cumulative default rates, the cost of loan servicing, and Prime rate expectations. The Company used an assumed prepayment speed of 15% based on current market conditions and historical experience for the loan portfolio, against a prepayment curve developed from NSBF historical experience to calculate expected loan prepayments in a given year. Defaults are defined as any loan placed on non-accrual status as of March 31, 2014. The default rate, defined as the percent of loan balance that will enter final liquidation in a given year, was estimated to be 25%, and was derived from NSBF historical experience. The mix of NSBF's loan portfolio continues to shift from start-up businesses, to predominately originating to existing businesses. Our historical default and loss rates demonstrate that this particular segment (i.e. Existing Business) of our SBA loan portfolio continues to experience the lowest rate of defaults and ultimate losses over our nine year history of originating loans. When computing the cumulative default rate to be applied to the performing portfolio loan balances, the Company excluded the last three years of originations as those loans have not seasoned yet. The discounted cash flow resulted in a price equivalent of 93.97% of the par amount on our loans held for investment as of March 31, 2014.

If a loan measured at fair value is subsequently impaired, then the fair value of the loan is measured based on the present value of expected future cash flows discounted at the loan's market interest rate, or the fair value of the collateral if the loan is collateral dependent. The significant unobservable inputs used in the fair value measurement of the impaired loans involve management's judgment in the use of market data and third party estimates regarding collateral values. Such estimates are further discounted by 20% - 80% to reflect the cost of liquidating the various assets under collateral. Any subsequent increases or decreases in any of the inputs would result in a corresponding decrease or increase in the reserve for loan loss or fair value of SBA loans, depending on whether the loan was originated prior or subsequent to October 1, 2010. Because the loans bear interest at a variable rate, NSBF does not have to factor in interest rate risk.

Edgar Filing: NEWTEK BUSINESS SERVICES, INC. - Form 10-Q

Below is a summary of the activity in SBA loans held for investment, at fair value for the three months ended March 31, 2014 and the year ended December 31, 2013, respectively, (in thousands):

	<b>Three Months Ended March 31, 2014</b>	<b>Year Ended December 31, 2013</b>
Balance, beginning of period	\$ 78,951	\$ 43,055
SBA loans held for investment, originated	11,385	42,773
Loans transferred to other real estate owned		(362)
Payments received	(1,479)	(4,886)
Fair value loss	(1,187)	(1,629)
Balance, end of period	\$ 87,670	\$ 78,951



**Table of Contents****SBA Loans Held For Sale**

For guaranteed portions funded, but not yet traded at each measurement date, management elected to fair value SBA loans held for sale within the fair value hierarchy that prioritizes observable and unobservable inputs used to measure fair value utilizing Level 2 assets. These inputs include debt securities with quoted prices that are traded less frequently than exchange-traded instruments or have values determined using a pricing model with inputs that are observable in the market. The secondary market for the guaranteed portions is extremely robust with broker dealers acting as primary dealers. NSBF sells regularly into the market and can quickly price its loans for sale. The Company values the guaranteed portion based on market prices equal to the guaranteed loan amount plus a premium that includes both an upfront cash payment (utilizing quoted prices) and the value of a stream of payments representing servicing income received in excess of NSBF's servicing cost (valued using a pricing model with inputs that are observable in the market).

**Other Fair Value Measurements**

Assets Measured at Fair Value on a Non-recurring Basis are as follows (in thousands):

**Fair Value Measurements at March 31, 2014 Using:**

	<b>Total</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total Losses</b>
<b>Assets</b>					
Impaired loans	\$ 3,194	\$	\$	\$ 3,194	\$ (120)
Other real-estate owned	571		571		(20)
Total assets	\$ 3,765	\$	\$ 571	\$ 3,194	\$ (140)

**Fair Value Measurements at December 31, 2013 Using:**

	<b>Total</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total Losses</b>
<b>Assets</b>					
Impaired loans	\$ 3,441	\$	\$	\$ 3,441	\$ (1,022)
Other real-estate owned	798		798		(182)
Total assets	\$ 4,239	\$	\$ 798	\$ 3,441	\$ (1,204)

**Impaired loans**

Impairment of a loan is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate, or the fair value of the collateral less estimated liquidation costs if the loan is collateral dependent. Impaired loans for which the carrying amount is based on fair value of the underlying collateral are included in assets and balances include fair value measurements on a non-recurring basis, both at initial recognition of impairment and on an on-going basis until recovery or charge-off of the loan amount. The significant unobservable

inputs used in the fair value measurement of the impaired loans involve management's judgment in the use of market data and third party estimates regarding collateral values. Such estimates are further discounted by 20% - 80% to reflect the cost of liquidating the various assets under collateral. Valuations in the level of impaired loans and corresponding impairment affect the level of the reserve for loan losses. Any subsequent increases or decreases in any of the inputs would result in a corresponding decrease or increase in the reserve for loan loss or fair value of SBA loans, depending on whether the loan was originated prior or subsequent to October 1, 2010.

**Table of Contents****Other real-estate owned (included in Prepaid expenses and other assets)**

The estimated fair value of other real-estate owned is calculated using observable market information, including bids from prospective purchasers and pricing from similar market transactions where available. The value is generally discounted between 20-25% based on market valuations as well as expenses associated with securing the Company's interests. Where bid information is not available for a specific property, the valuation is principally based upon recent transaction prices for similar properties that have been sold. These comparable properties share comparable demographic characteristics. Other real estate owned is generally classified within Level 2 of the valuation hierarchy.

**NOTE 4 SBA LOANS:**

SBA loans are geographically concentrated in New York (13.16%). Below is a summary of the activity in the SBA loans held for investment, net of SBA loan loss reserves for the three months ended March 31, 2014 (in thousands):

Balance at December 31, 2013	\$ 89,640
SBA loans funded for investment	11,385
Fair value adjustment	(1,187)
Payments received	(2,159)
Provision for SBA loan losses	205
Discount on loan originations, net	23
<b>Balance at March 31, 2014</b>	<b>\$ 97,907</b>

Below is a summary of the activity in the reserve for loan losses, cost basis, for the three months ended March 31, 2014 (in thousands):

<b>Allowance for loan losses, cost basis:</b>	
Balance, beginning of year	\$ 1,811
Provision for loan losses	(205)
Loans charged-off	(59)
Recoveries	6
 Balance, end of year	 \$ 1,553
 Individually evaluated for impairment	 \$ 1,362
Collectively evaluated for impairment	191
 Balance, end of year	 \$ 1,553
 <b>Total loans, cost basis</b>	
Individually evaluated for impairment	\$ 3,195
Collectively evaluated for impairment	9,409

Balance, end of year	\$ 12,604
----------------------	-----------

Below is a summary of the activity in the SBA loans held for sale for the three months ended March 31, 2014 (in thousands):

Balance at December 31, 2013	\$ 4,734
Originations of SBA loans held for sale	34,224
Fair value adjustment	(79)
SBA loans sold	(34,955)
Balance at March 31, 2014	\$ 3,924

All loans are priced at the Prime interest rate plus approximately 2.75% to 3.75%. The only loans with a fixed interest rate are defaulted loans of which the guaranteed portion sold is repurchased from the secondary market by the SBA, while the unguaranteed portion of the loans still remains with the Company. As of March 31, 2014 and December 31, 2013, SBA loans receivable held for investment with adjustable interest rates amounted to \$99,399,000 and \$91,083,000, respectively.

**Table of Contents**

For the three months ended March 31, 2014 and 2013, the Company funded approximately \$45,680,000 and \$34,826,000 in loans and sold approximately \$34,955,000 and \$27,238,000 of the guaranteed portion of the loans, respectively. Receivables from loans traded but not settled of \$12,907,000 and \$13,606,000 as of March 31, 2014 and December 31, 2013, respectively, are presented as broker receivable in the accompanying condensed consolidated balance sheets.

The outstanding balances of loans past due over ninety days and still accruing interest as of March 31, 2014 was approximately \$843,000; there were no loans past due over ninety days and still accruing interest as of December 31, 2013.

At March 31, 2014 and December 31, 2013, total impaired loans amounted to \$7,371,000 and \$7,678,000, respectively. For the three months ended March 31, 2014 and for the year ended December 31, 2013, the average balance of impaired loans was \$7,559,000 and \$6,887,000, respectively, and approximately \$1,362,000 and \$1,609,000 in specific reserves included in the allowance for loan losses and \$618,000 and \$163,000 of SBA fair value discount were allocated against such impaired loans, respectively.

The following is a summary of SBA loans held for investment as of:

(in thousands):	March 31, 2014		December 31, 2013	
	Fair Value	Cost Basis	Fair Value	Cost Basis
Due in one year or less	\$	\$ 210	\$	\$ 319
Due between one and five years		4,404		4,509
Due after five years	93,894	7,990	83,988	8,513
Total	93,894	12,604	83,988	13,341
Less: Allowance for loan losses		(1,553)		(1,811)
Less: Deferred origination fees, net		(814)		(841)
Less: Fair value adjustment	(6,224)		(5,037)	
Balance (net)	\$ 87,670	\$ 10,237	\$ 78,951	\$ 10,689

The payment status of gross SBA loans held for investment is as follows:

Days Past Due	(in thousands)	
	March 31, 2014	December 31, 2013
Current	\$ 92,116	\$ 84,809
30 89	6,168	4,842
> 90	843	
Non-accrual	7,371	7,678
Balance (net)	\$ 106,498	\$ 97,329

The Company evaluates the credit quality of its loan portfolio by employing a risk rating system that is similar to the Uniform Classification System which is the asset classification system adopted by the Federal Financial Institution

Examinations Council. The Company's risk rating system is granular with multiple risk ratings in both the Acceptable and Substandard categories. Assignment of the ratings are predicated upon numerous factors, including credit risk scores, collateral type, loan to value ratios, industry, financial health of the business, payment history, other internal metrics/analysis, and qualitative assessments.

**Table of Contents**

Risk ratings are refreshed as appropriate based upon considerations such as market conditions, loan characteristics, and portfolio trends. The Company's gross SBA loans held for investment recorded at cost by credit quality indicator are as follows:

<b>Risk Rating</b>	<b>(in thousands)</b>	
	<b>March 31, 2014</b>	<b>December 31, 2013</b>
Acceptable	\$ 7,149	\$ 7,420
Other assets special mention	2,053	2,234
Substandard	3,141	3,283
Doubtful	252	395
Loss	9	9
Balance	\$ 12,604	\$ 13,341

The Company had loans renegotiated in troubled debt restructurings of \$3,381,000 as of March 31, 2014, of which \$1,477,000 was on non-accrual status and \$1,904,000 was on accrual status. As of December 31, 2013, there was approximately \$3,409,000 of loans renegotiated in trouble debt restructurings, of which \$1,332,000 was included in non-accrual loans and \$2,077,000 was on accrual status. The Company has no commitments to loan additional funds to borrowers whose existing loans have been modified in TDR.

An analysis of loans restructured in TDR for the periods ended March 31, 2014 and March 31, 2013, respectively, is as follows (in thousands):

<b>Type of Concession</b>	<b>March 31, 2014</b>		<b>March 31, 2013</b>	
	<b>Number of Notes</b>	<b>Principal Balance at Restructure Date</b>	<b>Number of Notes</b>	<b>Principal Balance at Restructure Date</b>
Payment reduction / Interest-only period	1	\$ 63	1	\$ 163

TDRs that return to a non-performing status post-modification are considered redefaulted loans and are treated in the same manner as other non-performing loans in the portfolio. For the period ended March 31, 2014, the Company had two TDR loans that subsequently defaulted with a corresponding principal balance of approximately \$134,000, and one loan that was subsequently charged-off with a corresponding principal balance of approximately \$ 24,000; for the period ended March 31, 2013, there were no TDR loans that subsequently defaulted or were charged-off.

**NOTE 5 SERVICING ASSETS:**

The Company reviews capitalized servicing assets for impairment. This review is performed based on risk strata, which are determined on a disaggregated basis given the predominant risk characteristics of the underlying loans. The predominant risk characteristics are loan terms and year of loan origination.

The following summarizes the activity pertaining to servicing assets for the three months ended March 31, 2014 (in thousands):

(in thousands):

Balance at December 31, 2013	\$ 6,776
Servicing rights capitalized	859
Servicing rights amortized	(348)
Balance at March 31, 2014	\$ 7,287

The carrying value of the capitalized servicing assets was \$7,287,000 and \$6,776,000 at March 31, 2014 and December 31, 2013, respectively, while the estimated fair value of capitalized servicing rights was \$8,649,000 and \$7,959,000 at March 31, 2014 and December 31, 2013, respectively. The estimated fair value of servicing assets at March 31, 2014 was determined using a discount factor that equates the present value of the expected servicing income to the strip multiple method valuation rate of 9%, weighted average prepayment speeds ranging from 5% to 13%, depending upon certain characteristics of the loan portfolio, weighted average life of 4.33 years, and an average default rate of 4.6%.

The estimated fair value of servicing assets at December 31, 2013 was determined using a discount factor that equates the present value of the expected servicing income to the strip multiple method valuation rate of 11%, weighted average prepayment speeds ranging from 0% to 11%, depending upon certain characteristics of the loan portfolio, weighted average life of 5.00 years, and an average default rate of 3%.



**Table of Contents**

The unpaid principal balances of loans serviced for others are not included in the accompanying condensed consolidated balance sheets. The unpaid principal balances of loans serviced for others within the NSBF originated portfolio were \$400,015,000 and \$372,366,000 as of March 31, 2014 and December 31, 2013, respectively. The unpaid principal balances of loans serviced for others which were not originated by NSBF and are outside of the Newtek portfolio were \$547,011,000 and \$561,092,000 as of March 31, 2014 and December 31, 2013, respectively.

**NOTE 6 NOTES PAYABLE AND CAPITAL LEASES:**

At March 31, 2014 and December 31, 2013, the Company had notes payable and capital leases comprised of the following (in thousands):

	<b>March 31, 2014</b>	<b>December 31, 2013</b>
Notes payable:		
Capital One lines of credit (NSBF)		
Guaranteed line	\$ 15,881	\$ 21,261
Unguaranteed line	5,872	4,691
Summit Partners Credit Advisors, L.P. (NBS)	8,740	8,650
Sterling National bank line of credit (NBC)	6,248	6,026
Capital One term loan (NTS)	486	590
Total notes payable	37,227	41,218
Note payable securitization trust DS)	57,786	60,140
Total notes payable	\$ 95,013	\$ 101,358
Capital lease obligation	\$ 585	\$ 642

**NOTE 7 STOCK OPTIONS AND RESTRICTED SHARES:**

The Company had three share-based compensation plans as of March 31, 2014 and 2013. For the three months ended March 31, 2014 and 2013, share-based compensation expense for those plans was \$158,000 and \$166,000, respectively, of which \$115,000 and \$136,000 are included in salaries and benefits, and \$43,000 and \$30,000 are included in other general and administrative costs for the three months ended March 31, 2014 and 2013, respectively. During the three months ended March 31, 2014, approximately 69,500 shares awarded under the plans were forfeited due to early termination or resignation by certain employees. The total forfeiture credit recognized for the three months ended March 31, 2014 was approximately \$66,000 and is included in share-based compensation expense.

During the third quarter of 2013, the Company granted certain employees an aggregate of 70,000 restricted shares of common stock valued at \$176,000 with 10,000 vesting on March 1, 2016 and 60,000 vesting on July 31, 2016. The fair value of these grants was determined using the fair value of the common shares at the grant date. The restricted shares are forfeitable upon early voluntary or involuntary termination of the employee's employment. Upon vesting, the grantee will receive one common share for each restricted share vested. Under the terms of the plan, these share awards do not include voting rights until the shares vest. The Company recorded \$13,000 to share-based compensation for the three months ended March 31, 2014 in connection with the vesting period associated with grants

that remain outstanding.

During the second quarter of 2013, the Company granted certain employees and executives an aggregate of 80,000 restricted shares of common stock valued at \$174,000 with a vesting date of March 1, 2016. The fair value of these grants was determined using the fair value of the common shares at the grant date. The restricted shares are forfeitable upon early voluntary or involuntary termination of the employee's employment. Upon vesting, the grantee will receive one common share for each restricted share vested. Under the terms of the plan, these share awards do not include voting rights until the shares vest. The Company recorded \$2,000 to share-based compensation for the three months ended March 31, 2014 in connection with the vesting period associated with grants that remain outstanding.

**Table of Contents**

During the first quarter of 2013, the Company granted certain employees, executives and directors an aggregate of 300,000 restricted shares of common stock valued at \$556,000. The employee and executive grants have a vesting date of March 1, 2016 while the directors vest July 1, 2015. The fair value of these grants was determined using the fair value of the common shares at the grant date. The restricted shares are forfeitable upon early voluntary or involuntary termination of the employee's employment. Upon vesting, the grantee will receive one common share for each restricted share vested. Under the terms of the plan, these share awards do not include voting rights until the shares vest. The Company recorded \$47,000 to share-based compensation for the three months ended March 31, 2014 in connection with the vesting period associated with grants that remain outstanding.

In the second quarter of 2012, Newtek granted certain employees and executives an aggregate of 123,000 restricted shares valued at \$184,000. The grants vest on July 1, 2014. The fair value of these grants was determined using the fair value of the common shares at the grant date. The restricted shares are forfeitable upon early voluntary or involuntary termination of the employee. Upon vesting, the grantee will receive one common share for each restricted share vested. Under the terms of the plan, these share awards do not include voting rights until the shares vest. The Company recorded \$13,000 to share-based compensation for the three months ended March 31, 2014 in connection with the vesting period associated with grants that remain outstanding.

In March 2011, Newtek granted certain employees, executives and board of directors an aggregate of 1,142,000 shares of restricted stock valued at \$1,941,000 or \$1.70 per share. The fair value of these grants was determined using the fair value of the common shares at the grant date. The restricted shares are forfeitable upon early voluntary or involuntary termination of the employee. Upon vesting, the grantee will receive one common share for each restricted share vested. Under the terms of the plan, these share awards do not include voting rights until the shares vest. The grants are valued using the straight-line method and vest on July 1, 2014. The Company recorded \$87,000 to share-based compensation for the three months ended March 31, 2014 in connection with the vesting period associated with grants that remain outstanding.

**NOTE 8 INCOME PER SHARE:**

Basic income per share is computed based on the weighted average number of common shares outstanding during the period. The effect of common share equivalents is included in the calculation of diluted loss per share only when the effect of their inclusion would be dilutive.

The calculations of income per share were:

<b>(In thousands except per share data):</b>	<b>Three months ended March 31:</b>	
	<b>2014</b>	<b>2013</b>
Numerator for basic and diluted EPS income available to common shareholders	\$ 1,391	\$ 1,452
Denominator for basic EPS weighted average shares	35,432	35,218
Effect of dilutive securities	2,954	2,518
Denominator for diluted EPS weighted average shares	38,386	37,736

Earnings per share: Basic and Diluted	\$ 0.04	\$ 0.04
---------------------------------------	---------	---------

The amount of anti-dilutive shares/units excluded from above is as follows:

Stock options and restricted shares		
Warrants		50
Contingently issuable shares	83	83

**NOTE 9 COMMITMENTS AND CONTINGENCIES:**

In the ordinary course of business and from time to time, we are named as a defendant in various legal proceedings. The Company evaluates such matters on a case by case basis and its policy is to contest vigorously any claims it believes are without compelling merit.

## **Table of Contents**

We recognize a liability for a contingency in accrued expenses and other liabilities when it is probable that a liability has been incurred and the amount of loss can be reasonably estimated. If the reasonable estimate of a probable loss is a range, we accrue the most likely amount of such loss, and if such amount is not determinable, then we accrue the minimum in the range as the loss accrual. The determination of the outcome and loss estimates requires significant judgment on the part of management.

The Company is currently involved in various contract claims and litigation matters. In addition, and as fully described in Item 1. Legal Proceedings, during the quarter ended June 30, 2013 the Federal Trade Commission amended an existing complaint in the matter Federal Trade Commission v. WV Universal Management, LLC et al. to include Universal Processing Services of Wisconsin, LLC ( UPS ), the Company's merchant processing subsidiary, as an additional defendant on one count. The Company does not believe that the facts or the FTC's legal theory support the FTC's allegations against UPS as set forth in the complaint, and the Company intends to vigorously challenge the FTC's claims. As such, we have not established a loss contingency for this matter.

In May 2013, Data Processing Service of Georgia, Inc. ( DPS ), the automated clearing house provider used by the Company's payroll processing subsidiary, PMT Payroll, LLC ( PMT ), ceased processing payments which resulted in the inability or refusal of DPS's processing bank, Bancorp Bank ( Bancorp ), to send the corresponding credits to PMT's customers' employees. The total amount debited from PMT's customer accounts and unsuccessfully credited to its customers' employees was approximately \$1,318,000. Upon learning of this failure, PMT and the Company immediately paid all funds owing directly to any of its affected customers' employees. Of this amount, the Company has successfully recovered approximately \$800,000 to date. On June 22, 2013, Bancorp filed an Interpleader Complaint in the United States District Court for the District of Delaware (the Court ) and deposited with the Court \$247,925.36, the balance remaining in the DPS settlement account maintained at Bancorp. Bancorp named as defendants PMT and the other payroll companies, and their clients, who Bancorp has alleged may have claims to the funds on deposit with the Court. On October 22, 2013, Bancorp Bank filed its Amended Interpleader Complaint. On December 20, 2013, PMT answered the Amended Interpleader Complaint and asserted cross-claims against DPS for breach of contract and conversion and counterclaims against Bancorp for aiding and abetting DPS's wrongful conduct. The Company is vigorously pursuing its claims against Bancorp and DPS, and believes it is reasonably possible a loss may occur if the Company is unsuccessful in the action. While such a loss is possible, the Company does not believe that it is probable or that the amount can be estimated at this time.

On January 21, 2014, NCMIC Finance Corporation ( NCMIC ) filed a complaint against Universal Processing Services of Wisconsin, LLC ( UPS ), the Company's merchant processing subsidiary, in the United States District Court for the Southern District of Iowa. The Complaint asserts claims against UPS for breach of the UPS and NCMIC agreement for the processing of credit card transactions, and seeks monetary relief. The Company believes that the claims asserted in the complaint are wholly without merit and intends to vigorously defend the action.

Management has determined that, in the aggregate, the pending legal actions should not have a material adverse effect on our consolidated results of operations, cash flows or financial condition. In addition, we believe that any amount that could be reasonably estimated of potential loss or range of potential loss is not material.

### **NOTE 10 SEGMENT REPORTING:**

Operating segments are organized internally primarily by the type of services provided. The Company has aggregated similar operating segments into six reportable segments: Electronic payment processing, Small business finance, Managed technology solutions, All other, Corporate and Capcos.

The Electronic payment processing segment is a processor of credit card transactions, as well as a marketer of credit card and check approval services to the small- and medium-sized business market. Expenses include direct costs (included in a separate line captioned electronic payment processing costs), salaries and benefits, and other general and administrative costs all of which are included in the respective caption on the condensed consolidated statements of income.

The Small business finance segment consists of Small Business Lending, Inc., a lender that primarily originates, sells and services government guaranteed SBA 7(a) loans to qualifying small businesses through NSBF, its licensed SBA lender; the Texas Whitestone Group which manages the Company's Texas Capco; and NBC which provides accounts receivable financing, billing and accounts receivable maintenance services to businesses. NSBF generates revenues from sales of loans, servicing income for those loans retained or contracted to service by NSBF and interest income earned on the loans themselves. The lender generates expenses for interest, salaries and benefits, depreciation and amortization, and provision for loan losses, all of which are included in the respective caption on the condensed consolidated statements of income. NSBF also has expenses such as loan recovery expenses, loan processing costs, professional fees, and other expenses that are all included in the other general and administrative costs caption on the condensed consolidated statements of income.

The Managed technology solutions segment consists of NTS, acquired in July 2004. NTS's revenues are derived primarily from web hosting services and consist of web hosting and set up fees. NTS generates expenses such as salaries and benefits, and depreciation and amortization, which are included in the respective caption on the accompanying condensed consolidated statements of income, as well as professional fees, licenses and fees, rent, and general office expenses, all of which are included in other general and administrative costs in the respective caption on the condensed consolidated statements of income.

The All other segment includes revenues and expenses primarily from qualified businesses that received investments made through the Company's Capcos which cannot be aggregated with other operating segments. The two largest entities in the segment are Newtek Insurance Agency, LLC, an insurance sales operation, and Business Connect, LLC, a provider of sales and processing services. Also included in this segment are: Newtek Payroll Services, a provider of payroll management, payment and tax reporting services, Exponential of New York, LLC, and Advanced Cyber Security Systems, LLC, ( ACS ), a start-up company formed to offer web-based security solutions to the marketplace.

**Table of Contents**

Corporate activities represent revenue and expenses not allocated to our segments. Revenue includes interest income and management fees earned from Capcos (and included in expenses in the Capco segment). Expenses primarily include corporate operations related to broad-based sales and marketing, legal, finance, information technology, corporate development and additional costs associated with administering the Capcos.

The Capco segment, which consists of the twelve Capcos, generates non-cash income from tax credits, interest income and gains from investments in qualified businesses which are included in other income. Expenses primarily include non-cash interest and insurance expense, management fees paid to Newtek (and included in the Corporate activities revenues), legal, and auditing fees and losses from investments in qualified businesses.

Management has considered the following characteristics when making its determination of its operating and reportable segments:

the nature of the product and services;

the type or class of customer for their products and services;

the methods used to distribute their products or provide their services; and

the nature of the regulatory environment (for example, banking, insurance, or public utilities).

**Table of Contents**

The accounting policies of the segments are the same as those described in the summary of significant accounting policies.

The following table presents the Company's segment information for the periods ended March 31, 2014 and 2013 and total assets as of March 31, 2014 and December 31, 2013 (in thousands):

	<b>For the three months ended March 31, 2014</b>	<b>For the three months ended March 31, 2013</b>
<b>Third Party Revenue</b>		
Electronic payment processing	\$ 21,528	\$ 21,679
Small business finance	10,038	7,449
Managed technology solutions	4,056	4,394
All other	576	646
Corporate activities	199	200
Capcos	104	50
<b>Total reportable segments</b>	<b>36,501</b>	<b>34,418</b>
Eliminations	(414)	(274)
<b>Consolidated Total</b>	<b>\$ 36,087</b>	<b>\$ 34,144</b>
<b>Inter-Segment Revenue</b>		
Electronic payment processing	\$ 907	\$ 724
Small business finance	155	126
Managed technology solutions	145	147
All other	428	446
Corporate activities	1,001	1,004
Capcos	190	204
<b>Total reportable segments</b>	<b>2,826</b>	<b>2,651</b>
Eliminations	(2,826)	(2,651)
<b>Consolidated Total</b>	<b>\$</b>	<b>\$</b>
<b>Income (loss) before income taxes</b>		
Electronic payment processing	\$ 1,718	\$ 1,835
Small business finance	2,691	2,175
Managed technology solutions	751	896
All other	(399)	(462)
Corporate activities	(2,187)	(1,956)
Capcos	(271)	(286)



<b>Total reportable segments</b>	2,303	2,202
<b>Eliminations</b>	(87)	( )

<b>Totals</b>	\$ 2,216	\$ 2,202
---------------	----------	----------

<b>Depreciation and amortization</b>		
--------------------------------------	--	--

Electronic payment processing	\$ 61	\$ 113
Small business finance	369	271
Managed technology solutions	337	326
All other	51	51
Corporate activities	37	45
Capcos		1

<b>Totals</b>	\$ 855	\$ 807
---------------	--------	--------

**Table of Contents**

	<b>As of March 31, 2014</b>	<b>As of December 31, 2013</b>
<b>Identifiable assets</b>		
Electronic payment processing	\$ 8,697	\$ 9,060
Small business finance	152,324	156,444
Managed technology solutions	12,234	12,027
All other	3,733	3,828
Corporate activities	8,156	9,357
Capco	7,304	7,896
<b>Consolidated Total</b>	<b>\$ 192,448</b>	<b>\$ 198,612</b>

---

**Table of Contents**

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

**Introduction and Certain Cautionary Statements**

*The following discussion and analysis of our financial condition and results of operations is intended to assist in the understanding and assessment of significant changes and trends related to the results of operations and financial position of the Company together with its subsidiaries. This discussion and analysis should be read in conjunction with the condensed consolidated financial statements and the accompanying notes.*

*The statements in this Quarterly Report on Form 10-Q may contain forward-looking statements relating to such matters as anticipated future financial performance, business prospects, legislative developments and similar matters. The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements. In order to comply with the terms of the safe harbor, we note that a variety of factors could cause our actual results to differ materially from the anticipated results expressed in the forward-looking statements such as intensified competition and/or operating problems in its operating business projects and their impact on revenues and profit margins or additional factors as described in the Company's Annual Report on Form 10-K.*

*Our Capcos operate under a different set of rules in each of the six jurisdictions which place varying requirements on the structure of our investments. In some cases, particularly in Louisiana, we don't control the equity or management of a qualified business but that cannot always be presented orally or in written presentations.*

**Executive Overview**

For the quarter ended March 31, 2014, the Company reported income before income taxes of \$2,216,000, which was essentially unchanged from the \$2,202,000 reported for the same quarter of 2013. Net income decreased by \$61,000 to \$1,391,000 in the first quarter of 2014 from \$1,452,000 in the year ago quarter. Total revenues increased by \$1,943,000 to \$36,087,000 from \$34,144,000 for the quarter ended March 31, 2014 compared with the same period in 2013, due primarily to the increased revenues in the Small business finance segment.

In Electronic payment processing, the segment had a decrease in revenue primarily due to a reduction in the average number of merchants, as well as a reduction in the average dollar volume per transaction. EPP margin also decreased from 15.7% to 14.8% due in part to competitive pricing as well as a reduction in the mix of merchant sales volumes recorded in the current quarter. Net income before taxes decreased by 6% to \$1,718,000 for the three months ended March 31, 2014 compared with the year ago quarter.

In the Small business finance segment, the SBA lender expanded its total volume of loan originations growing the total amount funded by \$10,854,000, a 31% increase over the year ago period, and the aggregate servicing portfolio increased by 96% compared with the year ago period. In the current quarter, our external servicing portfolio increased by 227% to \$547,279,000, and the NSBF originated portfolio increased by 38% to \$521,460,000, bringing our aggregate portfolio to over \$1 billion at March 31, 2014. Total servicing fee income increased by 80% and totaled \$2,625,000 for the three months ended March 31, 2014. Interest income also increased by \$550,000 as a result of the average outstanding performing portfolio of SBA loans held for investment, which increased by \$34,518,000 over the same quarter of 2013. Overall, the lending segment reported \$2,691,000 in income before taxes for the first quarter of 2014, a 24% increase compared with the three months ended March 31, 2013.

Managed technology solutions segment revenue decreased by 8% to \$4,056,000 for the three months ended March 31, 2014, a \$338,000 decrease in web hosting and web design revenue compared with the same quarter in 2013. Total expenses decreased by 6% primarily in other general and administrative costs, resulting in a \$145,000 decrease in

income before taxes between quarters.

In the All other segment, total revenue decreased by 11% for the quarter ended March 31, 2014 compared with the same period in 2013, due primarily to a decrease in insurance commission revenue. Reductions in salaries and benefits, as well as other general and administrative costs in this segment offset the decrease in revenue and resulted in a \$63,000 improvement in loss before income taxes for the quarter over quarter period. The loss before income taxes in the Corporate segment increased by 12% to \$2,187,000, due primarily to an increase in marketing expense in connection with the Company's television ad campaign, and the loss in the Capco segment had a modest improvement decreasing by 5% to \$271,000 for the three months ended March 31, 2014.

On October 1, 2013, the company filed a Form N-2 Registration Statement with the Securities and Exchange Commission. The Company's intention is to file an election to be regulated as a Business Development Company ( BDC ) under the Investment Company Act of 1940 prior to the completion of an offering, and intends to operate subsequently as an internally managed, non-diversified closed-end investment company. The Company also intends to elect to be treated as a Regulated Investment Company

**Table of Contents**

( RIC ) under Subchapter M of the Internal Revenue Code (the Code ) for U.S. federal income tax purposes. We intend to use the net proceeds of the offering primarily to expand our small to medium-sized business, ( SMB ) lending, make direct investments in portfolio companies in accordance with our investment objectives and strategies described in the prospectus, and for general corporate purposes. We believe that transitioning to a BDC and RIC will provide us with access to lower-cost capital and a business structure conducive to expanding our lending activities and will assist in maximizing our value to shareholders by, among other things, permitting us to value our assets and controlled portfolio companies at fair value. As a BDC, we will seek to generate both current income and capital appreciation primarily through loans originated by our small business finance platform and our equity investments in certain portfolio companies that we control. While our primary investment focus as a BDC will continue to be making loans and providing business services to the SMB market through our controlled portfolio companies, we may also make opportunistic investments in larger or smaller companies. We expect to continue to grow our business organically, both directly and through our controlled portfolio companies, as we have historically. The Company has filed amendments to the Registration Statement, and the related Proxy-Prospectus on Form N-14, in response to comments received from staff of the SEC and is continuing to pursue this course of action.

**Table of Contents****Business Segment Results:**

The results of the Company's reportable segments for the three months ended March 31, 2014 and 2013 are discussed below:

**Electronic Payment Processing**

<b>(In thousands):</b>	<b>Three months ended March 31:</b>		<b>\$ Change</b>	<b>% Change</b>
	<b>2014</b>	<b>2013</b>		
<b>Revenue:</b>				
Electronic payment processing	\$ 21,528	\$ 21,677	\$ (149)	(1)%
Interest income		2	(2)	(100)%
<b>Total revenue</b>	<b>21,528</b>	<b>21,679</b>	<b>(151)</b>	<b>(1)%</b>
<b>Expenses:</b>				
Electronic payment processing costs	18,350	18,272	78	%
Salaries and benefits	937	982	(45)	(5)%
Professional fees	116	147	(31)	(21)%
Depreciation and amortization	61	113	(52)	(46)%
Insurance expense related party	12	12		%
Other general and administrative costs	334	318	16	5%
<b>Total expenses</b>	<b>19,810</b>	<b>19,844</b>	<b>(34)</b>	<b>%</b>
<b>Income before income taxes</b>	<b>\$ 1,718</b>	<b>\$ 1,835</b>	<b>\$ (117)</b>	<b>(6)%</b>

Electronic payment processing ( EPP ) segment revenue decreased \$149,000 or 1% between years. Revenue decreased primarily due to a 1% reduction in the average number of merchants, as well as a 1% reduction in average dollar value per MasterCard/Visa transaction and a 2% reduction in an average discount income per MasterCard/Visa transaction processing between years. This was partially offset by a 2% increase in MasterCard/Visa processing volume between years due to the growth in processing volumes from existing merchants.

EPP costs increased \$78,000 or less than 1% between years. Processing revenues less electronic payment processing costs ( margin ) decreased from 15.7% in 2013 to 14.8% in 2014. Margin decreased due to both competitive pricing considerations, particularly for larger processing volume merchants, and the mix of merchant sales volumes realized between periods.

Excluding electronic payment processing costs, other expenses decreased \$112,000 or 7% between years. Depreciation and amortization decreased \$52,000 between periods as the result of previously acquired portfolio intangible assets becoming fully amortized between periods. Payroll related costs decreased by \$45,000 principally as a result of a salaries being capitalized for internally developed software. Professional fees decreased by \$31,000 principally due to legal fees incurred related to remediation expenses incurred in the 2013 period in connection with a chargeback loss.

Income before income taxes decreased \$117,000 to \$1,718,000 in 2014 from \$1,835,000 in 2013. The decrease in income before income taxes was principally due to the decrease in the margin (operating revenues less electronic payment processing costs) of \$227,000 due to the reasons noted above, partially offset by the reduction in payroll related costs, professional fees and depreciation and amortization between years.

**Table of Contents****Small Business Finance**

(In thousands):	Three months ended March 31:			
	2014	2013	\$ Change	% Change
<b>Revenue:</b>				
Premium income	\$ 5,137	\$ 4,259	\$ 878	21%
Servicing fee NSBF portfolio	832	614	218	36%
Servicing fee external portfolio	1,793	847	946	112%
Interest income	1,558	1,008	550	55%
Other income	718	721	(3)	%
<b>Total revenue</b>	<b>10,038</b>	<b>7,449</b>	<b>2,589</b>	<b>35%</b>
<b>Net change in fair value of:</b>				
SBA loans held for sale	(79)	255	(334)	(131)%
SBA loans held for investment	(1,187)	(631)	(556)	(88)%
<b>Total net change in fair value</b>	<b>(1,266)</b>	<b>(376)</b>	<b>(890)</b>	<b>(237)%</b>
<b>Expenses:</b>				
Salaries and benefits	2,266	1,805	461	26%
Interest	1,585	1,217	368	30%
Professional fees	254	305	(51)	(17)%
Depreciation and amortization	369	271	98	36%
Provision for loan losses	(207)	118	(325)	(275)%
Insurance expense related party	60	47	13	28%
Other general and administrative costs	1,754	1,135	619	55%
<b>Total expenses</b>	<b>6,081</b>	<b>4,898</b>	<b>1,183</b>	<b>24%</b>
<b>Income before income taxes</b>	<b>\$ 2,691</b>	<b>\$ 2,175</b>	<b>\$ 516</b>	<b>24%</b>

**Business Overview**

The Small business finance segment is comprised of NSBF which is a non-bank SBA lender that originates, sells and services loans for its own portfolio as well as portfolios of other institutions, and NBC which provides accounts receivable financing and billing services to businesses. Revenue is derived primarily from premium income generated by the sale of the guaranteed portions of SBA loans, interest income on SBA loans held for investment and held for sale, servicing fee income on the guaranteed portions of SBA loans sold, servicing income for loans originated by other lenders for which NSBF is the servicer, and financing and billing services, classified as other income above, provided by NBC. Most SBA loans originated by NSBF charge an interest rate equal to the Prime rate plus an additional percentage amount; the interest rate resets to the current Prime rate on a monthly or quarterly basis, which will result in changes to the amount of interest accrued for that month and going forward and a re-amortization of a loan's payment amount until maturity.



## **Accounting Policy**

On October 1, 2010, the Company elected to utilize the fair value option for SBA 7(a) loans funded on or after that date. For these fair value loans, premium on loan sales equals the cash premium and the value of the servicing asset paid by the purchaser in the secondary market, the discount created on the unguaranteed portion from the sale which formerly reduced premium income is now included in the fair value line item, and, by not capitalizing various transaction expenses, the salaries and benefits and loan processing expense lines portray a value closer to the cash cost to operate the lending business. The Company uses a discounted cash flow model to measure the fair value of performing loans held for investment. If a loan measured at fair value is subsequently impaired, then the fair value of the loan is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate, or the fair value of the collateral if the loan is collateral dependent. The significant

**Table of Contents**

unobservable inputs used in the fair value measurement of the impaired loans involve management's judgment in the use of market data and third party estimates regarding collateral values. Such estimates are further discounted by 20% - 80% to reflect the cost of liquidating the various assets under collateral. Any subsequent increases or decreases in any of the inputs would result in a corresponding decrease or increase in the reserve for loan loss or fair value of SBA loans, depending on whether the loan was originated prior or subsequent to October 1, 2010. Because the loans bear interest at a variable rate, NSBF does not have to factor in interest rate risk.

Consideration in arriving at the provision for loan loss includes past and current loss experience, current portfolio composition, future estimated cash flows, and the evaluation of real estate and other collateral, as well as current economic conditions. For all loans originated on or prior to September 30, 2010, management performed a loan-by-loan review of the estimated uncollectible portion of non-performing loans; subsequent to September 30, 2010, management began recording all loan originations on a fair value basis which requires a valuation reduction of the unguaranteed portion of loans held for investment to a level that takes into consideration future losses. This valuation reduction is reflected in the line item above: Net Change in Fair Value of SBA Loans Held for Investment

**Small Business Finance Summary**

<b>(In thousands):</b>	<b>Three months ended March 31, 2014</b>		<b>Three months ended March 31, 2013</b>	
	<b># Loans</b>	<b>\$0,000</b>	<b># Loans</b>	<b>\$0,000</b>
Loans sold in the quarter	43	\$ 34,955	34	\$ 25,111
Loans originated in the quarter	49	\$ 45,680	35	\$ 34,826
Premium income recognized		\$ 5,137		\$ 4,259
Average sale price as a percent of principal balance (1)		112.24%		114.03%

(1) Premiums greater than 110.00% must be split 50/50 with the SBA. The premium income recognized above reflects amounts net of split with the SBA.

For the three months ended March 31, 2014, the Company recognized \$5,137,000 of premium income from 43 loans sold aggregating \$34,955,000 as compared with \$4,259,000 of premium income from 34 loans sold aggregating \$25,111,000 for the three months ended March 31, 2013. Premiums on guaranteed loan sales averaged 112.24% with a 1% servicing fee for the quarter ended March 31, 2014 compared with 114.03% with a 1% servicing fee for the quarter ended March 31, 2013.

<b>(In thousands):</b>	<b>Three months ended March 31:</b>			
	<b>2014</b>	<b>2013</b>	<b>\$ Change</b>	<b>% Change</b>
Total NSBF originated servicing portfolio (1)	\$ 521,460	\$ 379,157	\$ 142,303	38%
Third party servicing portfolio	547,279	167,225	380,054	227%
Aggregate servicing portfolio	\$ 1,068,739	\$ 546,382	\$ 522,357	96%

Total servicing income earned - NSBF portfolio	\$	832	\$	614	\$	218	36%
Total servicing income earned - external portfolio		1,793		847		946	112%
Total servicing income earned	\$	2,625	\$	1,461	\$	1,164	80%

(1) Of this amount, total average NSBF originated portfolio earning servicing income was \$383,021,000 and \$277,750,000 for the three month period ended March 31, 2014 and 2013, respectively.

We are the contractor managing and servicing portfolios of SBA 7(a), USDA and other loans acquired by the FDIC from failed financial institutions, and we assist the FDIC in the packaging of these loans for sale. Our existing servicing facilities and

---

**Table of Contents**

personnel perform these activities supplemented by contract workers as needed. The size of the portfolio we will service for the FDIC, and thus the revenue earned, varies and depends on the level of bank failures and the needs of the FDIC in managing portfolios acquired from those banks as well as the success of being able to sell such portfolios. We continued to add third party loan servicing contracts in 2014, for both the FDIC and other third parties.

The \$1,164,000 increase in total servicing income was attributable primarily to the increase in FDIC servicing income of \$884,000 as a result of the addition in November 2013 of an additional portfolio, which we service for the FDIC as well as the addition of other third party loan servicing contracts which added an additional \$62,000 of income period over period. The average third party servicing portfolio increased from \$169,356,000 for the three month period ended March 31, 2013 to \$548,086,000 for the same three month period in 2014. Servicing fees received on the NSBF portfolio increased by \$218,000 period over period and was attributable to the expansion of the NSBF originated portfolio in which we earn servicing income. The portfolio increased from an average of \$277,750,000 for the three month period ending March 31, 2013 to an average of \$383,021,000 for the same three month period in 2014. This increase was the direct result of increased loan originations throughout 2013 and into 2014.

Interest income increased by \$550,000 for the three month period ended March 31, 2014 as compared to the same period in 2013. This increase was attributable to the average outstanding performing portfolio of SBA loans held for investment increasing from \$59,723,000 to \$94,241,000 for the quarters ended March 31, 2013 and 2014, respectively.

The change in fair value associated with SBA loans held for sale of \$334,000 is related to the amount of unsold guaranteed loans during a period, the timing of when those loans sell and the change in premium being received on those loans. The amount of unsold guaranteed loans decreased by \$731,000 at March 31, 2014 compared with December 31, 2013, while there was an increase of \$1,767,000 in unsold guaranteed loans at March 31, 2013 compared to December 31, 2012.

The increase in the change in fair value on SBA loans held for investment of \$556,000 is the result of the increased amount of unguaranteed loans originated period over period, as well as an increase of \$388,000 due to reclassification of allowance for loan losses to fair value discount. Loans originated, held for investment aggregated \$11,385,000 compared to \$7,588,000 for the quarters ended March 31, 2014 and 2013, respectively. During 2013, we applied a discounted cash flow methodology resulting in a decrease in the valuation adjustment applied of 7.5% of total principal as of March 31, 2013, to 6.03% of total principal as of March 31, 2014.

Salaries and benefits increased by \$461,000 primarily due to the addition of staff in all departments. Combined headcount increased by 39% from 69 employees at March 31, 2013 to 96 employees at March 31, 2014.

Interest expense increased by \$368,000 for the quarter ended March 31, 2014 compared with the same period in 2013. NSBF experienced an increase in interest expense of \$414,000 in connection with the closing of the 2013 securitization transactions in March and December 2013 offset by a decrease of \$30,000 related to the Capital One line of credit which increased from an average outstanding balance of \$14,855,000 for the quarter ended March 31, 2013 to \$15,323,000 for the same period in 2014. NBC experienced a decrease in interest expense of \$24,000 as average borrowings under the Sterling credit facility declined from \$7,800,000 to \$6,013,000.

Professional fees for the quarter ended March 31, 2014 decreased by \$51,000 when compared with the quarter ended March 31, 2013, primarily due to a decrease in accounting fees of \$76,000. These decreases were offset by an increase in servicer trustee fees of \$32,000.



**Table of Contents****Loan Loss Reserves and Fair Value Discount**

(In thousands):	Three months ended March 31:		\$ Change	% Change
	2014	2013		
Total reserves and discount, beginning of period	\$ 6,822	\$ 6,092	\$ 730	12%
Provision for loan loss	(207)	118	(325)	(275)%
Discount, loans held for investment at fair value	1,187	631	556	88%
Charge offs, Net	(53)	(535)	482	90%
Total reserves and discount, end of period	\$ 7,749	\$ 6,306	\$ 1,443	23%
Gross portfolio balance, end of period	\$ 106,413	\$ 70,371	\$ 36,042	51%
Total impaired nonaccrual loans, end of period	\$ 7,345	\$ 7,031	\$ 314	4%

The combined provision for loan loss and net change in fair value of loans held for investment increased from \$749,000 for the three months ended March 31, 2013 to \$980,000 for the same period in 2014, a net increase of \$231,000. The allowance for loan loss, together with the cumulative fair value adjustment related to the SBA loans held for investment, increased from \$6,306,000, or 9.0% of the gross portfolio balance of \$70,371,000 at March 31, 2013, to \$7,749,000, or 7.3% of the gross portfolio balance of \$106,413,000 at March 31, 2014. Of this, \$2,070,000 or 29.4% and \$1,952,000 or 26.6% of the allowance for loan losses and fair value discount was allocated as specific reserve against such impaired non-accrual loans, for the 2013 and 2014 periods, respectively. The year over year reduction in non-performing loans as a percentage results from an improvement in the overall economic climate. The year over year reduction in the specific reserve reflects both the relatively high level of overall collateralization on the non-performing portfolio as well as the increase in the portion of that portfolio making periodic payments pending return to performing status, reducing the need for a specific reserve at this time.

In determining the net change in fair value of loans held for investment for the quarter ended March 31, 2014, the Company used a discounted cash flow model which incorporated a series of expected future cash flows for the performing SBA 7(a) loan portfolio, and discounts those cash flows at a market clearing yield of 5.38%. The key assumptions used in the model are considered unobservable inputs and include anticipated prepayment speeds, cumulative default rates, the cost of loan servicing, and Prime rate expectations. The Company used an assumed prepayment speed of 15% based on current market conditions and historical experience for the loan portfolio, against a prepayment curve developed from NSBF historical experience to calculate expected loan prepayments in a given year. Defaults are defined as any loan placed on non-accrual status as of March 31, 2014. The cumulative default rate, defined as the percent of loan balance that will enter final liquidation in a given year, was estimated to be 25%, and was derived from NSBF historical experience. The mix of NSBF's loan portfolio continues to shift from start-up businesses, to predominately existing businesses. Our historical default and loss rates demonstrate that this particular segment (i.e. Existing Business) of our SBA loan portfolio continues to experience the lowest rate of defaults and ultimate losses over our nine year history of originating loans. When computing the cumulative default rate to be applied to the performing portfolio loan balances, the Company excluded the last three years of originations as those loans have not seasoned yet. The discounted cash flow analysis resulted in a price equivalent of 93.97% of the par amount on our loans held for investment.

Other general and administrative costs increased by \$619,000 due primarily to an increase at NSBF for referral fees on loans originated of \$175,000, increased loan servicing costs to the SBA of \$101,000, and increased loan recovery costs of \$78,000 which includes expenses and losses associated with the sale of foreclosed properties and collateral preservation costs. The remainder of the increase was mainly attributable to increased marketing expense of \$71,000 in connection with our television ad campaign. Additionally, NBC increased its reserves by \$200,000 in the current quarter as a result of potential losses relating to a receivable financing customer.

The increase of loan originations combined with improvements in servicing, and interest, generated by the addition to and enhanced performance of the portfolio as well as an increase in third party servicing, were sufficient to offset additional salaries, servicing, interest and origination expenses. The resulting pretax income of \$2,691,000 was a 24% improvement over the same three month period in 2013.

**Table of Contents****Managed Technology Solutions**

(In thousands):	Three months ended March 31:			
	2014	2013	\$ Change	% Change
<b>Revenue:</b>				
Web hosting and design	\$ 4,056	\$ 4,394	\$ (338)	(8)%
<b>Expenses:</b>				
Salaries and benefits	1,252	1,153	99	9%
Interest	18	24	(6)	(25)%
Professional fees	131	205	(74)	(36)%
Depreciation and amortization	337	326	11	3%
Insurance expense related party	2	3	(1)	(33)%
Other general and administrative costs	1,565	1,787	(222)	(12)%
Total expenses	3,305	3,498	(193)	(6)%
Income before income taxes	\$ 751	\$ 896	\$ (145)	(16)%

Revenue is derived primarily from recurring fees from hosting websites, through monthly contracts for shared hosting, dedicated servers and cloud instances (the plans). Less than 5% of revenues are derived from contracted services to design and maintain web sites. Web hosting and web design revenue decreased \$338,000, or 8%, to \$4,056,000 for the three months ended March 31, 2014. The reduction in web hosting revenue is the result of a decrease in the average monthly number of total plans by 5,693 or 12% between periods to 41,387 plans at March 31, 2014 from 47,080 plans in the first quarter of 2013. Partially offsetting the decrease in revenue was an increase in the average monthly revenue per plan of 5% to \$31.08 for the three months ended March 31, 2014 from \$29.50 in 2013. The average number of cloud instances decreased by 41 to an average of 629 from 670 in the first quarter of 2013. The average monthly number of dedicated server plans in the first quarter of 2014, which generate a higher monthly fee versus shared hosting plans, decreased by 293 between periods, or 22%, to an average of 1,021 from an average of 1,314 in the first quarter of 2013. The average monthly number of shared hosting plans in 2014 decreased by 5,360, or 12%, to an average of 39,736 from 45,096 in the first quarter of 2013. Competition from other web hosting providers as well as alternative website services continued to have a negative effect on web hosting plan count and revenue growth.

Management has taken and is planning a number of steps to reverse the trend of decreasing revenues in this segment.

Total expenses of \$3,305,000 in the first quarter of 2014 decreased 6% from \$3,498,000 in the first quarter of 2013. Salaries and benefits for the quarter increased \$99,000 or 9% between years to \$1,252,000. The increase was mainly due to the additional headcount, as well as the hiring of a Senior Vice President of Business Development. Depreciation and amortization increased \$11,000 between periods to \$337,000 due to an increase in capital expenditures. Professional fees decreased \$74,000 principally due to the decrease in web design development revenues between periods. Other costs decreased \$222,000 or 12% between periods, principally due to the decreases in license and permits of \$66,000, which is directly related to the number of plans in service, telephone and utilities of \$28,000, and decreases in marketing, processing fees and other office related expenses.



Segment income before income taxes decreased 16% or \$145,000 to \$751,000 in the first quarter of 2014 from \$896,000 in the first quarter of 2013. The decrease in segment profitability, principally due to a decline in web hosting revenue between periods, was only partially offset by lower operating costs between periods.

**Table of Contents****All Other**

(In thousands):	Three months ended March 31:			
	2014	2013	\$ Change	% Change
<b>Revenues:</b>				
Insurance commissions	\$ 385	\$ 444	\$ (59)	(13)%
Insurance commissions related party	47	42	5	12%
Other income	122	141	(19)	(13)%
Other income-related party	22	18	4	22%
Interest income		1	(1)	(100)
<b>Total revenue</b>	<b>576</b>	<b>646</b>	<b>(70)</b>	<b>(11)%</b>
<b>Expenses:</b>				
Salaries and benefits	628	667	(39)	(6)%
Professional fees	110	139	(29)	(21)%
Depreciation and amortization	51	51		%
Other general and administrative costs	186	251	(65)	(26)%
<b>Total expenses</b>	<b>975</b>	<b>1,108</b>	<b>(133)</b>	<b>(12)%</b>
Loss before income taxes	\$ (399)	\$ (462)	\$ 63	14%

The All Other segment includes revenues and expenses primarily from Newtek Insurance Agency, LLC ( NIA ), Newtek Payroll Services ( PAY ) and qualified businesses that received investments made through the Company's Capcos which cannot be aggregated with other operating segments.

In December 2012, the Company invested in Advanced Cyber Security Systems, LLC ( ACS ), a start-up company formed to offer web-based security solutions to the marketplace. ACS is accounted for as a variable interest entity ( VIE ).

Total revenue decreased by \$70,000 for the three months ended March 31, 2014 compared with the year ago period due primarily to a reduction in insurance commission revenue that included a decrease in renewals of direct bill policies as well as a decrease in premium on the force placed insurance book.

The decrease in revenue was offset by reductions in total expenses which decreased by \$133,000 in the three months ended March 31, 2014 compared with the year ago period. Salaries and benefits decreased by \$39,000 as a result of staff reductions in multiple divisions, and professional fees, which includes broker commissions paid to agents for insurance policy sales and are directly related to commission income which also decreased in the current period. The \$65,000 decrease in other general and administrative costs includes a \$92,000 reduction in other general and administrative costs at ACS which previously had been paying a monthly fee for a software license agreement in the year ago period. In June 2013, the Company exercised its warrant in ACS, and as part of the restructure, ACS made a final payment in September 2013 and now owns the software license. This reduction in cost was partially offset by a \$25,000 increase in software implementation costs and tax processing fees associated with PAY.

While the segment had a \$70,000 decrease in total revenue, this decrease was offset by a \$133,000 reduction in salaries and other expenses resulting in a \$63,000 improvement in loss before income taxes for the three months ended March 31, 2014 compared with the year ago period.

**Table of Contents****Corporate activities**

(In thousands):	Three months ended March 31:			
	2014	2013	\$ Change	% Change
<b>Revenue:</b>				
Management fees related party	\$ 199	\$ 199	\$	
Interest income		1	(1)	(100)%
<b>Total revenue</b>	<b>199</b>	<b>200</b>	<b>(1)</b>	<b>(1)%</b>
<b>Expenses:</b>				
Salaries and benefits	1,451	1,464	(13)	(1)%
Professional fees	357	397	(40)	(10)%
Depreciation and amortization	37	45	(8)	(18)%
Insurance expense related party	33	27	6	23%
Other general and administrative costs	508	223	285	128%
<b>Total expenses</b>	<b>2,386</b>	<b>2,156</b>	<b>230</b>	<b>11%</b>
<b>Loss before income taxes</b>	<b>\$ (2,187)</b>	<b>\$ (1,956)</b>	<b>\$ (231)</b>	<b>(12)%</b>

The Corporate activities segment implements business strategy, directs marketing, provides technology oversight and guidance, coordinates and integrates activities of the other segments, contracts with alliance partners, acquires customer opportunities, and owns our proprietary NewTracker referral system and all other intellectual property rights. This segment includes revenue and expenses not allocated to other segments, including interest income, Capco management fee income, and corporate operating expenses. These operating expenses consist primarily of internal and external public accounting expenses, internal and external corporate legal expenses, corporate officer salaries, sales and marketing expense and rent for the principal executive offices.

Revenue is derived primarily from management fees earned from the Capcos and remained unchanged at \$199,000 between periods. Management fees, which are eliminated upon consolidation, are expected to decline in the future as the Capcos mature and utilize their cash. If a Capco does not have current or projected cash sufficient to pay management fees, then such fees are not accrued.

Total expenses increased by \$230,000 for the three months ended March 31, 2014 over the same period in 2013 primarily due to the increase in other general and administrative costs, particularly in marketing costs, which increased \$241,000 from the Company's television ad campaign, a larger portion of which was absorbed by Corporate in the current period compared with the three months ended March 31, 2013. All other expenses remained essentially unchanged period over period.

The loss before income taxes increased by \$231,000 due primarily to the increase in other general and administrative costs noted above for the three months ended March 31, 2014, as compared to the same period in 2013.



**Table of Contents****Capcos**

<b>(In thousands):</b>	<b>Three months ended March 31:</b>			
	<b>2014</b>	<b>2013</b>	<b>\$ Change</b>	<b>% Change</b>
<b>Revenue:</b>				
Income from tax credits	\$ 13	\$ 26	\$ (13)	(50)%
Interest income	16	19	(3)	(16)%
Dividend Income related party	74		74	100%
Other income	1	5	(4)	(80)%
<b>Total revenue</b>	<b>104</b>	<b>50</b>	<b>54</b>	<b>108%</b>
<b>Net change in fair value of:</b>				
Credits in lieu of cash and Notes payable in credits in lieu of cash	1	19	(18)	(95)%
<b>Expenses:</b>				
Management fees related party	199	198	1	1%
Interest expense	24	56	(32)	(57)%
Professional fees	74	62	12	19%
Other general and administrative costs	79	39	40	103%
<b>Total expenses</b>	<b>376</b>	<b>355</b>	<b>21</b>	<b>6%</b>
<b>Loss before income taxes</b>	<b>\$ (271)</b>	<b>\$ (286)</b>	<b>\$ 15</b>	<b>5%</b>

As described in Note 3 to the condensed consolidated financial statements (unaudited), effective January 1, 2008, the Company adopted fair value accounting for its financial assets and financial liabilities concurrent with its election of the fair value option for substantially all credits in lieu of cash, notes payable in credits in lieu of cash and prepaid insurance. These are the financial assets and liabilities associated with the Company's Capco notes that are reported within the Company's Capco segment. The table above reflects the effects of the adoption of fair value measurement on the income and expense items (income from tax credits, interest expense and insurance expense) related to the revalued financial assets and liability for the three months ended March 31, 2014 and 2013. In addition, the net change to the revalued financial assets and liability for the three months ended March 31, 2014 and 2013 is reported in the line Net change in fair value of Credits in lieu of cash and Notes payable in credits in lieu of cash on the condensed consolidated statements of income.

The Company does not anticipate creating any new Capcos in the foreseeable future and the Capco segment will continue to incur losses going forward. The Capcos will continue to earn cash investment income on their cash balances and incur cash management fees and operating expenses. The amount of cash available for investment and to pay management fees will be primarily dependent upon future returns generated from investments in qualified businesses. Income from tax credits will consist solely of accretion of the discounted value of the declining dollar amount of tax credits the Capcos will receive in the future; the Capcos will continue to incur non-cash interest expense related to the tax credits.

Revenue is derived primarily from non-cash income from tax credits, interest and dividend income. The \$13,000 decrease in tax credits for the three months ended March 31, 2014 versus the same period in 2013 reflects the effect of the declining dollar amount of tax credits remaining in 2014. The amount of future income from tax credits revenue will fluctuate with future interest rates. However, over future periods through 2016, the amount of tax credits will decrease to zero. The increase in total revenue for the three months ended March 31, 2014 compared to year ago period is due to \$74,000 in accrued dividends from Small Business Lending, a related party, earned by three of the Capcos on equity investments made in 2013.

Expenses consist primarily of management fees and non-cash interest expense. Related party management fees for the three months ended March 31, 2014 remained essentially unchanged from the year ago period. Management fees, which are eliminated upon consolidation, are expected to decline in the future as the Capcos mature and utilize their cash. Interest expense decreased by \$32,000, for the three months ended March 31, 2014 compared with the year ago quarter as a result of the declining amount of notes payable in 2014. Other general and administrative costs increased \$40,000 compared with the year ago period in connection with the write off of two investments totaling \$46,000, which was partially offset by a reduction in rent expense.

## **Table of Contents**

Overall, the pretax loss before income taxes in the Capco segment decreased by \$15,000, period over period, primarily due to the increased income from dividends, and the decrease in interest expense for the three months ended March 31, 2014.

### **Critical Accounting Policies and Estimates:**

The Company's significant accounting policies are described in Note 2 of the Notes to Consolidated Financial Statements included in its Form 10-K for the fiscal year ended December 31, 2013. A discussion of the Company's critical accounting policies, and the related estimates, are included in Management's Discussion and Analysis of Results of Operations and Financial Position in its Form 10-K for the fiscal year ended December 31, 2013.

### **Liquidity and Capital Resources**

Cash requirements and liquidity needs over the next twelve months are anticipated to be funded primarily through operating results, available cash and cash equivalents, existing credit lines, proposed new credit lines, and additional securitizations of the Company's SBA lender's unguaranteed loan portions. As more fully described below, the Company's SBA lender ( NSBF ) will require additional funding sources to maintain current levels of SBA loan originations in the latter part of 2014 under anticipated conditions; although the failure to find these additional sources may require the reduction in the Company's SBA lending and related operations, it will not impair the Company's overall ability to operate. The Company will need to increase its levels of equity and debt financing in order to meet a higher level of loan fundings than in previous years. As such, the Company has signed a Letter of Intent with Capital One Bank for additional capital above its current facility. In addition, the Company has a signed Letter of Intent with Goldman Sachs Bank which would replace the Capital One line of \$27,000,000 and provide a larger warehouse line for SBA loans. The Company has also taken the initial steps to convert to a business development company ( BDC ) which would be undertaken in conjunction with a public offering of the Company's stock. Given weaker results in the business services segments which have historically been cash generators, and the need to raise additional capital, the inability to close these transactions could significantly reduce the rate of growth for the Company. If the Company should ever be unable to obtain the required approval for its financing arrangements from the SBA, it would likely be unable to continue to make loans.

NSBF depends on the availability of purchasers for SBA loans held for sale transferred to the secondary markets and the premium earned therein to support its lending operations. At this time the secondary market for the SBA loans held for sale is robust.

As an alternative to holding indefinitely the portions of SBA loans remaining after sale of the guaranteed portions in the SBA supervised secondary market, NSBF has undertaken to securitize these unguaranteed portions. In December 2010, the first such securitization trust established by NSBF issued notes to one investor in the amount of \$16,000,000 which received an S&P rating of AA. A second securitization, an amendment to the original transaction, was completed in December 2011, and resulted in an additional \$14,900,000 of notes issued to the same investor. NSBF used the cash generated from the first transaction to retire its outstanding term loan from Capital One, N.A. and to fund a \$3,000,000 account which during the first quarter of 2011 purchased unguaranteed portions originated subsequent to the securitization transaction. Similarly, the proceeds from the second securitization in 2011 were used to pay down its outstanding term loan with Capital One, N.A., and to fund a \$5,000,000 account used to fund additional originations in the first quarter of 2012. Additional securitizations were completed in March 2013 and December 2013 resulting in the issuance of notes in the amount of \$20,909,000 and \$24,434,000, respectively. Similarly, the proceeds of both transactions were used to pay down the outstanding term loan with Capital One, N.A., and a combined total of \$12,945,000 was used to fund an account used to purchase unguaranteed portions of loans throughout 2013, and during the first quarter of 2014. While this securitization process can provide a long-term



funding source for the SBA lender, there is no certainty that it can be conducted on an economic basis. In addition, the securitization mechanism itself does not provide liquidity in the short term for funding SBA loans.

In December 2010, the SBA lender entered into a new revolving loan agreement with Capital One, N.A. for up to \$12,000,000 to be used to fund the guaranteed portions of SBA loans and to be repaid with the proceeds of the sale in the secondary market of those portions. Also, in June 2011, the SBA lender entered into a new revolving loan agreement with Capital One, N.A. for up to \$15,000,000 to be used to fund the unguaranteed portions of SBA loans and to be repaid with the proceeds of loan repayments from the borrowers as well as excess cash flow of NSBF. As a result of these two facilities, the SBA lender was able to increase the amount of loans it can fund at any one time.

**Table of Contents**

In April 2010, the Company refinanced the existing line of credit between Capital One and NTS into a five year term loan for \$2,083,000.

Through February 28, 2011, the receivables financing unit, NBC, utilized a \$10,000,000 line of credit provided by Wells Fargo Bank to purchase and warehouse receivables. On February 28, 2011, NBC entered into a three year line of credit of up to \$10,000,000 with Sterling National Bank which replaced the Wells Fargo line. In December 2012, an amendment was signed providing that upon the achievement of certain profitability levels, the maximum amount of the line of credit under the Agreement can be increased from \$10,000,000 to \$15,000,000 at a later date upon NBC's request. The Amendment also extended the maturity date from February 28, 2014 to February 28, 2016. There is no cross collateralization between the Sterling lending facility and the Capital One term loan and credit facility; however, a default under the Capital One term loan or line of credit will create a possibility of default under the Sterling line of credit. The availability of the Sterling line of credit and the performance of the Capital One term loans are subject to compliance with certain covenants and collateral requirements as set forth in their respective agreements, as well as limited restrictions on distributions or loans to the Company by the respective debtor, none of which are material to the liquidity of the Company. At March 31, 2013, the Company and its subsidiaries were in full compliance with applicable loan covenants. The Company guarantees these loans for the subsidiaries up to the amount borrowed; in addition, the Company deposited \$750,000 with Sterling to collateralize the guarantee. In April 2012, the Company closed a \$15,000,000 credit facility with Summit comprised of a \$10,000,000 term loan, which was drawn at closing, and a \$5,000,000 delayed draw term loan to be made upon the satisfaction of certain conditions. The \$5,000,000 second tranche of this loan will not be drawn by the Company. The funds were used primarily for general corporate purposes including the origination of SBA 7(a) loans.

As of March 31, 2014, the Company's unused sources of liquidity consisted of \$313,000 available through its lines of credit, and \$10,234,000 in unrestricted cash and cash equivalents.

Restricted cash of \$10,569,000 as of March 31, 2014 is primarily held in the Lending and the All Other segments. The majority, or \$6,370,000 of restricted cash, is related to NSBF, and includes \$3,242,000 for a reserve in the event payments are insufficient to cover interest and/or principal with respect to the securitization, and \$150,000 set aside for servicer and prepaid interest fees. The remaining balance at NSBF of \$2,978,000 represents payments collected due to participants and amounts owed to the SBA. The Company also has \$2,187,000 in cash held in the companies aggregating our all other segment, the majority of which is held by PAY and represents monies held in the payroll escrow account. The remaining balance of \$2,012,000 includes \$750,000 which collateralizes the Sterling line of credit, and other amounts provided by sponsoring banks in connection with credit card processing and by customers for insurance premiums and our AR factoring business.

In summary, Newtek generated and used cash as follows:

(In thousands)	<b>Three</b>	
	<b>Months Ended</b>	
	<b>March 31,</b>	
	<b>2014</b>	<b>2013</b>
Net cash provided by (used in) operating activities	\$ 7,828	\$ (2,527)
Net cash used in investing activities	(9,886)	(7,308)
Net cash (used in) provided by financing activities	(216)	7,604

Edgar Filing: NEWTEK BUSINESS SERVICES, INC. - Form 10-Q

Net decrease in cash and cash equivalents	(2,274)	(2,231)
Cash and cash equivalents, beginning of period	12,508	14,229
Cash and cash equivalents, end of period	\$ 10,234	\$ 11,998

Net cash used in operating activities increased by \$10,355,000 to cash provided of \$7,828,000 for the period ended March 31, 2014, compared to cash used in operations of \$(2,527,000) for the period ended March 31, 2014. The change primarily reflects the operation of the SBA lender, which originated \$34,224,000 of SBA loans held for sale and sold \$34,955,000 of loans compared with \$27,238,000 originated and \$25,111,000 sold in the first three months of 2013. An additional \$4,876,000 of cash was provided by other assets in the current period that was mostly related to two loans that were funded, but did not close during 2013 and were recorded to other assets. An additional \$1,491,000 was provided through the fluctuation in the broker receivable, which arises from loans traded by not settled before quarter end, and represents the amount of cash due from the purchasing broker; the amount varies depending on loan origination volume and timing of sales and settlement at quarter end.

Net cash used in investing activities includes the unguaranteed portions of SBA loans, the purchase of fixed assets, changes in restricted cash and activities involving investments in qualified businesses. Net cash used in investing activities decreased by \$(2,578,000) to cash used of \$(9,886,000) for the period ended March 31, 2014 compared to cash used of \$(7,308,000) for the period ended March 31, 2013. The decrease was due primarily to a greater amount of SBA loans originated for investment of \$(11,385,000) for the three month period in 2014 compared with \$(7,640,000) in 2013 and a reduction in the return of

## **Table of Contents**

investments in qualified businesses which used \$72,000 of cash in 2014 compared with a provision of \$970,000 in 2013. This total use of cash in investing activities was partially offset by payments received on SBA loans which provided cash of \$2,159,000 in 2014 versus \$1,201,000 in the same period of 2013.

Net cash provided by financing activities primarily includes the net repayments on bank lines of credit and notes payable as well as securitization activities. While the change in restricted cash related to securitization provided \$11,221,000, and a reduction in the total amount of repayments on bank lines of credit provided \$2,553,000 of cash in the current period, the prior period included a cash provision related to the Company's March 2013 securitization transaction resulting in a current period reduction of \$(20,862,000). In sum, net cash provided by financing activities decreased by \$7,820,000 to cash used of \$(216,000) for the period ended March 31, 2014 from cash provided of \$7,604,000 for the period ended March 31, 2013.

### **Item 3. Quantitative and Qualitative Disclosures about Market Risk.**

We consider the principal types of risk in our business activities to be fluctuations in interest rates and loan portfolio valuations and the availability of the secondary market for our SBA loans held for sale. Risk management systems and procedures are designed to identify and analyze our risks, to set appropriate policies and limits and to continually monitor these risks and limits by means of reliable administrative and information systems and other policies and programs.

Our SBA lender primarily lends at an interest rate of prime, which resets on a quarterly basis, plus a fixed margin. Our receivable financing business purchases receivables priced to equate to a similar prime plus a fixed margin structure. The Capital One term loan and revolver loan, the securitization notes and the Sterling line of credit are on a prime plus a fixed factor basis. As a result, the Company believes it has matched its cost of funds to its interest income in its financing activities. However, because of the differential between the amount lent and the smaller amount financed a significant change in market interest rates will have a material effect on our operating income. In a rising interest rate climate, our cost of funds will increase at a slower rate than the interest income earned on the loans we have made; however, this benefit may be offset by a reduction in premium income. A rise in interest rates may cause an increase in prepayments, thus decreasing the future cash flows of a loan and impacting the premium price paid in the secondary market. Conversely, in a decreasing rate environment, the Company may experience a reduction in interest rate spread; that is, interest income will decline more quickly than interest expense resulting in a net reduction of benefit to operating income, offset by an increase in premium income.

Our lender depends on the availability of secondary market purchasers for the guaranteed portions of SBA loans and the premium received on such sales to support its lending operations. At this time the secondary market for the guaranteed portions of SBA loans is robust but during the 2008 and 2009 financial crisis the Company had difficulty selling its loans for a premium; although not expected at this time, if such conditions did recur our SBA lender would most likely cease making new loans and could experience a substantial reduction in profitability.

We do not have significant exposure to changing interest rates on invested cash which was approximately \$20,803,000 at March 31, 2014. We do not purchase or hold derivative financial instruments for trading purposes. All of our transactions are conducted in U.S. dollars and we do not have any foreign currency or foreign exchange risk. We do not trade commodities or have any commodity price risk.

We believe that we have placed our demand deposits, cash investments and their equivalents with high credit-quality financial institutions. Invested cash is held almost exclusively at financial institutions with ratings from S&P of A- or better. The Company invests cash not held in interest free checking accounts or bank money market accounts mainly in U.S. Treasury-only money market instruments or funds and other investment-grade securities. As of March 31,

2014, cash deposits in excess of FDIC and SIPC insurance totaled approximately \$7,741,000 and funds held in U.S. Treasury-only money market funds or equivalents in excess of SIPC insurance totaled approximately \$11,000.

**Table of Contents**

**Item 4. Controls and Procedures.**

***(a) Evaluation of Disclosure Controls and Procedures.***

Our management, with the participation of our Chief Executive Officer and Chief Accounting Officer, evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Accounting Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report and provide reasonable assurance that the information required to be disclosed by us in reports filed under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Exchange Act is accumulated and communicated to the issuer's management including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. A controls system, no matter how well designed and operated, cannot provide absolute assurance that the objectives of the controls systems are met, and no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected.

***(b) Change in Internal Control over Financial Reporting.***

No change in our internal control over financial reporting occurred during the quarter ended March 31, 2014 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

***(c) Limitations.***

A controls system, no matter how well designed and operated, can provide only reasonable, not absolute, assurances that the controls system's objectives will be met. Furthermore, the design of a controls system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all controls systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple errors or mistakes. Controls can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with its policies or procedures. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected. We periodically evaluate our internal controls and make changes to improve them.

**Table of Contents****PART II - OTHER INFORMATION****Item 1. Legal Proceedings**

In the ordinary course of business, the Company may from time to time be party to lawsuits and claims. The Company evaluates such matters on a case by case basis and its policy is to contest vigorously any claims it believes are without compelling merit. The Company is currently involved in various litigation matters. Management has reviewed all legal claims against the Company with counsel and has taken into consideration the views of such counsel, as to the outcome of the claims. In management's opinion, final disposition of all such claims will not have a material adverse effect on the results of operations, cash flows or financial position of the Company.

**Item 6. Exhibits**

<b>Exhibit No.</b>	<b>Description</b>
10.1	Amendment to Employment Agreement with Craig J. Brunet, dated April 1, 2014.
31.1	Certification by Principal Executive Officer required by Rule 13a-14(a) and 15d-14(a) under the Securities Exchange Act of 1934, as amended.
31.2	Certification by Principal Financial Officer required by Rule 13a-14(a) and 15d-14(a) under the Securities Exchange Act of 1934, as amended.
32.1	Certification by Principal Executive and Principal Financial Officers pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101.SCH8	XBRL Taxonomy Extension Schema Document
101.CAL8	XBRL Taxonomy Extension Calculation Linkbase Document
101.LAB8	XBRL Taxonomy Extension Labels Linkbase Document
101.PRE8	XBRL Taxonomy Extension Presentation Linkbase Document

**Table of Contents**

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) 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.

**NEWTEK BUSINESS SERVICES, INC.**

Date: May 12, 2014

By: /s/ Barry Sloane  
Barry Sloane

Chairman of the Board, Chief Executive Officer  
and Secretary

(Principal Executive Officer)

Date: May 12, 2014

By: /s/ Jennifer Eddelson  
Jennifer Eddelson

Chief Accounting Officer

(Principal Financial Officer and Principal  
Accounting Officer)