

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

MICROFINANCIAL INC
Form 10-Q
May 15, 2003

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

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES AND EXCHANGE ACT OF 1934
For the Quarterly Period Ended March 31, 2003

OR

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

Commission File No. 1-14771

MICROFINANCIAL INCORPORATED
(Exact name of Registrant as specified in its Charter)

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

10 M Commerce Way, Woburn, MA 01801
(Address of Principal Executive Offices)

(781) 994-4800
(Registrant's Telephone Number, Including Area Code)

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

As of May 2, 2003, 13,126,416 shares of the registrant's common stock were outstanding.

MICROFINANCIAL INCORPORATED
TABLE OF CONTENTS

	Page
Part I	
FINANCIAL INFORMATION	
Item 1	
Financial Statements (unaudited):	
Condensed Consolidated Balance Sheets	
December 31, 2002 and March 31, 2003	3
Condensed Consolidated Statements of Operations	
Three months ended March 31, 2002 and 2003	4
Condensed Consolidated Statements of Cash Flows	
Three months ended March 31, 2002 and 2003	5
Notes to Condensed Consolidated Financial Statements	7

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

Item 2	Management's Discussion and Analysis of Financial Condition and Results of Operations	14
Item 3	Quantitative and Qualitative Disclosures about Market Risk	19
Item 4	Controls and Procedures	19
Part II		
	OTHER INFORMATION	
Item 1	Legal Proceedings	20
Item 3	Recent Sales of Unregistered Securities	22
Item 5	Other Information	22
Item 6	Exhibits and Reports on Form 8-K	23
	Signatures	24
	Certifications	25

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

	December 31,
	----- 2002 -----
ASSETS	
Net investment in leases and loans:	
Receivables due in installments	\$ 334,623
Estimated residual value	30,754
Initial direct costs	4,891
Loans receivable	1,796
Less:	
Advance lease payments and deposits	(96)
Unearned income	(67,574)
Allowance for credit losses	(69,294)
Net investment in leases and loans	\$ 235,100
Investment in service contracts	14,463
Cash and cash equivalents	5,494
Restricted cash	18,516
Property and equipment, net	9,026
Income taxes receivable	8,652
Other assets	3,834
Total assets	\$ 295,085 =====
LIABILITIES AND STOCKHOLDERS' EQUITY	
Notes payable	\$ 168,927
Subordinated notes payable	3,262

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

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

Total liabilities	208,482

Stockholders' equity:	
Preferred stock, \$.01 par value; 5,000,000 shares authorized; no shares issued at 12/31/02 and 3/31/03	-
Common stock, \$.01 par value; 25,000,000 shares authorized; 13,410,646 and 13,730,500 shares issued at 12/31/02 and 3/31/03, respectively	134
Additional paid-in capital	47,723
Retained earnings	45,089
Treasury stock (588,700 shares of common stock at 12/31/02 and 3/31/03), at cost	(6,343)
Unearned compensation	0

Total stockholders' equity	86,603

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

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

3

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

	For the three months ended March 31,	
	2002	2003
	----	----
Revenues:		
Income on financing leases and loans	\$ 15,235	\$ 9,821
Income on service contracts	2,395	2,251
Rental income	9,863	8,547
Loss and damage waiver fees	1,526	1,483
Service fees and other	6,266	3,469
	-----	-----
Total revenues	35,285	25,571
	-----	-----
Expenses:		
Selling general and administrative	12,574	9,131
Provision for credit losses	10,964	10,799
Depreciation and amortization	3,639	4,270
Interest	2,747	2,629
	-----	-----
Total expenses	29,924	26,829

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

Income/(loss) before provision for income taxes	5,361	(1,258)
Provision/(benefit) for income taxes	2,145	(503)
Net income/(loss)	\$ 3,216	(\$ 755)
Net income/(loss) per common share - basic	\$ 0.25	(\$ 0.06)
Net income/(loss) per common share - diluted	\$ 0.25	(\$ 0.06)
Weighted-average shares used to compute:		
Basic net income per share	12,821,946	12,854,642
Fully diluted net income per share	12,853,061	12,854,642

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

4

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

	For the three months ended March 31,	
	2002	2003
	----	----
Cash flows from operating activities:		
Cash received from customers	\$ 46,729	\$ 39,652
Cash paid to suppliers and employees	(11,642)	(10,796)
Cash paid for income taxes	(988)	(8)
Interest paid	(2,310)	(3,181)
Interest received	154	44
Net cash provided by operating activities	31,943	25,711
Cash flows from investing activities:		
Investment in lease contracts	(20,027)	(1,423)
Investment in inventory	(1,018)	(71)
Investment in direct costs	(1,296)	(125)
Investment in service contracts	(2,326)	0
Investment in fixed assets	(138)	(50)
Repayment of notes from officers	10	0
Net cash used in investing activities	(24,795)	(1,669)

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

Cash flows from financing activities:		
Proceeds from secured debt	9,300	0
Repayment of secured debt	(14,218)	(23,736)
Proceeds from short term demand notes payable	(85)	0
(Increase) decrease in restricted cash	98	4,097
Repayment of capital leases	(101)	(95)
Payment of dividends	(642)	0
	-----	-----
Net cash used in financing activities	(5,648)	(19,734)
	-----	-----
Net (decrease) increase in cash and cash equivalents:	1,500	4,309
Cash and cash equivalents, beginning of period	146	5,494
	-----	-----
Cash and cash equivalents, end of period	\$ 1,646	\$ 9,803
	=====	=====

(continued on following page)

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

5

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

	For the three months ended March 31,	
	-----	-----
	2002	2003
	----	----
Reconciliation of net income to net cash provided by operating activities:		
Net income (loss)	\$ 3,216	(\$ 755)
Adjustments to reconcile net income to cash provided by operating activities		
Depreciation and amortization	3,639	4,270
Provision for credit losses	10,964	10,799
Recovery of equipment cost and residual value, net of revenue recognized	12,203	12,411
Decrease in current taxes	(988)	(172)
Decrease (increase) in deferred income taxes	2,145	(503)
Change in assets and liabilities:		
Increase (decrease) in other assets	416	(563)
Increase (decrease) in accounts payable	(16)	105
Increase in accrued liabilities	364	119
	-----	-----
Net cash provided by operating activities	\$ 31,943	\$ 25,711
	=====	=====
Supplemental disclosure of noncash activities:		
Accrual of common stock dividends	\$ 641	\$ 0

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

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

6

(A) Nature of Business:

MicroFinancial Incorporated (the "Company") which operates primarily through its wholly-owned subsidiary, Leasecomm Corporation, is a specialized commercial finance company that primarily leases and rents "microticket" equipment and provides other financing services in amounts generally ranging from \$400 to \$15,000 with an average amount financed of approximately \$3,500 and an average lease term of 38 months. The Company does not market its services directly to lessees but sources leasing transactions through a network of independent sales organizations and other dealer-based origination networks nationwide. The Company funded its operations primarily through borrowings under its credit facilities, issuances of subordinated debt and on balance sheet securitizations.

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

In an effort to improve its financial position, MicroFinancial has taken certain steps including the engagement of a financial and strategic advisory firm, Triax Capital Advisors, LLC. Management and its advisors are actively considering various financing, restructuring and strategic alternatives. In addition, Management has taken steps to reduce overhead, including a reduction in headcount from 380 at December 31, 2001 to 203 at December 31, 2002. During the three months ended March 31, 2003, the employee headcount was further reduced to 186 in a continued effort to maintain an appropriate cost structure.

Leasecomm Corporation periodically finances its lease and service contracts, together with unguaranteed residuals, through securitizations using special purpose vehicles. MFI Finance Corporation I and MFI Finance Corporation II, LLC are special purpose companies. The assets of such special purpose vehicles and cash collateral or other accounts created in connection with the financings in which they participate are not available to pay creditors of Leasecomm Corporation, MicroFinancial Incorporated, or other affiliates. While Leasecomm Corporation generally does not sell its interests in leases, service contracts or loans to third parties after origination, the Company does, from time to time, contribute certain leases, service contracts, or loans to

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

special-purpose entities for purposes of obtaining financing in connection with the related receivables. The contribution of such assets under the terms of such financings are intended to constitute "true sales" of such assets for bankruptcy purposes (meaning that such assets are legally isolated from Leasecomm Corporation). However, the special purpose entities to which such assets are contributed are not "qualifying special purpose entities" within the meaning Statement of Financial Accounting Standards ("SFAS") SFAS No. 140, and are required under generally accepted accounting principles to be consolidated in the financial statements of the Company. As a result, such assets and the related liability remain on the balance sheet and do not receive gain on sale treatment.

(B) Summary of Significant Accounting Policies:

Basis of Presentation:

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and the rules and regulations of the Securities and Exchange Commission for interim financial statements. Accordingly, the interim statements do not include all of the information and disclosures required for the annual financial statements. In the opinion of the

7

Company's management, the condensed consolidated financial statements contain all adjustments, consisting only of normal recurring adjustments, considered necessary for a fair presentation of these interim results. These financial statements should be read in conjunction with the consolidated financial statements and notes included in the Company's Annual Report and Form 10-K for the year ended December 31, 2002. The results for the three-month period ended March 31, 2003 are not necessarily indicative of the results that may be expected for the full year ended December 31, 2003.

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

Allowance for Credit Losses:

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

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

Balance of allowance for credit losses at December 31, 2002	\$ 69,294 =====
---	--------------------

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

Provision for credit losses	10,799	
Total provisions for credit losses		10,799
Charge-offs	16,348	
Recoveries	2,614	

Charge-offs, net of recoveries		13,734

Balance of allowance for credit losses at March 31, 2003		\$ 66,359
		=====

Earnings Per Share:

Basic net income per common share is computed based on the weighted-average number of common shares outstanding during the period. Dilutive net income per common share gives effect to all dilutive potential common shares outstanding during the period. The computation of diluted earnings per share does not assume the issuance of common shares that have an antidilutive effect on net income per common share. Options to purchase 1,936,000 shares of common stock were not included in the computation of diluted earnings per share for the three months ended March 31, 2002, because their effects were antidilutive. All stock options and unvested restricted stock were excluded from the computation of dilutive earnings per share for the three months ended March 31, 2003, because their inclusion would have had an antidilutive effect on earnings per share.

8

	For three months ended March 31,	
	2002	2003
Net income (loss)	\$ 3,216	(\$ 755)
Shares used in computation:		
Weighted average common shares outstanding used in computation of net income per common share	12,821,946	12,854,642
Dilutive effect of common stock options	31,115	-
	-----	-----
Shares used in computation of net income per common share - assuming dilution	12,853,061	12,854,642
	-----	-----
Net income (loss) per common share	\$ 0.25	(\$ 0.06)
Net income (loss) per common share assuming dilution	\$ 0.25	(\$ 0.06)

Stock-based Employee Compensation

All stock options issued to employees have an exercise price not less than the fair market value of the Company's common stock on the date of grant. In accordance with accounting for such options utilizing the intrinsic-value method, there is no related compensation expense recorded in the Company's financial statements. The Company follows the disclosure requirements of SFAS No. 123, Accounting for Stock-Based Compensation. SFAS No. 123 requires that

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

compensation under a fair value method be determined using the Black-Scholes option-pricing model and disclosed in a pro forma effect on earnings and earnings per share. The Company accounts for stock-based employee compensation plans under the recognition and measurement principles of APB Opinion No. 25, Accounting for Stock Issued to Employees, and related Interpretations. The current period amortization of deferred compensation expense relating to the restricted stock awards granted on February 12, 2003 is reflected in net income. No other stock-based employee compensation cost is reflected in net income, as either all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant or options granted that result in a variable compensation costs had an exercise price greater than the fair market value of the underlying common stock on March 31, 2003. The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS No. 123, Accounting for Stock-Based Compensation, to stock-based employee compensation.

9

	For the three months ended March 31,	
	2002	2003
Net income (loss), as reported	\$3,216	(\$ 755)
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(353)	(218)
Pro forma net income (loss)	\$2,863	(\$ 973)
Earnings (loss) per share:		
Basic - as reported	\$ 0.25	(\$ 0.06)
Basic - pro forma	\$ 0.22	(\$ 0.08)
Diluted - as reported	\$ 0.25	(\$ 0.06)
Diluted - pro forma	\$ 0.22	(\$ 0.08)

The fair value of option grants for options granted during the three months ended March 31, 2003 was estimated on the date of grant utilizing the Black-Scholes option-pricing model with the following weighted-average assumptions.

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

The weighted-average fair value at the date of grant for options granted during the three months ended March 31, 2003 approximated \$0.62 per option. The Company granted 200,000 options during the three months ended March

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

31, 2003.

Notes Payable:

On December 21, 1999, the Company entered into a revolving line of credit and term loan facility with a group of financial institutions whereby it may borrow a maximum of \$150,000,000 based upon qualified lease receivables. Outstanding borrowings with respect to the revolving line of credit bear interest based either at Prime for Prime Rate loans or the prevailing rate per annum as offered in the interbank Eurodollar market (Eurodollar) plus 1.75% for Eurodollar Loans. If the Eurodollar loans are not renewed upon their maturity they automatically convert into prime rate loans. On August 22, 2000, the revolving line of credit and term loan facility was amended and restated whereby the Company may now borrow a maximum of \$192,000,000 based upon qualified lease receivables, loans, rentals and service contracts. Outstanding borrowings with respect to the revolving line of credit bear interest based either at Prime minus 0.25% for Prime Rate Loans or the prevailing rate per annum as offered in the London Interbank Offered Rate (LIBOR) plus 1.75% for LIBOR Loans or the seven-day Money Market rate plus 2.00% for Swing Line Advances. If the LIBOR loans are not renewed upon their maturity they automatically convert into prime rate loans. The Swing Line Advances have a seven-day maturity, and upon their maturity they automatically convert into prime rate loans. In addition, the Company's aggregate outstanding principal amount of Swing Line Advances shall not exceed \$10 million. The prime rate at both December 31, 2002, and March 31, 2003 was 4.25%. The 90-day LIBOR rates at December 31, 2002 and March 31, 2003 were 1.40% and 1.27875% respectively.

10

The Company had borrowings outstanding under this agreement with the following terms:

Type	December 31, 2002		March 31, 2003	
	Rate	Amount	Rate	Amount
	(in thousands)		(in thousands)	
Prime	4.7500%	\$ 31,556	5.2500%	\$ 65,051
LIBOR	4.1875%	50,000	4.1875%	50,000
LIBOR	4.1875%	45,000		
Total Outstanding		\$126,556		\$115,051

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

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

to prime plus 1.00%.

At December 31, 2002, the Company was in default of certain of its debt covenants in its senior credit facility. The covenants that were in default with respect to the senior credit facility require that the Company maintain a fixed charge ratio in an amount not less than 130% of consolidated earnings, a consolidated tangible net worth minimum of \$77.5 million plus 50% of net income quarterly beginning with September 30, 2000 and compliance with the borrowing base. On April 14, 2003, the Company entered into a long-term agreement with its lenders. This long-term agreement waives the defaults described above, and in consideration for this waiver, requires the outstanding balance of the loan to be repaid over a term of 22 months beginning in April 2003 at an interest rate of prime plus 2.0%. Based on the amortization schedule in the new agreement, the Company is obligated to repay a minimum of \$54 million, plus applicable interest, over the next twelve months.

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

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

11

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

Series -----	December 31, 2002		March 31, 2003	
	Rate	Amount	Rate	Amount
	(in thousands)		(in thousands)	
MFI I				
2000-1 Notes	7.3750%	3,464	7.3750%	-
2000-2 Notes	6.9390%	17,983	6.9390%	13,917
2001-3 Notes	5.5800%	17,019	5.5800%	13,593

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

MFI II LLC				
2001-1 Notes	8.0000%	3,625	8.0000%	2,350
		-----		-----
Total Outstanding		\$ 42,091		\$ 29,860
		=====		=====

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

At December 31, 2002 and March 31, 2003, the Company also had other notes payable which totaled \$280,000. Of these notes, at December 2002 and March 31, 2003, \$30,000 are notes that are due on demand and bear interest at a rate of prime less 1.00%. As of December 31, 2002 and March 31, 2003, \$250,000 are two-year term notes that carry an interest rate of 7.5%.

Stock Options:

Under the 1998 Equity Incentive Plan (the "1998 Plan") which was adopted on July 9, 1998 the Company had reserved 4,120,380 shares of the Company's common stock for issuance pursuant to the 1998 Plan. The Company granted a total of 200,000 options and a total of 135,000 options were surrendered during the three months ended March 31, 2003. A total of 1,735,000 options were outstanding at March 31, 2003 of which 813,000 were vested.

On February 7, 2003, the Company offered non-director employees and executives who had been granted stock options in the past the opportunity to cancel any of the original option agreements in exchange for a grant of shares of restricted stock. All option awards subject to the offer were converted to restricted stock. In connection with this offer, on February 12, 2003, 1,325,000 options converted to 319,854 shares of common stock. The restricted stock vested 20% upon grant, and vests 5% on the first day of each quarter after the grant date, with accelerated vesting if the price of the Corporation's common stock exceeds certain thresholds during the vesting period. As of March 31, 2003, 63,971 of these shares were fully vested and \$51,000 had been amortized from deferred compensation expense to compensation expense.

Dividends:

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

Reclassification of Prior Year Balances:

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

Certain reclassifications have been made to prior years' consolidated financial Statements to conform to the current presentation.

Commitments and Contingencies:

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

Subsequent Events:

The Company entered into a long-term agreement with its lenders on April 14, 2003. This long-term agreement waives the covenant defaults, and in consideration for this waiver, requires the outstanding balance of the loan to be repaid over a term of 22 months beginning in April 2003 at an interest rate of prime plus 2.0%. Based on the amortization schedule in the new agreement, the Company is obligated to repay a minimum of \$54 million, plus applicable interest, over the next twelve months.

The Company received a waiver, which was set to expire on April 15, 2003, for the covenant violations in connection with the securitization agreement. Subsequently, the Company received a permanent waiver of the covenant defaults and the securitization agreement was amended so that going forward, the covenants are the same as those contained in the long-term agreement entered into on April 14, 2003, for the senior credit facility.

13

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

Three months ended March 31, 2003 as compared to the three months ended March 31, 2002.

Net income for the three months ended March 31, 2003 was a loss of approximately \$755,000, a decrease of \$4.0 million or 124% from the three months ended March 31, 2002. This represents diluted earnings per share for the three months ended March 31, 2003 of (\$0.06) per share on weighted-average outstanding shares of 12,854,642 as compared to \$0.25 per share on weighted-average outstanding shares of 12,821,946 for the three months ended March 31, 2002.

Total revenues for the three months ended March 31, 2003 were \$25.6 million, a decrease of \$9.7 million, or 28%, from the three months ended March 31, 2002. The decrease was primarily due to a decrease of \$5.4 million, or 36%, in financing leases and loans, \$2.8 million or 45% in fee and other income, and \$1.3 million or 13% in rental income. The decrease in income on financing leases and loans was due to the decreased number of leases originated primarily resulting from the Company's decision during the third quarter of 2002 to suspend the funding of new contracts. The decrease in fee income and other income is the result of decreased fees from the lessees related to the collection and legal process employed by the Company. The decrease in rental income is the result of a decrease in originations of rental contracts.

Selling, general and administrative expenses decreased by \$3.4 million, or 27%, for the three months ended March 31, 2003, as compared to the three months ended March 31, 2002. Compensation expenses decreased by \$1.8 million or 34% primarily due to staff reductions. Collections expense decreased by \$873,000 or 49%. Cost of goods sold expenses decreased \$556,000 or 71%. Inventory services expense decreased by \$199,000 or 86%.

Depreciation and amortization increased by \$631,000 or 17%, due to an

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

increase in the number of early terminations of monthly rental and service contracts.

The Company's provision for credit losses decreased by \$165,000 or 2%, for the three months ended March 31, 2003 as compared to the three months ended March 31, 2002, while net charge-offs increased 22% to \$13.7 million. This provision was based on the Company's historical policy, based on experience, of providing a provision for credit losses based upon the dealer fundings and revenue recognized in any period and reflects management's judgement of loss potential considering current economic conditions and the nature of the underlying receivables.

Interest expense decreased by \$118,000, or 4%, for the three months ended March 31, 2003 as compared to the three months ended March 31, 2002. This decrease resulted primarily from an overall decrease in the level of borrowings.

Dealer fundings were \$1.2 million for the three months ended March 31, 2003, down \$21.4 million, or 95% as compared to the three months ended March 31, 2002. This decrease is a result of the Company's decision during the third quarter of 2002 to suspend new contract originations until a new line of credit is obtained. Total cash from customers decreased by \$7.1 million or 15% to a total of \$39.7 million. This decrease is primarily the result of a decrease in the size of the overall portfolio. Investment in lease and loan receivables due in installments, estimated residuals, rental and service contracts were down from \$396.5 million in December of 2002 to \$357.4 million in March of 2003.

14

Critical Accounting Policies

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

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

The Company's lease contracts are accounted for as financing leases. At origination, the Company records the gross lease receivable, the estimated residual value of the leased equipment, initial direct costs incurred and the unearned lease income. Unearned lease income is the amount by which the gross lease receivable plus the estimated residual value exceeds the cost of the equipment. Unearned lease income and initial direct costs incurred are amortized over the related lease term using the interest method. Amortization of unearned lease income and initial direct costs is suspended if, in the opinion of

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

management, full payment of the contractual amount due under the lease agreement is doubtful. In conjunction with the origination of leases, the Company may retain a residual interest in the underlying equipment upon termination of the lease. The value of such interests is estimated at inception of the lease and evaluated periodically for impairment. Other revenues such as loss and damage waiver fees, service fees relating to the leases, contracts and loans, and rental revenues are recognized as they are earned.

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

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

The Company has developed and regularly updates proprietary credit scoring systems designed to improve its risk-based pricing. The Company uses credit scoring in most, but not all, of its extensions of credit. In addition, the Company aggressively employs collection procedures and a legal process to resolve any credit problems.

15

Exposure to Credit Losses

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

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

entire lease. Accordingly, the Company includes only the amount past due rather than the entire lease receivable in each category.

	As of December 31 ----- 2001 ----	2002 ----- ----- -----	As of March ----- 2003 -----
Cumulative amounts billed (in thousands)	\$ 602,649	\$ 600,637	\$ 584,774
31-60 days past due	1.8%	1.0%	0.8%
61-90 days past due	1.7%	1.0%	0.8%
Over 90 days past due	13.4%	22.9%	22.7%
	-----	-----	-----
Total past due	16.9%	24.9%	24.3%
	=====	=====	=====

Liquidity and Capital Resources

General

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

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

The Company utilizes its credit facilities to fund the origination and acquisition of leases that satisfy the eligibility requirements established pursuant to each facility. On August 22, 2000, the Company entered into a new \$192 million credit facility with nine banks, expiring on September 30, 2002. As of September 30, 2002 the credit facility failed to renew and the Company has been paying down the balance on the basis of a 36-month amortization plus interest. Based on the terms of the agreement, interest rates increased from Prime minus 0.25% to Prime plus 0.50% for prime based loans and from LIBOR plus 1.75% to LIBOR plus 2.50% for LIBOR based loans. In addition, based on the covenant defaults described below, the outstanding borrowings on all loans bear an additional 2.00% default interest. On January 3, 2003, the Company entered into a Forbearance and Modification Agreement from the senior credit facility which expired on February 7, 2003. Based on the terms of the Forbearance and Modification Agreement, interest rates increased again on the prime based loans to prime plus 1.00%. At March 31, 2003, the Company had approximately \$115.1 million outstanding under the facility. The Company also may use its subordinated debt program as a source of funding for potential acquisitions of portfolios and leases which otherwise are not eligible for funding under the credit facilities and for potential portfolio purchases. To date, cash flows from its portfolio and other fees have been sufficient to repay amounts borrowed under the senior credit facility and

subordinated debt, however, in October 2002, the Company suspended new contract originations until a new source of funding is obtained.

At December 31, 2002, the Company was in default of certain of its debt covenants in its senior credit facility and securitization agreements. The covenants that were in default with respect to the senior credit facility, require that the Company maintain a fixed charge ratio in an amount not less than 130% of consolidated earnings, a consolidated tangible net worth minimum of \$77.5 million plus 50% of net income quarterly beginning with September 30, 2000, and compliance with the borrowing base. On April 14, 2003, the Company entered into a long-term agreement with its lenders. This long-term agreement waives the defaults described above, and in consideration for this waiver, requires the outstanding balance of the loan to be repaid over a term of 22 months beginning in April 2003 at an interest rate of prime plus 2.0%. Based on the amortization schedule in the new agreement, the Company is obligated to repay a minimum of \$54 million, plus applicable interest, over the next twelve months. The covenants that were in default with respect to the securitization agreements, require that the Company maintain a fixed charge ratio in an amount not less than 125% of consolidated earnings and a consolidated tangible net worth greater than \$90 million plus 50% of net income for each fiscal quarter after June 30, 2001. The Company received a waiver, which was set to expire on April 15, 2003, for the covenant violations in connection with the securitization agreement. Subsequently, the Company received a permanent waiver of the covenant defaults and the securitization agreement was amended so that going forward, the covenants are the same as those contained in the long-term agreement entered into on April 14, 2003, for the senior credit facility.

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

Contractual Obligations and Commercial Commitments

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

At March 31, 2003 the repayment schedules for outstanding long term debt, minimum lease payments under non-cancelable operating leases and future minimum lease payments under capital leases were as follows:

For the year ended December 31, -----	Long-Term Debt ----	Operating Leases -----	Capital Leases -----	Total -----
2003	\$ 67,924	\$ 1,321	\$ 132	\$ 69,377
2004	60,776	867	169	61,812
2005	17,151	227	55	17,433
2006	2,600	-	-	2,600
Thereafter	2	-	-	2
	-----	-----	-----	-----
Total	\$ 148,453	\$ 2,415	\$ 356	\$ 151,224
	=====	=====	=====	=====

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

Note on Forward-Looking Information

Statements in this document that are not historical facts are forward-looking statements made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. In addition, words such as "believes," "anticipates," "expects," and similar expressions are intended to identify forward-looking statements. The Company cautions that a number of important factors could cause actual results to differ materially from those expressed in any forward-looking statements made by or on behalf of the Company. Such statements contain a number of risks and uncertainties, including but not limited to: the Company's dependence on point-of-sale authorization systems and expansion into new markets; the Company's significant capital requirements; risks associated with economic downturns; higher interest rates; intense competition; change in regulatory environment

17

and risks associated with acquisitions. Readers should not place undue reliance on forward-looking statements, which reflect the management's view only as of the date hereof. The Company undertakes no obligation to publicly revise these forward-looking statements to reflect subsequent events or circumstances. The Company cannot assure that it will be able to anticipate or respond timely to changes which could adversely affect its operating results in one or more fiscal quarters. Results of operations in any past period should not be considered indicative of results to be expected in future periods. Fluctuations in operating results may result in fluctuations in the price of the Company's common stock. For a more complete description of the prominent risks and uncertainties inherent in the Company's business, see the risks factors described in the Company's Form S-1 Registration Statement and other documents filed from time to time with the Securities and Exchange Commission.

18

ITEM 3 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market-Rate-Sensitive Instruments and Risk Management

The following discussion about the Company's risk management activities includes forward-looking statements that involve risk and uncertainties. Actual results could differ materially from those projected in the forward-looking statements.

In the normal course of operations, the Company also faces risks that are either nonfinancial or nonquantifiable. Such risks principally include country risk, credit risk, and legal risk, and are not represented in the analysis that follows.

Interest Rate Risk Management

The implicit yield to the Company on all of its leases, contracts and loans is on a fixed interest rate basis due to the leases, contracts and loans having scheduled payments that are fixed at the time of origination of the lease. When the Company originates or acquires leases, contracts, and loans it bases its pricing in part on the spread it expects to achieve between the implicit yield rate to the Company on each lease and the effective interest cost it will pay when it finances such leases, contracts and loans through its credit

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

facility. Increases in interest rates during the term of each lease, contract or loan could narrow or eliminate the spread, or result in a negative spread. The Company has adopted a policy designed to protect itself against interest rate volatility during the term of each lease, contract or loan.

Given the relatively short average life of the Company's leases, contracts and loans, the Company's goal is to maintain a blend of fixed and variable interest rate obligations. As of March 31, 2003, the Company's outstanding fixed-rate indebtedness outstanding under the Company's securitizations and subordinated debt represented 20.2% of the Company's total outstanding indebtedness.

ITEM 4. CONTROLS AND PROCEDURES

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

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

19

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Management believes, after consultation with counsel, that the allegations against the Company included in the lawsuits described below are subject to substantial legal defenses, and the Company is vigorously defending each of the allegations. The Company also is subject to claims and suits arising in the ordinary course of business. At this time, it is not possible to estimate the ultimate loss or gain, if any, related to these lawsuits, nor if any such loss will have a material adverse effect on the Company's results of operations or financial position.

A. The Company filed an action in the United States District Court for the District of Massachusetts against Sentinel Insurance Company, Ltd., ("Sentinel"), Premier Holidays International, Inc., ("Premier") and Daniel DelPiano ("DelPiano") arising from Premier's October, 1999, default on its repayment obligations to the Company under a Twelve Million Dollar (\$12,000,000) loan. Judgment has been entered in this case against Sentinel, which had issued a business performance insurance policy guaranteeing repayment of the loan, in the amount of Fourteen Million Dollars (\$14,000,000). This judgment has not been satisfied. Sentinel is currently undergoing liquidation proceedings, and a claim in this amount has been filed with the bankruptcy court. Premier has asserted a counterclaim against the Company for Seven Hundred Sixty Nine Million Three Hundred Fifty Thousand dollars (\$769,350,000) in actual and consequential damages, and for Five Hundred Million Dollars (\$500,000,000) in punitive damages, plus interest, cost and attorney's fees. The counterclaim is based upon an alleged representation by the Company that it would lend Premier an

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

additional Forty-Five Million Dollars (\$45,000,000), when all documents evidencing the Premier loan refer only to the Twelve Million (\$12,000,000) amount actually loaned and not repaid. The Company denies any liability on the counterclaim, which the Company is vigorously contesting. The Company's motion for summary judgment seeking dismissal of the counterclaim and the award of full damages on the Company's claims was denied by Court Order, without a written decision. The Company's motion for the appointment of a special master was also denied without a written decision. Because of the uncertainties inherent in litigation, we cannot predict whether the outcome will have a material adverse effect.

B. On January 29, 2002, Leasecomm was served with an Amended Complaint ("Complaint") in an action entitled *People v. Roma Computer Solutions, Inc.*, et al., Ventura County Superior Court Case No. CIV207490. The Complaint asserts two claims, one for violation of the California Business Professions Code Section 17500 (false advertising), and the other for violation of the California Business and Professions Code Section 17200 (unfair or unlawful acts or practices). The claims arise from the marketing and selling activities of other defendants, including *Roma Computer Solutions, Inc.*, and/or *Maro Securities, Inc.* The Complaint seeks to have Leasecomm held liable for the acts of other defendants, alleging that Leasecomm directly participated in those acts and received proceeds and the assignment of lease contracts as a result of those acts. The Complaint requests injunctive relief, rescission, restitution, and a civil penalty. The Company has filed an Answer denying the claims. Because of the uncertainties inherent in litigation, we cannot predict whether the outcome will have a material adverse affect.

C. In October, 2002, the Company was served with a Complaint in an action in the United States District Court for the Southern District of New York filed by approximately 170 present and former lessees asserting individual claims. The Complaint contains claims for violation of RICO (18 U.S.C. Section 1964), fraud, unfair and deceptive acts and practices, unlawful franchise offerings, and intentional infliction of mental anguish. The claims purportedly arise from Leasecomm's dealer relationships with *Themeware*, *E-Commerce Exchange*, *Cardservice International, Inc.*, and *Online Exchange* for the leasing of websites and virtual terminals. The Complaint asserts that the Company is responsible for the conduct of its dealers in trade shows, infomercials and web page advertisements, seminars, direct mail, telemarketing, all which are alleged to constitute unfair and deceptive acts and practices. Further, the Complaint asserts that Leasecomm's lease contracts as well as its collection practices and late fees are unconscionable. The Complaint seeks restitution, compensatory and treble damages, and injunctive relief. The Company filed a Motion to Dismiss the Complaint on January 31, 2003, and expects that the Motion will be argued sometime after June 30, 2003. Because of the uncertainties inherent in litigation, we cannot predict whether the outcome will have a material adverse effect.

D. On March 31, 2002, plaintiffs *Robert Hayden* and *Renono Wesley* filed a Complaint against Leasecomm Corporation alleging a violation of California Business & Professions Code Section 17200. The Complaint was filed on behalf of *Hayden* and *Wesley* individually, on behalf of a class of people similarly situated, and on behalf of

the general public. The case is venued in San Francisco Superior Court. Specifically, plaintiffs allege that Leasecomm's practice of filing suits against lessees in Massachusetts courts constitutes an unfair business practice under California law. On March 12, 2003, the San Francisco County Superior Court granted Leasecomm's Motion to dismiss this action.

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

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

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

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

H. On April 29, 2003, Leasecomm was served with a Complaint filed in the Orange County Superior Court for the State of California. In that Complaint, Maria J. Smith purports to bring a claim against Leasecomm and two other defendants (Galaxy Mall, Inc. and Electronic Commerce International, Inc.) for unfair business practices and competition under California Business and Professions Code section 17200 et seq. The essence of the claim is that Smith and others who are similarly situated were defrauded in connection with their acquisition of certain licenses that were financed by Leasecomm. Leasecomm currently is expected to respond to the complaint by May 29, 2003. Management expects to defend the action vigorously.

Leasecomm has been served with Civil Investigative Demands and subpoenas by the Offices of the Attorney General for the states of Kansas, Illinois, Florida, and Texas, and for the Commonwealth of Massachusetts. Those Offices of the Attorney General, in conjunction with the Northwest Region Office of the Federal Trade Commission, the Offices of the Attorney General for North Carolina and North Dakota, and the Ventura County, California, District Attorney's Office, have informed Leasecomm that they are seeking to coordinate their investigations (collectively, the "Government Investigators"). At this time, the principal focus of the investigations appears to be software license

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

leases (principally virtual terminals) and leases from certain vendor/dealers whose activities included business opportunity seminars. Leasecomm has further been informed that the investigations cover certain lease provisions, including the forum selection clause and language concerning the non-cancellability of the lease. In addition, the investigations include, among other things, whether Leasecomm's lease termination, or rollover, provisions, are legally sufficient; whether a Leasecomm lease is an enforceable lease; whether there were potential problems with its leases of which Leasecomm had knowledge; whether the leases are enforceable in accordance with their terms; whether three day right of rescission notices were required and, if required, whether proper notices were given; whether any lease prices were unconscionable; whether the lease of a software license is the lease of a

21

service, not a good; whether any lease of satellites or computers are leases to consumers which must comply with certain consumer statutes; whether electronic fund transfer payments pursuant to a lease violate Reg. E; whether any Leasecomm billing and collection practices or charges are unreasonable, or constitute unfair or deceptive trade practices; whether Leasecomm's course of dealings with its vendors/dealers makes Leasecomm liable for any of the activities of its vendors/dealers. In April, 2002, Leasecomm and the Government Investigators entered into provisional relief and tolling agreements which provide for Leasecomm to take certain interim actions, toll the running of the statute of limitations as of January 29, 2002, and require advance notice by Leasecomm of its withdrawal from the provisional relief agreement and advance notice by each of the Government Investigators of its intention to commence legal action. The tolling agreement has been extended several times, and is currently to expire in June, 2003. The parties have reached an agreement in principle, subject to final approval by the Government Investigators, which would conclude the investigations through the entry of consent judgments.

Additionally, from time-to-time Leasecomm receives complaints, requests or directives from various state enforcement agencies with respect to individual lessees or groups of lessees which are fewer than 100 in number. While these requests or directives can occur regularly, they concern relatively few leases and, therefore, are not likely to have a material adverse effect on the Company.

Since the investigations have not been concluded, and no legal action has been commenced against Leasecomm, there can be no assurance as to the eventual outcome.

ITEM 3. RECENT SALES OF UNREGISTERED SECURITIES

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

ITEM 5. OTHER INFORMATION

The Company's chief executive officer and chief financial officer have furnished to the SEC the certification with respect to this Form 10-Q that is required by Section 906 of the Sarbanes-Oxley Act of 2002.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) The following exhibits are filed herewith:

- 10.1 Second Amendment to Fourth Amended and Restated Revolving Credit Agreement dated April 14, 2003 among Leasecomm Corporation, Fleet National Bank, as agent, and the other Lenders named therein
- 10.2 Warrant Purchase Agreement dated April 14, 2003 among the Company, Fleet National Bank, as agent, and the other Lenders named therein
- 10.3 Form of Warrants to purchase Common Stock of the Company issued April 14, 2003, together with schedule of warrant holders
- 10.4 Co-Sale Agreement dated April 14, 2003 among the Company, Peter R. Bleyleben, Torrence C. Harder, Brian E. Boyle, Richard F. Latour, Alan J. Zakon, and James R. Jackson, Jr., and the Lenders named therein
- 10.5 Registration Rights Agreement dated April 14, 2003 among the Company and the Lenders named therein
- 10.6 Direction and Permanent Waiver of Trigger Events and Servicer Events of Default dated April 15, 2003 among Ambac Assurance Corporation, Wells Fargo Bank Minnesota, National Association ("Wells Fargo"), as indenture trustee, MFI Finance Corp. I and Leasecomm Corporation waiving certain covenants under the Amended and Restated Indenture dated as of September 1, 2001 and related documents thereto, all with respect to MFI Finance Corp. I
- 10.7 MFI Finance II, LLC 8.00% Asset-Backed Notes, Series 2001-1: MFI II Permanent Waiver dated April 15, 2003 between N M Rothschild & Sons Limited and the Company waiving certain covenants under the Amended and Restated Indenture dated as of September 1, 2001 and related documents thereto, all with respect to MFI Finance Corp. II
- 10.8 First Amendment to Amended and Restated Indenture dated April 15, 2003 among the Company, MFI Finance Corp I, Wells Fargo, as back-up servicer and Wells Fargo, as indenture trustee
- 10.9 Third Amendment to Servicing Agreement dated April 15, 2003 among the Company, MFI Finance Corp I, Wells Fargo, as back-up servicer and Wells Fargo, as indenture trustee
- 10.10 First Amendment to Fourth Amended and Restated Revolving Credit Agreement dated September 21, 2001 among Leasecomm Corporation, Fleet National Bank, as agent, and the other Lenders named therein
- 10.11 Forbearance and Modification Agreement dated January 3, 2003 among Leasecomm Corporation, Fleet National Bank, as agent, and the other Lenders named therein

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

- 10.12 Forbearance and Modification Agreement dated January 24, 2003 among Leasecomm Corporation, Fleet National Bank, as agent, and the other Lenders named therein
- 10.13 Second Amendment to Servicing Agreement dated October 14, 2002 among the Company, MFI Finance Corp I, Wells Fargo, as back-up servicer and Wells Fargo, as indenture trustee
- 10.14 Letter Agreement dated April 14, 2003 among Fleet National Bank, as Agent, the Company, and the holders of the Company's 7.5% Term Notes
- 10.15 Letter Agreement dated April 14, 2003 among Fleet National Bank, as Agent, the Company, and the holders of the Company's Subordinated Capital Notes
- 99.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 99.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(b) A form 8-K was filed on March 11, 2003, to announce the results for the year ended December 31, 2002. A second report on Form 8-K was filed on March 19, 2003 disclosing other events. A third report on Form 8-K was filed on April 16, 2003 to announce the results for the quarter and year ended December 31, 2002 and that the Company has secured an amendment to its Credit Agreement and received permanent waivers under its securitization facility.

23

SIGNATURES

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

MicroFinancial Incorporated

By: /s/ Richard F. Latour

President and Chief Executive Officer

By: /s/ James R. Jackson Jr.

Vice President and Chief Financial Officer

Date: May 15, 2003

24

CERTIFICATION

I, Richard F. Latour, certify that:

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

1. I have reviewed this quarterly report on Form 10-Q of MicroFinancial Incorporated;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
 - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
 - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
 - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
 - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officer and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

/s/ RICHARD F. LATOUR

Richard F. Latour
President and Chief Executive Officer

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

Date: May 15, 2003

25

CERTIFICATION

I, James R. Jackson Jr., certify that:

1. I have reviewed this quarterly report on Form 10-Q of MicroFinancial Incorporated;
3. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
 - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
 - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
 - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
 - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
7. The registrant's other certifying officer and I have indicated in this quarterly report whether or not there were significant changes in

Edgar Filing: MICROFINANCIAL INC - Form 10-Q

internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

/s/ JAMES R. JACKSON JR.

James R. Jackson Jr.
Vice President and Chief Financial Officer

Date: May 15, 2003