

MICROFINANCIAL INC
Form 10-K
March 31, 2009

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-K**

- þ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2008
- or**
- o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**Commission file no. 1-14771
MicroFinancial Incorporated**
(Exact name of Registrant as Specified in its Charter)

Massachusetts
*(State or other jurisdiction of
incorporation or organization)*

04-2962824
*(I.R.S. Employer
Identification No.)*

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

01801
(Zip Code)

**Registrant's telephone number, including Area Code:
(781) 994-4800**

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
Common Shares, \$0.01 par value per share	The Nasdaq Stock Market LLC

**Securities registered pursuant to Section 12(g) of the Act:
None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes No

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 preceding 12 months (or for such shorter period that the registrant was

required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company
(Do not check if a smaller reporting company)

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

The aggregate market value of the registrant's voting and non-voting common equity held by non-affiliates of the registrant as of June 30, 2008 the last day of the registrant's most recently completed second fiscal quarter, was approximately \$32,161,000 computed by reference to the closing price of such stock as of such date.

As of March 16, 2009, 14,139,942 shares of the registrant's common stock were outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's proxy statement to be filed pursuant to Regulation 14A within 120 days after the Registrant's fiscal year end of December 31, 2008, are incorporated by reference in Part III hereof.

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PART I

Item 1. *Business*

General

MicroFinancial Incorporated (referred to as MicroFinancial, we, us or our) was formed as a Massachusetts corporation on January 27, 1987. We operate primarily through our wholly-owned subsidiaries, TimePayment Corp. (TimePayment) and Leasecomm Corporation (Leasecomm). TimePayment is a specialized commercial finance company that leases and rents microticket equipment and provides other financing services. TimePayment commenced originating leases in July 2004. Leasecomm started originating leases in January 1986 and in October 2002 suspended virtually all originations due to a lack of financing. The average amount financed by TimePayment in 2008 was approximately \$5,500 while Leasecomm historically financed contracts averaging approximately \$1,900. We have used proprietary software in developing a sophisticated, risk-adjusted pricing model and in automating our credit approval and collection systems, including a fully-automated Internet-based application, credit scoring and approval process.

We provide financing alternatives to a wide range of lessees ranging from start-up businesses to established businesses. We primarily lease and rent low-priced commercial equipment, which is used by these lessees in their daily operations. We do not market our services directly to lessees. We primarily source our originations through a nationwide network of independent equipment vendors, sales organizations, brokers and other dealer-based origination networks. We fund our operations through cash provided by operating activities and borrowings under our line of credit.

TimePayment finances a wide variety of products with no single product representing more than 25% of the amount financed in its portfolio as of December 31, 2008. The Leasecomm portfolio consists primarily of contracts for authorization systems for point-of-sale (POS), card-based payments by debit, credit, gift and charge cards. POS authorization systems require the use of a POS terminal capable of reading a cardholder s account information from the card s magnetic strip and combining this information with the amount of the sale entered via a POS terminal keypad, or POS software used on a personal computer to process a sale. The terminal electronically transmits this information over a communications network to a computer data center and then displays the returned authorization or verification response on the POS terminal.

We depend heavily on external financing to fund new leases and contracts. On August 2, 2007, we entered into a three-year \$30 million line of credit with a bank syndicate led by Sovereign Bank (Sovereign) based on qualified TimePayment lease receivables. On July 9, 2008 we entered into an amended agreement to increase our line of credit with Sovereign to \$60 million. The maturity date of the amended agreement is August 2, 2010. Outstanding borrowings are collateralized by eligible lease contracts and a security interest in all of our other assets. Until February 2009, borrowings bore interest at the prime rate (Prime) or at the 90-day London Interbank Offered Rate (LIBOR) plus 2.75%. Under the terms of the facility, loans are Prime Rate Loans, unless we elect LIBOR Loans. If a LIBOR Loan is not renewed at maturity it automatically converts to a Prime Rate Loan.

On February 10, 2009, we entered into an amended agreement to increase our line of credit with Sovereign to \$85 million. Under the amended agreement, outstanding borrowings bear interest at either Prime plus 1.75% or LIBOR plus 3.75%, in each case subject to a minimum interest rate of 5%. All other terms of the facility remained the same.

In June 2004, MicroFinancial secured a \$10 million credit facility, comprised of a one-year \$8 million line of credit and a \$2 million three-year subordinated note which allowed us to resume originations after suspending originations in 2002 when our then-existing credit facility failed to renew. In conjunction with raising new capital, we also established TimePayment as a new wholly-owned operating subsidiary. In September 2004, MicroFinancial secured a three-year, \$30 million, senior secured revolving line of credit from CIT Commercial Services, a unit of CIT Group (CIT). This line of credit replaced the \$8 million line of credit under more favorable terms and conditions. In addition, we retired the outstanding senior credit facility with the former bank group. On July 20, 2007, by mutual agreement between CIT and us, we paid off and terminated the CIT line of credit without penalty.

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Leasing, Servicing and Financing Programs

We originate leases for products that typically have limited distribution channels and high selling costs. We facilitate sales of such products by allowing dealers to make them available to their customers for a small monthly lease payment rather than a higher initial purchase price. We primarily lease and rent low-priced commercial equipment to small merchants. We currently lease a wide variety of equipment including POS authorization systems, advertising and display equipment, security equipment, paging systems, water coolers and restaurant equipment. In addition, in the past we have acquired service contracts and contracts in certain other financing markets, and continue to look for opportunities to invest in these types of assets. Our current portfolio also includes a limited amount of consumer financings which consist of service contracts from dealers that primarily provide residential security monitoring services, as well as consumer leases for a wide range of consumer products.

Since resuming originations in June 2004 we have originated and continue to service contracts in all 50 states and the District of Columbia. As of December 31, 2006, leases in California, Florida, Texas, Massachusetts and New York accounted for approximately 40% of our portfolio. No state accounted for more than 10% of such total. As of December 31, 2007, California, Florida, Texas and New York accounted for approximately 13%, 13%, 8%, and 7%, respectively, of the total portfolio. No other state accounted for more than 5% of such total. As of December 31, 2008, Florida, California, Texas and New York accounted for approximately 13%, 12%, 8%, and 7%, respectively, of the total portfolio. No other state accounted for more than 5% of such total.

Terms of Equipment Leases

Substantially all equipment leases originated or acquired by us are non-cancelable. We generally originate leases on transactions referred to us by a dealer where we buy the underlying equipment from the referring dealer upon funding the approved application. Leases are structured with limited recourse to the dealer, with risk of loss in the event of default by the lessee residing with us in most cases. We perform all the processing, billing and collection functions under our leases.

During the term of a typical lease, we receive payments sufficient, in the aggregate, to cover our borrowing cost, the cost of the underlying equipment, and to provide us with an appropriate profit. Throughout the term of the lease, we charge late fees, prepayment penalties, loss and damage waiver fees and other service fees, when applicable. Initial terms of the leases we funded in 2008 generally range from 12 to 60 months, with an average initial term of 45 months.

The terms and conditions of all of our leases are substantially similar. In most cases, the contracts require lessees to: (i) maintain, service and operate the equipment in accordance with the manufacturer's and government-mandated procedures; (ii) insure the equipment against property and casualty loss; (iii) pay all taxes associated with the equipment; and (iv) make all scheduled contract payments regardless of the performance of the equipment. Our standard lease forms provide that in the event of a default by the lessee, we can require payment of liquidated damages and can seize and remove the equipment for sale, refinancing or other disposal at our discretion. Any additions, modifications or upgrades to the equipment, regardless of the source of payment, are automatically incorporated into, and deemed a part of, the equipment financed.

We seek to protect ourselves from credit exposure relating to dealers by entering into limited recourse agreements with our dealers, under which the dealer agrees to reimburse us for defaulted contracts under certain circumstances, primarily upon evidence of dealer errors or misrepresentations in originating a lease or contract.

Residual Interests in Underlying Equipment

We typically own a residual interest in the equipment covered by our leases. The value of such interest is estimated at inception of the lease based upon our estimate of the fair market value of the asset at lease maturity. At the end of the lease term, the lessee has the option to buy the equipment at the fair market value, return the equipment or continue to rent the equipment on a month-to-month basis. If the equipment is returned, we may either sell the equipment, or place it into our used equipment rental or leasing program.

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Service Contracts

In the past we have also from time to time acquired service contracts, under which a homeowner purchases a security system and simultaneously signs a contract with the dealer for the monitoring of that system for a monthly fee. Upon approval of the monitoring application and verification with the homeowner that the system is installed, we would purchase the right to the payment stream under the monitoring contract from the dealer at a negotiated multiple of the monthly payments. We have not purchased any new security service contracts since 2004, although we do originate security equipment leases that include monitoring. Our service contract portfolio represents a less significant portion of our revenue stream over time.

Dealers

We provide financing to obligors under microticket leases and contracts through a nationwide network of equipment vendors, independent sales organizations and brokers. We do not sign exclusive agreements with our dealers. Dealers interact directly with potential lessees and typically market not only their products and services, but also the financing arrangements offered through us. Historically, we had over 1,000 different dealers originating leases and contracts on a regular basis. When we suspended nearly all of our contract originations in October 2002 due to a lack of financing sources, the number of dealers we utilized for the limited number of contracts we were able to originate declined substantially. As we began to originate more contracts following the establishment of our line of credit with CIT in September 2004, we also began to expand the number of dealers in our network. During the year ended 2008 we had over 800 different dealers originating leases and contracts.

During the year ended December 31, 2006 our top dealer accounted for 13.91% of the leases originated. During the year ended December 31, 2007 our top dealer accounted for 10.03% of the leases originated. During the year ended December 31, 2008 our top dealer accounted for 4.5% of the leases originated.

Use of Technology

Our business is operationally intensive, due in part to the small average amount financed. Accordingly, technology and automated processes are critical in keeping servicing costs to a minimum while providing quality customer service.

We have developed TimePaymentDirect, an Internet-based application processing, credit approval and dealer information tool. Using TimePaymentDirect, a dealer can input an application and obtain almost instantaneous approval automatically over the Internet, all without any contact with our employees. We also offer InstaleaseR, a program that allows a dealer to submit applications to us by telephone, telecopy or e-mail, receive approval, and complete a sale from a lessee's location. By assisting the dealers in providing timely, convenient and competitive financing for their equipment contracts and offering dealers a variety of value-added services, we simultaneously promote equipment contract sales and the utilization of TimePayment as the preferred finance provider, thus differentiating us from our competitors.

We have used our proprietary software to develop a multidimensional credit-scoring model which generates pricing of our leases and contracts commensurate with the risk assumed. This software does not produce a binary yes or no decision, but rather, for a yes decision, determines the price at which the lease or contract might be profitably underwritten. We use credit scoring in most, but not all, of our credit decisions.

Underwriting

The nature of our business requires that the underwriting process perform two levels of review: the first focused on the ultimate end-user of the equipment or service and the second focused on the dealer. The approval process begins with the submission by telephone, facsimile or electronic transmission of a credit application by the dealer. Upon submission, we either manually or through TimePaymentDirect conduct our own independent credit investigation of the lessee using our proprietary database. In order to facilitate this process we will use recognized commercial credit reporting agencies such as Dun & Bradstreet, Paynet and Experian. Our software evaluates this information on a two-dimensional scale, examining both credit depth (how much information exists on an applicant) and credit quality (credit performance, including past payment history). We use this information to

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underwrite a broad range of credit risks and provide financing in situations where our competitors may be unwilling to provide such financing. The credit-scoring model is complex and automatically adjusts for different transactions. In situations where the amount financed is over \$10,000 we may go beyond our own data base and recognized commercial credit reporting agencies to obtain information from less readily available sources such as banks. In certain instances, we will require the lessee to provide verification of employment and salary.

The second aspect of the credit decision involves an assessment of the originating dealer. Dealers undergo both an initial screening process and ongoing evaluation, including an examination of dealer portfolio credit quality and performance, lessee complaints, cases of fraud or misrepresentation, aging studies, number of applications and conversion rates for applications. This ongoing assessment enables us to manage our dealer relationships, including ending relationships with poorly performing dealers.

Upon credit approval, we require receipt of a signed lease on our standard or other pre-approved lease form. After the equipment is shipped and installed, the dealer invoices us and we verify that the lessee has received and accepted the equipment. Upon the completion of a satisfactory verification with the lessee, the lease is forwarded to our funding and documentation department for payment to the dealer and the establishment of the accounting and billing procedures for the transaction.

Bulk and Portfolio Acquisitions

In addition to originating leases through our dealer relationships, from time to time we have also purchased lease portfolios from dealers. While certain of these leases may not have met our underwriting standards at inception, we will purchase the leases once the lessee demonstrates a satisfactory payment history. We prefer to acquire these smaller lease portfolios in situations where the seller will continue to act as a dealer following the acquisition. We have not purchased any material portfolio in 2008, 2007 nor 2006.

Servicing and Collections

We perform all the servicing functions on our leases and contracts through our automated servicing and collection system. Servicing responsibilities generally include billing, processing payments, remitting payments to dealers, paying taxes and insurance and performing collection and liquidation functions.

Our automated lease administration system handles application tracking, invoicing, payment processing, automated collection queuing, portfolio evaluation and report writing. The system is linked with our bank acco