

NICHOLAS FINANCIAL INC  
Form 10-Q  
February 10, 2014  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, DC 20549**

**FORM 10-Q**

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

**FOR THE QUARTERLY PERIOD ENDED December 31, 2013**

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

**FOR THE TRANSITION PERIOD FROM \_\_\_\_\_ TO \_\_\_\_\_.**

**Commission file number: 0-26680**

**NICHOLAS FINANCIAL, INC.**

**(Exact Name of Registrant as Specified in its Charter)**

**British Columbia, Canada**  
**(State or Other Jurisdiction of**  
**Incorporation or Organization)**

**8736-3354**  
**(I.R.S. Employer**  
**Identification No.)**

**2454 McMullen Booth Road, Building C**

**Clearwater, Florida**  
**(Address of Principal Executive Offices)**

**33759**  
**(Zip Code)**

**(727) 726-0763**

**(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 and 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter periods that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

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

Large accelerated filer  Accelerated filer   
Non-accelerated filer  Smaller reporting company

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

As of January 31, 2014, the registrant had 12,217,574 shares of common stock outstanding.

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**NICHOLAS FINANCIAL, INC.**

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Nicholas Financial, Inc. and Subsidiaries

Consolidated Balance Sheets

|   | <b>December 31,<br/>2013<br/>(Unaudited)</b> | <b>March 31,<br/>2013</b> |
|---|--|---------------------------|
| <b>Assets</b>   |  |                           |
| Cash  | \$ 4,089,466                                 | \$ 2,797,716              |
| Finance receivables, net  | 261,254,324                                  | 249,825,801               |
| Assets held for resale  | 1,758,171                                    | 1,203,664                 |
| Income taxes receivable   | 276,823                                      | 102,999                   |
| Prepaid expenses and other assets   | 711,834                                      | 736,746                   |
| Property and equipment, net   | 765,198                                      | 741,581                   |
| Interest rate swap agreements   | 181,976                                      |                           |
| Deferred income taxes   | 7,048,360                                    | 8,426,961                 |
| <b>Total assets</b>   | <b>\$ 276,086,152</b>                        | <b>\$ 263,835,468</b>     |
| <b>Liabilities and shareholders equity</b>  |  |                           |
| Line of credit  | \$ 127,000,000                               | \$ 125,500,000            |
| Drafts payable  | 1,570,755                                    | 2,096,311                 |
| Accounts payable and accrued expenses   | 6,677,051                                    | 7,405,579                 |
| Interest rate swap agreements   | 4,839  | 504,852                   |
| Deferred revenues   | 2,018,582                                    | 1,363,630                 |
| <b>Total liabilities</b>  | <b>137,271,227</b>                           | <b>136,870,372</b>        |
| <b>Shareholders equity</b>  |  |                           |
| Preferred stock, no par: 5,000,000 shares authorized; none issued   |  |                           |
| Common stock, no par: 50,000,000 shares authorized; 12,208,719 and 12,154,069 shares issued and outstanding, respectively | 30,888,690                                   | 30,031,548                |
| Retained earnings   | 107,926,235                                  | 96,933,548                |
| <b>Total shareholders equity</b>  | <b>138,814,925</b>                           | <b>126,965,096</b>        |
| <b>Total liabilities and shareholders equity</b>  | <b>\$ 276,086,152</b>                        | <b>\$ 263,835,468</b>     |

*See accompanying notes.*



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## Nicholas Financial, Inc. and Subsidiaries

## Consolidated Statements of Income

(Unaudited)

|   | Three months ended<br>December 31, |               | Nine months ended<br>December 31, |               |
|---|------------------------------------|---------------|-----------------------------------|---------------|
|   | 2013                               | 2012          | 2013                              | 2012          |
| <b>Revenue:</b>                                       |                                    |               |                                   |               |
| Interest and fee income on finance receivables        | \$ 20,756,034                      | \$ 20,594,614 | \$ 62,168,567                     | \$ 61,708,812 |
| Sales   | 5,196                              | 10,247        | 17,322                            | 29,196        |
|   | 20,761,230                         | 20,604,861    | 62,185,889                        | 61,738,008    |
| <b>Expenses:</b>                                      |                                    |               |                                   |               |
| Cost of sales   | 2,125                              | 3,895         | 6,961                             | 9,067         |
| Marketing   | 350,408                            | 362,159       | 1,109,997                         | 1,091,989     |
| Salaries and employee benefits                        | 4,859,897                          | 4,451,546     | 14,542,906                        | 13,539,636    |
| Professional fees                                     | 1,060,863                          | 187,220       | 2,012,249                         | 639,032       |
| Administrative  | 2,223,531                          | 2,046,004     | 6,607,094                         | 5,960,778     |
| Provision for credit losses                           | 4,183,035                          | 3,484,811     | 10,797,930                        | 9,849,798     |
| Dividend taxes  |                                    | 1,286,694     | 142,557                           | 1,419,152     |
| Depreciation  | 78,755                             | 69,998        | 230,909                           | 212,718       |
| Interest expense                                      | 1,441,175                          | 1,275,015     | 4,288,979                         | 3,717,386     |
| Change in fair value of interest rate swap agreements | (98,346)                           | (37,348)      | (681,989)                         | 645,772       |
|   | 14,101,443                         | 13,129,994    | 39,057,593                        | 37,085,328    |
| Operating income before income taxes                  | 6,659,787                          | 7,474,867     | 23,128,296                        | 24,652,680    |
| Income tax expense                                    | 2,833,019                          | 2,878,811     | 9,284,483                         | 9,499,030     |
| Net income  | \$ 3,826,768                       | \$ 4,596,056  | \$ 13,843,813                     | \$ 15,153,650 |
| <b>Earnings per share:</b>                            |                                    |               |                                   |               |
| Basic   | \$ 0.32                            | \$ 0.38       | \$ 1.15                           | \$ 1.27       |
| Diluted   | \$ 0.31                            | \$ 0.38       | \$ 1.13                           | \$ 1.24       |
| Dividends declared per share                          | \$                                 | \$ 2.12       | \$ 0.24                           | \$ 2.34       |

*See accompanying notes.*



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Nicholas Financial, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

(Unaudited)

|  | <b>Nine months ended<br/>December 31,</b> |               |
|--|---|---------------|
|  | <b>2013</b>                               | <b>2012</b>   |
| <b>Cash flows from operating activities</b>  |   |               |
| Net income   | \$ 13,843,813                             | \$ 15,153,650 |
| Adjustments to reconcile net income to net cash provided by operating activities:    |   |               |
| Depreciation   | 230,909                                   | 212,718       |
| Gain on sale of property and equipment   | (21,800)                                  | (5,615)       |
| Provision for credit losses  | 10,797,930                                | 9,849,798     |
| Amortization of dealer discounts   | (9,911,725)                               | (8,797,978)   |
| Deferred income taxes  | 1,378,601                                 | 900,165       |
| Share-based compensation   | 405,264                                   | 658,707       |
| Change in fair value of interest rate swap agreements                                | (681,989)                                 | 645,772       |
| Changes in operating assets and liabilities:   |   |               |
| Prepaid expenses and other assets  | 24,912                                    | 52,644        |
| Accounts payable and accrued expenses  | (728,528)                                 | (1,093,360)   |
| Income taxes receivable  | (173,824)                                 | (899,926)     |
| Deferred revenues  | 654,952                                   | 25,237        |
| Net cash provided by operating activities  | 15,818,515                                | 16,701,812    |
| <b>Cash flows from investing activities</b>  |   |               |
| Purchase and origination of finance receivables                                      | (111,941,584)                             | (100,603,313) |
| Principal payments received  | 99,626,856                                | 95,471,545    |
| Increase in assets held for resale   | (554,507)                                 | (392,302)     |
| Purchase of property and equipment   | (273,507)                                 | (212,808)     |
| Proceeds from sale of property and equipment   | 40,781                                    | 6,670         |
| Net cash used in investing activities  | (13,101,961)                              | (5,730,208)   |
| <b>Cash flows from financing activities</b>  |   |               |
| Net draws on line of credit  | 1,500,000                                 | 18,500,000    |
| Change in drafts payable   | (525,556)                                 | 150,802       |
| Payment of cash dividends  | (2,851,126)                               | (28,383,040)  |
| Proceeds from exercise of stock options  | 275,772                                   | 422,400       |
| Excess tax benefits from exercise of stock options and vesting of other share awards | 176,106                                   | 201,836       |



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|  |              |              |
|--|--------------|--------------|
| Net cash provided (used) by financing activities | (1,424,804)  | (9,108,002)  |
| Net increase in cash                             | 1,291,750    | 1,863,602    |
| Cash, beginning of period                        | 2,797,716    | 2,803,054    |
| Cash, end of period                              | \$ 4,089,466 | \$ 4,666,656 |

*See accompanying notes.*

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Nicholas Financial, Inc. and Subsidiaries

Notes to the Consolidated Financial Statements

(Unaudited)

**1. Basis of Presentation**

The accompanying consolidated balance sheet as of March 31, 2013, which has been derived from audited financial statements, and the accompanying unaudited interim consolidated financial statements of Nicholas Financial, Inc. (including its subsidiaries, the Company) have been prepared in accordance with accounting principles generally accepted in the United States (U.S. GAAP) for interim financial information and with the instructions to Form 10-Q pursuant to the Securities and Exchange Act of 1934, as amended in Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete consolidated financial statements, although the Company believes that the disclosures made are adequate to ensure the information is not misleading. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for interim periods are not necessarily indicative of the results that may be expected for the year ending March 31, 2014. It is suggested that these consolidated financial statements be read in conjunction with the consolidated financial statements and accompanying notes thereto included in the Company's Annual Report on Form 10-K for the year ended March 31, 2013 as filed with the Securities and Exchange Commission on June 14, 2013. The March 31, 2013 consolidated balance sheet included herein has been derived from the March 31, 2013 audited consolidated balance sheet included in the aforementioned Form 10-K.

The preparation of consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for credit losses on finance receivables and the fair value of interest rate swap agreements.

As previously disclosed in the Company's Annual Report on Form 10-K for the year ended March 31, 2013, the Company made error corrections for departures from U.S. GAAP and revised previously reported amounts. One of the corrections is related to the accounting treatment for dealer discounts. A dealer discount represents the difference between the amount of a finance receivable, net of unearned interest, based on the terms of a Contract with the borrower, and the amount of money the Company actually pays the dealer for the Contract. Prior to the correction, Contracts were recorded at the net initial investment with the gross Contract balance recorded offset by the dealer discounts which were recorded as an allowance for credit losses for the acquired Contracts. The Company determined that this accounting treatment was incorrect as U.S. GAAP prohibits carrying over valuation allowances in the initial accounting for acquired loans. Accordingly, the Company has now applied an acceptable method under U.S. GAAP, deferring and netting dealer discounts against finance receivables as unearned discounts, and recognizing dealer discounts into income as an adjustment to yield over the life of the loan using the interest method.

The allowance for loan losses is now established solely through charges to earnings through the provision for credit losses. The Company has evaluated the significance of the departure from U.S. GAAP to the consolidated financial statements. Under both the former accounting policy and U.S. GAAP, the dealer discount remains a reduction of gross finance receivables in arriving at the carrying amount of finance receivables, net. Accordingly, finance receivables continue to be initially recorded at the net initial investment at the time of purchase. Subsequently, the allowance for

credit losses is maintained at an amount that reduces the net carrying amount of finance receivables. The change in this accounting presentation does not result in a change to the net carrying amount of finance receivables or to net income as historical losses incurred, and estimated incurred losses as of the balance sheet date, are generally in excess of the original dealer discount. The removal of the dealer discount from the allowance requires an equal replacement of provision expense as that portion of the allowance is necessary to absorb probable incurred losses. This correction also did not have an impact on previously reported assets, liabilities, working capital, equity, earnings, or cash flows.

The second correction related to the accounting treatment and presentation of certain fees charged to dealers and costs incurred in purchasing loans from dealers. The costs related principally to evaluating borrowers subject to Contracts in relation to the Company's underwriting guidelines in making a determination to acquire Contracts. Prior to the correction, fees charged to dealers were reduced by certain costs incurred to purchase Contracts, deferred on a net basis and then amortized into income over the lives of the loans using the interest method. Under U.S. GAAP, the fees charged to dealers are considered to be a part of the unearned dealer discount as they are a determinant of the net amount of cash paid to the dealer. Further, U.S. GAAP specifies that costs incurred in connection with acquiring purchased loans or committing to purchase loans shall be charged to expense as incurred. Such costs do not qualify as origination costs to be deferred as the Contracts have already been originated by the dealers.

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## Nicholas Financial, Inc. and Subsidiaries

## Notes to the Consolidated Financial Statements (Continued)

(Unaudited)

**1. Basis of Presentation (continued)**

The Company evaluated the significance of the departures from U.S. GAAP to the consolidated financial statements. After an adjustment to beginning equity and the opening balance of unearned dealer discounts, net of tax, for the initial period presented, there is a limited effect on earnings and no impact on cash flows.

The changes to consolidated financial statement captions and earnings per share, if any, are as follows:

|  | <b>December 31,<br/>2012 as Reported</b>                            | <b>Correction</b> | <b>December 31,<br/>2012 as Corrected</b>                            |
|--|---|-------------------|--|
| <b><u>Consolidated Balance Sheet</u></b>               |   |                   |  |
| Finance receivables, net                               | \$ 246,342,674  | \$ (1,009,292)    | \$ 245,333,382   |
| Deferred income taxes                                  | 7,836,774   | 386,358           | 8,223,132  |
| Retained earnings, December 31,<br>2012                | 94,230,663  | (622,934)         | 93,607,729   |
| <br>   |   |                   |  |
|  | <b>Three months ended<br/>December 31,<br/>2012 as<br/>Reported</b> | <b>Correction</b> | <b>Three months ended<br/>December 31,<br/>2012 as<br/>Corrected</b> |
| <b><u>Consolidated Statement of Income</u></b>         |   |                   |  |
| <b><u>Three months ended December 31,<br/>2012</u></b> |   |                   |  |
| Interest and fee income on finance<br>receivables      | \$ 17,878,745   | \$ 2,715,869      | \$ 20,594,614  |
| Provision for credit losses                            | 818,903   | 2,665,908         | 3,484,811  |
| Operating income                                       | 7,424,906   | 49,961            | 7,474,867  |
| Income tax expense                                     | 2,859,686   | 19,125            | 2,878,811  |
| Net income   | 4,565,220   | 30,836            | 4,596,056  |
| Earnings per share basic                               | 0.38  |                   | 0.38   |
| Earnings per share diluted                             | 0.37  | 0.01              | 0.38   |

|   | <b>Nine months ended<br/>December 31,<br/>2012 as<br/>Reported</b> | <b>Correction</b> | <b>Nine months ended<br/>December 31,<br/>2012 as<br/>Corrected</b> |
|---|--|-------------------|---|
| <b><u>Consolidated Statement of Income</u></b>    |  |                   |   |
| <b><u>Nine months ended December 31, 2012</u></b> |  |                   |   |
| Interest and fee income on finance receivables    | \$ 52,910,831  | \$ 8,797,981      | \$ 61,708,812   |
| Provision for credit losses                       | 1,137,615  | 8,712,183         | 9,849,798   |
| Operating income                                  | 24,566,882   | 85,798            | 24,652,680  |
| Income tax expense                                | 9,466,187  | 32,843            | 9,499,030   |
| Net income  | 15,100,695   | 52,955            | 15,153,650  |
| Earnings per share basic                          | 1.26   | 0.01              | 1.27  |
| Earnings per share diluted                        | 1.24   |                   | 1.24  |

|   | <b>Nine months ended<br/>December 31,<br/>2012 as Reported</b> | <b>Correction</b> | <b>Nine months ended<br/>December 31,<br/>2012 as Corrected</b> |
|---|--|-------------------|---|
| <b><u>Consolidated Statements of Cash Flows</u></b> |  |                   |   |
| <b><u>(Operating Activities)</u></b>                |  |                   |   |
| Net income  | \$ 15,100,695  | \$ 52,955         | \$ 15,153,650   |
| Provision for credit losses                         | 1,137,615  | 8,712,183         | 9,849,798   |
| Deferred income taxes                               | 867,325  | 32,840            | 900,165   |
| Amortization of dealer discounts                    |  | (8,797,978)       | (8,797,978)   |
| Net cash provided by operating activities           | 16,701,812   |                   | 16,701,812  |

In addition the Company has corrected these errors in the finance receivables disclosure in Note 4. The following table sets forth a reconciliation of the changes in the allowance for credit losses on Contracts:

|                                  | <b>Three months ended<br/>December 31,<br/>2012 as Reported</b> |             | <b>Correction</b> | <b>Three months ended<br/>December 31,<br/>2012 as Corrected</b> |             |
|----------------------------------|---|-------------|-------------------|--|-------------|
| Balance at beginning of year     | \$  | 34,100,661  | \$ (15,743,844)   | \$   | 18,356,817  |
| Discounts acquired on new volume |   | 2,485,560   | (2,485,560)       |  |             |
| Provision for credit losses      |   | 757,347     | 2,665,908         |  | 3,423,255   |
| Losses absorbed                  |   | (5,571,903) |                   |  | (5,571,903) |
| Recoveries                       |   | 786,891     |                   |  | 786,891     |
| Discounts accreted               |   | (404,994)   | 404,994           |  |             |
| Balance at end of year           | \$  | 32,153,562  | \$ (15,158,502)   | \$   | 16,995,060  |

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## Nicholas Financial, Inc. and Subsidiaries

## Notes to the Consolidated Financial Statements (Continued)

(Unaudited)

**1. Basis of Presentation (continued)**

|                                  | <b>Nine months ended<br/>December 31,<br/>2012 as Reported</b> | <b>Correction</b> | <b>Nine months ended<br/>December 31,<br/>2012 as Corrected</b> |
|----------------------------------|--|-------------------|---|
| Balance at beginning of year     | \$ 35,495,684  | \$ (15,996,476)   | \$ 19,499,208   |
| Discounts acquired on new volume | 8,469,382  | (8,469,382)       |   |
| Provision for credit losses      | 971,746  | 8,712,183         | 9,683,929   |
| Losses absorbed                  | (14,527,271)   |                   | (14,527,271)  |
| Recoveries                       | 2,339,194  |                   | 2,339,194   |
| Discounts accreted               | (595,173)  | 595,173           |   |
| Balance at end of year           | \$ 32,153,562  | \$ (15,158,502)   | \$ 16,995,060   |

**2. Revenue Recognition**

Finance receivables consist of automobile finance installment contracts ( Contracts ) and direct consumer loans ( Direct Loans ). Interest income on finance receivables is recognized using the interest method. Accrual of interest income on finance receivables is suspended when a loan is contractually delinquent for 60 days or more or the collateral is repossessed, whichever is earlier.

When the Company receives a payment for a loan that was contractually delinquent for more than 60 days, the payment is posted to the account. At the time of the payment, the interest that was paid is recorded as income by the Company and the loan is no longer considered over 60 days contractually delinquent; therefore, the accruing of interest is resumed. As of December 31, 2013 and March 31, 2013 the amount of gross finance receivables not accruing interest was approximately \$10,478,000 and \$4,132,000, respectively, as discussed further in Note 4.

A dealer discount represents the difference between the finance receivable, net of unearned interest, of a Contract, and the amount of money the Company actually pays for the Contract. The discount negotiated by the Company is a function of the lender, the wholesale value of the vehicle and competition in any given market. In making decisions regarding the purchase of a particular Contract the Company considers the following factors related to the borrower: place and length of residence; current and prior job status; history in making installment payments for automobiles; current income; and credit history. In addition, the Company examines its prior experience with Contracts purchased from the dealer from which the Company is purchasing the Contract, and the value of the automobile in relation to the purchase price and the term of the Contract. The entire amount of discount is amortized as an adjustment to yield using the interest method over the life of the loan. The average dealer discount associated with new volume for the nine months ended December 31, 2013 and 2012 was 8.47% and 8.59%, respectively in relation to gross finance

receivables.

The amount of future unearned income is computed as the product of the Contract rate, the Contract term, and the Contract amount. Deferred revenues consist primarily of commissions received from the sale of ancillary products. These products include automobile warranties, roadside assistance programs, accident and health insurance, credit life insurance and forced placed automobile insurance. These commissions are amortized over the life of the contract using the interest method.

Sales relate principally to telephone support agreements and the sale of business forms to small businesses located primarily in the Southeastern United States. The aforementioned sales of the Nicholas Data Services, Inc. subsidiary, ( NDS ) represent less than 1% of the Company's consolidated revenues.



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## Nicholas Financial, Inc. and Subsidiaries

## Notes to the Consolidated Financial Statements (Continued)

(Unaudited)

**3. Earnings Per Share**

Basic earnings per share is calculated by dividing the reported net income for the period by the weighted average number of shares of common stock outstanding. Diluted earnings per share includes the effect of dilutive options and other share awards. Basic and diluted earnings per share have been computed as follows:

|  | <b>Three months ended<br/>December 31,</b> |              | <b>Nine months ended<br/>December 31,</b> |               |
|--|--|--------------|---|---------------|
|  | <b>2013</b>                                | <b>2012</b>  | <b>2013</b>                               | <b>2012</b>   |
| Numerator for earnings per share net income                      | \$ 3,826,768                               | \$ 4,596,056 | \$ 13,843,813                             | \$ 15,153,650 |
| Denominator:   |  |              |   |               |
| Denominator for basic earnings per share weighted average shares | 12,108,988                                 | 11,981,627   | 12,088,835                                | 11,961,886    |
| Effect of dilutive securities:                                   |  |              |   |               |
| Stock options and other share awards                             | 225,191                                    | 211,831      | 197,136                                   | 229,895       |
| Denominator for diluted earnings per share                       | 12,334,179                                 | 12,193,458   | 12,285,971                                | 12,191,781    |
| Earnings per share:  |  |              |   |               |
| Basic  | \$ 0.32                                    | \$ 0.38      | \$ 1.15                                   | \$ 1.27       |
| Diluted  | \$ 0.31                                    | \$ 0.38      | \$ 1.13                                   | \$ 1.24       |

For the three months ended December 31, 2013 and 2012, potential common stock from stock options totaling 10,000 and 114,500, respectively, were not included in the diluted earnings per share calculation because their effect is anti-dilutive. For the nine months ended December 31, 2013 and 2012 potential common stock from stock options totaling 10,000 and 114,500, respectively, were not included in the diluted earnings per share calculation because their effect is anti-dilutive.

**4. Finance Receivables**

Finance receivables consist of automobile finance installment Contracts and Direct Loans and are detailed as follows:

|   | <b>December 31,<br/>2013</b> | <b>March 31,<br/>2013</b> |
|---|------------------------------|---------------------------|
| Finance receivables, gross contract   | \$ 411,105,001               | \$ 395,721,730            |
| Unearned interest   | (119,523,851)                | (112,922,191)             |
| Finance receivables, net of unearned interest                               | 291,581,150                  | 282,799,539               |
| Unearned dealer discounts   | (16,708,367)                 | (16,415,169)              |
| Finance receivables, net of unearned interest and unearned dealer discounts | 274,872,783                  | 266,384,370               |
| Allowance for credit losses   | (13,618,459)                 | (16,558,569)              |
| Finance receivables, net  | \$ 261,254,324               | \$ 249,825,801            |

The terms of the Contracts range from 12 to 72 months and the Direct Loans range from 6 to 48 months. The Contracts and Direct Loans bear a weighted average effective interest rate of 23.12% and 26.33% as of December 31, 2013, respectively and 23.31% and 25.84% as of March 31, 2013, respectively.

Finance receivables consist of Contracts and Direct Loans, each of which comprises a portfolio segment. Each portfolio segment consists of smaller balance homogeneous loans which are collectively evaluated for impairment.

The following table sets forth a reconciliation of the changes in the allowance for credit losses on Contracts:

|                                | <b>Three months ended<br/>December 31,</b> |               | <b>Nine months ended<br/>December 31,</b> |               |
|--------------------------------|--|---------------|---|---------------|
|                                | <b>2013</b>                                | <b>2012</b>   | <b>2013</b>                               | <b>2012</b>   |
| Balance at beginning of period | \$ 13,479,022                              | \$ 18,356,817 | \$ 16,090,652                             | \$ 19,499,208 |
| Current period provision       | 4,157,616                                  | 3,423,255     | 10,525,262                                | 9,683,929     |
| Losses absorbed                | (5,540,334)                                | (5,571,903)   | (16,218,673)                              | (14,527,271)  |
| Recoveries                     | 884,373                                    | 786,891       | 2,583,436                                 | 2,339,194     |
| Balance at end of period       | \$ 12,980,677                              | \$ 16,995,060 | \$ 12,980,677                             | \$ 16,995,060 |

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## Nicholas Financial, Inc. and Subsidiaries

## Notes to the Consolidated Financial Statements (Continued)

(Unaudited)

**4. Finance Receivables (continued)**

The Company purchases Contracts from automobile dealers at a negotiated price that is less than the original principal amount being financed by the purchaser of the automobile. The Contracts are predominately for used vehicles. As of December 31, 2013, the average model year of vehicles collateralizing the portfolio was a 2006 vehicle. The average loan to value ratio, which expresses the amount of the Contract as a percentage of the value of the automobile, is approximately 94%. The Company utilizes a static pool approach to track portfolio performance. If the allowance for credit losses is determined to be inadequate for a static pool, then an additional charge to income through the provision is used to maintain adequate reserves based on management's evaluation of the risk inherent in the loan portfolio, the composition of the portfolio, and current economic conditions. Such evaluation, considers among other matters, the estimated net realizable value or the fair value of the underlying collateral, economic conditions, historical loan loss experience, management's estimate of probable credit losses and other factors that warrant recognition in providing for an adequate allowance for credit losses. In determining the provision and allowance for credit losses, we consider the reduction in the net carrying amount of finance receivables resulting from dealer discounts.

The following table sets forth a reconciliation of the changes in the allowance for credit losses on Direct Loans:

|                                | <b>Three months ended<br/>December 31,</b> |             | <b>Nine months ended<br/>December 31,</b> |             |
|--------------------------------|--|-------------|---|-------------|
|                                | <b>2013</b>                                | <b>2012</b> | <b>2013</b>                               | <b>2012</b> |
| Balance at beginning of period | \$ 659,615                                 | \$ 531,101  | \$ 467,917                                | \$ 492,184  |
| Current period provision       | 25,419                                     | 61,556      | 272,668                                   | 165,869     |
| Losses absorbed                | (56,424)                                   | (57,006)    | (126,997)                                 | (131,201)   |
| Recoveries                     | 9,172                                      | 6,739       | 24,194                                    | 15,538      |
| Balance at end of period       | \$ 637,782                                 | \$ 542,390  | \$ 637,782                                | \$ 542,390  |

Direct Loans are originated directly between the Company and the consumer. These loans are typically for amounts ranging from \$1,000 to \$8,000 and are generally secured by a lien on an automobile, watercraft or other permissible tangible personal property. The majority of Direct Loans are originated with current or former customers under the Company's automobile financing program. The typical Direct Loan represents a significantly better credit risk than our typical Contract due to the customer's historical payment history with the Company. In deciding whether or not to make a loan, the Company considers the individual's credit history, job stability, income and impressions created during a personal interview with a Company loan officer. Additionally, because most of Direct Loans made by the Company to date have been made to borrowers under Contracts previously purchased by the Company, the payment history of the borrower under the Contract is a significant factor in making the loan decision. As of December 31,

2013, loans made by the Company pursuant to its Direct Loan program constituted approximately 3% of the aggregate principal amount of the Company's loan portfolio.

Changes in the allowance for credit losses for both Contracts and Direct Loans were driven by current economic conditions and trends over several reporting periods which are useful in estimating future losses and overall portfolio performance.

A performing account is defined as an account that is less than 61 days past due. A non-performing account is defined as an account that is contractually delinquent for 61 days or more and the accrual of interest income is suspended. When an account is 120 days contractually delinquent, the account is written off. Effective April 1, 2013, the Company changed its policy in regards to bankrupt accounts. Prior to April 1, 2013 the Company would charge-off the entire principal balance of a bankrupt account in the month following confirmation from the bankruptcy court. Subsequent to the charge-off the Company would collect monthly payments from the bankruptcy court recording the recovery payments and reducing charge-off totals in the month collected. Under the new method, the Company no longer charges off the entire principal balance at the time of bankruptcy. Upon notification of a bankruptcy, an account is monitored for collection with other bankrupt accounts. In the event the debtors balance has been reduced by the bankruptcy court, the Company will record a loss equal to the amount of principal balance reduction. The remaining balance will be reduced as payments are received by the bankruptcy court. In the event an account is dismissed from bankruptcy, the Company will decide, based on several factors, to begin repossession proceedings to allow the customer to begin making regularly scheduled payments. This approach to bankrupt accounts aligns the Company with typical industry practice.

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## Nicholas Financial, Inc. and Subsidiaries

## Notes to the Consolidated Financial Statements (Continued)

(Unaudited)

**4. Finance Receivables (continued)**

The following table is an assessment of the credit quality by creditworthiness:

|                         | December 31,<br>2013  |                      | March 31,<br>2013     |                     |
|-------------------------|-----------------------|----------------------|-----------------------|---------------------|
|                         | Contracts             | Direct<br>Loans      | Contracts             | Direct<br>Loans     |
| Non-bankrupt accounts   | \$ 395,782,832        | \$ 11,301,076        | \$ 386,324,594        | \$ 5,721,768        |
| Bankrupt accounts       | 4,002,282             | 18,811               | 615,499               |                     |
| <b>Total</b>            | <b>\$ 399,785,114</b> | <b>\$ 11,319,887</b> | <b>\$ 386,940,093</b> | <b>\$ 5,721,768</b> |
| Performing accounts     | \$ 389,390,841        | \$ 11,236,408        | \$ 382,843,130        | \$ 5,685,981        |
| Non-performing accounts | 10,394,273            | 83,479               | 4,096,963             | 35,787              |
| <b>Total</b>            | <b>\$ 399,785,114</b> | <b>\$ 11,319,887</b> | <b>\$ 386,940,093</b> | <b>\$ 5,721,768</b> |

The following tables present certain information regarding the delinquency rates experienced by the Company with respect to Contracts and under its Direct Loans:

|                     | Gross Balance<br>Outstanding | Delinquencies |              |              |               |              | Total |
|---------------------|------------------------------|---------------|--------------|--------------|---------------|--------------|-------|
|                     |                              | 31            | 60 days      | 61           | 90 days       | Over 90 days |       |
| <b>Contracts</b>    |                              |               |              |              |               |              |       |
| December 31, 2013   | \$ 399,785,114               | \$ 18,740,543 | \$ 5,200,159 | \$ 5,194,114 | \$ 29,134,816 |              |       |
|                     |                              | 4.69%         | 1.30%        | 1.30%        | 7.29%         |              |       |
| December 31, 2012   | \$ 380,519,395               | \$ 17,287,813 | \$ 4,529,766 | \$ 2,254,123 | \$ 24,071,702 |              |       |
|                     |                              | 4.54%         | 1.19%        | 0.59%        | 6.32%         |              |       |
| <b>Direct Loans</b> |                              |               |              |              |               |              |       |
| December 31, 2013   | \$ 11,319,887                | \$ 176,446    | \$ 40,887    | \$ 42,592    | \$ 259,925    |              |       |
|                     |                              | 1.56%         | 0.36%        | 0.38%        | 2.30%         |              |       |

|                   |              |            |           |           |            |
|-------------------|--------------|------------|-----------|-----------|------------|
| December 31, 2012 | \$ 8,861,098 | \$ 116,251 | \$ 29,295 | \$ 22,501 | \$ 168,047 |
|                   |              | 1.31%      | 0.33%     | 0.25%     | 1.89%      |

## 5. Line of Credit

The Company has an agreement with its consortium of lenders for a line of credit facility (the Line ) for an amount of \$150,000,000. In December 2012, the Company executed an amendment to the Line that extends the maturity date to November 30, 2014. The pricing of the Line is 300 basis points above 30-day LIBOR with a 1% floor on LIBOR (4.00% at December 31, 2013 and March 31, 2013). Pledged as collateral for this credit facility are all of the assets of the Company. The outstanding amount of the credit facility was approximately \$127,000,000 and \$125,500,000 as of December 31, 2013 and March 31, 2013, respectively. The amount available under the line of credit was approximately \$23,000,000 and \$24,500,000 as of December 31, 2013 and March 31, 2013, respectively.

The facility requires compliance with certain financial ratios and covenants and satisfaction of specified financial tests, including maintenance of asset quality and performance tests. Dividends do not require consent in writing by the agent and majority lenders under the new facility as long as the Company is in compliance with a net income covenant. As of December 31, 2013, the Company was in full compliance with all debt covenants.

## 6. Interest Rate Swap Agreements

The Company utilizes interest rate swap agreements to manage exposure to variability in expected cash flows attributable to interest rate risk. The interest rate swap agreements convert a portion of the floating rate debt to a fixed rate, more closely matching the interest rate characteristics of finance receivables.

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Nicholas Financial, Inc. and Subsidiaries

Notes to the Consolidated Financial Statements (Continued)

(Unaudited)

**6. Interest Rate Swap Agreements (continued)**

The following table summarizes the activity in the notional amounts of interest rate swap agreements:

|                                 | <b>Nine months ended<br/>December 31,</b> |               |
|---------------------------------|---|---------------|
|                                 | <b>2013</b>                               | <b>2012</b>   |
| Notional amounts at April 1     | \$ 50,000,000                             | \$            |
| New contracts                   |   | 50,000,000    |
| Matured contracts               |   |               |
| Notional amounts at December 31 | \$ 50,000,000                             | \$ 50,000,000 |

Interest rate swap agreements effective as of December 31, 2013 and during the three and nine months ended December 31, 2013 and 2012 are detailed as follows:

| <b>Date Entered</b> | <b>Effective Date</b> | <b>Notional Amount</b> | <b>Fixed Rate<br/>Of Interest</b> | <b>Maturity Date</b> |
|---------------------|-----------------------|------------------------|-----------------------------------|----------------------|
| June 1, 2012        | June 13, 2012         | \$ 25,000,000          | 1.00%                             | June 13, 2017        |
| July 30, 2012       | August 13, 2012       | \$ 25,000,000          | 0.87%                             | August 14, 2017      |

The interest rate swap agreements are not designated as hedges. The changes in the fair value of interest of interest rate swaps (unrealized gains and losses) are recorded in earnings. The Company does not use interest rate swap agreements for speculative purposes. Such instruments continue to be intended for use as economic hedges.

The locations and amounts of (gains) losses in income are as follows:

|  | <b>Three months ended<br/>December 31,</b> |             | <b>Nine months ended<br/>December 31,</b> |             |
|--|--|-------------|---|-------------|
|  | <b>2013</b>                                | <b>2012</b> | <b>2013</b>                               | <b>2012</b> |
| Periodic change in fair value of interest rate swap agreements | \$ (98,346)                                | \$ (37,348) | \$ (681,989)                              | \$ 645,772  |

|  |                   |                  |                     |                   |
|--|-------------------|------------------|---------------------|-------------------|
| Periodic settlement differentials included in interest expense | 95,641            | 91,468           | 284,680             | 184,892           |
| <b>Total</b>   | <b>\$ (2,705)</b> | <b>\$ 54,120</b> | <b>\$ (397,309)</b> | <b>\$ 830,664</b> |

The Company recorded realized losses from the swap agreements in the interest expense line item of the consolidated statement of income. The following table summarizes the variable rate received and fixed rate paid under the swap agreements.

|                        | <b>Three months ended</b> |             | <b>Nine months ended</b> |             |
|------------------------|---------------------------|-------------|--------------------------|-------------|
|                        | <b>December 31,</b>       |             | <b>December 31,</b>      |             |
|                        | <b>2013</b>               | <b>2012</b> | <b>2013</b>              | <b>2012</b> |
| Variable rate received | 0.17%                     | 0.21%       | 0.18%                    | 0.24%       |
| Fixed rate paid        | 0.94%                     | 0.94%       | 0.94%                    | 0.95%       |

## 7. Fair Value Disclosures

The Company measures specific assets and liabilities at fair value, which is an exit price, representing the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. When applicable, the Company utilizes market data or assumptions that market participants would use in pricing the asset or liability under a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value. These tiers include: Level 1, defined as observable inputs such as quoted prices in active markets; Level 2, defined as inputs other than quoted prices in active markets that are either directly or indirectly observable; and Level 3, defined as unobservable inputs about which little or no market data exists, therefore requiring an entity to develop its own assumptions.



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## Nicholas Financial, Inc. and Subsidiaries

## Notes to the Consolidated Financial Statements (Continued)

(Unaudited)

**7. Fair Value Disclosures (continued)****Assets and Liabilities Recorded at Fair Value on a Recurring Basis**

The Company estimates the fair value of interest rate swap agreements based on the estimated net present value of the future cash flows using a forward interest rate yield curve in effect as of the measurement period, adjusted for nonperformance risk, if any, including a quantitative and qualitative evaluation of both the Company's credit risk and the counterparty's credit risk. Accordingly, the Company classifies interest rate swap agreements as Level 2.

| Description                    | Fair Value Measurement |                  |         | Fair Value   |
|--------------------------------|------------------------|------------------|---------|--------------|
|                                | Level 1                | Using<br>Level 2 | Level 3 |              |
| Interest rate swap agreements: |                        |                  |         |              |
| December 31, 2013:             |                        |                  |         |              |
| Effective June 13, 2012        | \$                     | \$ 181,976       | \$      | \$ 181,976   |
| Effective August 13, 2012      | \$                     | \$ (4,839)       | \$      | \$ (4,839)   |
| March 31, 2013                 | \$                     | \$ (504,852)     | \$      | \$ (504,852) |

**Financial Instruments Not Measured at Fair Value**

The Company's financial instruments consist of finance receivables and the Line. For each of these financial instruments the carrying value approximates fair value.

Finance receivables, net approximates fair value based on the price paid to acquire indirect loans. The price paid reflects competitive market interest rates and purchase discounts for the Company's chosen credit grade in the economic environment. This market is highly liquid as the Company acquires individual loans on a daily basis from dealers. The initial terms of the Contracts range from 12 to 72 months. The initial terms of the Direct Loans range from 6 to 48 months. In addition, there have been minimal changes in interest rates and purchase discounts related to these types of loans. If liquidated outside of the normal course of business, the amount received may not be the carrying value.

The Line was amended within the quarter ended December 31, 2012. Based on current market conditions, any new or renewed credit facility would contain pricing that approximates the Company's current Line. Based on these market conditions, the fair value of the Line as of December 31, 2013 was estimated to be equal to the book value. The interest rate for the Line is a variable rate based on LIBOR pricing options.

## Fair Value Measurement Using

| Description                 | Level 1 | Level 2        | Level 3        | Fair Value     |
|-----------------------------|---------|----------------|----------------|----------------|
| <b>Finance receivables:</b> |         |                |                |                |
| December 31, 2013           | \$      | \$             | \$ 261,254,000 | \$ 261,254,000 |
| March 31, 2013              | \$      | \$             | \$ 249,826,000 | \$ 249,826,000 |
| <b>Line of credit:</b>      |         |                |                |                |
| December 31, 2013           | \$      | \$ 127,000,000 | \$             | \$ 127,000,000 |
| March 31, 2013              | \$      | \$ 125,500,000 | \$             | \$ 125,500,000 |

Assets and Liabilities Recorded at Fair Value on a Nonrecurring Basis

The Company may be required, from time to time, to measure certain assets and liabilities at fair value on a nonrecurring basis. The Company does not currently have any assets or liabilities measured at fair value on a nonrecurring basis.

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Nicholas Financial, Inc. and Subsidiaries

Notes to the Consolidated Financial Statements (Continued)

(Unaudited)

**8. Cash Dividend**

Dividends recorded during the nine months ended December 31, 2013 and 2012 were declared and paid as follows. On May 7, 2013 the Board of Directors announced a quarterly cash dividend equal to \$0.12 per common share, to be paid on June 28, 2013 to shareholders of record as of June 21, 2013. On August 13, 2013 the Board of Directors announced a quarterly cash dividend equal to \$0.12 per common share, to be paid on September 27, 2013 to shareholders of record as of September 20, 2013. On May 2, 2012, the Company's Board of Directors announced a quarterly cash dividend of \$0.10 to be paid on June 6, 2012. On August 7, 2012 the Board of Directors declared a quarterly dividend equal to \$0.12 per common share, to be paid on September 6, 2012 to shareholders of record as of August 30, 2012.

Payment of cash dividends results in a 5% withholding tax payable by the Company under the Canada-United States Income Tax Convention which is included in earnings under the caption of dividend tax.

**9. Arrangement Agreement**

On December 17, 2013, the Company entered into an Arrangement Agreement (the "Arrangement Agreement") whereby the Company has agreed to sell all of its issued and outstanding Common Shares to an indirect wholly-owned subsidiary of Prospect Capital Corporation ("Prospect") pursuant to a plan of arrangement (the "Arrangement") under the Business Corporations Act (British Columbia).

**10. Contingencies**

The following is a brief summary of litigation filed against the Company related to the Arrangement Agreement:

Jason Simpson v. Nicholas Financial, Inc., et al., Case No. 13-011726-CI (Circuit Court, Pinellas County, Florida), filed December 24, 2013; Gabriella Rago v. Nicholas Financial, Inc., et al., Case No. 8:13-cv-03261-VMC-TGW (U.S. District Court, Tampa, Florida), filed December 30, 2013; Matthew John Leonard v. Nicholas Financial, Inc., et al., Case No. 13-011811-CI (Circuit Court, Pinellas County, Florida), filed December 31, 2013; Michelangelo Lombardo v. Nicholas Financial, Inc., et al., Case No. 14-000095-CI (Circuit Court, Pinellas County, Florida), filed January 3, 2014; and Edward Opton v. Stephen Bragin, et al., Case No. 14-000139-CI (Circuit Court, Pinellas County, Florida), filed January 6, 2014. The five pending, substantially similar lawsuits were filed in connection with the Arrangement contemplated by the Arrangement Agreement. Each plaintiff purports to represent a class of all of the Company's shareholders other than the defendants and any person or entity related to or affiliated with any defendant. Four of the lawsuits name as defendants the Company, the Company's directors, Prospect, and the Prospect affiliates that are parties to the Arrangement Agreement (collectively, Prospect and such affiliates are referred to as the "Prospect Parties"). The fifth lawsuit names those same parties as defendants, with the exception of two of the Prospect Parties. Each plaintiff alleges that the consideration to be paid for the Company's Common Shares is inadequate and that certain terms of the Arrangement Agreement are contrary to the interests of the Company's public shareholders. Each plaintiff asserts a breach of fiduciary duty claim against the Company's directors, and an aiding and abetting claim

against the Company and/or certain of the Prospect Parties. The plaintiff to the U.S. District Court action also asserts claims under Sections 14(a) and 20(a) of the Securities Exchange Act of 1934 against the Company, the Company's directors and/or Prospect, alleging that the Registration Statement on Form N-14 filed by Prospect on January 13, 2014 misrepresents and omits certain material information related to the proposed transaction. Each plaintiff seeks declaratory relief, injunctive relief, other equitable relief and/or damages with respect to the proposed transaction, and an award of attorneys' fees. The Prospect Parties, the Company and the Company's directors do not believe that there is any merit to any of the pending actions, and they intend to defend vigorously against such actions.

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

**Forward-Looking Information**

This report on Form 10-Q contains various statements, other than those concerning historical information, that are based on management's beliefs and assumptions, as well as information currently available to management, and should be considered forward-looking statements. This notice is intended to take advantage of the safe harbor provided by the Private Securities Litigation Reform Act of 1995 with respect to such forward-looking statements. When used in this document, the words "anticipate", "estimate", "expect", and similar expressions are intended to identify forward-looking statements. Although the Company believes that the expectations reflected in such forward-looking statements are reasonable, it can give no assurance that such expectations will prove to be correct. Such statements are subject to certain risks, uncertainties and assumptions. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those anticipated, estimated or expected. Among the key factors that may have a direct bearing on the Company's operating results are fluctuations in the economy, the ability to access bank financing, the degree and nature of competition, demand for consumer financing in the markets served by the Company, the Company's products and services, increases in the default rates experienced on Contracts, adverse regulatory changes in the Company's existing and future markets, the Company's ability to expand its business, including its ability to complete acquisitions and integrate the operations of acquired businesses, to recruit and retain qualified employees, to expand into new markets and to maintain profit margins in the face of increased pricing competition. All forward looking statements included in this report are based on information available to the Company on the date hereof, and the Company assumes no obligations to update any such forward looking statement. You should also consult factors described from time to time in the Company's filings made with the Securities and Exchange Commission, including its reports on Forms 10-K, 10-Q, 8-K and annual reports to shareholders.

**Arrangement Agreement**

On December 17, 2013, the Company entered into an Arrangement Agreement (the "Arrangement Agreement") whereby the Company has agreed to sell all of its issued and outstanding Common Shares to an indirect wholly-owned subsidiary of Prospect Capital Corporation ("Prospect") pursuant to a plan of arrangement (the "Arrangement") under the Business Corporations Act (British Columbia).

Prospect (NASDAQ: PSEC) ([www.prospectstreet.com](http://www.prospectstreet.com)) is a closed-end investment company that lends to and invests in private and public middle market businesses. Prospect's investment objective is to generate both current income and long-term capital appreciation through debt and equity investments.

Prospect has elected to be treated as a business development company under the Investment Company Act of 1940 ("1940 Act"). Prospect is required to comply with a series of regulatory requirements under the 1940 Act as well as applicable NASDAQ, federal and state rules and regulations. Prospect has elected to be treated as a regulated investment company under the Internal Revenue Code of 1986. Failure to comply with any of the laws and regulations that apply to Prospect could have an adverse effect on Prospect and its shareholders.

Pursuant to the terms of the Arrangement, the Company's shareholders are to receive (subject to applicable dissenters rights under the Business Corporations Act (British Columbia)), in exchange for each Common Share of the Company held immediately prior to the effective time of the Arrangement, the number of shares of common stock of Prospect (or fraction thereof) determined by dividing US \$16.00 by the volume-weighted average price, or VWAP, of Prospect common stock for the twenty (20) trading days prior to and ending on the trading day immediately preceding the

effective time of the Arrangement. In addition, each option to acquire Common Shares of the Company outstanding immediately prior to the effective time of the Arrangement will be cancelled or transferred by the holder thereof to the Company (subject to applicable dissenters' rights under the Business Corporations Act (British Columbia)) in exchange for a cash amount equal to the amount by which (i) the product obtained by multiplying (x) the number of Common Shares of the Company underlying such option by (y) US \$16.00 exceeds (ii) the aggregate exercise price payable under such option.

The transactions contemplated by the Arrangement Agreement will not be consummated unless certain conditions typical for this type of transaction are either satisfied or waived prior to closing. These conditions include, among other things, that the Arrangement Agreement and the transactions contemplated thereby are approved by the securityholders of the Company in accordance with the Business Corporations Act (British Columbia) and the Company's Articles. An information circular providing further information regarding the Arrangement Agreement and the parties thereto will be mailed to securityholders of the Company in advance of the special meeting thereof expected to be held for the purpose of approving, among other things, the Arrangement Agreement and the Arrangement contemplated thereby.

Janney Montgomery Scott LLC is acting as the exclusive financial adviser to the Company and rendered a fairness opinion regarding the transaction to our Board of Directors.

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**Litigation and Legal Matters**

See Item 1. Legal Proceedings in Part II of this quarterly report below.

**Corrections to Consolidated Financial Statements**

In connection with the audit of our consolidated financial statements for the fiscal year ended March 31, 2013, the Company determined that it was necessary to correct its consolidated financial statements.

One of the corrections is related to the accounting treatment for dealer discounts. A dealer discount represents the difference between the amount of a finance receivable, net of unearned interest, based on the terms of a Contract with the borrower, and the amount of money the Company actually pays the dealer for the Contract. Prior to the correction, Contracts were recorded at the net initial investment, with the gross Contract balances recorded offset by the dealer discounts which were recorded as an allowance for credit losses for the acquired Contracts. The Company determined that this accounting treatment was incorrect as U.S. GAAP prohibits carrying over valuation allowances in the initial accounting for acquired loans. Accordingly, the Company has now applied an acceptable method under U.S. GAAP, deferring and netting dealer discounts against finance receivables as unearned discounts, and recognizing dealer discounts into income as an adjustment to yield over the life of the each loan using the interest method.

The allowance for loan losses is now established solely through charges to earnings through the provision for credit losses. The Company has evaluated the significance of the departure from U.S. GAAP to the consolidated financial statements. Under both the former accounting policy and U.S. GAAP, the dealer discount remains a reduction of gross finance receivables in arriving at the carrying amount of finance receivables, net. Accordingly, finance receivables continue to be initially recorded at the net initial investment at the time of purchase. Subsequently, the allowance for credit losses is maintained at an amount that reduces the net carrying amount of finance receivables for incurred losses. The change in this accounting presentation does not result in a change to the net carrying amount of finance receivables or to net income as historical losses incurred, and estimated incurred losses as of the balance sheet date, are generally in excess of the original dealer discount. The removal of the dealer discount from the allowance requires an equal replacement of provision expense as that portion of the allowance is necessary to absorb probable incurred losses. This correction also did not have an impact on previously reported assets, liabilities, working capital, equity, earnings, or cash flows.

The second correction related to the accounting treatment and presentation of certain fees charged to dealers and costs incurred in purchasing loans from dealers. Such costs related principally to evaluating borrowers subject to Contracts in relation to the Company's underwriting guidelines in making a determination to acquire Contracts. Prior to the correction, fees charged to dealers were reduced by certain costs incurred to purchase Contracts, deferred on a net basis and then amortized into income over the lives of the loans using the interest method. Under U.S. GAAP, the fees charged to dealers are considered to be a part of the unearned dealer discount as they are a determinant of the net amount of cash paid to the dealer. Further, U.S. GAAP specifies that costs incurred in connection with acquiring purchased loans or committing to purchase loans shall be charged to expense as incurred. Such costs do not qualify as origination costs to be deferred as the Contracts have already been originated by the dealers. The Company evaluated the significance of the departure from U.S. GAAP to the consolidated financial statements. After an adjustment to beginning equity and the opening balance of unearned dealer discounts, net of tax, for the initial period presented, there is a limited effect on earnings and no impact on cash flows.

Management corrected the errors and retroactively adjusted amounts as of and for the three and nine months ended December 31, 2012 to ensure the errors would not result in a material difference in future periods.

The changes to the Company's consolidated financial statements for the three and nine months ended December 31, 2012 resulting from such corrections are set forth in Note 2. Summary of Significant Accounting Policies - Corrections to the consolidated financial statements of the Company included in Item 1. Financial Statements (Unaudited) of this Report.

Prior period interim financial information appearing elsewhere in this Report has also been revised in light of the foregoing corrections. The changes resulting from such corrections are immaterial and, accordingly, we are not amending or restating any previously filed SEC reports or the consolidated financials included therein.

**Critical Accounting Policy**

The Company's critical accounting policy relates to the allowance for credit losses. It is based on management's opinion of an amount that is adequate to absorb losses in the existing portfolio. The allowance for credit losses is established through a provision for losses based on management's evaluation of the risk inherent in the loan portfolio, the composition of the portfolio, and current economic conditions. Such evaluation, considers among other matters, the estimated net realizable value or the fair value of the underlying collateral, economic conditions, historical loan loss experience, management's estimate of probable credit losses and other factors that warrant recognition in providing for an adequate credit loss allowance.



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Because of the nature of the customers under the Company's Contracts and its Direct Loans, the Company considers the establishment of adequate reserves for credit losses to be imperative. The Company segregates its Contracts into static pools for purposes of establishing reserves for losses. All Contracts purchased by a branch during a fiscal quarter comprise a static pool. The Company pools Contracts according to branch location because the branches purchase Contracts in different geographic markets. This method of pooling by branch and quarter allows the Company to evaluate the different markets where the branches operate. The pools also allow the Company to evaluate the different levels of customer income, stability, credit history, and the types of vehicles purchased in each market. Each such static pool consists of the Contracts purchased by a branch office during the fiscal quarter.

Contracts are purchased from many different dealers and are all purchased on an individual Contract by Contract basis. Individual Contract pricing is determined by the automobile dealerships and is generally the lesser of state maximum interest rates or the maximum interest rate the customer will accept. In certain markets, competitive forces will drive down Contract rates from the maximum rate to a level where an individual competitor is willing to buy an individual Contract. The Company only buys Contracts on an individual basis and never purchases Contracts in batches, although the Company may consider portfolio acquisitions as part of its growth strategy.

The Company has detailed underwriting guidelines it utilizes to determine which Contracts to purchase. These guidelines are specific and are designed to cause all of the Contracts that the Company purchases to have common risk characteristics. The Company utilizes its District Managers to evaluate their respective branch locations for adherence to these underwriting guidelines. The Company also utilizes an internal audit department to assure adherence to its underwriting guidelines. The Company utilizes the branch model, which allows for Contract purchasing to be done on the branch level. Each Branch Manager may interpret the guidelines differently, and as a result, the common risk characteristics tend to be the same on an individual branch level but not necessarily compared to another branch.

The allowance for loan losses is established through charges to earnings through the provision for credit losses. The allowance for credit losses is maintained at an amount that reduces the net carrying amount of finance receivables for incurred losses. If a static pool is fully liquidated and has any remaining reserves, the excess provision is immediately reversed during the period. For static pools that are not fully liquidated that are deemed to have excess reserves, such amounts are reversed against provision for credit losses during the period.

In analyzing a static pool, the Company considers the performance of prior static pools originated by the branch office, the performance of prior Contracts purchased from the dealers whose Contracts are included in the current static pool, the credit rating of the customers under the Contracts in the static pool, and current market and economic conditions. Each static pool is analyzed monthly to determine if the loss reserves are adequate, and adjustments are made if they are determined to be necessary.

## **Introduction**

Consolidated net income decreased 17% to approximately \$3.8 million for the three-month period ended December 31, 2013 as compared to \$4.6 million for the corresponding period ended December 31, 2012. Diluted earnings per share decreased 18% to \$0.31 as compared to \$0.38 for the three months ended December 31, 2013 and December 31, 2012. Consolidated net income decreased 9% to approximately \$13.8 million for the nine-month period ended December 31, 2013 as compared to \$15.2 million for the corresponding period ended December 31, 2012. Diluted earnings per share decreased 9% to \$1.13 for the nine months ended December 31, 2013 as compared to \$1.24 for the nine months ended December 31, 2012.

The results for the three- and nine-month periods ended December 31, 2013 were adversely affected by a reduction in the gross portfolio yield and significant professional fees associated with the previously announced sale of the

Company. Also, after-tax earnings were increasingly impacted as a significant portion of the professional fees were not deductible for income tax purposes resulting in a higher effective tax rate and after-tax impact of \$0.07 per share. Our results for the the three- and nine-month periods ended December 31, 2012 were affected by an after-tax charge of \$747,000 or \$0.06 per share related to a 5% withholding tax associated with the one-time special cash dividend of \$2.00 per share paid in December 2012.

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The Company's software subsidiary, Nicholas Data Services, did not contribute significantly to consolidated operations in the three or nine months ended December 31, 2013 or 2012.

| <b>Portfolio Summary</b>  | <b>Three months ended<br/>December 31,</b> |                | <b>Nine months ended<br/>December 31,</b> |                |
|---|--|----------------|---|----------------|
|   | <b>2013</b>                                | <b>2012</b>    | <b>2013</b>                               | <b>2012</b>    |
| Average finance receivables, net of unearned interest (1)   | \$ 291,620,270                             | \$ 281,553,866 | \$ 289,110,042                            | \$ 281,242,951 |
| Average indebtedness (2)  | \$ 128,500,000                             | \$ 114,131,239 | \$ 127,545,256                            | \$ 111,293,746 |
| Interest and fee income on finance receivables (3)*   | \$ 20,756,034                              | \$ 20,594,614  | \$ 62,168,566                             | \$ 61,708,812  |
| Interest expense  | 1,441,175                                  | 1,275,015      | 4,288,979                                 | 3,717,386      |
| Net interest and fee income on finance receivables*   | \$ 19,314,859                              | \$ 19,319,599  | \$ 57,879,587                             | \$ 57,991,426  |
| Weighted average contractual rate (4)   | 23.33%                                     | 23.34%         | 23.20%                                    | 23.55%         |
| Average cost of borrowed funds (2)  | 4.49%                                      | 4.47%          | 4.48%                                     | 4.45%          |
| Gross portfolio yield (5)*  | 28.47%                                     | 29.26%         | 28.67%                                    | 29.26%         |
| Interest expense as a percentage of average finance receivables, net of unearned interest   | 1.98%                                      | 1.81%          | 1.98%                                     | 1.76%          |
| Provision for credit losses as a percentage of average finance receivables, net of unearned interest*   | 5.74%                                      | 4.95%          | 4.98%                                     | 4.67%          |
| Net portfolio yield (5)*  | 20.75%                                     | 22.50%         | 21.71%                                    | 22.83%         |
| Marketing, salaries, employee benefits, depreciation, administrative, professional fee expenses and dividend taxes as a percentage of average finance receivables, net of unearned interest (6) | 11.68%                                     | 11.86%         | 11.29%                                    | 10.76%         |
| Pre-tax yield as a percentage of average finance receivables, net of  | 9.07%                                      | 10.64%         | 10.42%                                    | 12.07%         |

## unearned interest (7)\*

|                               |       |       |       |       |
|-------------------------------|-------|-------|-------|-------|
| Write-off to liquidation (8)  | 7.62% | 7.94% | 7.24% | 6.82% |
| Net charge-off percentage (9) | 6.34% | 6.75% | 6.20% | 5.74% |

**Note:** All three and nine month key performance indicators expressed as percentages have been annualized.

- (1) Average finance receivables, net of unearned interest, represents the average of gross finance receivables, less unearned interest throughout the period.
  - (2) Average indebtedness represents the average outstanding borrowings under the Line. Average cost of borrowed funds represents interest expense as a percentage of average indebtedness.
  - (3) Interest and fee income on finance receivables does not include revenue generated by Nicholas Data Services, Inc., ( NDS ) the wholly-owned software subsidiary of Nicholas Financial, Inc.
  - (4) Weighted average contractual rate represents the weighted average annual percentage rate ( APR ) of all Contracts purchased and Direct Loans originated during the period.
  - (5) Gross portfolio yield represents finance revenues as a percentage of average finance receivables, net of unearned interest. Net portfolio yield represents finance revenue minus (a) interest expense and (b) the provision for credit losses as a percentage of average finance receivables, net of unearned interest.
  - (6) Administrative expenses included in the calculation above are net of administrative expenses associated with NDS which approximated \$58,000 and \$54,000 during the three-month periods ended December 31, 2013 and 2012 and \$161,000 and \$172,000 during the nine-month periods ended December 31, 2013 and 2012, respectively. For the three and nine months ended December 31, 2013, the numerators include expenses associated with the potential sale of the Company. Absent these expenses, the percentages would have been 10.55% and 10.75%, respectively. For the three and nine months ended December 31, 2012, the numerators include a tax associated with cash dividends. Absent the dividend tax, the percentages would have been 10.03% and 10.08%, respectively.
  - (7) Pre-tax yield represents net portfolio yield minus administrative expenses as a percentage of average finance receivables, net of unearned interest.
  - (8) Write-off to liquidation percentage is defined as net charge-offs divided by liquidation. Liquidation is defined as beginning gross receivable balance plus current period purchases minus voids and refinances minus ending gross receivable balance.
  - (9) Net charge-off percentage represents net charge-offs divided by average finance receivables, net of unearned interest, outstanding during the period.
- \* The amounts for the three and nine months periods ended December 31, 2012 have been revised as discussed in Note 2 to the consolidated financial statements.

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**Table of Contents****Three months ended December 31, 2013 compared to three months December 31, 2012****Interest Income and Loan Portfolio**

Interest and fee income on finance receivables, predominately finance charge income, increased 1% to approximately \$20.8 million for the three-month period ended December 31, 2013 from \$20.6 million for the corresponding period ended December 31, 2012. Average finance receivables, net of unearned interest equaled approximately \$291.6 million for the three-month period ended December 31, 2013, an increase of 3.6% from \$281.6 million for the corresponding period ended December 31, 2012. The primary reason average finance receivables, net of unearned interest, increased was the increase in the receivable base of several existing branches in younger markets and also the opening of one new branch location (see Contract Procurement and Loan Origination below). The gross finance receivable balance increased 6% to approximately \$411.1 million as of December 31, 2013, from \$389.4 million as of December 31, 2012. The primary reason interest income increased was the increase in the outstanding loan portfolio. The gross portfolio yield decreased to 28.47% for the three-month period ended December 31, 2013 compared to 29.26% for the three-month period ended December 31, 2012. The net portfolio yield decreased to 20.75% for the corresponding period ended December 31, 2013 from 22.50% for the three-month period ended December 31, 2012. The gross and net portfolio yields decreased due to a decrease in the weighted APR earned on finance receivables.

**Marketing, Salaries, Employee Benefits, Depreciation, Administrative, Professional Fee Expenses and Dividend Taxes**

Marketing, salaries, employee benefits, depreciation, administrative, professional fee expenses and dividend taxes increased to approximately \$8.6 million for the three-month period ended December 31, 2013 from approximately \$8.4 million for the corresponding period ended December 31, 2012. There were no dividends or related taxes for the three-month period ended December 31, 2013. Dividend taxes approximated \$1,287,000 for the three months ended December 31, 2012. The absence of the dividend tax was offset by an increase in professional fees of \$874,000 associated with the potential sale of the Company and a \$586,000 increase in salaries, employee benefits and administrative expenses. The increase in salaries, employee benefits and administrative expenses was primarily attributable to one new branch location and an increase in costs associated with maintaining the finance receivable portfolio. The Company operated 65 and 64 branch locations as of December 31, 2013 and 2012, respectively. The Company opened one additional branch and increased average headcount to 329 for the three-month period ended December 31, 2013 from 314 for the three-month period ended December 31, 2012. Marketing, salaries, employee benefits, depreciation, administrative, professional fee expenses and dividend taxes as a percentage of finance receivables, net of unearned interest, decreased to 11.68% for the three-month period ended December 31, 2013 from 11.86% for the three-month period ended December 31, 2012. For the three months ended December 31, 2013, the numerator includes the expenses associated with the potential sale of the Company. Absent these expenses, the percentage would have been 10.55%. For the three months ended December 31, 2012, the numerator includes the taxes associated with a one-time special cash dividend. Absent the dividend taxes, the percentage would have been 10.03%.

**Interest Expense**

Interest expense increased to approximately \$1.4 million for the three-month period ended December 31, 2013 from \$1.3 million for the three-month period ended December 31, 2012. The following table summarizes the Company's average cost of borrowed funds:

|   | <b>Three months ended December 31,</b> |             |
|---|--|-------------|
|   | <b>2013</b>                            | <b>2012</b> |
| Variable interest under the line of credit facility | 0.36%                                  | 0.45%       |
| Settlements under interest rate swap agreements     | 0.30%                                  | 0.32%       |
| Credit spread under the line of credit facility     | 3.83%                                  | 3.70%       |
| Average cost of borrowed funds                      | 4.49%                                  | 4.47%       |

The Company's average cost of funds remained relatively flat. The credit spread increased and the variable interest decreased due to a decrease in LIBOR rates in the three months ended December 31, 2013.

The weighted average notional amount of interest rate swap agreements was \$50.0 million at a weighted average fixed rate of 0.94% for the three months ended December 31, 2013. For further discussions regarding the effect of interest rate swap agreements see Note 6 Interest Rate Swap Agreements .

**Table of Contents****Nine months ended September 30, 2013 compared to nine months ended December 31, 2012****Interest Income and Loan Portfolio**

Interest and fee income on finance receivables, predominately finance charge income, increased 1% to approximately \$62.2 million for the nine-month period ended December 31, 2013 from \$61.7 million for the corresponding period ended December 31, 2012. Average finance receivables, net of unearned interest equaled approximately \$289.1 million for the nine-month period ended December 31, 2013, an increase of 3% from \$281.2 million for the corresponding period ended December 31, 2012. The primary reason average finance receivables, net of unearned interest, increased was the increase in the receivable base of several existing branches in younger markets and also the opening of one new branch location (see Contract Procurement and Loan Origination below). The gross finance receivable balance increased 6% to approximately \$411.1 million as of December 31, 2013, from \$389.4 million as of December 31, 2012. The primary reason interest income increased was the increase in the outstanding loan portfolio. The gross portfolio yield decreased to 28.67% for the nine-month period ended December 31, 2013 from 29.26% for the nine-month period ended December 31, 2012. The net portfolio yield decreased to 21.71% for the period ended December 31, 2013 from 22.83% for the nine-month period ended December 31, 2012. The gross portfolio yield decreased primarily due to a decrease in the weighted APR earned on finance receivables. The net portfolio yield decreased primarily due to an increase in the actual and expected net charge-offs and an increase in the provision for credit losses which are discussed below under Analysis of Credit Losses.

**Marketing, Salaries, Employee Benefits, Depreciation, Administrative, Professional Fee Expenses and Dividend Taxes**

Marketing, salaries, employee benefits, depreciation, administrative, professional fee expenses and dividend taxes increased to approximately \$24.6 million for the nine-month period ended December 31, 2013 from approximately \$22.9 million for the corresponding period ended December 31, 2012. Dividend taxes were \$1,277,000 greater for the nine months ended December 31, 2012. The decrease in dividend taxes was offset by an increase in professional fees of \$1,373,000 associated with the potential sale of the Company and a \$1,650,000 increase in salaries, employee benefits and administrative expenses. The increase in salaries, employee benefits and administrative expenses was primarily attributable to a new branch location and an increase in costs associated with maintaining the finance receivable portfolio. The Company opened one additional branch and increased average headcount to 325 for the nine-month period ended December 31, 2013 from 308 for the nine-month period ended December 31, 2012. Marketing, salaries, employee benefits, depreciation, administrative, professional fee expenses and dividend taxes as a percentage of finance receivables, net of unearned interest, increased to 11.29% for the nine-month period ended December 31, 2013 from 10.76% for the nine-month period ended December 31, 2012. For the nine months ended December 31, 2013, the numerator includes the expenses associated with the potential sale of the Company. Absent these expenses, the percentage would have been 10.75%. For the nine months ended December 31, 2012, the numerator includes significant taxes associated with a one-time special cash dividend. Absent the additional dividend taxes, the percentage would have been 10.08%.

**Interest Expense**

Interest expense increased to approximately \$4.3 million for the nine-month period ended December 31, 2013 from \$3.7 million for the nine-month period ended December 31, 2012. The following table summarizes the Company's average cost of borrowed funds for the nine-month period ended December 31:

|   | <b>Nine months ended</b> |             |
|---|--------------------------|-------------|
|   | <b>December 31,</b>      |             |
|   | <b>2013</b>              | <b>2012</b> |
| Variable interest under the line of credit facility | 0.36%                    | 0.51%       |
| Settlements under interest rate swap agreements     | 0.30%                    | 0.22%       |
| Credit spread under the line of credit facility     | 3.82%                    | 3.72%       |
| <br>Average cost of borrowed funds                  | <br>4.48%                | <br>4.45%   |

The Company's average cost of funds increased slightly due to an increase in the interest rate swap settlements which is partially offset by the decrease in the unused line fees during the nine months ended December 31, 2013. The credit spread also increased and the variable interest decreased due to a decrease in LIBOR rates for the nine months ended December 31, 2013.

The weighted average notional amount of interest rate swap agreements was \$50.0 million at a weighted average fixed rate of 0.94% for the nine months ended December 31, 2013. The weighted average notional amount of interest rate swap agreements was \$31.2 million at a weighted average fixed rate of 0.95% for the nine months ended December 31, 2012. For further discussions regarding the effect of interest rate swap agreements see Note 6 Interest Rate Swap Agreements .



**Table of Contents****Contract Procurement**

The Company purchases Contracts in the fifteen states listed in the table below. The Contracts purchased by the Company are predominately for used vehicles; for the three and nine month periods ended December 31, 2013 and 2012, less than 2% were for new vehicles.

The following tables present selected information on Contracts purchased by the Company, net of unearned interest.

| State | Three months ended<br>December 31, |               | Nine months ended<br>December 31, |                |
|-------|------------------------------------|---------------|-----------------------------------|----------------|
|       | 2013                               | 2012          | 2013                              | 2012           |
| FL    | \$ 11,735,597                      | \$ 9,977,985  | \$ 36,060,726                     | \$ 32,956,621  |
| GA    | 3,658,423                          | 3,213,167     | 12,106,958                        | 11,226,294     |
| NC    | 2,407,374                          | 3,474,070     | 11,148,966                        | 11,015,882     |
| SC    | 937,853                            | 844,289       | 3,861,730                         | 2,617,501      |
| OH    | 5,300,116                          | 4,420,025     | 17,304,458                        | 15,209,269     |
| MI    | 1,482,660                          | 931,609       | 4,734,261                         | 3,079,204      |
| VA    | 1,474,651                          | 1,081,670     | 4,166,493                         | 3,645,234      |
| IN    | 1,374,439                          | 1,824,059     | 5,372,001                         | 5,833,759      |
| KY    | 1,914,143                          | 2,106,658     | 6,455,058                         | 6,415,816      |
| MD    | 847,833                            | 466,178       | 2,057,133                         | 1,576,783      |
| AL    | 1,087,795                          | 818,633       | 4,437,886                         | 3,799,938      |
| TN    | 1,098,554                          | 927,196       | 4,358,732                         | 3,694,356      |
| IL    | 1,181,598                          | 325,813       | 2,849,941                         | 2,501,016      |
| MO    | 1,414,162                          | 611,282       | 4,176,562                         | 3,386,462      |
| KS    | 326,063                            | 394,963       | 991,585                           | 935,394        |
| Total | \$ 36,241,261                      | \$ 31,417,597 | \$ 120,082,490                    | \$ 107,893,529 |

| Contracts                         | Three months ended<br>December 31, |               | Nine months ended<br>December 31, |                |
|-----------------------------------|------------------------------------|---------------|-----------------------------------|----------------|
|                                   | 2013                               | 2012          | 2013                              | 2012           |
| Purchases                         | \$ 36,241,261                      | \$ 31,417,597 | \$ 120,082,490                    | \$ 107,893,529 |
| Weighted APR                      | 23.05%                             | 23.10%        | 22.96%                            | 23.37%         |
| Average discount                  | 8.58%                              | 8.64%         | 8.47%                             | 8.59%          |
| Weighted average term<br>(months) | 52                                 | 50            | 52                                | 49             |
| Average loan                      | \$ 10,578                          | \$ 10,459     | \$ 10,638                         | \$ 10,228      |
| Number of Contracts               | 3,426                              | 3,004         | 11,288                            | 10,549         |

**Loan Origination**

The following table presents selected information on Direct Loans originated by the Company, net of unearned interest.

| <b>Direct Loans Originated</b> | <b>Three months ended</b> |              | <b>Nine months ended</b> |              |
|--------------------------------|---------------------------|--------------|--------------------------|--------------|
|                                | <b>December 31,</b>       |              | <b>December 31,</b>      |              |
|                                | <b>2013</b>               | <b>2012</b>  | <b>2013</b>              | <b>2012</b>  |
| Originations                   | \$ 2,683,337              | \$ 2,337,021 | \$ 7,978,194             | \$ 6,637,991 |
| Weighted APR                   | 27.14%                    | 26.51%       | 26.74%                   | 26.41%       |
| Weighted average term (months) | 28                        | 27           | 29                       | 28           |
| Average loan                   | \$ 3,363                  | \$ 3,108     | \$ 3,391                 | \$ 3,238     |
| Number of loans                | 798                       | 752          | 2,353                    | 2,050        |

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**Table of Contents****Analysis of Credit Losses**

As of December 31, 2013, the Company had 1,412 active static pools. The average pool upon inception consisted of 59 Contracts with aggregate finance receivables, net of unearned interest, of approximately \$608,000.

The Company anticipates losses absorbed as a percentage of liquidation (see note 8 in the Portfolio Summary table on page 17 for the definition of write-off to liquidation) will be in the 5%-10% range during the remainder of the current fiscal year; however, no assurances can be given that the actual losses absorbed may not be higher as a result of continued fierce competition. The longer-term outlook for portfolio performance will depend largely on the competition. Other indicators include the overall economic conditions, the unemployment rate, and the price of oil which impacts the cost of gasoline, food and many other items used or consumed by the average person. Also, the Company's ability to monitor, manage and implement its underwriting philosophy in additional geographic areas as it strives to continue its expansion will impact future portfolio performance. The Company does not believe there have been any significant changes in loan concentrations or terms of Contracts purchased during the three and nine months ended December 31, 2013.

The provision for credit losses increased to approximately \$4.2 million from approximately \$3.5 million for the three months ended December 31, 2013 and 2012, respectively. The provision for credit losses increased to approximately \$10.8 million from approximately \$9.8 million for the nine months ended December 31, 2013 and 2012, respectively. The Company has experienced favorable variances between projected write-offs and actual write-offs on many seasoned pools which has resulted in an increase in expected future cash flows. However, due to increased competition in more recent periods, the percentage of loans acquired that are categorized in the lower tiers of the Company's guidelines has increased. During the current periods, static pools originated during fiscal 2014 and 2013, while still performing at acceptable net charge-off levels, have experienced losses higher than static pools originated in previous years. Consequently, if this trend continues, the Company would expect the provision for credit losses to remain higher for future static pools. Accordingly, the amount of additional provision necessary to maintain an adequate allowance to absorb incurred losses in the existing portfolio was greater than the provision in fiscal 2013. The Company's losses as a percentage of liquidation decreased to 7.62% from 7.94% for the three months ended December 31, 2013 and 2012, respectively. The Company's losses as a percentage of liquidation increased to 7.24% and 6.82% for the nine months ended December 31, 2013 and 2012, respectively. The Company has also experienced increased losses in part due to a decrease in auction proceeds from repossessed vehicles. These proceeds are dependent upon several variables including the general market for repossessed vehicles. During the three months ended December 31, 2013 and 2012 auction proceeds from the sale of repossessed vehicles averaged approximately 47% and 50%, respectively of the related principal balance.

The Company believes delinquency trends over several reporting periods are useful in estimating future losses and overall portfolio performance. The Company also estimates future portfolio performance by considering various factors, the most significant of which are described as follows. The Company analyzes historical static pool performance for each branch location when determining appropriate reserve levels. Additionally, the Company utilizes results from internal branch audits as an indicator of future static pool performance. The Company also considers such things as the current unemployment rate in markets the Company operates in, the percentage of voluntary repossessions as compared to prior periods, the percentage of bankruptcy filings as compared to prior periods and other leading economic indicators. The delinquency percentage for Contracts more than thirty days past due as of December 31, 2013 was 7.29% as compared to 6.32% as of December 31, 2012. This increase is primarily as a result of increased competition in all markets that the Company presently operates in. Increased competition typically reduces discounts on contracts purchased and also results in a greater percentage of contracts, while still within guidelines, that result in lower credit quality. The delinquency percentage for Direct Loans more than thirty days past due as of December 31, 2013 was 2.30% as compared to 1.89% as of December 31, 2012. See Note 4

Finance Receivables for changes in allowance for credit losses, credit quality and delinquencies. Such increases the delinquency percentage for Contracts and the losses as a percentage of liquidation were contemplated in determining the appropriate reserve levels, particularly for less seasoned pools.

Recoveries as a percentage of charge-offs increased to approximately 17.7% for the three months ended December 31, 2013 from approximately 15.6% for the three months ended December 31, 2012. Recoveries as a percentage of charge-offs increased to approximately 17.8% for the nine months ended December 31, 2013 from approximately 17.5% for the nine months ended December 31, 2012. Historically, recoveries as a percentage of charge-off s fluctuate from period to period, and the Company does not attribute this increase to any particular change in operational strategy or economic event.

In accordance with our policies and procedures, certain borrowers qualify for, and the Company offers, one-month principal payment deferrals on Contracts and Direct Loans. For the three months ended December 31, 2013 and December 31, 2012 the Company granted deferrals to approximately 6.99% and 6.91%, respectively, of total Contracts and Direct Loans. For the nine months ended December 31, 2013 and December 31, 2012 the Company granted deferrals to approximately 18.70% and 19.14%, respectively, of total Contracts and Direct Loans. The number of deferrals is influenced by portfolio performance, general economic conditions and the unemployment rate.

**Table of Contents****Income Taxes**

The provision for income taxes decreased to approximately \$2.8 million for the three months ended December 31, 2013 from approximately \$2.9 million for the three months ended December 31, 2012. The Company's effective tax rate increased to 42.54% for the three months ended December 31, 2013 from 38.51% for the three months ended December 31, 2012. The provision for income taxes decreased to approximately \$9.3 million for the nine months ended December 31, 2013 from approximately \$9.5 million for the nine months ended December 31, 2012. The Company's effective tax rate increased to 40.14% for the nine months ended December 31, 2013 from 38.54% for the nine months ended December 31, 2012. The increase in the effective tax rate is related to an increase in non-deductible expenses. The increase in the effective tax rate in each period is related to certain non-deductible professional fees associated with the potential sale of the Company.

**Liquidity and Capital Resources**

The Company's cash flows are summarized as follows:

|  | <b>Nine months ended<br/>December 31,</b> |                     |
|--|---|---------------------|
|  | <b>2013</b>                               | <b>2012</b>         |
| <b>Cash provided by (used in):</b>                     |   |                     |
| Operating activities                                   | \$ 15,818,515                             | \$ 16,701,812       |
| Investing activities (primarily purchase of Contracts) | (13,101,961)                              | (5,730,208)         |
| Financing activities                                   | (1,424,804)                               | (9,108,002)         |
| <b>Net increase in cash</b>                            | <b>\$ 1,291,750</b>                       | <b>\$ 1,863,602</b> |

The Company's primary use of working capital during the nine months ended December 31, 2013, was the funding of the purchase of Contracts which are financed substantially through cash from principal payments received and cash from operations. The Line is secured by all of the assets of the Company and has a maturity date of November 30, 2014. The Company may borrow up to \$150.0 million. Borrowings under the Line may be under various LIBOR pricing options plus 300 basis points with a 1% floor on LIBOR. As of December 31, 2013, the amount outstanding under the Line was approximately \$127.0 million, and the amount available under the Line was approximately \$23.0 million.

The Company will continue to depend on the availability of the Line, together with cash from operations, to finance future operations. Amounts outstanding under the Line have increased by approximately \$1.5 million during the nine months ended December 31, 2013. The increase of the Line is principally related to the fact that cash needed to fund new contracts exceeded cash received from operations. The amount of debt the Company incurs from time to time under these financing mechanisms depends on the Company's need for cash and ability to borrow under the terms of the Line. The Company believes that borrowings available under the Line as well as cash flow from operations will be sufficient to meet its short-term funding needs.

The Line requires compliance with certain debt covenants including financial ratios, asset quality and other performance tests. The Company is in compliance with all of its debt covenants.

On May 7, 2013 the Board of Directors announced a quarterly cash dividend equal to \$0.12 per common share, to be paid on June 28, 2013 to shareholders of record as of June 21, 2013. On August 13, 2013 the Board of Directors announced a quarterly cash dividend equal to \$0.12 per common share, to be paid on September 27, 2013 to shareholders of record as of September 20, 2013.

### **Contractual Obligations**

The following table summarizes the Company's material obligations as of December 31, 2013.

|                               | <b>Total</b>          | <b>Payments Due by Period</b> |                         |                         |                              |
|-------------------------------|-----------------------|-------------------------------|-------------------------|-------------------------|------------------------------|
|                               |                       | <b>Less than<br/>1 year</b>   | <b>1 to 3<br/>years</b> | <b>3 to 5<br/>years</b> | <b>More than<br/>5 years</b> |
| Operating leases              | \$ 3,900,200          | \$ 1,677,488                  | \$ 1,830,708            | \$ 392,004              | \$ 0                         |
| Line of credit                | 127,000,000           | 127,000,000                   | 0                       | 0                       | 0                            |
| Interest on Line <sup>1</sup> | 5,215,467             | 5,215,467                     | 0                       | 0                       | 0                            |
| <b>Total</b>                  | <b>\$ 136,115,667</b> | <b>\$ 133,892,955</b>         | <b>\$ 1,830,708</b>     | <b>\$ 392,004</b>       | <b>\$ 0</b>                  |

<sup>1</sup> Interest on outstanding borrowings under the Line as of December 31, 2013, is based on an effective interest rate of 4.48% and the estimated effect of the interest rate swap settlement at December 31, 2013. The effective interest rate used in the above table does not contemplate the possibility of entering into interest rate swap agreements in the future.

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### **Future Expansion**

The Company currently operates a total of sixty-five branch locations in fifteen states, including twenty in Florida; eight in Ohio; six in North Carolina and Georgia; three in Kentucky, Indiana, Missouri, Michigan, and Alabama; two in Virginia, Tennessee, Illinois, and South Carolina; and one each in Maryland, and Kansas. Each office is budgeted (size of branch, number of employees and location) to handle up to 1,000 accounts and up to \$7.5 million in gross finance receivables. To date, thirteen of our branches meet this capacity. The Company continues to evaluate additional markets for future branch locations, and subject to market conditions, would expect to open one additional branch location during fiscal 2014.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Market risks relating to the Company's operations result primarily from changes in interest rates. The Company does not engage in speculative or leveraged transactions, nor does it hold or issue financial instruments for trading purposes.

#### **Interest rate risk**

Management's objective is to minimize the cost of borrowing through an appropriate mix of fixed and floating rate debt. Derivative financial instruments, such as interest rate swap agreements, may be used for the purpose of managing fluctuating interest rate exposures that exist from ongoing business operations. The Company does not use interest rate swap agreements for speculative purposes.

### **ITEM 4. CONTROLS AND PROCEDURES**

**Evaluation of disclosure controls and procedures.** In accordance with Rule 13a-15(b) of the Securities Exchange Act of 1934 (the Exchange Act), as of the end of the period covered by this Quarterly Report on Form 10-Q, the Company's management evaluated, with the participation of the Company's President and Chief Executive Officer and Senior Vice President and Chief Financial Officer, the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act). Based upon their evaluation of these disclosure controls and procedures, the President and Chief Executive Officer and the Senior Vice President and Chief Financial Officer have concluded that the disclosure controls and procedures were effective as of the date of such evaluation to ensure that material information relating to the Company, including its consolidated subsidiaries, was made known to them by others within those entities, particularly during the period in which this Quarterly Report on Form 10-Q was being prepared.

**Changes in internal controls.** There have been no changes in the Company's internal control over financial reporting that occurred during the Company's last fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## **PART II - OTHER INFORMATION**

### **ITEM 1. LEGAL PROCEEDINGS**

The following is a brief summary of litigation filed against the Company related to the Arrangement Agreement:

Jason Simpson v. Nicholas Financial, Inc., et al., Case No. 13-011726-CI (Circuit Court, Pinellas County, Florida), filed December 24, 2013; Gabriella Rago v. Nicholas Financial, Inc., et al., Case No. 8:13-cv-03261-VMC-TGW (U.S. District Court, Tampa, Florida), filed December 30, 2013; Matthew John Leonard v. Nicholas Financial, Inc., et al., Case No. 13-011811-CI (Circuit Court, Pinellas County, Florida), filed December 31, 2013; Michelangelo Lombardo v. Nicholas Financial, Inc., et al., Case No. 14-000095-CI (Circuit Court, Pinellas County, Florida), filed January 3, 2014; and Edward Opton v. Stephen Bragin, et al., Case No. 14-000139-CI (Circuit Court, Pinellas County, Florida), filed January 6, 2014. The five pending, substantially similar lawsuits were filed in connection with the Arrangement contemplated by the Arrangement Agreement. Each plaintiff purports to represent a class of all of the Company's shareholders other than the defendants and any person or entity related to or affiliated with any defendant. Four of the lawsuits name as defendants the Company, the Company's directors, Prospect, and the Prospect affiliates that are parties to the Arrangement Agreement (collectively, Prospect and such affiliates are referred to as the Prospect Parties). The fifth lawsuit names those same parties as defendants, with the exception of two of the Prospect Parties. Each plaintiff alleges that the consideration to be paid for the Company's Common Shares is inadequate and that certain terms of the Arrangement Agreement are contrary to the interests of the Company's public shareholders. Each plaintiff asserts a breach of fiduciary duty claim against the Company's directors, and an aiding and abetting claim against the Company and/or certain of the Prospect Parties. The plaintiff to the U.S. District Court action also asserts claims under Sections 14(a) and 20(a) of the Securities Exchange Act of 1934 against the Company, the Company's directors and/or Prospect, alleging that the Registration Statement on Form N-14 filed by Prospect on January 13, 2014 misrepresents and omits certain material



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information related to the proposed transaction. Each plaintiff seeks declaratory relief, injunctive relief, other equitable relief and/or damages with respect to the proposed transaction, and an award of attorneys' fees. The Prospect Parties, the Company and the Company's directors do not believe that there is any merit to any of the pending actions, and they intend to defend vigorously against such actions.

Additionally, from time to time the Company may be a party to claims that arise in the ordinary course of business, none of which, in our view, is expected to have a material adverse effect on our consolidated financial position or results of operations.

**ITEM 1A. RISK FACTORS**

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I Item 1A. Risk Factors in the Company's Annual Report on Form 10-K for the year ended March 31, 2013, which could materially affect our business, financial condition or future results. The risks described in the Form 10-K are not the only risks facing the Company. Additional risks and uncertainties not currently known to the Company or that the Company currently deems to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

**Item 6. EXHIBITS**

See exhibit index following the signature page.

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**SIGNATURES**

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

**NICHOLAS FINANCIAL, INC.**  
(Registrant)

Date: February 10, 2014

/s/ Peter L. Vosotas  
Peter L. Vosotas  
Chairman of the Board, President,  
Chief Executive Officer and Director

Date: February 10, 2014

/s/ Ralph T. Finkenbrink  
Ralph T. Finkenbrink  
Senior Vice President,  
Chief Financial Officer and Director

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| <b>Exhibit No.</b> | <b>Description</b>   |
|--------------------|--|
| 10.9               | Form of Dealer Agreement and Schedule thereto listing dealers that are parties to such agreements                    |
| 31.1               | Certification of the President and Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2               | Certification of the Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002               |
| 32.1*              | Certification of the Chief Executive Officer Pursuant to 18 U.S.C. § 1350  |
| 32.2*              | Certification of the Chief Financial Officer Pursuant to 18 U.S.C. § 1350  |
| 101.INS**          | XBRL Instance Document   |
| 101.SCH**          | XBRL Taxonomy Extension Schema Document  |
| 101.CAL**          | XBRL Taxonomy Extension Calculation Linkbase Document  |
| 101.DEF**          | XBRL Taxonomy Extension Definition Linkbase Document   |
| 101.LAB**          | XBRL Taxonomy Extension Labels Linkbase Document   |
| 101.PRE**          | XBRL Taxonomy Extension Presentation Linkbase Document   |

\* This certification accompanies the Quarterly Report on Form 10-Q and is not filed as part of it.

\*\* Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.