

MICROFINANCIAL INC
Form 10-Q
August 14, 2009

Table of Contents

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q**

(Mark One)

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

For the quarterly period ended June 30, 2009

or

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

**Commission File No. 1-14771
MICROFINANCIAL INCORPORATED
(Exact name of registrant as specified in its charter)**

Massachusetts
(State or other jurisdiction of
incorporation or organization)

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

10 M Commerce Way, Woburn, MA 01801
(Address of principal executive offices)
(781) 994-4800

(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting
company

(Do not check if a smaller
reporting company)

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

As of July 31, 2009, 14,173,076 shares of the registrant's common stock were outstanding.

**MICROFINANCIAL INCORPORATED
TABLE OF CONTENTS**

| | Page |
|---|--------|
| <u>Part I - FINANCIAL INFORMATION</u> | |
| <u>Item 1. Financial Statements (unaudited):</u> | |
| <u>Condensed Consolidated Balance Sheets - June 30, 2009 and December 31, 2008</u> | 3 |
| <u>Condensed Consolidated Statements of Income - Three and six months ended June 30, 2009 and 2008</u> | 4 |
| <u>Condensed Consolidated Statements of Stockholders' Equity for the Six months ended June 30, 2009 and the twelve months ended December 31, 2008</u> | 5 |
| <u>Condensed Consolidated Statements of Cash Flows - Six months ended June 30, 2009 and 2008</u> | 6 |
| <u>Notes to Condensed Consolidated Financial Statements</u> | 7 |
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 13 |
| <u>Item 3. Quantitative and Qualitative Disclosures about Market Risk</u> | 23 |
| <u>Item 4. Controls and Procedures</u> | 23 |
| <u>Part II - OTHER INFORMATION</u> | |
| <u>Item 1. Legal Proceedings</u> | 24 |
| <u>Item 1A. Risk Factors</u> | 24 |
| <u>Item 4. Submission of Matters to a Vote of Security Holders</u> | 24 |
| <u>Item 5. Other Information</u> | 24 |
| <u>Item 6. Exhibits</u> | 24 |
| <u>Signatures</u> | 26 |
| <u>EX-10.1 Separation Agreement and General Release dated May 28, 2009 between Mr. Thomas Herlihy and TimePayment Corp.</u> | |
| <u>EX-31.1 Certification of Chief Executive Officer pursuant to Section 302</u> | |
| <u>EX-31.2 Certification of Chief Financial Officer pursuant to Section 302</u> | |
| <u>EX-32.1 Certification of Chief Executive Officer pursuant to Section 906</u> | |
| <u>EX-32.2 Certification of Chief Financial Officer pursuant to Section 906</u> | |

Table of Contents

MICROFINANCIAL INCORPORATED
CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share and per share data)

(Unaudited)

| | June 30, 2009 | December 31, 2008 |
|---|------------------|-------------------------|
| ASSETS | | |
| Cash and cash equivalents | \$ 1,003 | \$ 5,047 |
| Restricted cash | 772 | 528 |
| Net investment in leases: | | |
| Receivables due in installments | 159,740 | 142,881 |
| Estimated residual value | 17,146 | 15,257 |
| Initial direct costs | 1,380 | 1,211 |
| Less: | | |
| Advance lease payments and deposits | (1,545) | (982) |
| Unearned income | (52,793) | (49,384) |
| Allowance for credit losses | (13,509) | (11,722) |
| Net investment in leases | 110,419 | 97,261 |
| Investment in service contracts, net | 3 | 32 |
| Investment in rental contracts, net | 392 | 240 |
| Property and equipment, net | 682 | 759 |
| Other assets | 1,163 | 983 |
| Total assets | \$ 114,434 | \$ 104,850 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Revolving line of credit | \$ 40,956 | \$ 33,325 |
| Accounts payable | 1,694 | 1,648 |
| Capital lease obligation | 125 | 125 |
| Dividends payable | | 702 |
| Other liabilities | 1,943 | 1,308 |
| Income taxes payable | 499 | 8 |
| Deferred income taxes | 3,734 | 3,396 |
| Total liabilities | 48,951 | 40,512 |
| Stockholders equity: | | |
| Preferred stock, \$.01 par value; 5,000,000 shares authorized; no shares issued at June 30, 2009 and December 31, 2008 | | |
| Common stock, \$.01 par value; 25,000,000 shares authorized; 14,141,192 and 14,038,257 shares issued at June 30, 2009 and December 31, 2008, respectively | 141 | 140 |
| Additional paid-in capital | 46,038 | 45,774 |
| Retained earnings | 19,304 | 18,424 |

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| | | |
|--|------------|------------|
| Total stockholders' equity | 65,483 | 64,338 |
| Total liabilities and stockholders' equity | \$ 114,434 | \$ 104,850 |

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

Table of Contents

MICROFINANCIAL INCORPORATED
CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except share and per share data)

(Unaudited)

| | Three Months Ended | | Six Months Ended | |
|--|--------------------|-----------------|------------------|-----------------|
| | June 30, | | June 30, | |
| | 2009 | 2008 | 2009 | 2008 |
| Revenues: | | | | |
| Income on financing leases | \$ 7,098 | \$ 5,596 | \$ 13,887 | \$ 10,536 |
| Rental income | 2,138 | 2,484 | 4,347 | 5,236 |
| Income on service contracts | 175 | 240 | 364 | 499 |
| Loss and damage waiver fees | 1,018 | 768 | 2,004 | 1,456 |
| Service fees and other | 699 | 532 | 1,370 | 1,080 |
| Interest income | 1 | 27 | 14 | 87 |
| Total revenues | 11,129 | 9,647 | 21,986 | 18,894 |
| Expenses: | | | | |
| Selling, general and administrative | 3,492 | 3,198 | 7,064 | 6,437 |
| Provision for credit losses | 4,993 | 3,060 | 10,446 | 6,417 |
| Depreciation and amortization | 383 | 230 | 718 | 460 |
| Interest | 661 | 234 | 1,177 | 386 |
| Total expenses | 9,529 | 6,722 | 19,405 | 13,700 |
| Income before provision for income taxes | 1,600 | 2,925 | 2,581 | 5,194 |
| Provision for income taxes | 616 | 1,053 | 994 | 1,765 |
| Net income | \$ 984 | \$ 1,872 | \$ 1,587 | \$ 3,429 |
| Net income per common share basic | \$ 0.07 | \$ 0.13 | \$ 0.11 | \$ 0.25 |
| Net income per common share diluted | \$ 0.07 | \$ 0.13 | \$ 0.11 | \$ 0.24 |
| Weighted-average shares: | | | | |
| Basic | 14,141,192 | 13,987,528 | 14,122,259 | 13,981,216 |
| Diluted | 14,239,391 | 14,137,300 | 14,214,308 | 14,151,034 |

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

Table of Contents

MICROFINANCIAL INCORPORATED
CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

(In thousands, except share and per share data)

(Unaudited)

| | Common Stock Shares | Common Stock Amount | Additional Paid-in Capital | Retained Earnings | Total Stockholders' Equity |
|---|------------------------|------------------------|----------------------------------|----------------------|----------------------------------|
| Balance at December 31, 2007 | 13,960,778 | \$ 140 | \$45,412 | \$ 15,276 | \$60,828 |
| Stock options exercises | 17,500 | | 28 | | 28 |
| Stock issued for deferred compensation | 53,729 | | 241 | | 241 |
| Stock-based compensation | | | 74 | | 74 |
| Amortization of unearned compensation | 6,250 | | 19 | | 19 |
| Common stock dividends (\$0.20 per share) | | | | (2,802) | (2,802) |
| Net income | | | | 5,950 | 5,950 |
| Balance at December 31, 2008 | 14,038,257 | \$ 140 | \$45,774 | \$ 18,424 | \$64,338 |
| Stock issued for deferred compensation | 100,435 | 1 | 230 | | 231 |
| Stock-based compensation | | | 27 | | 27 |
| Amortization of unearned compensation | 2,500 | | 7 | | 7 |
| Common stock dividends (\$0.05 per share) | | | | (707) | (707) |
| Net income | | | | 1,587 | 1,587 |
| Balance at June 30, 2009 | 14,141,192 | \$ 141 | \$46,038 | \$ 19,304 | \$65,483 |

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

Table of Contents

MICROFINANCIAL INCORPORATED
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOW

(In thousands)

(Unaudited)

| | Six Months Ended June 30, | |
|---|------------------------------|--------------|
| | 2009 | 2008 |
| Cash flows from operating activities: | | |
| Cash received from customers | \$ 35,966 | \$ 27,866 |
| Cash paid to suppliers and employees | (7,768) | (7,215) |
| Income taxes paid | (164) | (182) |
| Interest paid | (952) | (386) |
| Interest received | 13 | 87 |
| Net cash provided by operating activities | 27,095 | 20,170 |
| Cash flows from investing activities: | | |
| Investment in lease and rental contracts | (36,353) | (34,644) |
| Investment in direct costs | (631) | (557) |
| Investment in property and equipment | (133) | (252) |
| Net cash used in investing activities | (37,117) | (35,453) |
| Cash flows from financing activities: | | |
| Proceeds from secured debt | 41,384 | 37,860 |
| Repayment of secured debt | (33,753) | (23,014) |
| Increase in restricted cash | (244) | (9) |
| Proceeds from capital lease obligation | 31 | 163 |
| Repayment of capital lease obligations | (31) | (13) |
| Payment of dividends | (1,409) | (1,397) |
| Net cash provided by financing activities | 5,978 | 13,590 |
| Net change in cash and cash equivalents | (4,044) | (1,693) |
| Cash and cash equivalents, beginning of period | 5,047 | 7,080 |
| Cash and cash equivalents, end of period | \$ 1,003 | \$ 5,387 |
| Reconciliation of net income to net cash provided by operating activities: | | |
| Net income | \$ 1,587 | \$ 3,429 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Amortization of unearned income, net of initial direct costs | (13,887) | (10,536) |

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| | | |
|---|-----------|-----------|
| Depreciation and amortization | 718 | 460 |
| Provision for credit losses | 10,446 | 6,417 |
| Recovery of equipment cost and residual value | 26,636 | 18,265 |
| Stock-based compensation expense | 34 | 47 |
| Changes in assets and liabilities: | | |
| Current taxes payable | 491 | 150 |
| Deferred income taxes | 338 | 1,434 |
| Other assets | (180) | (139) |
| Accounts payable | 277 | 25 |
| Other liabilities | 635 | 618 |
| Net cash provided by operating activities | \$ 27,095 | \$ 20,170 |

Supplemental disclosure of non-cash activities:

| | | |
|--|--------|--------|
| Fair market value of stock issued for compensation | \$ 231 | \$ 127 |
|--|--------|--------|

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

Table of Contents

MICROFINANCIAL INCORPORATED
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except share and per share data)

A. Nature of Business

MicroFinancial Incorporated (referred to as MicroFinancial, we, us or our) operates primarily through its wholly-owned subsidiaries, TimePayment Corp. and Leasecomm Corporation. TimePayment is a specialized commercial finance company that leases and rents microticket equipment and provides other financing services. The average amount financed by TimePayment through 2008 and year to date 2009 was approximately \$5,500, while Leasecomm historically financed contracts of approximately \$1,900. We primarily source our originations through a nationwide network of independent equipment vendors, sales organizations, brokers and other dealer-based origination networks. We fund our operations through cash provided by operating activities and borrowings under our revolving line of credit.

B. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America and the rules and regulations of the Securities and Exchange Commission for interim financial statements. Accordingly, our interim statements do not include all of the information and disclosures required for our annual financial statements. In the opinion of our management, the condensed consolidated financial statements contain all adjustments, consisting only of normal recurring adjustments, considered necessary for a fair presentation of these interim results. These financial statements should be read in conjunction with our consolidated financial statements and notes included in our Annual Report on Form 10-K for the year ended December 31, 2008. The results for the six months ended June 30, 2009 are not necessarily indicative of the results that may be expected for the full year ending December 31, 2009.

The balance sheet at December 31, 2008 has been derived from the audited financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2008.

Allowance for Credit Losses

We maintain an allowance for credit losses on our investment in leases, service contracts and rental contracts at an amount that we believe is sufficient to provide adequate protection against losses in our portfolio. Given the nature of the microticket market and the individual size of each transaction, the business does not warrant the creation of a formal credit review committee to review individual transactions. As a result of approving a wide range of credits, we experience a relatively high level of delinquency and write-offs in our portfolio. We periodically review the credit scoring and approval process to ensure that the automated system is making appropriate credit decisions. Given the nature of the microticket market and the individual size of each transaction, we do not evaluate transactions individually for the purpose of determining the adequacy of the allowance for credit losses. Contracts in our portfolio are not re-graded subsequent to the initial extension of credit and the allowance is not allocated to specific contracts. Rather, we view the contracts as having common characteristics and maintain a general allowance against our entire portfolio utilizing historical collection statistics and an assessment of current credit risk in the portfolio as the basis for the amount.

We have adopted a consistent, systematic procedure for establishing and maintaining an appropriate allowance for credit losses for our microticket transactions. We estimate the likelihood of credit losses net of recoveries in the portfolio at each reporting period based upon a combination of the lessee's bureau reported credit score at lease inception and the current delinquency status of the account. In addition to these elements, we also consider other relevant factors including general economic trends, trends in delinquencies and credit losses, static pool analyses of our portfolio, trends in recoveries made on charged off accounts, and other relevant factors which might affect the performance of our portfolio. This combination of historical experience, credit scores, delinquency levels, trends in credit losses, and the review of current factors provide the basis for our analysis of the adequacy of the allowance for credit losses. We take charge-offs against our receivables when such receivables are deemed uncollectible. In general, a receivable is deemed uncollectible when it is 360 days past due where no contact has been made with the

Table of Contents

MICROFINANCIAL INCORPORATED
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except share and per share data)

lessee for 12 months or, if earlier, when other adverse events occur with respect to an account. Historically, the typical monthly payment under our microticket leases has been small and as a result, our experience is that lessees will pay past due amounts later in the process because of the small amount necessary to bring an account current.

A summary of the activity in our allowance for credit losses is as follows:

| | Six Months Ended June 30, | |
|--|------------------------------|----------|
| | 2009 | 2008 |
| Allowance for credit losses, beginning | \$ 11,722 | \$ 5,722 |
| Provision for credit losses | 10,446 | 6,417 |
| Charge-offs | (10,675) | (4,801) |
| Recoveries | 2,016 | 2,161 |
| Allowance for credit losses, ending | \$ 13,509 | \$ 9,499 |

Net Income Per Share

Basic net income per common share is computed based on the weighted-average number of common shares outstanding during the period. Diluted net income per common share gives effect to all potentially dilutive common shares outstanding during the period. The computation of diluted net income per share does not assume the issuance of common shares that have an antidilutive effect on net income per common share. For the three and six months ended June 30, 2009, 1,108,028 options were excluded from the computation of diluted net income per share because their effect was antidilutive. For the three and six months ended June 30, 2008, 1,292,067 options were excluded from the computation of diluted net income per share because their effect was antidilutive.

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--------------------------------|------------|------------------------------|------------|
| | 2009 | 2008 | 2009 | 2008 |
| Net income | \$ 984 | \$ 1,872 | \$ 1,587 | \$ 3,429 |
| Weighted average common shares outstanding | 14,141,192 | 13,987,528 | 14,122,259 | 13,981,216 |
| Dilutive effect of common stock options, warrants and restricted stock | 98,199 | 149,772 | 92,049 | 169,818 |
| Shares used in computation of net income per common share - diluted | 14,239,391 | 14,137,300 | 14,214,308 | 14,151,034 |
| Net income per common share - basic | \$ 0.07 | \$ 0.13 | \$ 0.11 | \$ 0.25 |
| Net income per common share - diluted | \$ 0.07 | \$ 0.13 | \$ 0.11 | \$ 0.24 |

Stock-Based Employee Compensation

Under our 2008 Equity Incentive Plan, we reserved 1,000,000 shares of common stock for issuance. In February 2009, under our 2008 Equity Incentive Plan, we granted 10 year options to our executive officers to purchase 321,058 shares of common stock at an exercise price of \$2.30 per share. The fair value of these awards was \$0.55 per share. The options were valued at the date of grant using the following assumptions: expected life in years of 6.50, annualized volatility of 55.54%, expected dividend yield of 8.70%, and a risk free interest rate of 2.28%. The options vest over five years beginning on the second anniversary of the grant date. In February 2008, under our 1998 Equity Incentive Plan, we granted 10 year options to our executive officers to purchase 176,879 shares of common stock at an exercise price of \$5.85 per share. The fair value of these awards was \$1.78 per share.

Table of Contents

MICROFINANCIAL INCORPORATED
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except share and per share data)

The options were valued at the date of grant using the following assumptions: expected life in years of 6.25, annualized volatility of 41.30%, expected dividend yield of 3.70%, and a risk free interest rate of 2.66%. The options vest over five years beginning on the second anniversary of the grant date. During the six months ended June 30, 2009, 400,000 options originally granted to members of the Board of Directors in February of 1999 expired. In addition, 105,097 options granted to the former VP of Sales were forfeited upon his last date of employment in May of 2009.

Directors Fritz von Mering and John Everets were appointed to the Board as non employee directors on February 4, 2004, and August 15, 2006, respectively. In connection with their appointments, each director was granted 25,000 shares of restricted stock which vested 20% upon grant and 5% on the first day of each quarter subsequent to the grant date. The restricted share fair values were \$3.17 per share for Mr. von Mering and \$3.35 per share for Mr. Everets. The compensation expense associated with the grants is recognized as vesting occurs. As of June 30, 2009, 6,250 restricted shares remain unvested under Mr. Everets' grant.

Information relating to our outstanding stock options at June 30, 2009 is as follows:

| Exercise Price | Shares | Outstanding | | Exercisable | | |
|----------------|-----------|-------------------------------|-----------------|---------------------------------|---------|-----------------|
| | | Weighted-Average Life (Years) | Intrinsic Value | Weighted-Average Exercise Price | Shares | Intrinsic Value |
| \$ 9.78 | 350,000 | .65 | \$ | \$ 9.78 | 350,000 | \$ |
| 13.10 | 90,000 | 1.64 | | 13.10 | 90,000 | |
| 6.70 | 235,000 | 2.66 | | 6.70 | 235,000 | |
| 1.59 | 150,000 | 3.41 | 309,000 | 1.59 | 150,000 | 309,000 |
| 5.77 | 31,923 | 7.67 | | 5.77 | | |
| 5.85 | 142,382 | 8.58 | | 5.85 | | |
| 2.30 | 258,723 | 9.67 | 349,000 | 2.30 | | |
| | 1,258,028 | 4.36 | \$ 658,000 | 7.78 | 825,000 | \$ 309,000 |

During the three months ended June 30, 2009 and 2008, the total share based employee compensation cost recognized was \$4,000 and \$24,000, respectively. During the six months ended June 30, 2009 and 2008, the total share based employee compensation cost recognized was \$34,000 and \$47,000, respectively. For the period ended June 30, 2009, approximately \$23,000 of previously recognized employee compensation cost was reversed in connection with 105,097 options which were forfeited during the period.

Fair Value of Financial Instruments

For financial instruments including cash and cash equivalents, restricted cash, accounts payable, revolving line of credit, and other liabilities, we believe that the carrying amount approximates fair value. The fair value of the revolving line of credit is calculated based on the incremental borrowing rates currently available on loans with similar terms and maturities. The fair value of our revolving line of credit at June 30, 2009 approximates its carrying value.

Cash and Cash Equivalents

We consider all highly liquid instruments purchased with original maturities of less than three months to be cash equivalents. Cash equivalents consist principally of overnight investments, collateralized repurchase agreements, commercial paper, certificates of deposit and US government and agency securities.

Table of Contents

MICROFINANCIAL INCORPORATED
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except share and per share data)

We deposit our cash and invest in short-term investments primarily through national commercial banks. Deposits in excess of amounts insured by the Federal Deposit Insurance Corporation (FDIC) are exposed to loss in the event of nonperformance by the institution. The Company maintains cash deposits in excess of the FDIC insurance coverage.

C. Revolving line of credit

On August 2, 2007, we entered into a three-year \$30 million revolving line of credit with Sovereign Bank (Sovereign) based on qualified TimePayment lease receivables. On July 9, 2008, we entered into an amended agreement to increase our revolving line of credit with Sovereign to \$60 million. The maturity date of the amended agreement is August 2, 2010. Outstanding borrowings are collateralized by eligible lease contracts and a security interest in all of our other assets and, until February 2009, bore interest at Prime or at a London Interbank Offered Rate (LIBOR) plus 2.75%. Under the terms of the facility, loans are Prime Rate Loans, unless we elect LIBOR Loans. If a LIBOR Loan is not renewed at maturity it automatically converts to a Prime Rate Loan. On February 10, 2009, we entered into an amended agreement to increase our revolving line of credit with Sovereign to \$85 million. Under the amended agreement, outstanding borrowings bear interest at Prime plus 1.75% or LIBOR plus 3.75%, in each case subject to a minimum interest rate of 5%. All other terms of the facility remained the same. At June 30, 2009 and 2008 all of our loans were Prime Rate Loans. The interest rate on our revolving line of credit was 5.00% at June 30, 2009. The amount available on our revolving line of credit at June 30, 2009 was \$44 million. The revolving line of credit has financial covenants that we must comply with to obtain funding and avoid an event of default. As of June 30, 2009, we were in compliance with all covenants under the revolving line of credit.

The fair value of the revolving line of credit is calculated based on incremental borrowing rates currently available on loans with similar terms and maturities. The fair value of our revolving line of credit at June 30, 2009 approximates its carrying value.

D. Commitments and Contingencies*Legal Matters*

We are subject to claims and suits arising in the ordinary course of business. At this time, it is not possible to estimate the ultimate loss or gain, if any, related to these lawsuits, nor if any such loss will have a material adverse effect on our results of operation or financial position.

Lease Commitments

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

Dividends

On July 14, 2009, we declared a dividend of \$0.05 payable on August 14, 2009 to shareholders of record on July 30, 2009.

E. Recent Accounting Pronouncements

In December 2007, the FASB issued SFAS 160, Noncontrolling Interests in Consolidated Financial Statements An Amendment of ARB No. 51 . This statement addresses consolidation rules for noncontrolling interests. The objective is to improve the relevance, comparability, and transparency of the financial information that a reporting entity provides in its consolidated financial statements by establishing accounting and reporting standards for the

Table of Contents

MICROFINANCIAL INCORPORATED
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except share and per share data)

noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. It applies to all entities, but will affect only entities that have an outstanding noncontrolling interest in one or more subsidiaries or that deconsolidate a subsidiary. Statement 160 is effective as of the beginning of fiscal years that begin on or after December 15, 2008. The adoption of SFAS No. 160 did not have a material effect on our consolidated financial position or results of operations.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities* an amendment of FASB statement No. 133. This statement applies to all derivative instruments and related hedge items accounted for under SFAS No. 133. Entities are required to provide enhanced disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedge items are accounted for under Statement 133 and its related interpretations, and (c) how derivative instruments and related hedge items affect an entity's financial position, financial performance, and cash flows. SFAS No. 161 is effective for fiscal years and interim periods beginning after November 15, 2008. The adoption of SFAS No. 161 did not have a material effect on our consolidated financial position or results of operations.

In December 2007, the FASB issued SFAS No. 141(R) *Business Combinations* (SFAS 141R). SFAS 141R establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree. SFAS 141R also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. The guidance applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. The Company believes that this new pronouncement will have an impact on our accounting for future business combinations, but the effect is dependent upon the acquisitions that are made in the future.

In June 2008, the FASB issued Staff Position EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities* (FSP EITF 03-6-1), effective for fiscal years beginning after December 15, 2008. FSP EITF 03-6-1 clarifies that unvested share-based awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in computation of EPS pursuant to the two class method. The adoption of EITF 03-6-1 did not have a material effect on our consolidated financial position or results of operations.

In June 2008, the FASB issued Staff Position EITF 07-05, *Determining Whether an Instrument (or Embedded Feature) is Indexed to an Entity's Own Stock* (FSP EITF 07-05), effective for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. This Issue addresses the determination of whether an instrument (or an embedded feature) is indexed to an entity's own stock. If an instrument (or an embedded feature) that has the characteristics of a derivative instrument under the relative paragraphs of Statement 133 is indexed to an entity's own stock, it is still necessary to evaluate whether it is classified in stockholders' equity (or would be classified in stockholders' equity if it were a freestanding instrument). The guidance in this Issue shall be applied to outstanding instruments as of the beginning of the fiscal year in which this Issue is initially applied. The cumulative effect of the change in accounting principle shall be recognized as an adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that fiscal year, presented separately. However, in circumstances in which a previously bifurcated embedded conversion option in a convertible debt instrument no longer meets the bifurcation criteria in Statement 133 at initial application of this Issue, the carrying amount of the liability for the conversion option (that is, its fair value on the date of adoption) shall be reclassified to shareholders' equity. Any debt discount that was recognized when the conversion option was initially bifurcated from the convertible debt instrument shall continue to be amortized. The adoption of EITF 07-05 did not have a material effect on our consolidated financial position or results of operations.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements which defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles and expands disclosures about fair value measurements. SFAS No. 157 was effective for fiscal years beginning after

Table of Contents

MICROFINANCIAL INCORPORATED
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except share and per share data)

November 15, 2007, and interim periods within those fiscal years. In February 2008, FSP No. 157-2 delayed the effective date of SFAS No. 157 one year for all nonfinancial assets and nonfinancial liabilities except those recognized or disclosed at fair value in the financial statements on a recurring basis. The adoption of FSP 157-2 for nonfinancial assets and liabilities did not have a material effect on our consolidated financial position or results of operations.

Effective January 1, 2009, we have early adopted FSP FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments* an amendment to FASB Statement No. 107 (FAS 107) and APB Opinion No. 28 (APB 28). The FSP amends FAS 107, *Disclosures about Fair Value of Financial Instruments*, to require disclosures about fair value of financial instruments for interim reporting periods of publicly traded companies as well as in annual financial statements. This FSP also amends APB 28, *Interim Financial Reporting*, to require those disclosures in summarized financial information at interim reporting periods. The adoption of FSP FAS 107-1 and APB 28 has been included in the disclosures in this Form 10-Q.

In April 2009, the FASB issued FSP No. 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* (FSP FAS 157-4), which provides further clarification for guidance provided by SFAS No. 157, regarding measurement of fair values of assets and liabilities when the market activity has significantly decreased and in identifying transactions that are not orderly. The adoption of this staff position did not have a material effect on our consolidated financial position or results of operations.

On April 9, 2009, the FASB issued FSP FAS 115-2 and FAS 124-2, *Recognition and Presentation of other-Than-Temporary Impairments*. This FSP amends the other-than-temporary impairment guidance in GAAP for debt securities to make the guidance more operational and to improve the presentation and disclosure of other-than-temporary impairments on debt and equity securities in the financial statements. This FSP does not amend existing recognition and measurement guidance related to other-than-temporary impairments of equity securities. The adoption of this staff position did not have a material effect on our consolidated financial position or results of operations.

In May 2009, the FASB issued Statement No. 165, *Subsequent Events* (SFAS 165). This Statement establishes general standards of accounting for and disclosure of events that occur after the balance sheet date, but before financial statements are issued or are available to be issued. The Statement is effective for interim and annual fiscal periods ending after June 15, 2009. The Company has evaluated the effect of the adoption of this standard and has concluded it has no material effect on our financial position or results of operations. Management has reviewed events occurring through August 14, 2009, the date the financial statements were issued, and the Company has determined that no subsequent events occurred requiring accrual or disclosure

In June 2009 the FASB issued SFAS No. 168, *The FASB Accounting Standards Codification and the hierarchy of Generally Accepted Accounting Principles* which replaces statement 162 and establishes the FASB Accounting Standards Codification as the source of authoritative accounting principles recognized by the FASB to be applied by non governmental entities in the preparation of financial statements in conformity with GAAP. Rules and interpretive releases of the Securities and Exchange Commission (SEC) under authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. Following this statement, the Board will not issue new standards in the forms of Statements, FASB Staff Positions, or Emerging Issues Task Force Abstracts. Instead it will issue Accounting Standards Updates. This statement will be effective for financial statements issued for interim and annual periods ending after September 15, 2009.

Table of Contents

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

Introduction

The following information should be read in conjunction with our condensed consolidated financial statements and notes thereto in Part I, Item 1 of this Quarterly Report and with Management's Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report on Form 10-K for the year ended December 31, 2008.

Forward-Looking Information

Statements in this document that are not historical facts are forward-looking statements made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. In addition, words such as "believes," "anticipates," "expects," and similar expressions are intended to identify forward-looking statements. We caution that a number of important factors could cause actual results to differ materially from those expressed in any forward-looking statements made by us or on our behalf. Such statements contain a number of risks and uncertainties, including but not limited to: our need for financing in order to originate leases and contracts; our demand for the equipment types we offer, expansion into new markets and the development of a sizable dealer base; our significant capital requirements; risks associated with economic downturns; risks of defaults in our leases and the adequacy of our provision for credit losses; higher interest rates; intense competition; changes in our regulatory environment; the availability of qualified personnel, and risks associated with acquisitions. Readers should not place undue reliance on forward-looking statements, which reflect our view only as of the date hereof. We undertake no obligation to publicly revise these forward-looking statements to reflect subsequent events or circumstances. We cannot assure that we will be able to anticipate or respond timely to changes which could adversely affect our operating results. Results of operations in any past period should not be considered indicative of results to be expected in future periods. Fluctuations in operating results may result in fluctuations in the price of our common stock. Statements relating to past dividend payments or our current dividend policy should not be construed as a guarantee that any future dividends will be paid. For a more complete description of the prominent risks and uncertainties inherent in our business, see the risk factors included in our most recent Annual Report on Form 10-K and other documents we file from time to time with the Securities and Exchange Commission.

Overview

We are a specialized commercial finance company that provides "microticket" equipment leasing and other financing services. The average amount financed by TimePayment through 2008 and year to date 2009 was approximately \$5,500, while Leasecomm historically financed contracts of approximately \$1,900. Our existing portfolio consists of business equipment leased or rented primarily to small commercial enterprises.

We finance the funding of our leases and contracts primarily through cash on hand and our revolving line of credit. On August 2, 2007, we entered into a three-year \$30 million revolving line of credit with Sovereign based on qualified TimePayment lease receivables. On July 9, 2008, we entered into an amended agreement to increase our revolving line of credit with Sovereign to \$60 million. The maturity date of the amended agreement is August 2, 2010. Outstanding borrowings are collateralized by eligible lease contracts and a security interest in all of our other assets and, until February 2009, bore interest at Prime Rate or at LIBOR plus 2.75%. Under the terms of the facility, loans are Prime Rate Loans, unless we elect LIBOR Loans. If a LIBOR Loan is not renewed at maturity it automatically converts to a Prime Rate Loan.

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

In a typical lease transaction, we originate a lease through our nationwide network of equipment vendors, independent sales organizations and brokers. Upon our approval of a lease application and verification that the lessee has received the equipment and signed the lease, we pay the dealer for the cost of the equipment, plus the dealer's profit margin.

Table of Contents

In the past, we have also from time to time acquired service contracts under which a homeowner purchases a security system and simultaneously signs a contract with the dealer for the monitoring of that system for a monthly fee. Upon approval of the monitoring application and verification with the homeowner that the system is installed, we would purchase the right to the payment stream under the monitoring contract from the dealer at a negotiated multiple of the monthly payments. We have not purchased any new security monitoring contracts since 2004, and anticipate that service contract revenue will continue to decline over time.

Substantially all leases originated or acquired by us are non-cancelable. During the term of the lease, we are scheduled to receive payments sufficient to cover our borrowing costs and the cost of the underlying equipment and provide us with an appropriate profit. We pass along some of the costs of our leases and contracts by charging late fees, prepayment penalties, loss and damage waiver fees and other service fees, when applicable. Collection fees are imposed based on our estimate of the costs of collection. The loss and damage waiver fees are charged if a customer fails to provide proof of insurance and are reasonably related to the cost of replacing the lost or damaged equipment or product. The initial non-cancelable term of the lease is equal to or less than the equipment's estimated economic life and often provides us with additional revenues based on the residual value of the equipment at the end of the lease. Initial terms of the leases in our portfolio generally range from 12 to 60 months, with an average initial term of 45 months as of December 31, 2008.

Critical Accounting Policies

Our significant accounting policies are more fully described in Note B to the condensed consolidated financial statements included in this Quarterly Report and in Note B to the consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2008 filed with the Securities and Exchange Commission. Certain accounting policies are particularly important to the portrayal of our consolidated financial position and results of operations. These policies require the application of significant judgment by us and as a result, are subject to an inherent degree of uncertainty. In applying these policies, we make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and the related disclosures. We base our estimates and judgments on historical experience, terms of existing contracts, observance of trends in the industry, information obtained from dealers and other sources, and on various other assumptions that we believe to be reasonable and appropriate under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

Our critical accounting policies, including revenue recognition, maintaining the allowance for credit losses, determining provisions for income taxes, and accounting for share-based compensation are each discussed in more detail in our Annual Report on Form 10-K. We have reviewed and determined that those policies remain our critical accounting policies and we did not make any changes in those policies during the six months ended June 30, 2009.

Results of Operations - Three months ended June 30, 2009 compared to the three months ended June 30, 2008*Revenue*

| | Three Months Ended June 30, | | |
|-------------------------------|-----------------------------|--------|----------|
| | 2009 | Change | 2008 |
| | (Dollars in thousands) | | |
| Income on financing leases | \$ 7,098 | 26.8% | \$ 5,596 |
| Rental income | 2,138 | (13.9) | 2,484 |
| Income on service contracts | 175 | (27.1) | 240 |
| Loss and damage waiver fees | 1,018 | 32.6 | 768 |
| Service fees and other income | 699 | 31.4 | 532 |
| Interest income | 1 | (96.3) | 27 |
| Total revenues | \$ 11,129 | 15.4% | \$ 9,647 |

Our lease contracts are accounted for as financing leases. At origination, we record the gross lease receivable, the estimated residual value of the leased equipment, initial direct costs incurred and the unearned lease income. Unearned lease income is the amount by which the gross lease receivable plus the estimated residual value exceeds the cost of the equipment. Unearned lease income and initial direct costs incurred are amortized over the related

Table of Contents

lease term using the interest method. Other revenues such as loss and damage waiver fees, service fees relating to the leases and contracts, and rental revenues are recognized as they are earned.

Total revenues for the three months ended June 30, 2009 were \$11.1 million, an increase of \$1.5 million, or 15.4%, from the three months ended June 30, 2008. The overall increase was due to an increase of \$1.5 million in income on financing leases, an increase of \$0.4 in fees and other income, partially offset by a decrease of \$0.3 million in rental income, and a decrease of \$65,000 in income on service contracts. The increase in income on financing leases is a result of the continued growth in new lease originations. The decline in rental income is the result of the attrition of Leasecomm rental contracts which is partially offset by TimePayment lease contracts coming to term and converting to rentals. Service contact revenue continues to decline since we have not funded any new service contracts since 2004.

Selling, General and Administrative Expenses

| | Three Months Ended June 30, | | |
|-------------------------------------|-----------------------------|--------|----------|
| | 2009 | Change | 2008 |
| | (Dollars in thousands) | | |
| Selling, general and administrative | \$ 3,492 | 9.2% | \$ 3,198 |
| As a percent of revenue | 31.4% | | 33.2% |

Our selling, general and administrative (SG&A) expenses include costs of maintaining corporate functions including accounting, finance, collections, legal, human resources, sales and underwriting, and information systems. SG&A expenses also include service fees and other marketing costs associated with our portfolio of leases and rental contracts. SG&A expenses increased by \$294,000 for the three months ended June 30, 2009, as compared to the three months ended June 30, 2008. The increase was primarily driven by increases in compensation expense of \$304,000 and employee benefits of \$78,000, offset by a \$77,000 decrease in legal expenses. The increase in compensation related expenses is the result of an increase in the number of employees. The number of employees as of June 30, 2009 was 106 compared to 86 as of June 30, 2008.

Provision for Credit Losses

| | Three Months Ended June 30, | | |
|-----------------------------|-----------------------------|--------|----------|
| | 2009 | Change | 2008 |
| | (Dollars in thousands) | | |
| Provision for credit losses | \$ 4,993 | 63.2% | \$ 3,060 |
| As a percent of revenue | 44.9% | | 31.7% |

We maintain an allowance for credit losses on our investment in leases, service contracts and rental contracts at an amount that we believe is sufficient to provide adequate protection against losses in our portfolio. Our provision for credit losses increased by \$1.9 million for the three months ended June 30, 2009, as compared to the three months ended June 30, 2008, while net charge-offs increased by 215.8% to \$4.2 million. The provision is based on providing a general allowance on leases funded during the period and our analysis of actual and expected losses in our portfolio. The increase in the allowance reflects the growth in lease receivables associated with new lease originations, increased delinquency and charge off levels, and the current economic conditions.

Depreciation and Amortization

| | Three Months Ended June 30, | | |
|-------------------------------------|-----------------------------|--------|--------|
| | 2009 | Change | 2008 |
| | (Dollars in thousands) | | |
| Depreciation fixed assets | \$ 105 | 9.4% | \$ 96 |
| Depreciation rental equipment | 269 | 228.0 | 82 |
| Amortization service contracts | 9 | (82.7) | 52 |
| Total depreciation and amortization | \$ 383 | 66.5% | \$ 230 |

As a percent of revenue 3.4% 2.4%

Depreciation and amortization expense consists of depreciation on fixed assets and rental equipment, and the amortization of service contracts. Fixed assets are recorded at cost and depreciated over their expected useful lives. Certain rental contracts are originated as a result of the renewal provisions of our lease agreements where at

Table of Contents

the end of lease term, the customer may elect to continue to rent the leased equipment on a month-to-month basis. The rental equipment is recorded at its residual value and depreciated over a term of 12 months. This term represents the estimated life of a previously leased piece of equipment and is based upon our historical experience. In the event the contract terminates prior to the end of the 12 month period, the remaining net book value is expensed.

Depreciation expense on rental contracts increased by \$187,000 and amortization of service contracts decreased by \$43,000 for the three months ended June 30, 2009, as compared to the three months ended June 30, 2008. The increase in depreciation is primarily due to the increase in the number of TimePayment lease contracts coming to maturity and converting to rentals. Depreciation and amortization of property and equipment increased by \$9,000 for the three months ended June 30, 2009, as compared to the three months ended June 30, 2008.

Service contracts are recorded at cost and amortized over their estimated life of 84 months. In a typical service contract acquisition, a homeowner will purchase a home security system and simultaneously sign a contract with the security dealer for monthly monitoring of the system. The security dealer will then sell the rights to that monthly payment to us. We perform all of the processing, billing, collection and administrative work on the service contract. The estimated life is based upon the expected life of such contracts in the security monitoring industry and our historical experience. In the event the contract terminates prior to the end of the 84 month term, the remaining net book value is expensed.

Interest Expense

| | Three Months Ended June 30, | | |
|-------------------------|-----------------------------|--------|--------|
| | 2009 | Change | 2008 |
| | (Dollars in thousands) | | |
| Interest | \$ 661 | 182.5% | \$ 234 |
| As a percent of revenue | 5.9% | | 2.4% |

We pay interest on borrowings under our senior credit facility. Interest expense increased by \$427,000 for the three months ended June 30, 2009, as compared to the three months ended June 30, 2008. This increase resulted primarily from our increased level of borrowings and debt closing costs on our line of credit. At June 30, 2009, we had notes payable under our line of credit of \$41.0 million compared to notes payable of \$21.4 million at June 30, 2008.

Provision for Income Taxes

| | Three Months Ended June 30, | | |
|-------------------------------------|-----------------------------|---------|----------|
| | 2009 | Change | 2008 |
| | (Dollars in thousands) | | |
| Provision for income taxes | \$ 616 | (41.5)% | \$ 1,053 |
| As a percent of revenue | 5.5% | | 10.9% |
| As a percent of income before taxes | 38.5% | | 36.0% |

The provision for income taxes, deferred tax assets and liabilities and any necessary valuation allowance recorded against net deferred tax assets, involves summarizing temporary differences resulting from the different treatment of items, such as leases, for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are recorded on the balance sheet. We then assess the likelihood that deferred tax assets will be recovered from future taxable income or tax carry-back availability and to the extent we believe recovery is more likely than not, a valuation allowance is unnecessary. The provision for income taxes decreased by \$437,000 for the three months ended June 30, 2008, as compared to the three months ended June 30, 2007. This increase resulted primarily from the \$1.3 million decrease in pre-tax income and was partially offset by an increase in the effective tax rate from 36.0% for the three months ended June 30, 2008 to 38.5% for the three months ended June 30, 2009.

As of March 31, 2009, we had a liability of \$293,000 for unrecognized tax benefits and a liability of \$160,000 for accrued interest and penalties related to various state income tax matters. As of June 30, 2009 we had a liability of \$293,000 for unrecognized tax benefits and a liability of \$170,000 for accrued interest and penalties. Of these amounts, approximately \$300,000 would impact our effective tax rate after a \$161,000 federal tax benefit for state income taxes. The increase in the unrecognized tax benefits relates to \$10,000 in additional accrued interest

Table of Contents

expense. It is reasonably possible that the total amount of unrecognized tax benefits may change significantly within the next 12 months; however at this time we are unable to estimate the change.

Our federal income tax returns are subject to examination for tax years ended on or after December 31, 2004 and our state income tax returns are subject to examination for tax years ended on or after December 31, 2002.

Other Operating Data

Dealer funding was \$19.6 million for the three months ended June 30, 2009, an increase of \$1.1 million or 9.5%, compared to the six months ended June 30, 2008. We continue to concentrate on our business development efforts, which include increasing the size of our vendor base and sourcing a larger number of applications from those vendors. Receivables due in installments, estimated residual values, net investment in service contracts and net investment in rental contracts increased from \$170.3 million at March 31, 2009 to \$180.6 million at June 30, 2009. Net cash provided by operating activities increased by \$3.1 million, or 26.7%, to \$14.3 million during the three months ended June 30, 2009 as compared to the three months ended June 30, 2008.

Results of Operations - Six months ended June 30, 2009 compared to the six months ended June 30, 2008*Revenue*

| | Six Months Ended June 30, | | |
|-------------------------------|---------------------------|--------|-----------|
| | 2009 | Change | 2008 |
| | (Dollars in thousands) | | |
| Income on financing leases | \$ 13,887 | 31.8% | \$ 10,536 |
| Rental income | 4,347 | (17.0) | 5,236 |
| Income on service contracts | 364 | (27.1) | 499 |
| Loss and damage waiver fees | 2,004 | 37.6 | 1,456 |
| Service fees and other income | 1,370 | 26.9 | 1,080 |
| Interest income | 14 | (83.9) | 87 |
| Total revenues | \$ 21,986 | 16.4% | \$ 18,894 |

Our lease contracts are accounted for as financing leases. At origination, we record the gross lease receivable, the estimated residual value of the leased equipment, initial direct costs incurred and the unearned lease income. Unearned lease income is the amount by which the gross lease receivable plus the estimated residual value exceeds the cost of the equipment. Unearned lease income and initial direct costs incurred are amortized over the related lease term using the interest method. Other revenues such as loss and damage waiver fees, service fees relating to the leases and contracts, and rental revenues are recognized as they are earned.

Total revenues for the six months ended June 30, 2009 were \$22.0 million, an increase of \$3.1 million, or 16.4%, from the six months ended June 30, 2008. The overall increase was due to an increase of \$3.4 million in income on financing leases, and a \$0.8 increase in fees and other income partially offset by a decrease of \$0.8 million in rental income, a decrease of \$135,000 in service contracts and a decrease of \$73,000 in interest income. The increase in income on financing leases is a result of the continued growth in new lease originations. The decline in rental income is the result of the attrition of Leasecomm rental contracts which is partially offset by TimePayment lease contracts coming to term and converting to rentals. Service contract revenue continues to decline since we have not funded any new service contracts. The decrease in interest income is a direct result of the decrease in invested cash.

Selling, General and Administrative Expenses

| | Six Months Ended June 30, | | |
|-------------------------------------|---------------------------|--------|----------|
| | 2009 | Change | 2008 |
| | (Dollars in thousands) | | |
| Selling, general and administrative | \$ 7,064 | 9.7% | \$ 6,437 |
| As a percent of revenue | 32.1% | | 34.1% |

Our selling, general and administrative (SG&A) expenses include costs of maintaining corporate functions including accounting, finance, collections, legal, human resources, sales and underwriting, and information systems. SG&A expenses also include service fees and other marketing costs associated with our portfolio of leases and

Table of Contents

rental contracts. SG&A expenses increased by \$627,000 for the six months ended June 30, 2009, as compared to the six months ended June 30, 2008. The increase was primarily driven by increases in compensation expense of \$524,000 and an increase in employee benefits \$144,000 as a result of an increase in the number of employees.

Provision for Credit Losses

| | Six Months Ended June 30, | | |
|-----------------------------|---------------------------|--------|----------|
| | 2009 | Change | 2008 |
| | (Dollars in thousands) | | |
| Provision for credit losses | \$ 10,446 | 62.8% | \$ 6,417 |
| As a percent of revenue | 47.5% | | 34.0% |

We maintain an allowance for credit losses on our investment in leases, service contracts and rental contracts at an amount that we believe is sufficient to provide adequate protection against losses in our portfolio. Our provision for credit losses increased by \$4.0 million for the six months ended June 30, 2009, as compared to the six months ended June 30, 2008, while net charge-offs increased by 227.9% to \$8.7 million. The provision is based on providing a general allowance on leases funded during the period and our analysis of actual and expected losses in our portfolio. The increase in the allowance reflects the growth in lease receivables associated with new lease originations, increased delinquency and charge off levels, and the current economic conditions.

Depreciation and Amortization

| | Six Months Ended June 30, | | |
|-------------------------------------|---------------------------|--------|--------|
| | 2009 | Change | 2008 |
| | (Dollars in thousands) | | |
| Depreciation fixed assets | \$ 210 | 14.1% | \$ 184 |
| Depreciation rental equipment | 483 | 198.1 | 162 |
| Amortization service contracts | 25 | (78.1) | 114 |
| Total depreciation and amortization | \$ 718 | 56.1% | \$ 460 |
| As a percent of revenue | 3.3% | | 2.4% |

Depreciation and amortization expense consists of depreciation on fixed assets and rental equipment, and the amortization of service contracts. Fixed assets are recorded at cost and depreciated over their expected useful lives. Certain rental contracts are originated as a result of the renewal provisions of our lease agreements where at the end of lease term, the customer may elect to continue to rent the leased equipment on a month-to-month basis. The rental equipment is recorded at its residual value and depreciated over a term of 12 months. This term represents the estimated life of a previously leased piece of equipment and is based upon our historical experience. In the event the contract terminates prior to the end of the 12 month period, the remaining net book value is expensed.

Depreciation expense on rental contracts increased by \$321,000 and amortization of service contracts decreased by \$89,000 for the six months ended June 30, 2009, as compared to the six months ended June 30, 2008. The increase in depreciation is due to the increase in the overall size of our portfolio of rental equipment. Depreciation and amortization of property and equipment increased by \$26,000 for the six months ended June 30, 2009, as compared to the six months ended June 30, 2008.

Service contracts are recorded at cost and amortized over their estimated life of 84 months. In a typical service contract acquisition, a homeowner will purchase a home security system and simultaneously sign a contract with the security dealer for monthly monitoring of the system. The security dealer will then sell the rights to that monthly payment to us. We perform all of the processing, billing, collection and administrative work on the service contract. The estimated life is based upon the expected life of such contracts in the security monitoring industry and our historical experience. In the event the contract terminates prior to the end of the 84 month term, the remaining net book value is expensed.

Table of Contents*Interest Expense*

| | Six Months Ended June 30, | | |
|-------------------------|---------------------------|--------|--------|
| | 2009 | Change | 2008 |
| | (Dollars in thousands) | | |
| Interest | \$ 1,177 | 204.9% | \$ 386 |
| As a percent of revenue | 5.4% | | 2.0% |

We pay interest on borrowings under our revolving line of credit. Interest expense increased by \$791,000 for the six months ended June 30, 2009, as compared to the six months ended June 30, 2008. This increase resulted primarily from our increased level of borrowings and debt closing costs on our line of credit. At June 30, 2009, we had notes payable under our line of credit of \$41.0 million compared to notes payable of \$21.4 million at June 30, 2008.

Provision for Income Taxes

| | Six Months Ended June 30, | | |
|-------------------------------------|---------------------------|---------|----------|
| | 2009 | Change | 2008 |
| | (Dollars in thousands) | | |
| Provision for income taxes | \$ 994 | (43.7)% | \$ 1,765 |
| As a percent of revenue | 4.5% | | 9.3% |
| As a percent of income before taxes | 38.5% | | 34.0% |

The provision for income taxes, deferred tax assets and liabilities and any necessary valuation allowance recorded against net deferred tax assets, involves summarizing temporary differences resulting from the different treatment of items, such as leases, for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are recorded on the balance sheet. We then assess the likelihood that deferred tax assets will be recovered from future taxable income or tax carry-back availability and to the extent we believe recovery is more likely than not, a valuation allowance is unnecessary. The provision for income taxes decreased by \$771,000 for the six months ended June 30, 2009, as compared to the six months ended June 30, 2008. This increase resulted primarily from the \$2.6 million decrease in pre-tax income partially offset by an increase in the effective tax rate from 34.0% for the six months ended June 30, 2008 to 38.5% for the six months ended June 30, 2009. The 2008 effective tax rate was lower primarily due to the release of certain state reserves related to the expiration of statutes of limitation in the first and second quarters of 2008.

As of December 31, 2008, we had a liability of \$293,000 for unrecognized tax benefits and a liability of \$152,000 for accrued interest and penalties related to various state income tax matters. As of June 30, 2009 we had a liability of \$293,000 for unrecognized tax benefits and a liability of \$170,000 for accrued interest and penalties. Of these amounts, approximately \$300,000 would impact our effective tax rate after a \$161,000 federal tax benefit for state income taxes. The increase in the unrecognized tax benefits relates to \$18,000 in additional accrued interest expense. It is reasonably possible that the total amount of unrecognized tax benefits may change significantly within the next 12 months; however at this time we are unable to estimate the change.

Our federal income tax returns are subject to examination for tax years ended on or after December 31, 2004 and our state income tax returns are subject to examination for tax years ended on or after December 31, 2002.

Other Operating Data

Dealer funding was \$36.7 million for the six months ended June 30, 2009, an increase of \$1.4 million or 3.8%, compared to the six months ended June 30, 2008. We continue to concentrate on our business development efforts, which include increasing the size of our vendor base and sourcing a larger number of applications from those vendors. Receivables due in installments, estimated residual values, net investment in service contracts and investment in rental contracts increased from \$162.1 million at December 31, 2008 to \$180.6 million at June 30, 2009. Net cash provided by operating activities increased by \$6.9 million, or 34.3%, to \$27.1 million during the six months ended June 30, 2009 as compared to the six months ended June 30, 2008.

Table of Contents**Exposure to Credit Losses**

The amounts in the table below represent the balance of delinquent receivables on an exposure basis for all leases, rental contracts, and service contracts in our portfolio. An exposure basis aging classifies the entire receivable based on the invoice that is the most delinquent. For example, in the case of a rental or service contract, if a receivable is 90 days past due, all amounts billed and unpaid are placed in the over 90 days past due category. In the case of lease receivables, where the minimum contractual obligation of the lessee is booked as a receivable at the inception of the lease, if a receivable is 90 days past due, the entire receivable, including all amounts billed and unpaid as well as the minimum contractual obligation yet to be billed, will be placed in the over 90 days past due category.

| <i>(dollars in thousands)</i> | June 30, 2009 | | December 31, 2008 | |
|---------------------------------------|---------------|--------|-------------------|--------|
| Current | \$ 126,138 | 79.0% | \$ 110,423 | 77.3% |
| 31-60 days past due | 5,232 | 3.3 | 6,941 | 4.8 |
| 61-90 days past due | 4,550 | 2.8 | 5,079 | 3.6 |
| Over 90 days past due | 23,820 | 14.9 | 20,438 | 14.3 |
| Gross receivables due in installments | \$ 159,740 | 100.0% | \$ 142,881 | 100.0% |

Liquidity and Capital Resources*General*

Our lease and finance business is capital-intensive and requires access to substantial short-term and long-term credit to fund lease originations. Since inception, we have funded our operations primarily through borrowings under our credit facilities, on-balance sheet securitizations, the issuance of subordinated debt, free cash flow and our initial public offering completed in February 1999. We will continue to require significant additional capital to maintain and expand our funding of leases and contracts, as well as to fund any future acquisitions of leasing companies or portfolios. In the near term, we expect to finance our business utilizing the cash on hand and our line of credit which matures in August 2010. Additionally, our uses of cash include the payment of interest and principal on borrowings, selling, general and administrative expenses, income taxes and capital expenditures.

For the six months ended June 30, 2009 and throughout 2008, our primary sources of liquidity were cash provided by operating activities and borrowings on our revolving line of credit. We generated cash flow from operations of \$27.1 million for the six months ended June 30, 2009 compared to \$20.2 million for the six months ended June 30, 2008. At June 30, 2009, we had approximately \$41.0 million outstanding under our revolving line of credit facility and had available borrowing capacity of approximately \$44.0 million as described below.

We used net cash in investing activities of \$37.1 million during the six months ended June 30, 2009 and \$35.5 million for the six months ended June 30, 2008. Investing activities primarily relate to the origination of leases and the increase in cash used is consistent with our focused and targeted sales and marketing effort.

Net cash provided by financing activities was \$6.0 million for the six months ended June 30, 2009 and \$13.6 million for the six months ended June 30, 2008. Financing activities primarily consist of the borrowings and repayments under our revolving line of credit facility and dividend payments.

We believe that cash flows from our existing portfolio, cash on hand, and available borrowings under our amended credit facility will be sufficient to support our operations and lease origination activity in the near term. Given the tight credit conditions in the current marketplace, it may be difficult for us to obtain additional low cost capital. Our inability to obtain additional financing would significantly impact our ability to grow the business.

Borrowings

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

Table of Contents

| | June 30, 2009 | | | | December 31, 2008 | | | |
|---|---------------------|---------------|-----------------|-------------------------|---------------------|---------------|-----------------|-------------------------|
| | Amounts Outstanding | Interest Rate | Unused Capacity | Maximum Facility Amount | Amounts Outstanding | Interest Rate | Unused Capacity | Maximum Facility Amount |
| <i>(dollars in 000)</i> Revolving line of credit facility ⁽¹⁾ | \$40,956 | 5.0% | \$44,044 | \$ 85,000 | \$33,325 | 3.25% | \$26,675 | \$ 60,000 |

⁽¹⁾ The unused capacity is subject to the borrowing base formula.

On August 2, 2007, we entered into a three-year \$30 million revolving line of credit with Sovereign based on qualified TimePayment lease receivables. On July 9, 2008 we entered into an amended agreement to increase our revolving line of credit with Sovereign to \$60 million. The maturity date of the amended agreement is August 2, 2010. Outstanding borrowings are collateralized by eligible lease contracts and a security interest in all of our other assets and, until February 2009, bore interest at Prime or at LIBOR plus 2.75%. Under the terms of the facility, loans are Prime Rate Loans, unless we elect LIBOR Loans. If a LIBOR Loan is not renewed at maturity it automatically converts to a Prime Rate Loan.

On February 10, 2009 we entered into an amended agreement to increase our revolving line of credit with Sovereign to \$85 million. Under the amended agreement, outstanding borrowings bear interest at Prime plus 1.75% or LIBOR plus 3.75%, in each case subject to a minimum interest rate of 5%. All other terms of the facility remained the same. As of June 30, 2009 and 2008, all of our loans were Prime Rate Loans.

Dividends

On July 14, 2009 we declared a dividend of \$0.05 payable on August 14, 2009 to the shareholders of record on July 30, 2009. On April 16, 2009 we declared a dividend of \$0.05 payable on May 8, 2009 to shareholders of record on April 30, 2009. During the three months ended December 31, 2008, we declared a dividend of \$0.05 payable on January 19, 2009 to shareholders of record as of January 5, 2009.

On July 25, 2008 we declared a dividend of \$0.05 payable on August 15, 2008 to the shareholders of record on August 5, 2008. On April 25, 2008 we declared a dividend of \$0.05 payable on May 15, 2008 to shareholders of record on May 5, 2008. During the three months ended March 31, 2008 we did not declare a dividend.

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

Contractual Obligations and Lease Commitments***Contractual Obligations***

We have entered into various agreements, such as debt and operating lease agreements, that require future payments. For the six months ended June 30, 2009 we had borrowed \$41.4 million against our revolving line of credit and had repaid \$33.8 million. The \$41.0 million of outstanding borrowings as of June 30, 2009 will be repaid by the daily application of TimePayment receipts to our outstanding balance. Our future minimum lease payments under non-cancelable operating leases are \$237,000 annually for the years 2009 through 2010.

Lease Commitments

We accept lease applications on a daily basis and have a pipeline of applications that have been approved, where a lease has not been originated. Our commitment to lend does not become binding until all of the steps in the lease origination process have been completed, including but not limited to the receipt of a complete and accurate lease document, all required supporting information and successful verification with the lessee. Since we fund on the same day a lease is successfully verified, we have no firm outstanding commitments to lend.

Table of Contents

Recent Accounting Pronouncements

See Note E of the notes to the unaudited condensed consolidated financial statements for a discussion of the impact of recent accounting pronouncements.

Table of Contents

ITEM 3. Quantitative and Qualitative Disclosures about Market Risk

The following discussion about our risk management activities includes forward-looking statements that involve risk and uncertainties. Actual results could differ materially from those projected in the forward-looking statements. In the normal course of operations, we also face risks that are either non-financial or non-quantifiable. Such risks principally include credit risk and legal risk, and are not represented in the analysis that follows.

The implicit yield on all of our leases and contracts is on a fixed interest rate basis due to the leases and contracts having scheduled payments that are fixed at the time of origination. When we originate or acquire leases or contracts, we base our pricing in part on the spread we expect to achieve between the implicit yield on each lease or contract and the effective interest rate we expect to incur in financing such lease or contract through our credit facility. Increases in interest rates during the term of each lease or contract could narrow or eliminate the spread, or result in a negative spread.

Given the relatively short average life of our leases and contracts, our goal is to maintain a blend of fixed and variable interest rate obligations which limits our interest rate risk. As of June 30, 2009, we have repaid all of our fixed-rate debt and have \$41.0 million of outstanding variable interest rate obligations under our revolving line of credit.

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

We maintain an investment portfolio in accordance with our investment policy guidelines. The primary objectives of the investment guidelines are to preserve capital, maintain sufficient liquidity to meet our operating needs, and to maximize return. We minimize investment risk by limiting the amount invested in any single security and by focusing on conservative investment choices with short terms and high credit quality standards. We do not use derivative financial instruments or invest for speculative trading purposes.

ITEM 4. Controls and Procedures

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

Internal controls over financial reporting: During the fiscal quarter ended June 30, 2009, no changes were made in our internal control over financial reporting that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents**Part II - Other Information****ITEM 1. Legal Proceedings**

We are subject to claims and suits arising in the ordinary course of business. At this time, it is not possible to estimate the ultimate loss or gain, if any, related to these lawsuits, nor if any such loss will have a material adverse effect on our results of operation or financial position.

ITEM 1A. Risk Factors

For a discussion of the material risks that we face relating to our business, financial performance and industry, as well as other risks that an investor in our common stock may face, see the factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2008. The risks described in our Annual Report on Form 10-K and elsewhere in this report are not the only risks we face. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial may also materially adversely affect our business, financial condition or operating results.

ITEM 4. Submission of Matters to a Vote of Security Holders

The following matters were approved at our annual meeting of stockholders, which was held on May 14, 2009.

A. For the election of nominees for the Board of Directors:

| Name of Director | For | Authority Withheld |
|-------------------------|------------|---------------------------|
| Brian E. Boyle | 9,221,078 | 2,607,559 |
| Alan J. Zakon | 10,668,098 | 1,160,539 |

B. For the proposal to ratify the appointment of Caturano and Company, formerly known as Vitale, Caturano & Co., as our independent registered public accounting firm for the year ending December 31, 2009:

| For | Against | Abstain |
|------------|----------------|----------------|
| 11,795,564 | 33,073 | 0 |

ITEM 5. Other Information

On May 28, 2009, Mr. Thomas Herlihy, a named executive officer of the Company, entered into a Separation Agreement and General Release (Separation Agreement) with our operating subsidiary, TimePayment Corp. in connection with his last day of employment of May 18, 2009. Pursuant to the Separation Agreement, Mr. Herlihy has agreed to a general release in favor of the Company, and in consideration, the Company has agreed to pay to Mr. Herlihy four months of separation pay in the form of a bi-weekly payment. A copy of the Separation Agreement and General Release is being filed as Exhibit 10.1 to this Quarterly Report on Form 10-Q.

ITEM 6. Exhibits

(a) Exhibits index

- 3.1 Restated Articles of Organization, as amended (incorporated by reference to Exhibit 3.1 in the Registrant's Registration Statement on Form S-1, No. 333-56639, filed with the Securities and Exchange Commission on June 9, 1998).
- 3.2 Restated Bylaws, as amended (incorporated by reference to Exhibit 3.2 in the Registrant's Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 28, 2007).
- 10.1* Separation Agreement and General Release dated May 28, 2009 between Mr. Thomas Herlihy and TimePayment Corp., a wholly owned subsidiary of the Registrant.

Table of Contents

- 31.1* Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2* Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1* Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2* Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

* Filed herewith

Table of Contents

SIGNATURES

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

MicroFinancial Incorporated

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

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

Date: August 14, 2009