MICROFINANCIAL INC
Form 10-Q
November 15, 2004

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

FORM 10-Q

(Mark One)

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES AND EXCHANGE ACT OF 1934
For the Quarterly Period Ended September 30, 2004

OR

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

Commission File No. 1-14771

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

Massachusetts	04-2962824
(State or other jurisdiction of Incorporation or Organization)	(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. [X] Yes [ ] No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange

Act). [ ] Yes [X] No

As of November 1, 2004, 13,183,916 shares of the registrant's common stock, $0.01 par value, were outstanding.

MICROFINANCIAL INCORPORATED
TABLE OF CONTENTS

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

	December 31, 2003
ASSETS	
Cash and cash equivalents	$ 6,533
Net investment in leases:	
Receivables due in installments	$ 175,788
Estimated residual value	19,110
Initial direct costs	1,804
Less:	
Advance lease payments and deposits	(37)
Unearned income	(23,729)
Allowance for credit losses	(43,011)
Net investment in leases:	129,925
Investment in service contracts, net	8,844
Investment in rental contracts, net	3,758
Restricted cash	2,376
Property and equipment, net	2,086
Other assets	2,892
Deferred income taxes	-
Total assets	$ 156,414
LIABILITIES AND STOCKHOLDERS' EQUITY	

Notes payable	$ 58,843
Subordinated notes payable	3,262
Capitalized lease obligations	209
Accounts payable	3,186
Other liabilities	4,104
Income taxes payable	7,789
Deferred income taxes payable	7,755
Total liabilities	85,148
Stockholders' equity:	
Preferred stock, $.01 par value; 5,000,000 shares authorized; no shares issued at December 31, 2003 and September 30, 2004	-
Common stock, $.01 par value; 25,000,000 shares authorized; 13,410,646 shares issued at December 31, 2003 and September 30, 2004	134
Additional paid-in capital	44,245
Retained earnings	29,402
Treasury stock, at cost (234,230 and 226,730 shares at December 31, 2003 and September 30, 2004, respectively)	(2,515)
Unearned compensation	-
Total stockholders' equity	71,266
Total liabilities and stockholders' equity	$ 156,414

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

3

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

(Unaudited)

	For the three months ended September 30,		For the nine m Septembe
	2003	2004	2003
Revenues:			
Income on financing leases and loans	$ 7,173	$ 2,560	$ 25,372
Rental income	8,589	7,548	25,763
Income on service contracts	2,067	1,376	6,653
Loss and damage waiver fees	1,365	961	4,271
Service fees and other	2,863	1,780	9,533
Total revenues	22,057	14,225	71,592
Expenses:			
Selling, general and administrative	7,837	7,235	25,677
Provision for credit losses	13,852	10,295	39,900

Depreciation and amortization	4,106	3,161	12,463
Interest	1,589	559	6,364
Total expenses	27,384	21,250	84,404
Net loss before benefit for income taxes	(5,327)	(7,025)	(12,812)
Benefit for income taxes	(2,131)	(2,810)	(5,125)
Net loss	($ 3,196)	($ 4,215)	($ 7,687)
Net loss per common share - basic and diluted	($ 0.25)	($ 0.32)	($ 0.59)
Weighted-average shares used to compute:			
Basic and diluted net loss per share	12,999,035	13,183,916	12,999,035

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

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

	For the nine months ended September 30, 2003	2004
Cash flows from operating activities:		
Cash received from customers	$ 107,575	$ 67,561
Cash paid to suppliers and employees	(31,125)	(21,698)
Cash received for income taxes	9,264	20
Interest paid	(7,632)	(2,168)
Interest received	98	14
Net cash provided by operating activities	78,180	43,729
Cash flows from investing activities:		
Investment in lease contracts	(2,159)	(329)
Investment in inventory	(103)	(89)
Investment in direct costs	(137)	-
Investment in fixed assets	(205)	(76)
Net cash used in investing activities	(2,600)	(494)
Cash flows from financing activities:		
Proceeds from secured debt	-	11,322
Repayment of secured debt	(83,361)	(58,593)
Repayment of short term demand notes payable	(30)	-
Proceeds from issuance of subordinated debt	-	1,500
Decrease in restricted cash	9,785	2,376
Repayment of capital leases	(186)	(122)

Net cash used in financing activities	(73,792)	(43,517)
Net increase (decrease) in cash and cash equivalents:	1,788	(282)
Cash and cash equivalents, beginning of period	5,494	6,533
Cash and cash equivalents, end of period	$ 7,282	$ 6,251

(continued on following page)

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

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

	For the nine months ended September 30, 2003	2004
Reconciliation of net loss to net cash provided by operating activities:		
Net loss	($ 7,687)	($ 14,780)
Adjustments to reconcile net loss to cash provided by operating activities:		
Amortization of unearned income, net of initial direct costs	(25,372)	(9,962)
Depreciation and amortization	12,463	11,391
Provision for credit losses	39,900	37,885
Amortization of unearned compensation	-	24
Recovery of equipment cost and residual value	75,283	31,114
Change in assets and liabilities:		
Decrease (increase) in current taxes payable	448	20
Increase (decrease) in current taxes receivable	(8,652)	-
Decrease (increase) in deferred income taxes	(5,125)	(9,856)
Increase (decrease) in other assets	(1,892)	(565)
Increase (decrease) in accounts payable	(952)	195
Decrease in other liabilities	(234)	(1,737)
Net cash provided by operating activities	$ 78,180	$ 43,729
Supplemental disclosure of non-cash activities:		
Fair market value of warrants issued	$ 77	$ 784

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

MICROFINANCIAL INCORPORATED
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(A) Nature of Business:

MicroFinancial Incorporated (the "Company") which operates primarily through its wholly-owned subsidiary, Leasecomm Corporation, is a specialized commercial finance company that primarily leases and rents "microticket" equipment and provides other financing services in amounts generally ranging from $400 to $15,000 with an average amount financed of approximately $1,900 and an average lease term of 44 months. The Company does not market its services directly to lessees but sources leasing transactions through a network of independent sales organizations and other dealer-based origination networks nationwide. The Company has funded its operations primarily through borrowings under its credit facilities, issuances of subordinated debt and on balance sheet securitizations.

MicroFinancial incurred net losses of $22.1 million and $15.7 million for the years ended December 31, 2002 and 2003, respectively. The net losses incurred by the Company during the third and fourth quarters of 2002 caused the Company to be in default under certain debt covenants in its credit facility and securitization agreements. In addition, as of September 30, 2002, the Company's credit facility failed to renew and consequently, the Company was forced to suspend substantially all new origination activity as of October 11, 2002. MicroFinancial has taken certain steps in an effort to improve its financial position. In June 2004, MicroFinancial secured a $10.0 million credit facility, comprised of a one-year $8.0 million line of credit and a $2.0 million three-year subordinated note, that enabled the Company to resume microticket contract originations. In conjunction with raising new capital, the Company also inaugurated a new wholly owned operating subsidiary, TimePayment Corp. LLC. On September 29, 2004, MicroFinancial secured a three-year, $30.0 million, senior secured revolving line of credit from CIT Commercial Services, a unit of CIT Group. This line of credit replaced the previous one year, $8 million line of credit obtained in June 2004 under more favorable terms and conditions including, but not limited to, pricing at prime plus 1.5% or LIBOR plus 4%. In addition, it retired the existing outstanding debt with the former bank group.

Management has also continued to take steps to reduce overhead, including a reduction in headcount from 203 at December 31, 2002 to 136 at December 31, 2003. During the nine months ended September 30, 2004, the employee headcount was further reduced to 102 in a continued effort to maintain an infrastructure that is aligned with current business conditions.

MicroFinancial, through its wholly owned subsidiary, Leasecomm Corporation, periodically finances its lease and service contracts, together with unguaranteed residuals, through securitizations using special purpose entities. MFI Finance Corporation I (or "MFI I") is a special purpose vehicle. The assets of such special purpose entities and cash collateral or other accounts created in connection with the financings in which they participate are not available to pay creditors of Leasecomm Corporation, TimePayment Corp. LLC, MicroFinancial Incorporated, or other affiliates. While Leasecomm Corporation generally does not sell its interests in leases, service contracts or loans to third parties after origination, the Company does, from time to time, contribute certain leases, service contracts, or loans to special-purpose entities for purposes of obtaining financing in connection with the related receivables. The contribution of such assets under the terms of such financings are intended to constitute "true sales" of such assets for bankruptcy purposes (meaning that such assets are legally isolated from Leasecomm Corporation). However, the special purpose entities to which such assets are contributed are required under generally accepted accounting principles to be consolidated in the financial statements of the Company. As a result, such assets and the related liability remain on the balance sheet and do not receive gain on sale treatment.

MICROFINANCIAL INCORPORATED
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(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, the interim statements do not include all of the information and disclosures required for the annual financial statements. In the opinion of the Company's management, the condensed consolidated financial statements contain all adjustments, consisting only of normal recurring adjustments, considered necessary for a fair presentation of these interim results. These financial statements should be read in conjunction with the consolidated financial statements and notes included in the Company's Annual Report on Form 10-K for the year ended December 31, 2003. The results for the three-month and nine-month periods ended September 30, 2004 are not necessarily indicative of the results that may be expected for the full year ended December 31, 2004.

The balance sheet at December 31, 2003 has been derived from the audited financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2003.

Allowance for Credit Losses:

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

The following table sets forth the Company's allowance for credit losses as of December 31, 2003 and September 30, 2004 and the related provision, charge-offs and recoveries for the nine months ended September 30, 2004.

Balance of allowance for credit losses at December 31, 2003		$ 43,011
Provision for credit losses		37,885
Charge-offs	(61,480)	
Recoveries	4,293	
Charge-offs, net of recoveries		(57,187)
Balance of allowance for credit losses at September 30, 2004		$ 23,709

Net Income (Loss) Per Share:

Basic net income (loss) per common share is computed based on the weighted-average number of common shares outstanding during the period. Diluted net income (loss) per common share gives effect to all potentially dilutive common shares outstanding during the period. The computation of diluted net income (loss) per share does not assume the issuance of common shares that have an antidilutive effect on net income per common share. All stock options, common stock warrants, and unvested restricted stock were excluded from the computation of diluted net income (loss) per share for the three and nine month periods ended September 30, 2003 and September 30, 2004, because their inclusion would have had an antidilutive effect on net income (loss) per share. At September 30, 2003, 1,675,000 options, and 268,199 warrants, were excluded from the computation of diluted net income (loss)

per share. At September 30, 2004, 1,675,000 options, 663,035 warrants, and 17,500 shares of restricted stock were excluded from the computation of diluted net income (loss) per share.

	For three months ended September 30,		For nine months e September 30,	
	2003	2004	2003	
Net income (loss)	($ 3,196)	($ 4,215)	($ 7,687)	($
Shares used in computation:				
Weighted average common shares outstanding used in computation of net income (loss) per common share	12,999,035	13,183,916	12,999,035	13
Dilutive effect of common stock options	-	-	-	
Shares used in computation of net income (loss) per common share - assuming dilution	12,999,035	13,183,916	12,999,035	13
Net income (loss) per common share - basic and diluted	($ 0.25)	($ 0.32)	($ 0.59)	($

Stock Options

Under the 1998 Equity Incentive Plan (the "1998 Plan") which was adopted on July 9, 1998 the Company had reserved 4,120,380 shares of the Company's common stock for issuance pursuant to the 1998 Plan. No options were granted during the nine months ended September 30, 2004. A total of 1,675,000 options were outstanding at September 30, 2004 of which 1,148,000 were vested.

On February 4, 2004, one non-employee director was granted 25,000 shares of restricted stock. The restricted stock vested 20% upon grant, and vests 5% on the first day of each quarter after the grant date. As vesting occurs, compensation expense is recognized and unearned compensation on the balance sheet is reduced. As of September 30, 2004, 7,500 shares were fully vested, and $24,000 had been amortized from unearned compensation to compensation expense.

Stock-based Employee Compensation

The Company accounts for stock-based employee compensation plans under the recognition and measurement principles of APB Opinion No. 25, Accounting for Stock Issued to Employees, and related Interpretations. The current period amortization of unearned compensation expense relating to the restricted stock awards is reflected in net income (loss). No other stock-based employee compensation cost is reflected in net income (loss), as either all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant or options granted that result in variable compensation costs had an exercise price greater than the fair market value of the underlying common stock on September 30, 2004. The Company follows the disclosure only requirements of SFAS No. 123, Accounting for Stock-Based Compensation. SFAS No. 123 requires that compensation under a fair value method be determined using the Black-Scholes option-pricing model and disclosed in a pro forma effect on earnings and earnings per share. The following table illustrates the effect on net income (loss) and earnings per share if the Company had applied the fair value recognition provisions of SFAS No. 123, Accounting for Stock-Based Compensation, to stock-based employee compensation.

9

MICROFINANCIAL INCORPORATED
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

	For the three months ended September 30,		For the nine Septemb
	2003	2004	2003
Net income (loss), as reported	($ 3,196)	($ 4,215)	($ 7,687)
Add: Stock-based employee compensation expense included in reported net income	94	4	256
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards	(418)	(198)	(1,252)
Pro forma net income (loss)	($ 3,520)	($ 4,409)	($ 8,683)
Earnings (loss) per share:			
As reported - basic and diluted	($ 0.25)	($ 0.32)	($ 0.59)
Proforma - basic and diluted	($ 0.27)	($ 0.33)	($ 0.67)

There were no options granted during the nine months ended September 30, 2004. The fair value of option grants for options granted during the nine months ended September 30, 2003 was estimated on the date of grant utilizing the Black-Scholes option-pricing model with the following weighted-average assumptions.

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

The weighted-average fair value at the date of grant for options granted during the nine months ended September 30, 2003 approximated $0.62 per option. The Company granted 200,000 options during the nine months ended September 30, 2003.

Notes Payable:

The Company had borrowings outstanding under its respective credit facilities, securitization, and long-term debt agreements with the following terms:

		Amounts outstanding as of		
(dollars in thousands)	Interest Rate	December 31, 2003	March 31, 2004	June 30, 2004
Credit facility - old	prime + 2.0%	$ 55,346	$ 40,512	$ 26,108
Interim line of credit	15.60%	-	-	-
Credit facility - CIT	prime + 1.5%	-	-	-
MFI I term note securitization	5.58%	3,247	692	-
Term notes	7.50%	250	250	250
Subordinated notes	7.0%-13.0%	3,262	3,262	4,762
		$ 62,105	$ 44,716	$ 31,120

On September 29, 2004, the Company entered into a three-year senior secured revolving line of credit with CIT Commercial Services, a unit of CIT Group ("CIT"), whereby it may borrow a maximum of $30.0 million based

upon qualified lease receivables. Outstanding borrowings with respect to the revolving line of credit bear interest based at Prime plus 1.5% for Prime Rate Loans, or the prevailing rate per annum as offered in the London Interbank Offered Rate (LIBOR) plus 4.0% for LIBOR Loans. If the LIBOR Loans are not renewed upon their maturity they automatically convert into prime rate loans. The prime rates at December 31, 2003, and September 30, 2004 were 4.00% and 4.75% respectively. The 90-day LIBOR rate at September 30, 2004 was 2.02%.

In connection with the issuance of the above line of credit, the Company issued warrants to CIT to purchase an aggregate of 50,000 shares of the Company's common stock at an exercise price of $0.825 per share and expiring on June 10, 2007. The fair market value of the warrants, as determined using the Black-Scholes option-pricing model, was accounted for as additional paid in capital and discount on notes payable. The resulting notes payable discount was $139,000, which is being amortized to interest expense under the interest method.

Borrowings on the above senior secured revolving line of credit were used to pay off the Company's existing lending syndicate in full, and replaced the $8.0 million line of credit secured in June 2004, both of which are discussed further below. Outstanding borrowings are collateralized by eligible lease contracts pledged specifically to CIT. In addition, the Company granted CIT a security interest in all of the assets of the Company to further collateralize the outstanding borrowings.

Prior to obtaining the $30.0 million secured line of credit discussed above, the Company had borrowings outstanding under a $192.0 senior credit facility with a group of financial institutions (the lending syndicate), which had failed to renew as of September 30, 2002. While cash flows from its portfolio and other fees had been sufficient to repay amounts borrowed under the senior credit facility, securitizations and subordinated debt, in October 2002, the Company was forced to suspend virtually all new contract originations until a new source of liquidity was obtained or until such time as the senior credit facility was paid in full.

At December 31, 2002, the Company was in default of certain of its debt covenants in its senior credit facility. The covenants that were in default with respect to the senior credit facility required that the Company maintain a fixed charge ratio in an amount not less than 130% of consolidated earnings, a consolidated tangible net worth minimum of $77.5 million plus 50% of net income quarterly beginning with September 30, 2000, and compliance with the borrowing base. On April 14, 2003, the Company entered into a long-term agreement with its lenders. This long-term agreement waived the defaults described above, and in consideration for this waiver, required the outstanding balance of the loan to be repaid over a term of 22 months beginning in April 2003 at an interest rate of prime plus 2.0%. As of September 30, 2004, the loan under the senior credit facility had been fully repaid.

Also, on April 14, 2003, the Company issued warrants to purchase an aggregate of 268,199 shares of the Company's common stock at an exercise price of $.825 per share. The warrants were issued to the nine lenders in the Company's lending syndicate in connection with the waiver of defaults and an extension of the Company's term loan. Due to the anti-dilutive rights contained in the warrant agreement, on June 10, 2004, an additional 2,207 warrants were issued to the nine lenders in the Company's lending syndicate and all of the warrants were re-priced to $.818 per share. This was a result of the issuance of warrants in connection with the $10.0 million credit facility discussed below. The warrants held by the nine lenders in the Company's lending syndicate became 50% exercisable as of June 30, 2004. Since all of the Company's obligations to the lenders were paid in full prior to September 30, 2004, the remaining 50% of the warrants were automatically cancelled pursuant to the term of the agreement. Unless the warrants are exercised, they will expire on September 30, 2014. The fair market value of the warrants, as determined using the Black-Scholes option-pricing model, was accounted for as additional paid in capital. The resulting cost of the warrants was $77,000, which is being amortized to interest expense under the interest method. As of September 30, 2004, upon repayment of the debt in full, $77,000 had been accreted to interest expense and the resulting effective interest rate on the senior credit facility was prime plus 2.09%.

On June 10, 2004, the Company, through its new subsidiary, TimePayment Corp LLC entered into a one year revolving line of credit whereby it could borrow a maximum of $8.0 million based upon qualified lease receivables. Simultaneously, TimePayment Corp LLC secured a commitment for a three year subordinated note for $2.0 million. As of September 30, 2004, the Company had $1.5 million outstanding under the subordinated note. According to the agreements, outstanding borrowings with respect to the revolving line of credit bear interest at 15.6% and outstanding borrowings with respect to the subordinated note bear interest at 13.0%. Upon the closing of the $30.0

million senior secured revolving line of credit with CIT, the $8.0 million line of credit was terminated by the Company.

In connection with the issuance of the above $8.0 million line of credit, the Company issued warrants to purchase an aggregate of 100,000 shares of the Company's common stock at an exercise price of $6.00 per share and expiring on June 10, 2007. The fair market value of the warrants, as determined using the Black-Scholes option-pricing model, was accounted for as additional paid in capital and discount on notes payable. The resulting discount was $117,000, which was being amortized to interest expense under the interest method. Since the $8.0 million line of credit was cancelled as of September 29, 2004, as of September 30, 2004, the entire discount had been accreted to interest expense.

In connection with the issuance of the above subordinated note, the Company issued warrants to purchase 110,657 shares of the Company's common stock at an exercise price of $2.00 per share and 191,685 shares of the Company's common stock at an exercise price of $2.91 per share, both expiring on June 10, 2007. In the event the lender does not make the second of two installments of the subordinated note available to TimePayment Corp LLC, the warrants to purchase 27,664 shares of the Company's common stock at an exercise price of $2.00 per share and 47,939 shares of the Company's common stock at an exercise price of $2.91 per share will be automatically cancelled. The fair market value of the warrants, as determined using the Black-Scholes option-pricing model, was accounted for as additional paid in capital and discount on subordinated notes payable. The resulting discount was $396,000, which is being amortized to interest expense under the interest method. As of September 30, 2004, $30,000 had been accreted to interest expense and the resulting effective interest rate on the subordinated note was the base rate plus 12.4%.

MFI I issued three series of notes, the 2000-1 Notes, the 2000-2 Notes, and the 2001-3 Notes. In March 2000, MFI I issued the 2000-1 Notes in aggregate principal amount of $50,056,686. In December 2000, MFI I issued the 2000-2 Notes in aggregate principal amount of $50,561,633. In September 2001, MFI I issued the 2001-3 Notes in aggregate principal amount of $39,397,354. As of September 30, 2004, all of the notes issued by MFI I had been fully repaid.

At December 31, 2003 and September 30, 2004, the Company also had other notes payable which totaled $250,000. These notes are term notes that carry an interest rate of 7.5% and are due in November 2004.

Dividends:

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

New Accounting Pronouncements:

In July 2004, the FASB issued EITF Issue No. 04-8 ("EITF 04-14") "The Effect of Contingently Convertible Debt on Diluted Earnings per Share." EITF 04-8 includes new guidance for determining when the dilutive effect of contingently convertible debt investments ("Co-Cos") should be included in diluted earnings per share. The accounting guidance provided in EITF 04-8 is effective for reporting periods beginning after December 15, 2004. The Company does not expect the adoption of EITF 04-8 to have a material impact on its financial position or results of operations.

12

MICROFINANCIAL INCORPORATED
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Reclassification of Prior Year Balances:

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

Commitments and Contingencies:

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

The Company accepts lease applications on daily basis and as a result has a pipeline of applications that have been approved, where a lease has not been originated. The Company's commitment to lend, however, 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 and all required supporting information and successful verification with the lessee. Since the Company funds on the same day a lease is successfully verified, at any given time, the Company has no firm outstanding commitments to lend.

13

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

Three months ended September 30, 2004 as compared to the three months ended September 30, 2003.

Results of Operations

	For the three months ended September 30,		
	2003	Change	2004
		(in thousands)	
Income on financing leases and loans	$ 7,173	(64.3)%	$ 2,560
Rental income	8,589	(12.1)%	7,548
Income on service contracts	2,067	(33.4)%	1,376
Service fees, waiver fees and other	4,228	(35.2)%	2,741
Total revenues	22,057	(35.5)%	14,225

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

Total revenues for the three months ended September 30, 2004 were $14.2 million, a decrease of $7.8 million, or 35.5%, from the three months ended September 30, 2003. The decrease was primarily due to a decrease of $4.6 million, or 64.3%, in income on financing leases and loans, $1.5 million or 35.2% in service fees, loss and damage waiver fees and other income, $1.0 million, or 12.1% in rental income, and $691,000, or 33.4% in service contract income. The overall decrease in revenue can be attributed to the decrease in the overall size of the Company's portfolio of leases, rentals and service contracts. The shrinking portfolio is a direct result of the Company being forced to suspend virtually all new originations from October 2002 to June 2004, as a result of its Lenders not renewing the revolving credit facility on September 30, 2002. Revenues are expected to continue to decline so long as the Company is not originating new contracts.

Selling, General and Administrative

	For the three months ended September 30,		
	2003	Change	2004
		(in thousands)	
Selling, general and administrative.....	7,837	(7.7)%	7,235
As a percent of revenue................	35.5%		50.9%

Our selling, general and administrative (SG&A) expenses include costs of maintaining corporate functions including accounting, finance, collections, legal, human resources, information systems and communications. SG&A expenses also include commissions, service fees and other marketing costs associated with the Company's portfolio of leases and rental contracts. SG&A expenses decreased by $602,000, or 7.7%, for the three months ended September 30, 2004, as compared to the three months ended September 30, 2003. The decrease was primarily driven by a reduction in sales program expense approximately $524,000, $427,000 in personnel related expenses as management reduced headcount from 144 to 102, and $150,000 reduction in insurance expense. The expense reductions were achieved as management continued to align the Company's infrastructure with the current business conditions.

14

Provision for Credit Losses

	For the three months ended September 30,		
	2003	Change	2004
		(thousands)	
Provision for credit losses............	13,852	(25.7)%	10,295
As a percent of revenue................	62.8%		72.4%

The Company maintains an allowance for credit losses on its investment in leases, service contracts, rental contracts and loans at an amount that it believes is sufficient to provide adequate protection against losses in its portfolio. The Company's provision for credit losses decreased by $3.6 million, or 25.7%, for the three months ended September 30, 2004, as compared to the three months ended September 30, 2003, while net charge-offs decreased 7.7% to $17.8 million. The provision was based on the Company's historical policy of providing a provision for credit losses based upon the dealer fundings and revenue recognized in any period, as well as taking into account actual and expected losses in the portfolio as a whole and the relationship of the allowance to the net investment in leases, service contracts, rental contracts and loans.

Depreciation and Amortization

	For the three months ended September 30, 2003	Change	2004
		(thousands)	
Depreciation - fixed assets	335	(48.1)%	174
Depreciation and amortization - contracts	3,771	(20.8)%	2,987
Total depreciation and amortization	4,106	(23.0)%	3,161
As a percent of revenue	18.6%		22.2%

Depreciation and amortization expenses consist primarily of the depreciation taken against fixed assets and rental contracts, and the amortization of the Company's investment in service contracts. The Company's investment in fixed assets is recorded at cost and amortized over the expected life of the service period of the asset. Rental equipment is either recorded at estimated residual value and depreciated using the straight-line method over a period of 12 months or at the acquisition cost and depreciated using the straight line method over a period of 36 months. Service contracts are recorded at cost and amortized over 84 months. The Company periodically evaluates whether events or circumstances have occurred that may affect the estimated useful life or recoverability of the asset and any resulting charge is made to depreciation and amortization expense. Depreciation and amortization related to rental and service contracts decreased by $784,000, or 20.8%, for the three months ended September 30, 2004, as compared to the three months ended September 30, 2003. The decrease in depreciation and amortization can be attributed to the decrease in the overall size of the Company's portfolio of leases, rentals and service contracts. Depreciation related to the Company's property plant and equipment decreased by $161,000, or 48.1%, for the three months ended September 30, 2004, as compared to the three months ended September 30, 2003.

Interest Expense

	For the three months ended September 30, 2003	Change	2004
		(in thousands)	
Interest..............................	1,589	64.8)%	559
As a percent of revenue................	7.2%		3.9%

The Company pays interest on borrowings under the senior credit facility, subordinated debt and the on balance sheet securitizations. Interest expense decreased by $1.0 million, or 64.8%, for the three months ended September 30, 2004, as compared to the three months ended September 30, 2003. This decrease resulted primarily from the Company's decreased level of borrowings. During the three months ended September 30, 2004, the Company repaid the amounts borrowed through its on-balance sheet securitization in full. At September 30, 2004, the Company had notes payable of $11.4 million (including $11.3 million of borrowings on the CIT credit facility, net of discounts of $139,000, and $250,000 of term notes), compared to $85.5 million at September 30, 2003.

Other Operating Data

Dealer fundings were $222,000 for the three months ended September 30, 2004, an increase of $75,000, or 51.0%, compared to the three months ended September 30, 2003. The Company was forced to suspend virtually all originations from October 2002 until June 2004 when the Company was able to secure a limited amount of new financing. During the third quarter of 2004, the Company focused its efforts on securing a larger, lower priced line of credit and restarting its origination business with a few select vendors. Receivables due in installments, estimated residual values, loans receivable, investment in service contracts, and investment in rental equipment decreased from $218.3 million for the year ended December 31, 2003 to $114.9 million in September 30, 2004. Net cash provided by operating activities decreased by $8.1 million, or 39.1%, to $12.7 million during the three months ended September 30, 2004.

Nine months ended September 30, 2004 as compared to the nine months ended September 30, 2003.

Results of Operations

	For the nine months ended September 30,		
	2003	Change	2004
		(in thousands)	
Income on financing leases and loans	$25,372	(60.7)%	$ 9,962
Rental income	25,763	(6.2)%	24,177
Income on service contracts	6,653	(29.8)%	4,671
Service fees, waiver fees and other	13,804	(33.3)%	9,205
Total revenues	71,592	(32.9)%	48,015

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

Total revenues for the nine months ended September 30, 2004 were $48.0 million, a decrease of $23.6 million, or 32.9%, from the nine months ended September 30, 2003. The decrease was primarily due to a decrease of $15.4 million, or 60.7%, in income on financing leases and loans, $4.6 million or 33.3% in service fees, loss and damage waiver fees and other income, $2.0 million, or 29.8% in service contract income, and $1.6 million or 6.2% in rental income. The overall decrease in revenue can be attributed to the decrease in the overall size of the Company's portfolio of leases, rentals and service contracts. The shrinking portfolio is a direct result of the Company being forced to suspend virtually all new originations in October 2002, as a result of its Lenders not renewing the revolving credit facility on September 30, 2002. Revenues are expected to continue to decline so long as the Company is not originating new contracts.

Selling, General and Administrative

	For the nine months ended September 30,		
	2003	Change	2004

		(in thousands)	
Selling, general and administrative.....	25,677	(16.8)%	21,359
As a percent of revenue................	35.9%		44.5%

Our selling, general and administrative (SG&A) expenses include costs of maintaining corporate functions including accounting, finance, collections, legal, human resources, information systems and communications. SG&A expenses also include commissions, service fees and other marketing costs associated with the Company's portfolio of leases and rental contracts. SG&A expenses decreased by $4.3 million, or 16.8%, for the nine months ended September 30, 2004, as compared to the nine months ended September 30, 2003. The decrease was primarily driven by a reduction in personnel related expenses of approximately $2.1 million, as management reduced

16

headcount from 144 to 102, $1.3 million in sales program expense, and $887,000 in rent expense. The expense reductions were achieved as management continued to align the Company's infrastructure with the current business conditions.

Provision for Credit Losses

	For the nine months ended September 30,		
	2003	Change	2004
		(thousands)	
Provision for credit losses............	39,900	(5.1)%	37,885
As a percent of revenue................	55.7%		78.9%

The Company maintains an allowance for credit losses on its investment in leases, service contracts, rental contracts and loans at an amount that it believes is sufficient to provide adequate protection against losses in its portfolio. The Company's provision for credit losses decreased by $2.0 million, or 5.1%, for the nine months ended September 30, 2004, as compared to the nine months ended September 30, 2003, while net charge-offs increased 1.0% to $57.2 million. The provision was based on the Company's historical policy of providing a provision for credit losses based upon the dealer fundings and revenue recognized in any period, as well as taking into account actual and expected losses in the portfolio as a whole and the relationship of the allowance to the net investment in leases, service contracts, rental contracts and loans.

Depreciation and Amortization

	For the nine months ended September 30,		
	2003	Change	2004
		(thousands)	
Depreciation - fixed assets................	1,154	(43.8)%	649
Depreciation and amortization - contracts..	11,309	(5.0)%	10,742
Total depreciation and amortization........	12,463	(8.6)%	11,391
As a percent of revenue................	17.4%		23.7%

Depreciation and amortization expenses consist primarily of the depreciation taken against fixed assets and rental equipment, and the amortization of the Company's investment in service contracts. The Company's investment in fixed assets is recorded at cost and amortized over the expected life of the service period of the asset. Rental equipment is either recorded at estimated residual value and depreciated using the straight-line method over a period of 12 months or at the acquisition cost and depreciated using the straight line method over a period of 36 months. Service contracts are recorded at cost and amortized over 84 months. The Company periodically evaluates whether events or circumstances have occurred that may affect the estimated useful life or recoverability of the asset and any resulting charge is made to depreciation and amortization expense. Depreciation and amortization related to rental and service contracts decreased by $567,000, or 5.0%, for the nine months ended September 30, 2004, as compared to the nine months ended September 30, 2003. The decrease in depreciation and amortization can be attributed to the decrease in the overall size of the Company's portfolio of leases, rentals and service contracts. Depreciation related to the Company's property plant and equipment decreased by $505,000, or 43.8%, for the nine months ended September 30, 2004, as compared to the nine months ended September 30, 2003.

Interest Expense

	For the nine months ended September 30,		
	2003	Change	2004
		(in thousands)	
Interest................................	6,364	(68.3)%	2,016
As a percent of revenue................	8.9%		4.2%

The Company pays interest on borrowings under the senior credit facility, subordinated debt and the on balance sheet securitizations. Interest expense decreased by $4.3 million, or 68.3%, for the nine months ended September 30, 2004, as compared to the nine months ended September 30, 2003. This decrease resulted primarily from the Company's decreased level of borrowings. At September 30, 2004, the Company had notes payable of $11.4 million

17

(including $11.3 million of borrowings on the CIT credit facility, net of discounts of $139,000, and $250,000 of term notes), compared to $85.5 million at September 30, 2003.

Other Operating Data

Dealer fundings were $288,000 for the nine months ended September 30, 2004, a decrease of $1.3 million, or 81.3%, compared to the nine months ended September 30, 2003. In 2003, the Company was able to fund a limited number of new contracts using its own free cash flow, however, the amount and timing of the new originations was restricted by the amount of available cash and the terms of the Company's banking agreements. The long term bank agreement entered into on April 14, 2003 placed further restriction on the Company's ability to originate new contracts, until the Company was able to secure a limited amount of financing in June 2004. During the third quarter of 2004, the Company focused its efforts on securing a larger, lower priced line of credit and restarting its origination business with a few select vendors. Receivables due in installments, estimated residual values, loans receivable, investment in service contracts, and investment in rental equipment also decreased from $218.3 million for the year ended December 31, 2003 to $114.9 million in September 30, 2004. Net cash provided by operating activities decreased by $34.5 million, or 44.1%, to $43.7 million during the nine months ended September 30, 2004.

Critical Accounting Policies

In response to the SEC's release No. 33-8040, "Cautionary Advice regarding Disclosure About Critical Accounting Policies," Management identified the most critical accounting principles upon which our financial status depends. The

Company determined the critical principles by considering accounting policies that involve the most complex or subjective decisions or assessments. We identified our most critical accounting policies to be those related to revenue recognition and maintaining the allowance for credit losses. These accounting policies are discussed below as well as within the notes to the consolidated financial statements.

Revenue Recognition

The Company's lease contracts are accounted for as financing leases. At origination, the Company records the gross lease receivable, the estimated residual value of the leased equipment, initial direct costs incurred and the unearned lease income. Unearned lease income is the amount by which the gross lease receivable plus the estimated residual value exceeds the cost of the equipment. Unearned lease income and initial direct costs incurred are amortized over the related lease term using the interest method. Amortization of unearned lease income and initial direct costs is suspended if, in the opinion of management, full payment of the contractual amount due under the lease agreement is doubtful. In conjunction with the origination of leases, the Company may retain a residual interest in the underlying equipment upon termination of the lease. The value of such interests is estimated at inception of the lease and evaluated periodically for impairment. Other revenues such as loss and damage waiver fees, service fees relating to the leases, contracts and loans, and rental revenues are recognized as they are earned.

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

Allowance for Credit Losses

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

credit losses taking into account actual and expected losses in the portfolio as a whole and the relationship of the allowance to the net investment in leases, service contracts, rental contracts and loans. Such provisions generally represent a percentage of funded amounts of leases, contracts and loans. The resulting charge is included in the provision for credit losses.

Leases, service contracts, rental contracts and loans are charged against the allowance for credit losses and are put on non-accrual when they are deemed to be uncollectable. Generally, the Company deems leases, service contracts, rental contracts and loans to be uncollectable when one of the following occurs:

(i) the obligor files for bankruptcy; (ii) the obligor dies, and the equipment is returned; or (iii) when an account has become 360 days delinquent without contact with the lessee. The typical monthly payment under the Company's leases is between $30 and $50 per month. As a result of these small monthly payments, the Company's experience is that lessees will pay past due amounts later in the process because of the small amount necessary to bring an account current (at 360 days past due, a lessee may only owe lease payments of between $360 and $600).

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

Income taxes

Significant management judgement is required in determining the provision for income taxes, deferred tax assets and liabilities and any necessary valuation allowance recorded against net deferred tax assets. The process involves summarizing temporary differences resulting from the difference treatment of items, for example, leases, for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are recorded on the balance sheet. Management must then assess the likelihood that deferred tax assets will be recovered from future taxable income or tax carry-back availability and to the extent management believes recovery is more likely than not, no valuation allowance is deemed necessary. No valuation allowance has been established against net deferred tax assets, as management believes these assets to be realizable through future taxable income.

Exposure to Credit Losses

The following table sets forth certain information as of December 31, 2002 and 2003 and September 30, 2004 with respect to delinquent leases, service contracts and loans. The percentages in the table below represent the aggregate on such date of the actual amounts not paid on each invoice by the number of days past due, rather than the entire balance of a delinquent receivable, over the cumulative amount billed at such date from the date of origination on all leases, service contracts, and loans in the Company's portfolio. For example, if a receivable is 90 days past due, the portion of the receivable that is over 30 days past due will be placed in the 31-60 days past due category, the portion of the receivable which is over 60 days past due will be placed in the 61-90 days past due category and the portion of the receivable which is over 90 days past due will be placed in the over 90 days past due category. The Company historically used this methodology of calculating its delinquencies because of its experience that lessees who miss a payment do not necessarily default on the entire lease. Accordingly, the Company includes only the amount past due rather than the entire lease receivable in each category.

(dollars in thousands)	As of December 31, 2002		As of December 31, 2003		As of September 30, 2004	
Cumulative amounts billed	$600,637		$478,791		$343,711	
31-60 days past due	$ 5,772	1.0%	$ 5,446	1.1%	$ 2,139	0.6%
61-90 days past due	6,019	1.0%	3,995	0.8%	2,051	0.6%
Over 90 days past due	137,607	22.9%	85,883	17.9%	47,305	13.8%

Total past due	$149,398	24.9%	$ 95,324	19.8%	$ 51,495	15.0%

Alternatively, 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 the Company's portfolio as of September 30, 2004. 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.

(dollars in thousands)	September 30, 2004	
Current	$26,596	30.7%
31-60 days past due	1,188	1.4%
61-90 days past due	1,021	1.2%
Over 90 days past due	57,758	66.7%
Total receivables due in installments	$86,563	100.0%

Liquidity and Capital Resources

General

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

For the nine months ended September 30, 2004 and September 30, 2003, respectively, the Company's primary source of liquidity was cash provided by operating activities. The Company generated cash flow from operations of $43.7 million for the nine months ended September 30, 2004 and $78.2 million for the nine months ended September 30, 2003.

The Company used net cash in investing activities of $494,000 for the nine-months ended September 30, 2004 and $2.6 million for the nine-months ended September 30, 2003. Investing activities primarily relate to the origination of new leases and contracts as well as capital expenditures.

Net cash used in financing activities was $43.5 million for the nine-months ended September 30, 2004 and $73.8 million for the nine-months ended September 30, 2003. Financing activities include net borrowings and repayments on our various financing sources.

The Company believes that cash flows from its existing portfolio, and borrowings on the existing credit facility will be sufficient to support the Company's operations and lease origination activity for the foreseeable future.

Borrowings

The Company utilizes its credit facilities to fund the origination and acquisition of leases that satisfy the eligibility requirements established pursuant to each facility.

20

Borrowings outstanding under the Company's revolving credit facilities and long-term debt consist of the following:

	As of December 31, 2003		A Septemb	
(dollars in thousands)	Amounts Outstanding	Interest Rate	Amounts Outstanding	Interes Rate
Revolving credit facility - old (1)	$ 55,346	6.00%	$ -	6.
Revolving credit facility - new (2)	-		11,322	6.
MFI I term note securitization (3)	3,247	5.58%	-	5.
Term notes (4)	250	7.50%	250	7.
Subordinated notes (5)	3,262	7.0%-12.5%	4,762	7.75%-13
	$ 62,105		$ 16,334	

(1) After September 30, 2002 this facility failed to renew and the Company no longer had the ability to draw down additional amounts.

(2) The unused capacity is subject to lease eligibility and the borrowing base formula

(3) The MFI I term note securitization is a one-time funding that pays down over time, without any ability for the Company to draw down additional amounts.

(4) The term notes were a one-time funding, without any ability for the Company to draw down additional amounts.

(5) Subordinated notes are generally one-time fundings, without any ability for the Company to draw down additional amounts, however in June 2004, the Company issued a $2.0 million subordinated note, of which only $1.5 million was outstanding as of September 30,2004. The note holder advanced the additional $500,000 in October 2004.

On September 29, 2004, the Company entered into a three-year senior secured revolving line of credit with CIT Commercial Services, a unit of CIT Group (CIT),whereby it may borrow a maximum of $30.0 million based upon qualified lease receivables. Outstanding borrowings with respect to the revolving line of credit bear interest based at Prime plus 1.5% for Prime Rate Loans, or the prevailing rate per annum as offered in the London Interbank Offered Rate (LIBOR) plus 4.0% for LIBOR Loans. If the LIBOR Loans are not renewed upon their maturity they automatically convert into prime rate loans. The prime rates at December 31, 2003, and September 30, 2004 were 4.00% and 4.75% respectively. The 90-day LIBOR rate at September 30, 2004 was 2.02%.

Prior to obtaining the $30.0 million secured line of credit discussed above, the Company had borrowings outstanding under a $192.0 senior credit facility with a group of financial institutions, which had failed to renew as of September 30, 2002. While cash flows from its portfolio and other fees had been sufficient to repay amounts borrowed under the senior credit facility, securitizations and subordinated debt, in October 2002, the Company was forced to suspend virtually all new contract originations until a new source of liquidity was obtained or until such time as the senior credit facility was paid in full.

At December 31, 2002, the Company was in default of certain of its debt covenants in its senior credit facility. The covenants that were in default with respect to the senior credit facility require that the Company maintain a fixed charge ratio in an amount not less than 130% of consolidated earnings, a consolidated tangible net worth minimum of $77.5 million plus 50% of net income quarterly beginning with September 30, 2000, and compliance with the borrowing base. On April 14, 2003, the Company entered into a long-term agreement with its lenders. This long-term agreement waived the defaults described above, and in consideration for this waiver, required the outstanding balance of the loan to be repaid over a term of 22 months beginning in April 2003 at an interest rate of prime plus 2.0%. As of September 30, 2004, the loan under the senior credit facility had been fully repaid.

The Company, through its wholly owned subsidiary, Leasecomm Corporation, periodically finances its lease and service contracts, together with unguaranteed residuals, through securitizations using special purpose entities. The assets of such special purpose entities and cash collateral or other accounts created in connection with the financings in which they participate are not available to pay creditors of Leasecomm Corporation, MicroFinancial

Incorporated, or other affiliates. However, the special purpose entities to which such assets are required under generally accepted accounting principles to be consolidated in the financial statements of the Company. As a result, such assets and the related liability remain on the balance sheet and do not receive gain on sale treatment. The amounts borrowed under the securitization were fully repaid as of September 30, 2004.

Contractual Obligations and Commercial Commitments

Contractual Obligations

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

At September 30, 2004, the repayment schedules for outstanding borrowings on the revolving credit facility, long-term debt, minimum lease payments under non-cancelable operating leases and future minimum lease payments under capital leases were as follows:

For the period ended December 31,	Revolving Credit Facility(1)	Long-Term Debt	Operating Leases	Capital Leases	Total
2004	$11,322	$ 362	$ 146	$ 40	$ 548
2005	-	2,050	585	55	2,690
2006	-	2,600	-	-	13,922
2007	-	-	-	-	-
2008	-	-	-	-	-
2009	-	-	-	-	-
Thereafter	-	-	-	-	-
	$ 11,322	$ 5,012	$ 731	$ 95	$ 17,160

(1) The Company's obligation to repay the revolving credit facility in the current year is subject to lease collateral availability and the borrowing base formula. The credit facility expires on September 29, 2007.

Commitments

The Company accepts lease applications on daily basis and as a result has a pipeline of applications that have been approved, where a lease has not been originated. The Company's commitment to lend, however, 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 and all required supporting information and successful verification with the lessee. Since the Company funds on the same day a lease is successfully verified, at any given time, the Company has no firm outstanding commitments to lend.

Note on Forward-Looking Information

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

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

ITEM 3 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market-Rate-Sensitive Instruments and Risk Management

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

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

Interest Rate Risk Management

The implicit yield to the Company on all of its leases, contracts and loans is on a fixed interest rate basis due to the leases, contracts and loans having scheduled payments that are fixed at the time of origination of the lease. When the Company originates or acquires leases, contracts, and loans it bases its pricing in part on the spread it expects to achieve between the implicit yield rate to the Company on each lease and the effective interest cost it will pay when it finances such leases, contracts and loans through its credit facility. Increases in interest rates during the term of each lease, contract or loan could narrow or eliminate the spread, or result in a negative spread. The Company has followed the practice described below, which is designed to protect itself against interest rate volatility during the term of each lease, contract or loan.

Given the relatively short average life of the Company's leases, contracts and loans, the Company's goal is to maintain a blend of fixed and variable interest rate obligations. Currently, given the fixed repayment schedules of the Company's outstanding debt over the past two years, the Company has been limited in its ability to manage the blend of fixed and variable rate interest obligations. As of September 30, 2004, the Company's outstanding fixed-rate indebtedness outstanding under the Company's securitizations and subordinated debt represented 27.8% of the Company's total outstanding indebtedness.

ITEM 4 CONTROLS AND PROCEDURES

Disclosure controls and procedures: As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to the Exchange Act Rule 13a-15. Based upon the evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's 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 Company 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: As of the date of the evaluation described above, there have not been any significant changes in the Company's internal controls or in other factors that could significantly affect those controls.

PART II. OTHER INFORMATION

ITEM 1 LEGAL PROCEEDINGS

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

A. The Company filed an action in the United States District Court for the District of Massachusetts against Sentinel Insurance Company, Ltd., ("Sentinel"), Premier Holidays International, Inc., ("Premier") and Daniel DelPiano ("DelPiano") arising from Premier's October, 1999, default on its repayment obligations to the Company under a Twelve Million Dollar ($12,000,000) loan. Judgment has been entered in this case against Sentinel, which had issued a business performance insurance policy guaranteeing repayment of the loan, in the amount of Fourteen Million Dollars ($14,000,000). This judgment has not been satisfied. Sentinel is currently undergoing liquidation proceedings, and a claim in this amount has been filed with the bankruptcy court. The Company does not expect to receive any amount as a result of its claim. The Company's case against Premier and DelPiano was tried in November 2003 and was decided by the Court in March, 2004. The Court entered a judgment for the Company against Premier and DelPiano, jointly and severally, on all of the Company's counts, including fraud and violation of Massachusetts General Laws, Chapter 93A, and dismissing with prejudice all of Premier and DelPiano's claims and counterclaims. The Court awarded the Company Twenty Three Million Dollars ($23,000,000) in damages. The case was appealed to the United States Court of Appeals for the First Circuit. All appellate briefs were filed and heard on September 15, 2004. On October 5, 2004, the First Circuit Court of Appeals affirmed the District Court's Judgment in favor of the Company. Collection of this award is not assumed and therefore it is not reflected in the financial statements as of September 30, 2004.

B. In October 2002, the Company was served with a Complaint in an action in the United States District Court for the Southern District of New York filed by approximately 170 present and former lessees asserting individual claims. The Complaint contains claims for violation of RICO (18 U.S.C. Section 1964), fraud, unfair and deceptive acts and practices, unlawful franchise offerings, and intentional infliction of mental anguish. The claims purportedly arise from Leasecomm's dealer relationships with Themeware, E-Commerce Exchange, Cardservice International, Inc., and Online Exchange for the leasing of websites and virtual terminals. The Complaint asserts that the Company is responsible for the conduct of its dealers in trade shows, infomercials and web page advertisements, seminars, direct mail, telemarketing, all which are alleged to constitute unfair and deceptive acts and practices. Further, the Complaint asserts that Leasecomm's lease contracts as well as its collection practices and late fees are unconscionable. The Complaint seeks restitution, compensatory and treble damages, and injunctive relief. The Company filed a Motion to Dismiss the Complaint on January 31, 2003. By decision dated September 30, 2003, the court dismissed the complaint with leave to file an amended complaint. An Amended Complaint was filed in November 2003. The Company filed a Motion to Dismiss the

Amended Complaint, which was denied by the U.S. District Court in September 2004. The Company is preparing to file an answer to the Amended Complaint denying the Plaintiff's allegations. Because of the uncertainties inherent in litigation, the Company cannot predict whether the outcome will have a material adverse effect.

C. On August 22, 2002, Plaintiff Aaron Cobb filed a Complaint against Leasecomm Corporation and MicroFinancial, Inc. and another Entity known as Galaxy Mall, Inc. alleging breach of contract; Fraud, Suppression and Deceit; Unjust Enrichment; Conspiracy; Conversion; Theft by Deception; and violation of Alabama Usury Laws. The Complaint was filed on behalf of Aaron Cobb individually, and on behalf of a class of persons and entities similarly situated in the State of Alabama. More specifically, the Plaintiff purports to represent a class of persons and small business in the State of Alabama who allegedly were induced to purchase services and/or goods from any of the Defendants named in the Complaint. The case is venued in Bullock County, Alabama. On March 31, 2003 the trial court entered an Order denying the Company's Motion to Dismiss. An appeal of the Order was filed with the Alabama Supreme Court on May 12, 2003. On February 20, 2004, the Alabama Supreme Court overruled

the Company's application for rehearing. On February 24, 2004, Plaintiff filed a First Amended Class Action Complaint in which Plaintiff added Electronic Commerce International ("ECI") as an additional party defendant. No new allegations were asserted against the Company in the Amended Complaint. On March 31, 2004 the Company filed an answer to the Amended Complaint denying the Plaintiff's allegations. The Company continues to deny any wrongdoing and plans to vigorously defend this claim. The Company has also filed an additional motion to enforce a forum selection clause, which, if successful, would cause this case to be dismissed with leave to re-file in Massachusetts. Galaxy Mall has filed a similar motion. These motions are scheduled to be heard in September 2004. Also, all discovery in this case has been halted, pending a discovery order to be entered into in connection with a schedule for class certification proceedings. Because of the uncertainties inherent in litigation, the Company cannot predict whether the outcome will have a material adverse effect.

D. In March 2003, a purported class action was filed in Superior Court in Massachusetts against Leasecomm and one of its dealers. The class sought to be certified is a nationwide class (excluding certain residents of the State of Texas) who signed identical or substantially similar lease agreements with Leasecomm covering the same product. After the Company had filed a motion to dismiss, but before the motion to dismiss was heard by the Court, plaintiffs filed an Amended Complaint. The Amended Complaint asserts claims against the Company for declaratory relief, absence of consideration, unconscionability, and violation of Massachusetts General Laws Chapter 93A, Section 11. The Company filed a motion to dismiss the Amended Complaint. The Court allowed the Company's motion to dismiss the Amended Complaint in March 2004. In May 2004, a purported class action on behalf of the same named plaintiffs and asserting the same claims was filed in Cambridge District Court. The Company has filed a Motion to Dismiss the Complaint, which was heard in August 2004, and denied by the District Court. On September 16, 2004, the Company filed an answer to the Amended Complaint denying the Plaintiff's allegations. Because of the uncertainties in litigation, the Company can not predict whether the outcome will have a material adverse effect.

E. On April 28, 2003, Plaintiff Wallace Dickey filed a purported class action against Leasecomm Corporation, Cardservice International, Inc., Linkpoint International, Inc., and Clear Commerce Corporation alleging that he lease-financed through Leasecomm the right to use certain computer software manufactured, distributed, and sold by the other defendants. The Plaintiff did not allege that Leasecomm failed to provide the lease financing contemplated by the Leasecomm lease. Instead, the Plaintiff alleged that the other defendants' software failed to operate as well as he believed it would. He sued for a declaration that would allow him to rescind his contract, to recover money paid in the course of the transaction, and to recover damages allegedly caused by unspecified deceptive trade practices. The Plaintiff asserted his claims "on behalf of himself and all others similarly situated." Leasecomm denied all of the Plaintiff's allegations. The defendants agreed to a proposed class action settlement with the Plaintiff and his counsel. The proposed settlement, if granted final approval by the Court, would apply to all Texas residents who lease-financed through Leasecomm the same software rights that the Plaintiff lease-financed. The Court preliminarily approved certification of the Texas class for settlement purposes only, and the parties distributed notice to all class members in accordance with the Court's instructions. Upon expiration of the notice period, the Parties sought and the Court granted final approval to the settlement class. The Court's final judgment became final on October 8, 2004.

F. On April 29, 2003, Leasecomm was served with a Complaint filed in the Orange County Superior Court for the State of California. In that Complaint, Maria J. Smith purports to bring a claim against Leasecomm and two other defendants (Galaxy Mall, Inc. and Electronic Commerce International, Inc.) for unfair business practices and competition under California Business and Professions Code section 17200 et seq. The essence of the claim is that Smith and others who are similarly situated were defrauded in connection with their acquisition of certain licenses that were financed by Leasecomm. In May 2003, Leasecomm filed a motion to stay the action in favor of a Massachusetts forum based on a forum selection clause contained in plaintiff's lease agreement with Leasecomm. After filing the motion, Leasecomm entered into settlement negotiations with plaintiff's counsel to explore the possibility of resolving the matter on a class wide basis without the need for further litigation (meaning the settlement would, if accepted, apply not only to the named plaintiff but to others similarly situated). The parties signed a stipulation setting forth the terms of their agreement and the Court has preliminarily approved the settlement, approved the form of notice to class members. On October 15, 2004, the Parties sought and the Court granted final approval to the settlement class.

G. In October 2003, the Company was served with a purported class action complaint which was filed in the United States District Court for the District of Massachusetts alleging violations of federal securities law. The

26

purported class would consist of all persons who purchased Company securities between February 5, 1999 and October 30, 2002. The Complaint asserts that during this period the Company made a series of materially false or misleading statements about the Company's business, prospects and operations, including with respect to certain lease provisions, the Company's course of dealings with its vendor/dealers, and the Company's reserves for credit losses. In April 2004, an Amended Class Action Complaint was filed which added additional defendants and expanded upon the prior allegations with respect to the Company. The Company filed a Motion to Dismiss the Amended Complaint, which is awaiting decision by the Court. Because of the uncertainties inherent in litigation, the Company cannot predict whether the outcome will have a material adverse effect.

H. In February 2004, a purported class action was filed in Superior Court in Massachusetts against Leasecomm, a dealer, and a party purportedly related to the dealer. The class sought to be certified is a nationwide class who signed lease agreements identical to, or substantially similar to, the plaintiff's lease agreement with Leasecomm, and covering the same product. The Complaint asserts claims for declaratory judgment, absence of consideration, unconscionability, and violation of Massachusetts General Laws Chapter 93A, Section 11. The claims concern the validity, enforceability, and alleged unconscionability of the lease of a product which enabled a merchant to process credit card payments. The Complaint seeks rescission of lease agreements with Leasecomm, restitution, multiple damages and attorneys fees under Chapter 93A, and injunctive relief. The Company has filed a Motion to Dismiss the Complaint, which is awaiting decision by the Court. Because of the uncertainties inherent in litigation the Company cannot predict whether the outcome will have a material adverse effect.

I. In February 2003, Leasecomm received a Civil Investigative Demand ("CID") from the Office of the Attorney General, State of Washington, to which it has responded. The CID concerns an investigation of monitoring agreements between Priority One, Inc. and various State of Washington consumers, as to which Leasecomm appears to be the assignee of the right to receive monthly payments and monitoring agreements between former Priority One, Inc. customers and security monitoring companies. Since the investigation is in process, and no legal action has been commenced against Leasecomm, the Company can not predict whether the outcome will have a material adverse effect.

J. On June 21, 2004, Leasecomm was named as defendant in a punitive class action complaint filed in the Los Angeles County Superior Court for the State of California. In that Complaint, styled as Margarita Hinojosa, et al. v. Leasecomm Corporation, case no. BC317371, plaintiffs purport to bring claims against Leasecomm on behalf of themselves and others similarly situated for fraud, unfair business practices under California Business & Professions Code section 17200 et seq., false advertising under California Business & Professions Code section 17500 et seq. and violations of various California consumer protection statutes. The essence of the claim is that plaintiffs and others who are similarly situated were defrauded in connection with their acquisition of credit card swipe machines that were financed by Leasecomm and which plaintiffs claim they intended to use to add value to telephone calling cards that could be used for their personal use or resale to others. During negotiations with plaintiffs' counsel prior to the filing of the Complaint, Leasecomm reached a proposed class action settlement of all claims. In September 2004, the Court preliminarily approved the settlement, approved the form of notice to class members and has set a final approval hearing for January 11, 2005. The settlement must receive final approval to become effective. Because of the uncertainties inherent in litigation, the Company cannot predict whether the outcome will have a material adverse effect.

ITEM 2 RECENT SALES OF UNREGISTERED SECURITIES

(c) On September 29, 2004, the Company issued warrants to purchase an aggregate of 50,000 shares of the Company's common stock at an exercise price of $0.825 per share and expiring on June 10, 2007. The warrants were issued to the lender in the Company's new $30.0 million credit line. The exemption from registration relied on by the Company was Section 4(2) of the Securities Act of 1933. The investor was an accredited investor and the offering otherwise met the requirements of Regulation D under the Securities Act.

On September 29, 2004, the Company issued warrants to purchase an aggregate of 75,000 shares of the Company's common stock at an exercise price of $3.704 per share and expiring on June 10, 2007. The warrants were issued to the financial advisor the Company engaged to secure the Company's new $30.0 million credit line. The exemption from registration relied on by the Company was Section 4(2) of the Securities Act of 1933. The investor was an accredited investor and the offering otherwise met the requirements of Regulation D under the Securities Act.

ITEM 6 EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits index

10.1 Revolving Credit Agreement, dated as of September 29, 2004, by and among Leasecomm Corporation and TimePayment Corp. LLC, as Borrowers, MicroFinancial Incorporated, The CIT Group/Commercial Services, Inc., as Agent, and the other financial institutions from time to time party thereto, as Lenders. (incorporated by reference to Exhibit 10.1 of the Registrant's Form 8-K filed on October 4, 2004)

10.2 $30,000,000 Revolving Credit Note, dated as of September 29, 2004, issued by Leasecomm Corporation and TimePayment Corp. LLC and payable to the order of The CIT Group/Commercial Services, Inc. (incorporated by reference to Exhibit 10.2 of the Registrant's Form 8-K filed on October 4, 2004)

10.3 Guaranty, dated as of September 29, 2004, by MicroFinancial Incorporated in favor of The CIT Group/Commercial Services, Inc., as Agent. (incorporated by reference to Exhibit 10.3 of the Registrant's Form 8-K filed on October 4, 2004)

10.4 Pledge Agreement, dated as of September 29, 2004, by and between MicroFinancial Incorporated and The CIT Group/Commercial Services, Inc., as Secured Party, on behalf of the Lenders. (incorporated by reference to Exhibit 10.4 of the Registrant's Form 8-K filed on October 4, 2004)

10.5 Security Agreement, dated as of September 29, 2004, by and among Leasecomm Corporation, TimePayment Corp. LLC and The CIT Group/Commercial Services, Inc., as Agent. (incorporated by reference to Exhibit 10.5 of the Registrant's Form 8-K filed on October 4, 2004)

10.6 Intellectual Property Security Agreement, dated as of September 29, 2004, by and among Leasecomm Corporation, TimePayment Corp. LLC and The CIT Group/Commercial Services, Inc., as Agent. (incorporated by reference to Exhibit 10.6 of the Registrant's Form 8-K filed on October 4, 2004)

10.7 Revolving Credit Assignment of Leases, dated as of September 29, 2004, by and among Leasecomm Corporation, TimePayment Corp. LLC and The CIT Group/Commercial Services, Inc., as Agent. (incorporated by reference to Exhibit 10.7 of the Registrant's Form 8-K filed on October 4, 2004)

10.8 Warrant Purchase Agreement, dated as of September 29, 2004, by and between MicroFinancial Incorporated and The CIT Group/Commercial Services, Inc., as Investor. (incorporated by reference to Exhibit 10.8 of the Registrant's Form 8-K filed on October 4, 2004)

10.9 Warrant Certificate, dated as of September 29, 2004, for the purchase of 50,000 shares of common stock, issued by MicroFinancial Incorporated in favor of The CIT Group/Commercial Services, Inc. (incorporated by reference to Exhibit 10.9 of the Registrant's Form

8-K filed on October 4, 2004)

10.10 Registration Rights Agreement, dated as of September 29, 2004, by and between MicroFinancial Incorporated and The CIT Group/Commercial Services, Inc., as Holder. (incorporated by reference to Exhibit 10.10 of the Registrant's Form 8-K filed on October 4, 2004)

10.11* Warrant Certificate, dated as of September 29, 2004 for the purchase of 75,000 shares of common stock, issued by MicroFinancial Incorporated in favor of Stonebridge Associates LLC

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

(b) Reports on Form 8-K

A form 8-K was filed on July 8, 2004, to announce that the Company satisfies NYSE Continued Listing Compliance Plan.

A form 8-K was furnished on August 2, 2004, to announce the Company's financial results for the second quarter and six months ended June 30, 2004.

(b) Reports on Form 8-K (continued)

A form 8-K was filed on August 5, 2004, to announce that the Company continues to reduce its outstanding debt obligations.

A form 8-K was filed on September 3, 2004 to announce that the Company continues to reduce its outstanding debt obligations.

A form 8-K was filed on October 4, 2004 to announce that on September 29, 2004, Leasecomm Corporation and TimePayment Corp. LLC, wholly-owned subsidiaries of the Company, signed a $30 million credit agreement with The CIT Group/Commercial Services, Inc.

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: November 15, 2004