NEWTEK BUSINESS SERVICES INC
Form 10-K
April 02, 2007
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2006

Commission file number: 001-16123

NEWTEK BUSINESS SERVICES, INC.

New York	**11-3504638**
(State or other jurisdiction of	**(I.R.S. Employer**
incorporation or organization)	**Identification No.)**
1440 Broadway,17th Floor New York, New York	**10018**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code: (212) 356-9500

Securities Registered Pursuant to Section 12(g) of the Act:

Common Shares, par value $0.02 per share

(Title of class)

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

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

Indicate by check mark whether the registrant:1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the past 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 x

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (all as defined in Rule 12b-2 of the Act).

Large Accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer x

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

The aggregate market value of the voting stock held by non-affiliates of the registrant was approximately $44,066,000 as of the last business day of the registrant s second fiscal quarter of 2006.

As of March 26, 2007 there were 36,689,131 shares issued and outstanding of the registrant s Common Shares, par value $0.02 per share.

Table of Contents

NEWTEK BUSINESS SERVICES, INC.

TABLE OF CONTENTS

Table of Contents

PART I

Item 1 BUSINESS
Overview

Newtek Business Services, Inc. (Newtek) is a holding company for several wholly- and majority-owned subsidiaries, including 15 certified capital companies which we refer to as Capcos, and several portfolio companies in which the Capcos own non-controlling or minority interests. We are a direct distributor of business services to the small and medium-sized business market. Our target market represents a very significant marketplace in the United States gross domestic product or GDP. According to statistics published by the U.S. Small Business Administration, approximately 51% of the GDP in the United States comes from small-to medium-size businesses and 99% of businesses in the United States which have one or more employees fit into this market segment. As of December 31, 2006, we had over 75,000 business accounts. We use state of the art Web-based proprietary technology to be a low cost acquirer and provider of products and services to our small-and medium- size business clients. We partner with AIG, Merrill Lynch, Morgan Stanley, UBS, the Credit Union National Association with its 8,700 credit unions and 80 million members, the Navy Federal Credit Union with 2.7 million members, PSCU Financial Services, Inc., the nation s largest credit union service organization, General Motors Minority Dealers Association and Daimler Chrysler Minority Dealers Association, all of whom have elected to offer certain of our business services and financial products rather than try to provide some or all of them directly for their customers. We have deemphasized our Capco business in favor of growing our operating businesses and do not anticipate creating any new Capcos in the foreseeable future.

The Company s principal business segments are:

Electronic Payment Processing: Marketing, credit card processing and check approval services to the small- and medium-sized business market.

Web Hosting: CrystalTech Web Hosting, Inc. which offers shared and dedicated web hosting and related services to the small- and medium-sized business market.

SBA Lending: Newtek Small Business Finance, Inc., a nationally licensed, U.S. Small Business Administration lender that originates, sells and services loans to qualifying small businesses, which are partially guaranteed by the SBA.

All Other: Includes results from businesses formed from Investments in Qualified Businesses made through Capco programs which cannot be aggregated with other operating segments.

Corporate Activities: Revenue and expenses not allocated to our other segments, including interest income, Capco management fee income and corporate operations expenses.

Capcos: Fifteen certified capital companies, which invest in small- and medium-sized businesses. They generate non-cash income from tax credits and non-cash interest and insurance expenses.

Table of Contents

Business Strategy

Key elements of our strategy to grow our business are:

Continue to focus our business model to serve the small- and medium-sized business market. We are focused on developing and marketing business services and financial products and services aimed at the small-and medium-sized business market. Our business model is to get that market to view us as The Company to go to for all their business needs. We are now providing one or more services to approximately 75,000 client accounts. We intend to continue to leverage the Newtek brand as a one stop shop provider for small and medium size business market, and further develop direct marketing efforts through our website and our direct sales program.

Continue to implement a strategy of acquiring customers at low cost. We seek to acquire customers at a low cost through a national strategy centered on our alliance partners and our NewTracker technology. Our alliance partners use our proprietary NewTracker referral system to refer customers to us for sales and customer referral, tracking and processing. We use the same proprietary system as our gateway for direct sales through our website and our Biz Exec program.

Further develop national marketing of the Newtek brand through our alliance partners. We have formed key marketing alliances with national business organizations such as AIG, Merrill Lynch, Navy Federal Credit Union, PSCU Financial Services, Inc. and UBS, Inc., and trade organizations such as the Credit Union National Association, the General Motors Minority Dealers Association, and Daimler Chrysler Minority Dealers Association.We seek to build on the endorsement of our technology, high level of customer service, and competitively priced products and services by these partners.

Continue to develop our state-of-the-art technology to process business applications and financial transactions. We are expanding our proprietary NewTracker referral system which allows us to process new business utilizing a web-based, centralized processing point. We are implementing a project of combining all data assets into a seamless, enterprise wide accessible master database in order to facilitate cross marketing, selling and servicing, real-time data mining, and business intelligence.

Cross sell additional products and services to small- and medium-sized businesses. We are developing our processing systems to facilitate cross selling multiple products and services. We are actively seeking to add additional products and services to meet the demands of the small and medium- sized business market. In addition we are implementing a multi-channel marketing strategy to expand our reach.

Opportunistically acquire companies or assets to provide complementary products and services. By strategically acquiring companies or assets in our primary product and service markets, we can expand our customer base and create cross-selling opportunities for our growing suite of complementary goods and services.

Continue to fulfill our obligations under the current Capco programs. Our emphasis is on continuing our exemplary regulatory compliance program in order to successfully complete the investment cycles for all Capcos. At December 31, 2006, we had reached the final investment requirements in all 15 Capco programs in which we participate directly, that we believe ensured that 100% of the tax credits are beyond risk of recapture.

During our year ended December 31, 2006:

Revenue from our three major operating segments (electronic payment processing, web hosting and SBA lending) totaled $66,694,000 in 2006, a 23% increase as compared with $54,111,000 in 2005. These segments represented 76% of total revenue in

2006 as compared to 56% in 2005.

Our three major operating segments earned $7,022,000 in 2006, a 21% increase as compared with $5,823,000 in 2005.

Our three major operating segments achieved $13,753,000 in positive cash provided by operating activities in 2006. In addition, for the first time as a publicly traded company, we achieved consolidated positive cash provided by operating activities, which totaled $1,881,000.

In 2006 we prepaid $7,000,000 of the $8,000,000 note payable to TICC which was incurred in 2005 in conjunction with the purchase of CrystalTech Web Hosting, Inc. This prepayment was made primarily from CrystalTech s positive cash provided by operating activities.

History

We were founded in 1998 to participate in the Capco programs. We have since developed our branded line of business services and financial products and services for the small and medium-sized business market. At December 31, 2006, we had 37 majority-owned companies excluding our 15 Capcos, many of which were a result of investments through the Capco programs**.** From 1999 to 2005, Capcos generated significant cash flows reflected as financing activities on our consolidated cash flow statement. We do not anticipate creating any new Capcos in the foreseeable future, although we continue to invest in small businesses through our existing Capcos and meet the goals of the Capco programs. We are concentrating our efforts on creating a distribution channel for the small and medium-sized business market.

We believe that Fortune 500 companies are seeking to expand their client base into the lucrative small to medium -size business market. We believe that to enter this market effectively they will require the use of a cost-effective distribution channel such as the one we have built using proprietary technology and systems. We believe that most Fortune 500 companies try to use the same distribution methods used for their existing consumer or corporate customers in order to reach this market, only to find it too expensive or unproductive to address small to medium-sized businesses. We view the small business owner and decision maker as unique and requiring a different distribution channel, as well as different products, packaging and service tailored to meet the needs of small and medium-sized businesses.

We market ourselves to our small and medium- sized business customers through our motto of we do it differently and we do it better. An example of how we seek to do this is our 24/7 call center which we believe is a valuable feature for most small business owners that need help at off hours and on weekends. We use Web-based applications as an in-house tool to make our employees and associates efficient, smart and productive. Instead of using expensive six-figured salaried employees that a typical bank or an insurance company would use to market financial products and business services to small- and medium-sized business customers, we use very smart, efficient, high-quality technology and dedicated loyal non-executive salary plus bonus employees.

We believe that our business service specialists on all product lines understand the needs of the small business owner. We conduct telephone interviews with our target customers across all product lines to deepen our understanding of their needs. We have tailored our offerings to avoid our small and medium- sized business customers having to fill out multiple handwritten forms or type data into a keyboard, which we believe is the most aggravating factor facing our customers. We have modeled our back-office and business operations after customer centered operational models, such as that of Progressive Insurance. We stress our responsive customer service, and we endeavor to excel in addressing and resolving issues and problems that our customers may face. We intend to provide our 24/7 customer service functions in Spanish to service the growing Hispanic owned and operated small business customer base in the United States.

The Newtek Referral System

Our proprietary NewTracker referral system allows us to process new business utilizing a web-based, centralized processing point. Our trained representatives use these web-based applications as a tool to acquire and process data through telephonic interviews, eliminating the need for face to face contact and the requirement that a customer complete multiple paper forms or data entry for multiple product lines. This approach is customer friendly, allows us to process applications very efficiently and allows us to store client information for further processing and cross-selling efforts while offering what we believe to be the highest level of customer service. It also assures our alliance partners full transaction transparency. This system permits our alliance partners to have a window to our back office processing 24 hours a day, 7 days a week, to see every communication and interaction between our sales and processing representatives and their referred customers without sharing customer or alliance partner sensitive data on the application. NewTracker enables the processing and tracking of services in a manner similar to the bar code system used by overnight delivery services.

We are implementing a project of combining of all data assets into a seamless, enterprise wide accessible master database in order to facilitate cross marketing, selling and servicing, real-time data mining, and business intelligence and further enhance our use of NewTracker .

Table of Contents

Alliances

Each of the operating businesses benefit from the receipt of significant numbers of customer referrals from our alliance partners, pursuant to agreements negotiated and structured by our holding company management and staff. We are focused on using strategic business affiliations to identify likely small to mid-sized business customers and others to be serviced by our operating businesses. We seek to ally Newtek with companies and organizations that wish to offer one or more of our principal business lines to their customers or members. We provide one-stop shopping for alliance partners that want to launch or expand their business services. For example, many credit unions are serving small business owners with consumer lending applications, and can use our alliance with Credit Union National Association or PCSU Financial Services to expand their offering of services. We believe our comprehensive portfolio of business services can help small businesses grow, which benefits the business owner and their credit union.

These alliance partners are able to provide greater service to their customers and members and derive a steady flow of referral payments from us. On the other hand, our operating companies are receiving significant numbers of referrals for our services in the areas of small business loans, insurance and electronic payment processing and are thus acquiring customers at a low cost. NewTracker , our proprietary, internally developed referral system technology facilitates this transfer of information and also permits our customer service representatives, their supervisors and the referring alliance partners to all observe the real time processing of each referral, from intake to completion. For a Merrill Lynch financial advisor who refers a customer for electronic payment processing, he or she can follow the processing and know when decisions are made, what they are, when the referral fees are earned as well as observe and oversee the operational performance of our customer service representatives. The process is analogous to the bar code system used by overnight delivery services to track the movement of a package, where critical processing points are input and the customer is able to access the company s password-protected web site and monitor the movement of the package from pick up to delivery.

We have entered into agreements to provide for one or more business services with the following entities:

AIG

UBS

Merrill Lynch

Morgan Stanley

Maxim Group, LLC

Bank Atlantic

Credit Union National Association

Daimler Chrysler Minority Dealers Association

General Motors Minority Dealership Association

Navy Federal Credit Union

New Alliance Bank

NCMIC Financial, Inc.

PCSU Financial Services, Inc.

Primary Business Segments

Electronic Payment Processing

We are a provider of payment processing services to over 12,300 small business merchants throughout the US. We enable our clients to accept all major credit cards as well as debit and ATM cards for payment whether they are a retail, service, mail-order or Internet merchant. We work with clients to set up merchant payment processing and to customize value added programs that help drive customers to them such as personalized gift card programs, and check guarantee services. At December 31, 2006 we processed transactions at an annualized rate exceeding $2.1 billion.

6

Table of Contents

Universal Processing Services Wisconsin, LLC, d/b/a Newtek Merchant Solutions of Wisconsin, or UPS-WI, provides credit card, debit card, gift card processing and check approval services directly to merchants. UPS-WI obtains its merchant customers primarily through the Newtracker referral system and our agreements with alliance partners, agreements with independent sales organizations, including our affiliates below, and other associations throughout the country. UPS-WI pays these organizations and associations a percentage of the processing revenue derived from their respective merchants. UPS-WI in turn contracts with large scale data processing companies to provide the data processing and funds settlement services for the merchants. UPS-WI assists merchants with their initial installation of equipment and initial and on-going service and any other special processing needs that they may have. On a wholesale basis, UPS-WI acts as a processor for merchants that are brought to it through our alliance partners, affiliated companies and other third-party marketing organizations. UPS-WI had contracts with 160 independent sales consultants as of December 31, 2006, and has grown its customer base significantly during each year of operations since 2002. UPS-WI is currently adding approximately 300 customers per month, and has reached a customer base of approximately 7,900 as of December 31, 2006. UPS-WI had positive cash flow and earnings for the year and processed transactions at a monthly annualized rate of approximately $1.6 billion at December 31, 2006.

The following five subsidiaries operate under the name Newtek Merchant Solutions :

Universal Processing Services of New York, LLC, d/b/a Newtek Merchant Solutions of New York, was organized in March 2001 and is based in New York City.

Universal Processing Services of Colorado, LLC, d/b/a Newtek Merchant Solutions of Colorado, was organized in December 2002 and is based in Evergreen, Colorado.

First BankCard Alliance of Alabama, LLC, d/b/a Newtek Merchant Solutions of Alabama, was organized in 2004 and is based in Montgomery, Alabama. Newtek Merchant Solutions of Alabama currently services approximately 300 merchants, and processed transactions at an annualized rate of approximately $28 million.

Summit Systems & Design, LLC, d/b/a Newtek Webhosting Services, was organized in 2005 and is based in Brownsville, Texas. Summit currently services approximately 2,700 merchants, and processed transactions at an annualized rate of approximately $287 million.

Automated Merchant Services, Inc., d/b/a Newtek Merchant Services of Florida, or NMS-FL, was acquired by our Florida Capco and us in August 2003. NMS-FL currently services approximately 1,400 merchants, and processed transactions at an annualized rate of approximately $177 million.

Each of these affiliates markets credit and debit card processing services, check approval services and ancillary processing equipment and software to merchants who accept credit cards, debit cards, checks and other non-cash forms of payment. Each also contracts with local independent representatives to sell and service payment processing services. In addition to marketing these services to local markets, each company is currently establishing relationships with local and regional banks that do not offer their own merchant processing in order to enable them to offer these services to their clients through Newtek Merchant Solutions. Each contract for the actual processing services provided to its merchants and customers through an agreement with UPS-WI. Each of these Newtek Merchant Solutions companies has steadily increased the number of customers and has experienced a continued increase in its receipt of monthly residual payments and all but one have now achieved profitability.

All of our electronic payment processing businesses rely on the ability to obtain data processing services from organizations equipped to perform the large volume of highly sophisticated data processing operations. There are two aspects to the processing: the initial authorization of a payment (referred to as the front end processing) and the merchant credit and cardholder charge transaction (the back end processing). Our payment processing businesses rely on up to 5 of each of the front end and back end processors which means that our risk of reliance on any one company is reduced and also gives us the option of utilizing different processors to match the needs of particular customers or situations.

As a result of the exposure of these companies to liability for merchant fraud, chargebacks and other losses inherent in the merchant payment processing business, our operating companies have developed practices and policies which attempt to assess and counter these risks. Activities in which we engage in order to mitigate such risks are:

underwriting the initial application of a merchant to identify unusual risks, structure the relationship in a manner consistent with acceptable risks and in almost all cases obtaining a personal guarantee from the merchant;

monitoring the daily and monthly activity of each merchant to identify any departures from normative charging behavior of each merchant, monitoring the largest of our merchants and those with high levels of refunds or chargebacks, so as to ensure an opportunity to address any credit or chargeback problems at the earliest possible time; and requiring all of our merchants to agree to the establishment of cash reserves to protect us against merchant failures to pay for chargebacks and other fees, and making adjustments in these reserves as merchant experience indicates.

We believe that these procedures will enable our electronic payment processing subsidiaries to avoid most material problems related to merchant or customer fraud and similar potential losses. The development and growth of this business will be primarily through customers identified for us by our alliance partners and to a much lesser extent by our independent representatives. We are different than most electronic payment processing companies who acquire their clients primarily through independent agents in that we acquire most of our clients and processing volume through our Newtracker and alliance partner relationships. We believe that our business model provides us with a competitive advantage by enabling us to acquire electronic payment processing clients which process at levels higher than the industry average at a lower cost because we do not have to pay the expenses associated with third party commissions, although we do pay referral fees. We also believe that our clients are more loyal to Newtek than to the industry standard independent agent which tends to move clients around.

Website Hosting Services

Through our subsidiary CrystalTech Web Hosting, Inc., we provide website hosting services to what is now more than 90,000 domains in over 100 different countries. Founded in 1997, CrystalTech provides simple shared hosting plans and more complex dedicated hosting plans, for which it receives recurring monthly fees, as well as other fees such as set-up fees, consulting fees, domain name registrations and others. Ninety percent of all fees are paid in advance by credit card.

CrystalTech s dedication to superior customer service is reflected in the growth of its customer base, from approximately 11,500 accounts in 2002 to approximately 59,000 at the end of 2006. CrystalTech currently primarily uses Microsoft Windows® technology. Microsoft has described CrystalTech as the second largest hosting service in the world providing exclusively Microsoft Windows 2003® hosting. Because of the efficiency of CrystalTech s operations and its firm commitment to customer service, CrystalTech has been able to build a business with significant growth in its customer base and increasing positive cash flow and profitability. During 2006 CrystalTech earned pre-tax income of $3,769,000 on revenues of $13,610,000 and generated EBITDA of $6,800,000.

Over seventy- five percent of the growth in customers by CrystalTech has come as a result of customer referrals without material expenditures for marketing or advertising. Many of CrystalTech s competitors are very price sensitive, offering minimal services at cut-rate pricing. CrystalTech has instead emphasized higher quality service with fair but reasonable monthly fees.

In 2006, CrystalTech added Linux-based web hosting and web-based data storage and back-up services to its product line. CrystalTech operates currently one network control center of over 3000 square feet in Phoenix, Arizona, utilizing redundant networking and backup systems, affording customers the greatest level of performance and protection.

Small Business Lending

Newtek Small Business Finance, Inc., or NSBF specializes in making, servicing and selling small business loans guaranteed by the SBA for the purpose of acquiring commercial real estate, machinery, equipment and inventory and to refinance debt, fund franchises, working capital and business acquisitions. NSBF is one of 14 non-banking companies SBA licensed as a Small Business Loan Corporation to provide loans nationwide under the federal section 7(a) loan program for small businesses. This federal program is authorized each year by Congress to guaranty small business loans in an amount determined by Congress. The authorization for 2006 was $16.5 billion. NSBF has received preferred lenders program (PLP) status, a designation whereby the SBA authorizes the most experienced SBA lenders to place SBA guarantees on loans without seeking prior SBA review and approval. Being a national lender, PLP status allows NSBF to serve its clients in an expedited manner since it is not required to present applications to individual SBA offices. The operations of NSBF are heavily dependent on the nature of the regulations imposed on it as a Small Business Loan Corporation and its ability to remain in compliance with those regulations.

Currently Newtek and its affiliated companies own 80% of the equity of NSBF. The balance of the equity of NSBF is owned by CSFB Management Holdings, Inc., an affiliate of Credit Suisse.

During 2006, NSBF funded 146 loans for a total of $40 million. At December 31, 2006 it was servicing a portfolio of loans for others at December 31, 2006 totaling $163 million and its own portfolio of $33 million aggregating $196 million of loan servicing. NSBF earned pre-tax net income for 2006 of $317,000 on a segment basis.

We are currently exploring options to provide lower cost funding to NSBF as well as offer a more expansive lending platform other than just the government backed SBA program which limits our ability to lend by restricting use to one type of loan. In 2006, we looked at approximately $1 billion dollars in lending opportunities and only closed on 4% of those, or $40 million in loans.

8

Table of Contents

Other Business Lines

Small Business Insurance Products and Services: We offer small business insurance products and services through Newtek Insurance Agency, LLC, based in Washington, D.C., with a presence in New York, Illinois and Texas. Newtek Insurance Agency, LLC is licensed in 50 states and serves as a retail and wholesale agency specializing in the sale of personal and commercial lines insurance products to customers of all our affiliated companies as well as our alliance partners. In 2006, we integrated our insurance operations with our NewTracker referral system, which now serves as the single point of entry and reporting for the agency. We offer multiple insurance products from multiple insurance carriers providing a wide range of choice for our customers. In 2006 we implemented a program with the Navy Federal Credit Union to market commercial and homeowners insurance to their 2.7 million members, and formed a strategic alliance with AIG Small Business to provide agent services to small business clients who link to us from the AIG Small Business website. We are continuing our efforts to implement programs with alliance partners to market commercial and personal insurance. On February 16, 2007, we announced an alliance with PSCU Financial Services, Inc., which intends to provide our insurance products and services to its 500 member credit unions as part of its promotion of our services. We believe that these new alliances will increase the importance of this business to Newtek and its business clients.

Financial Information Systems: We offer administrative and technological support for small businesses by designing and implementing specialized financial and management reporting systems and by providing outsourced financial management functions including digital bookkeeping that reduce costs and management requirements for our customers. We also provide tax filing, preparation and advisory services to small- and medium-sized businesses.

Business Plan Preparation: We also offer business plan preparation services in connection with the formation or expansion of small and medium- sized businesses.

Marketing

We market our services primarily from referrals from our alliance partners such as AIG Small Business, Merrill Lynch, Credit Union National Association, Navy Federal Credit Union and Bank Atlantic, using our proprietary NewTracker referral system. In addition, Electronic Payment Processing is also marketed through independent representatives and CrystalTech services are marketed through third party development companies, and internet based marketing. A common thread across all business lines relates to acquiring customers at low cost. We seek to bundle our marketing efforts through our brand, our portal, our proprietary Newtracker technology, and one easy entry point of contact.

We currently cross market primarily at the alliance level. The Credit Union National Association, PSCU Financial Services, Inc. and AIG Small Business are examples of cross marketing at the alliance level.

We are currently in the process of implementing a multi-channel marketing strategy that will consist of:

Direct: We have launched our new website, www.newtekbusinessservices.com, in October of 2006. We have created a place on our website for small business owners/operators to go to acquire one or more of the Newtek services directly. We anticipate marketing this through ads, seminars, magazine placements and internet key words and/or general promotion.

Indirect: We have initiated the BizExec Program and are recruiting individual professionals such as insurance agents, lawyers, and accountants who will utilize NewTracker either through the establishment of a new website or through a link to NewTracker from their own site. They will have access to the Newtracker system to track their own leads and referrals from alliance partners such as Morgan Stanley or Merrill Lynch.

Direct Sales Force Contracted, fee and bonus based employees that have as their primary responsibility to drive quality referrals into NewTracker thru daily interaction with their assigned alliances and business owners/operators in their territories. We currently have 12 individuals acting in this capacity across the United States.

Table of Contents

Direct Alliance Small business owners/operators go to the website of an alliance partner in order to acquire one or more of the Newtek services. Driven by ads, keywords, seminars, conferences and/or general promotion. This is currently in place with AIG, NCMIC Financial, Inc. and PCSU Financial Services, Inc.

Intellectual Property

Newtek has developed software which is the core of its NewTracker referral system and in September, 2006 filed a patent application with the United States Patent Office Covering NewTracker™.

CrystalTech uses specialized software to conduct its business under a perpetual, royalty free license from its developer, the former owner of CrystalTech, acquired at the time of the acquisition of the business.

We have several trademarks and service marks, all of which are of material importance to us.

The following trademarks and service marks are the subject of pending trademark applications filed with the United States Patent Trademark Office:

1. NEWTEK
2. NEWT, NEWTEK
3. AT NEWTEK, WE DO IT BETTER
4. BIZEXEC
5. CRYSTALTECH
6. CRYSTALTECH WEB HOSTING
7. CT & Design
8. NEWTEK BIZEXEC
9. NEWTEK BUSINESS SERVICES
10. NEWTEK BUSINESS SOLUTIONS
11. NEWTEK FINANCIAL INFORMATION SYSTEMS
12. NEWTEK HOSTING SERVICES
13. NEWTEK INTERACT
14. NEWTEK INTERACTIVE
15. NEWTEK NEWT
16. NEWTEK Newt & Design
17. NEWTEK REFERRAL SYSTEM
18. NEWTEKTRACKER
19. NEWTRACKER
20. WEBCONTROLCENTER

Litigation, which could result in substantial cost to and diversion of our efforts, may be necessary to enforce trademarks issued to us or to determine the enforceability, scope and validity of the proprietary rights of others. Adverse determinations in any litigation or interference proceeding could subject us to costs related to changing names and a loss of established brand recognition.

Competition

We compete in a number of markets for the sale of services to small and medium sized businesses. Each of our principal operating segments competes not only against suppliers in their particular state or region of the country but also against suppliers operating on a national or even a multi-national scale. None of the markets in which our companies compete are dominated by a small number of companies that could materially alter the terms of the competition.

Our electronic payment processing segment competes with Heartland Payment Systems, First National Bank of Omaha and Paymentech, L.P. Our web hosting segment competes with Host My Site, Discount ASP, Maxum ASP and Microsoft Live. Our small business lending segment competes with regional and national banks and non bank lenders such as CIT and Business Loan Express.

In many cases, the competitors whom our companies face are not as able as our companies to take advantage of changes in business practices due to technological developments and, for those with a larger size, are unable to offer the personalized service that many small business owners and operators seem to want.

Table of Contents

While we compete with many different providers in our various businesses, we have been unable to identify any direct and comprehensive competitors that deliver the same broad suite of services focused on the needs of the small and medium- sized business market with the same marketing strategy as we do. Some of our competitive advantages include:

- Our proprietary NewTracker referral system allows us to process new business utilizing a web-based, centralized processing point.
- Our focus on developing and marketing business services and financial products and services aimed at the small and medium-sized business market.
- Our ability to offer personalized service and competitive rates.
- A strategy of multiple channel distribution which gives us maximum exposure in the marketplace.
- Unparalleled customer service 24x7x365 across business lines, with a focus primarily on absolute customer service.
- Our telephone interview operations, as opposed to requiring hand written or data typing processes, allow us to offer high levels of customer service and satisfaction, particularly for small business owners who do not get this service from our competitors.
- Our Business Suite Portal allows our alliance partners to offer a centralized access point for their small to medium-sized business clients as part of their larger strategic approach to marketing, and allows them to demonstrate that they are focused on providing a suite of services to the small business market in addition to their core service.

Certified Capital Companies

We have deemphasized our Capco business in favor of growing our operating businesses and do not anticipate creating any new Capcos in the foreseeable future. The features of the Capco programs have facilitated our use of the Capco funds in support of our development as a holding company for a network of small business service providers. While observing all requirements of the Capco programs and, in particular, financing qualified businesses meeting applicable state requirements as to limitations on the proportion of ownership of qualified businesses, we have been able to use this funding source as a means to facilitate the growth of our businesses, which are strategically focused on providing goods and services to small businesses such as those in which our Capcos invest.

Overview: A Capco is either a corporation or a limited liability company established in and chartered by one of the nine jurisdictions currently with authorizing legislation: Alabama, District of Columbia, Florida, Louisiana, Colorado, New York, Texas and Wisconsin. (Missouri has an older program which pre-dates the start of our business and in which we do not participate.) Aside from seed capital provided by an organizer such as Newtek, a Capco will issue debt and equity instruments exclusively to insurance companies and the Capcos then are authorized under the respective state statutes to make targeted equity or debt investments in companies. In some states, the law permits Capco investments in majority-owned or primarily controlled companies. In others, such as Louisiana, Colorado, Texas and the most recent programs in New York, there are some limitations on the percentage of ownership a Capco may acquire in a qualified business. In conjunction with the Capcos investment in these companies, the Capcos may also provide loans to the companies. In most cases, the tax credits provided by the states are equal to the par amount of investment by the insurance companies in the securities of the Capcos, which can be utilized by them generally over a period of four to ten years. These credits are unaffected by the returns or lack of returns on investments made by the Capcos.

The authorizing statutes in all of the states in which our Capcos operate explicitly allow and encourage the Capcos to take minority equity interests, and in some cases majority or controlling interests, in companies. Consequently in all of the states we operate Capcos, we may, consistent with our business objectives, acquire equity interests in companies through the use of the funds in the Capcos and provide management and other services to these companies. The investments by the Capcos create jobs and foster economic development consistent with the objectives of the programs as stated in most Capco statutes. Furthermore, because our Capcos have arranged for the repayment of a portion of the Capco notes by The National Union Fire Insurance Company of Pittsburgh or The American International Specialty Lines Insurance Company, both affiliates of The American International Group, Inc., and a portion of the Capco notes is paid through the delivery of tax credits, our Capcos are under no pressure to generate short-term profits and may invest for long-term profitability. Due to the nature of the Capco programs, we are able to accept the higher level of losses common to start up companies because we have the ability to devote the time, attention and resources to these companies which they require to become successful.

Table of Contents

Because we use insurance to protect the principal of funds loaned to our Capcos by insurance companies as well as the tax credits which they receive from us, and in light of the cost of such insurance, in all of the Capcos we have organized, after payment of the organizational costs and the Capco insurance premium, the remaining cash is equal to approximately 50% of the amount initially raised. An important feature of all Capco programs is that a minimum of 50% of the initial investment in the Capcos must be placed in qualified business investments within a specified time, usually four or five years. As each Capco receives repayment of debt plus interest, as well as receives return of and on equity investments, it is able to reinvest the funds in other qualified businesses, which in some states may be its affiliated companies or others. It is through this investment-return-and-reinvestment process that our Capcos are able to meet the minimum investment requirements of the Capco programs. In 2004 our Capcos received total repayments or returns of approximately $12.6 million, in 2005 they received approximately $4.86 million and in 2006 they received approximately $13.6 million. These funds supplemented the funds available for meeting minimum investment requirements. At December 31, 2006, all of our 16 operating or managed Capcos had met their respective minimum 50% investment requirements. On a cumulative basis through December 2006, our Capcos have received insurance company funds of $236 million. As of December 31, 2006, we were in full compliance with all of our Capco funding requirements and met all or our investment benchmarks. Two of our Capcos have invested 100% of their certified capital and are in the process of applying to the State of New York and the State of Louisiana for voluntary decertification, and if granted, they would no longer be subject to regulation and could eventually distribute their assets and/or continue to operate without government regulation. There can be no assurance that we will be able to obtain such voluntary decertification.

The recognition of revenue by our Capcos has declined, representing approximately 18% of revenue in 2006, 38% of our gross revenue in 2005 and 48% in 2004. This trend demonstrates clearly the shift in our business from reliance on the Capco funding to the development of operating businesses generating increasing amounts of revenues, income and cash flows.

We and our Capcos do not generate any revenue for goods or services sold to the companies in which we invest. The companies in which the Capcos invest do provide services, and to a much lesser degree goods, to each other. However, the effect of such inter-company revenues and expenses are eliminated in the consolidated financial statements. We rely on the annual management fees of 2.5% of certified (initial) capital, as fixed by the Capco statutes and profits from non Capco operations as our contingent source of cash to cover some of our operating expenses. This covers all supportive services generally provided by us; however, the management fee is paid out of Capco cash on hand and is not set aside or reserved for payment out of the funds received by the Capcos. The management fee is protected and established by statute.

In order to make the Capco investments successful, and thus to fulfill the public policy objectives of the Capco programs, we have enhanced the Capco funding mechanism by offering management resources, technical, operational and professional expertise and non-Capco funds to the investee companies. Depending on the state Capco program and to the extent permitted by state law and regulation, the services can range from advice and assistance with strategic relationships to direct and daily involvement in policy making and management. For example, in the state of Louisiana the Capco is precluded from controlling the policy making, management and operations of the investee company and accordingly the Capcos only participate in the policy making of the company by exercising their rights under the terms of the investment.

Tax Credits: In return for the Capcos making investments in the targeted companies, the states provide tax credits, generally equal to funds invested in the Capco by the insurance companies that provide the funds to the Capcos. In order to maintain its status as a Capco and to avoid recapture or forfeiture of the tax credits, each Capco must meet a number of specific investment requirements, including a minimum investment schedule. The final loss of Capco status (i.e., decertification as a Capco) could result in loss or possible recapture of the tax credit. To protect against such losses, our Capcos have agreed with their funding insurance companies to provide, in the event of decertification, payments by the Capco or, as described below, by the Capco insurer to the insurance companies in the nature of compensatory payments to replace the lost tax credits.

Investment Requirements: Each of the state Capco programs has a requirement that a Capco, in order to maintain its certified status, must meet certain investment requirements, both qualitative and quantitative.

Quantitative Requirements: These include minimum investment amounts and time periods for investment of certified capital (the amount of the original funding of the Capco by the insurance companies). For example in the state of New York, a Capco must invest at least 25% of its certified capital by 24 months from the initial investment date, 40% by 36 months and 50% by 48 months. The minimum investment requirements and time periods, along with the related tax credit recapture requirements are set out in detail below. See: Management s Discussion and Analysis Income from Tax Credits and Note 1 to the Consolidated Financial Statements Revenue Recognition. The minimum requirements are calculated on a cumulative basis and allow the Capcos to receive a return of an investment and re-invest the funds for full additional credit towards the minimum requirements.

Table of Contents

Qualitative Requirements: These include limitations on the initial size of the recipients of the Capco funds, including the number of their employees, the location within the respective state of the recipients and the recipients commitment to remain therein for a specified period of time, the types of business conducted by the recipients, and the terms of the investments in the recipients. Most significant for our business is the fact that most of the Capco programs generally do not pose any obstacle to investments in qualified businesses which result in significant, majority or, in some cases, controlling ownership positions (the state of Louisiana precludes the Capco from taking controlling and majority ownership positions in investee companies). This enables us to achieve both public policy objectives of the Capco programs, of increasing the number of small businesses and job opportunities in the state, as well as our own objectives of developing a number of small business service companies which may become profitable and return a meaningful return both to our shareholders and to the local participants in the businesses. In addition, because the businesses that we invest in provide needed, and in management s judgment, cost effective goods and services to other small businesses, the growth of this important segment of a state s economy may be accelerated.

Investment Limitations: The states of Louisiana, Colorado, Texas and in the two most recent programs in New York (out of the 5 we have participated in) have had or recently added to their Capco programs limitations on the equity investment Capcos can make in qualified businesses. These programs or program changes seek to preclude a Capco from owning all or a majority of the voting equity of the invested business. While Newtek has in the past made use of the ability to make profitable majority-owned investments, we have also made minority or more passive investments in qualified businesses. Newtek s Capcos are in full compliance with these types of investment limitations and management foresees no significant difficulty in continuing to do so.

Enforcement of Requirements: The various states, which administer these programs through their insurance, banking or commerce departments, conduct periodic reviews and on site examinations of the Capcos in order to verify that the Capcos have met applicable investment requirements and are otherwise acting in conformance with the statutes and rules. Capcos are required to maintain detailed records so as to demonstrate to state examiners compliance with all applicable requirements. A failure of a Capco to meet one of the statutory minimum *quantitative* investment benchmarks within the time specified would constitute grounds for the loss of the Capco s status, or its decertification, and the loss and recapture of some or all of the tax credits previously passed through the Capco to its investors. A decertification of one of our Capcos would have a material adverse effect on our business in that it would require the Capco insurer to make compensatory payments equal to the lost tax credits and would permit the insurer to assume control over the assets of the Capco in order to cover its losses. Compliance with these requirements is reflected in contractual provisions of the agreements between each Capco and its investors. The Capcos covenant to their investors to use the funds only for investments as permitted by the Capco laws or for related expenses and to refrain from taking any action which would cause the Capco to fail to continue in good standing.

Compliance: As of the end of 2006, all of our Capcos were in compliance with all applicable requirements and our 15 operational and one managed Capco had met their final, minimum 50% investment thresholds. This eliminates any material risk of decertification and tax credit recapture or loss for its insurance company investors in these Capcos.

Insurance. The Capco notes require, as a condition precedent to the funding of the notes, that insurance be purchased to cover the risks associated with the operation of its Capcos. This insurance is purchased from American International Specialty Lines Insurance Company and National Union Fire Insurance Company of Pittsburgh, both subsidiaries of American International Group, Inc., (AIG) an international insurer. In order to comply with this condition to the funding, the closing on the Capco notes are structured as follows: (1) the investors wire the cash proceeds from the notes issuance directly into an escrow account (2) the escrow agent, pursuant to the requirements under the notes and escrow agreement, automatically and simultaneously funds the purchase of the Capco insurance from the proceeds received. We are not entitled to the use and benefit of the net proceeds received until the escrow agent has completed the purchase of the insurance. AIG and its subsidiaries noted above are AA+ rated by Standard & Poor s. Under the terms of this insurance, which is for the benefit of the investors, the Capco insurer incurs the primary obligation to repay the investors a substantial portion of the debt as well as to make compensatory payments in the event of a loss of the availability of the related tax credits. In the event of either a threat of or a final decertification by a state, the Capco insurer would be authorized to assume partial or complete control of the business of the particular Capco so as to ensure compliance with investment or other requirements. This would likely avoid final decertification and the necessity of insurance or cash payments in lieu of forfeited or recaptured tax credits. However, control by the Capco insurer would also result in significant disruption of the particular Capco s business and likely result in significant financial loss to that Capco. Decertification would also likely impair our ability to obtain certification for Capcos in additional states as new legislation makes other opportunities available. The Capcos are individually insured, and the assets of one are not at risk for the obligations of the others. AIG itself has not agreed to guarantee the obligations of its subsidiary insurers but has agreed to transfer the obligations to another of its subsidiaries if the insurers are down-rated.

Table of Contents

We have also made investments, usually smaller or in the form of debt, in a number of other companies. We are generally not actively involved in the management or day-to-day operations of companies in which our equity ownership and voting power is less than 25%. Instead, we offer these businesses advisory services or assistance with particular projects, as well as the collaborative services of our affiliated companies. In pursuing business objectives, we intend to hold a decreasing portion of our total assets in companies in which we have voting power of less than 25 percent.

Finally, a number of companies which we have invested in through our Capcos have proven to be unsuccessful for a variety of reasons. Such investments made by our Capcos in small and new businesses we expected to and have had a high failure rate. As these problems become apparent and are dealt with, we attempt to terminate the businesses or transfer the assets so as to preserve maximum value. While losses from these ventures have been present, they have not been of such a magnitude as to have a material effect on our overall profitability.

Government Regulation: Investment Company Act of 1940

Overview. Because of the nature of our business, our management has addressed the question of the application of the Investment Company Act of 1940, as amended (the Investment Company Act), to the business of Newtek. As discussed below, the application of the Investment Company Act to us would impose requirements and limitations that are materially inconsistent with our current and intended business strategy. However, with our increased investment focus on operating companies, management believes that concern for unintended holding company status has been decreased materially.

Companies that are publicly offered in the U.S. and which (1) are, or hold themselves out as being, engaged primarily or proposing to engage primarily in the business of investing, reinvesting or trading in securities, or (2) own or hold investment securities exceeding 40% of the value of their total assets (adjusted to exclude U.S. government securities and cash) and are engaged in the business of investing, reinvesting, owning, holding or trading in securities, are considered to be investment companies under the Investment Company Act. Unless an exclusion from registration were available or obtained by grant of a Securities and Exchange Commission (SEC) order, these companies must register under this Act and, thus, become subject to extensive regulation regarding several aspects of their operations.

The SEC has adopted Rule 3a-1 that provides an exclusion from registration as an investment company if a company meets both an asset and an income test and is not otherwise primarily engaged in an investment company business by, among other things, holding itself out to the public as such or by taking controlling interests in companies with a view to realizing profits through subsequent sales of these interests. A company satisfies the asset test of Rule 3a-1 if it has no more than 45% of the value of its total assets (adjusted to exclude U.S. government securities and cash) in the form of securities other than interests in majority owned subsidiaries and companies which it primarily and actively controls. A company satisfies the income test of Rule 3a-1 if it has derived no more than 45% of its net income for its last four fiscal quarters combined from securities other than interests in majority owned subsidiaries and primarily and actively controlled companies.

Our business strategy and business activities focus upon participating actively in their management and development of the businesses we invest in. We believe that this strategy and the scope of our business activities would not cause us to fall within the definition of an investment company or, if so, provide us with a basis for an exclusion from the definition of an investment company under the Investment Company Act.

Government Regulation: State Capco Regulations

Each of the states which operate Capco tax credit programs have established administrative mechanisms to monitor compliance with the requirements of the programs, to verify that the Capcos have met applicable minimum investment requirements and are otherwise acting in conformance with the statutes and rules. Requirements include limitations on the initial size of the recipients of the Capco funds, including the number of their employees, the location within the respective state of the recipients and the recipients commitment to remain therein for a specified period of time, the types of business conducted by the recipients, and the terms of the investments in the recipients. Capcos are required to maintain detailed records so as to demonstrate to state examiners compliance with all applicable requirements. Contrary to other programs, the regulatory requirements applicable to Capcos are, generally, limited to the minimum investment requirements. The Capcos we operate are currently in full compliance with all applicable requirements and management anticipates no difficulty in maintaining that status in the future.

Government Regulation: Sarbanes-Oxley Act of 2002

On July 30, 2002, the President of the United States signed the Sarbanes-Oxley Act of 2002 into law. The Sarbanes-Oxley Act provides for sweeping changes with respect to corporate governance, accounting policies and disclosure requirements for public companies, and also for their directors and officers. Section 302 of the Sarbanes-Oxley Act (Corporate Responsibility for Financial Reports) required the SEC to adopt new rules to implement the requirements of the Sarbanes-Oxley Act. These requirements include new financial reporting requirements and rules concerning corporate

governance. New SEC rules require a reporting company s chief executive and chief financial officers to certify certain financial and other information included in our quarterly and annual reports. The rules also require these officers to certify that they are responsible for establishing, maintaining and regularly evaluating the effectiveness of our disclosure controls and procedures; that they have made certain disclosures to the auditors and to the audit committee of the board of directors about our controls and procedures; and that they have included information in their quarterly and annual filings about their evaluation and whether there have been significant changes to the controls and procedures or other factors which would significantly impact these controls. (See Section 9A for management s current assessment of related control matters).

See: Certifications for certifications by Newtek s Chief Executive Officer and Chief Financial Officer of the financial statements and other information included in this Annual Report on Form 10-K. The certifications required by Section 906 of the Sarbanes-Oxley Act also accompany this Form 10-K.

Employees

As of December 31, 2006, we and the companies in which we hold a controlling interest had approximately 382 employees, independent representatives and contract employees. We believe our labor relations are good and none of its employees are covered by a collective bargaining agreement. All of our employees with access to customer or sensitive information and, where appropriate consultants, have executed confidentiality agreements and it is our policy to require all new employees to do so as well.

Confidentiality Agreements

All our employees have signed confidentiality agreements, and it is our standard practice to require newly hired employees and, when appropriate, independent consultants, to execute confidentiality agreements. These agreements provide that the employee or consultant may not use or disclose confidential information except in the performance of his or her duties for the company, or in other limited circumstances. The steps taken by us may not, however, be adequate to prevent the misappropriation of our proprietary rights or technology.

Revenues and Assets by Geographic Area

During the years ended December 31, 2006, 2005, and 2004 all of our revenue was derived from customers in the United States.

Available Information

We are subject to the informational requirements of the Securities Exchange Commission and in accordance with those requirements file reports, proxy statements and other information with the Securities and Exchange Commission. You may read and copy the reports, proxy statements and other information that we file with the Commission under the informational requirements of the Securities Exchange Act at the Commission s Public Reference Room at 450 Fifth Street N.W., Washington, DC 20549. Please call 1-800-SEC-0339 for information about the Commission s Public Reference Room. The Commission also maintains a web site that contains reports, proxy and information statements and other information regarding registrants that file electronically with the Commission. The address of the commission s web site is http://www.sec.gov. Our web site is http://www.newtekbusinesservices.com. We make available through our web site, free of charge, our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q. Current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, as soon as reasonably practicable after we electronically file such material with, or furnish it to, the Commission. Information contained on our web site is not a part of this report.

Item 1A RISK FACTORS

If any of the following risks occur, our business, financial condition and results of operations could be materially and adversely affected. In that case, the value of our common shares could decline and stockholders may lose all or part of their investment. The risks set out below are not the only risks we face.

Table of Contents

RISKS RELATING TO OUR BUSINESS GENERALLY

Our business focuses on the investment in and acquisition of small businesses, which typically have a high rate of failure, may take some time to become profitable and may never become profitable.

We have placed emphasis on the investment in and acquisition of small businesses with the objective of developing a network of profitable businesses, most of which will principally serve the small and medium-sized business market. Early stage businesses historically have a higher rate of failure than larger businesses, and many that do not fail will have only limited profitability. Moreover, profit generated by any of our majority-owned companies or other investments could be offset by losses generated by others. Our profitability resulting from the operations of our businesses may be delayed for the foreseeable future.

We have generated and carry goodwill as an asset resulting from some of our acquisition transactions. In 2005, management wrote down the value of goodwill by approximately $878,000, all related to the Capco segment. We can make no assurance that our current or future additional goodwill will not be written down pursuant to applicable accounting standards. A significant write down of a major asset, such as goodwill, could have a material adverse effect on our business, a negative impact on earnings and the value of our common shares.

Each of our major investments and affiliated companies may be impacted by a variety of adverse economic, governmental, industrial and internal company factors unique to that business and outside our control. If our investments and affiliated companies do not succeed in overcoming these adverse factors, the value of our assets and the price of our shares would fall.

In the past few years we have increasingly concentrated our investments in companies participating in small business lending, electronic payment processing, web hosting and insurance. Each of these businesses has numerous risks associated with them and you should read the specific risk factors set forth below with respect to each of these businesses.

As we have concentrated our investments in companies which are part of our nationwide marketing strategy of providing a variety of services to small and medium-sized businesses, our exposure and that of our affiliated companies to risks specific to these business lines has increased. We discuss below some of the risks of our significant operations in government-guaranteed small business lending, acting as an independent sales organization in the electronic card processing business, web hosting business and operating as an insurance agency. If we are not successful in implementing this business strategy and developing and marketing our new products and services, our results of operations will be negatively impacted.

If we do not manage our growth effectively, our financial performance could be harmed.

Our rapid revenue growth has placed, and will continue to place, certain pressures on our management, administrative, operational and financial infrastructure. As we continue to grow our business, such growth could require capital, systems development and human resources beyond current capacities. As evidence of our internal growth, on December 31, 2001, we and all of our consolidated and majority-owned affiliates had approximately 20 employees, and on December 31, 2006 we had approximately 382 employees and independent contractors. The increase in the size of our operations may make it more difficult for us to ensure that we execute our present businesses and future strategies. The failure to manage our growth effectively could have a material adverse effect on our financial condition, results of operations and cash flows.

If we are unable to obtain the resources required for the growth and development of our affiliated companies, they will be highly susceptible to failure, which would directly affect our profitability and value.

Early-stage businesses often fail due to their limited capital and human resources. The effective implementation of our business model is dependent upon the ability of the affiliated companies, with assistance from us, to arrange for the managerial, capital and other resources which they usually require in order to become and remain profitable.

We may not be able to integrate acquired companies into our company and, as we acquire more and larger interests in affiliated companies, our resources available to assist our affiliated companies may be insufficient.

We have made strategic acquisitions and we intend to continue to make acquisitions in accordance with our business plan. Each acquisition involves a number of risks, including:

the diversion of our management s attention to the assimilation and ongoing assistance with the operations and personnel of the acquired business, which could strain the management resources we have available;

the potential for our affiliated companies to grow rapidly and adversely affect our ability to assist our affiliated companies as intended;

possible adverse effects on our results of operations and cash flows; and

16

Table of Contents

possible inability by us to achieve the intended objective of the acquisition.

Any strain on our ability to assist our affiliated companies as intended or to acquire and integrate businesses under our business plan could have a negative impact on our operations, financial results and cash flows.

Our business may be adversely affected by the highly regulated industries in which we operate.

Many of the industries in which we operate are highly regulated and we cannot assure you that we or our affiliated companies are, or that we will continue to be, in full compliance with current laws, rules and regulations. If we or our affiliated companies are unable to comply with applicable laws or regulations or if new laws limit or eliminate some of the benefits of our business lines, our financial condition, results of operations and our cash flows could be materially adversely affected.

Our method of income recognition derived from the Capco tax credits causes most of such income to be received in the first five years of the programs. In the absence of income from our investments or other sources, we would sustain material losses in later years.

In our Capco programs we recognize the majority of our income from the tax credits in the early years of the programs because income recognition is tied to the schedule by which the tax credits become irrevocable and beyond recapture (approximately five years). We recognize the majority of our income from an average ten year Capco programs in the first five years and will not be recognizing significant tax credit income in the latter part of the program. However, we will continue to incur costs for the administration of the Capcos and (non-cash) interest expense on the Capco notes and amortization of the prepaid insurance. In the absence of income from other sources, such as our investments in small businesses and affiliated companies, our income would decrease materially and we will likely sustain material losses in the later years of the programs and in particular in 2007 and 2008.

Our success depends upon our ability to enforce and maintain our intellectual property rights.

Our success depends, in significant part, on the proprietary nature of our technology, including both patentable and non-patentable intellectual property related to our Newtracker referral system. We have filed a patent application with the United States Patent office but there can be no assurance that such patent will be granted. To the extent that a competitor is able to reproduce or otherwise capitalize on our technology, it may be difficult, expensive or impossible for us to obtain necessary legal protection. In addition to patent protection of intellectual property rights, we consider elements of our product designs and processes to be proprietary and confidential. We rely upon employee, consultant and vendor non-disclosure agreements and contractual provisions and a system of internal safeguards to protect our proprietary information. However, any of our registered or unregistered intellectual property rights may be challenged or exploited by others in the industry, which might harm our operating results. We have several trademarks which are of material importance to us. Litigation, which could result in substantial cost to and diversion of our efforts, may be necessary to enforce trademarks issued to us or to determine the enforceability, scope and validity of the proprietary rights of others. Adverse determinations in any litigation or interference proceeding could subject us to costs related to changing names and a loss of established brand recognition.

Our affiliated companies depend upon the ability to utilize the Internet for the conduct of a significant portion of their business; disruption to that system could make it impossible for them to continue to conduct their current businesses.

Possible disruption to the normal functioning of the Internet through, for example, power failure or terrorist sabotage, could make it impossible for aspects of the lending, electronic payment processing, web hosting and in fact our referral system to function. Each of our businesses have addressed the possibilities of short term disruptions and planned accordingly. However, in the event of a major disruption, and assuming that the disruptions would be long lived, we would be required to make extensive changes in the way these companies do business. There is no assurance that we will have the time and resources to make these changes.

We and our affiliated companies depend on our ability to attract and retain key personnel and any loss of ability to attract these personnel could adversely affect us.

Our success depends upon the ability of our affiliated companies and other investments to attract and retain qualified personnel and our ability to supplement those capabilities with our senior management personnel. Competition for qualified employees is intense. If our affiliated companies lose the services of key personnel, or are unable to attract additional qualified personnel, the business, financial condition, results of operations and cash flows of us or one or more of our affiliated companies could be materially adversely affected. It can take a significant period of time to identify and hire personnel with the combination of skills and attributes required in carrying out our strategy.

Table of Contents

Our business relies heavily on the expertise of our senior management, particularly Messrs. Barry Sloane, Michael J. Holden and Jeffrey G. Rubin, our CEO, CFO and President, respectively. Messrs. Sloane and Rubin currently serve pursuant to employment agreements which expire on December 31, 2007. The loss of the services of these individuals could have a material adverse effect on our financial condition, results of operations and cash flows and it is likely that it will be difficult to find adequate replacements.

Our success depends on our ability to compete effectively in the highly competitive industries in which we operate.

We face intense competition in organizing Capcos, originating SBA loans, processing electronic payments and offering insurance, as well as in the other industries in which we or our affiliated companies operate. Low barriers to entry often result in a steady stream of new competitors entering certain of these businesses. Current and potential competitors are or may be better established, substantially larger and have more capital and other resources than we do. If we expand into additional geographical markets, we will face competition from others in those markets as well.

Our success also depends on our ability to use effectively our electronic referral and processing system.

We have developed an electronic referral and processing system for the applications necessary for the sales of each of our business lines other than web site hosting. This system is critical to our ability to process such business with a low cost advantage and to obtain referrals from our alliance partners. In particular, their ability to access the referral system and to track the progress of a referred customer is a major feature of the perceived attractiveness of our system. If this referral system should develop problems which we cannot address, it would have a material negative impact on our business strategy.

A major feature of our business strategy is the development of opportunities for our service and product provider businesses to market to the customers of our other business lines and to the customer bases of our alliance partners.

Although our business strategy contemplates the referral of prospects between wholly-owned and partially owned companies in our network, there is no history of such cross-selling and there can be no assurances that any effort to make referrals across our network of affiliated companies will result in additional revenue opportunities. In order for our referral network to achieve the desired result, each of the constituent companies must have proper incentives and feel comfortable making such introduction, and furthermore, the service provider receiving such referral must properly service such referred client. In addition, our marketing alliances are terminable and, if we make serious errors or fail to produce sufficient revenues for our alliance partners, we are at risk of losing these relationships.

The inability of any one of our business segments to service customers adequately referred to it from within our other companies could impair our overall relationship with such customers.

A significant benefit of our structure and strategy is the ability to cross market between our SBA, electronic payment processing and other business customers, however, should the business relationship between one of our business segments and customers deteriorate for any reason, such customers may opt to withdraw their business from our other businesses. Such a loss of business could negatively impact our results of operations and cash flows.

We rely on information processing systems, and our strategy of cross marketing to customers among our majority-owned subsidiaries will increase this reliance; the interruption, loss or failure of which would materially and adversely affect our business.

Our ability to provide business services depends, and will increasingly depend, on our capacity to store, retrieve, process and manage significant amounts of data and expand and upgrade our information processing capabilities. Interruption or loss of our information processing capabilities through loss of stored data, breakdown or malfunctioning of computer equipment and software systems, telecommunications failure or damage caused by acts of god or other disruption, could have a material adverse effect on our business, financial condition, results of operations and cash flows. Although we have disaster recovery procedures in place and insurance to protect against such contingencies, we cannot be certain that our disaster recovery systems or insurance will continue to be available at reasonable prices to cover all our losses or compensate us for the possible loss of clients occurring during any period that we are unable to provide outsourced business services.

RISKS RELATING TO OUR SBA LENDING BUSINESS

We may be adversely affected by the regulated environment in which we operate.

The activities of our SBA lending business are subject to the supervision and regulation by the federal government and to a lesser degree the state governments, as well as various laws and judicial and administrative decisions. Our possible inability to remain in compliance with these multiple requirements could result in the revocation or suspension of our license or the imposition of fines and penalties.

Table of Contents

We have specific risks associated with small business administration loans.

We have generally sold the guaranteed portion of SBA loans in the secondary market. There can be no assurance that we will be able to continue originating these loans, or that a secondary market will exist for, or that we will continue to realize premiums upon the sale of, the guaranteed portions of the SBA loans.

We believe that our SBA loan portfolio does not involve more than a normal risk of collection. However, since we sell the guaranteed portion of substantially our entire SBA loan portfolio, we incur credit risk on the non-guaranteed portion of the SBA loans. We share pro rata with the SBA in any recoveries. In the event of default on an SBA loan, our pursuit of remedies against a borrower is subject to SBA approval, and where the SBA establishes that its loss is attributable to deficiencies in the manner in which the loan application has been prepared and submitted, the SBA may decline to honor its guarantee with respect to our SBA loans or it may seek the recovery of damages from us. If we should experience significant problems with our underwriting of SBA loans, such failure to honor a guarantee or the cost to correct the problems could have a material adverse effect on us. Although the SBA has never declined to honor its guarantees with respect to SBA loans made by us since our acquisition of the lender, no assurance can be given that the SBA would not attempt to do so in the future.

Curtailment of the government guaranteed loan programs could cut off an important segment of our business.

There can be no assurance that the federal government will maintain the SBA program, or that it will continue to guarantee loans at current levels. If we cannot continue making and selling government guaranteed loans, we will generate fewer origination fees and our ability to generate gains on sale of loans will decrease. From time to time, the government agencies that guarantee these loans reach their internal budgeted limits and cease to guarantee loans for a stated time period. In addition, these agencies may change their rules for loans. Also, Congress may adopt legislation that would have the effect of discontinuing or changing the programs. Non-governmental programs could replace government programs for some borrowers, but the terms might not be equally acceptable. If these changes occur, the volume of loans to small business and industrial borrowers of the types that now qualify for government guaranteed loans could decline, as could the profitability of these loans.

Changing interest rates may reduce our income from lending.

Fluctuations in general economic conditions and in interest rates may affect customer demand for our loans and other products and services as well as the performance of our existing portfolio. Our lending business may increase during times of falling interest rates and, conversely, decrease during times of significantly higher interest rates. Significant fluctuations in interest rates and loan demand could have a potentially adverse effect on our results of operations and cash flows.

An increase in non-performing assets would reduce our income and increase our expenses.

If our level of non-performing assets in our SBA lending business rises in the future, it could adversely affect our revenue and earnings. Non-performing assets are primarily loans on which borrowers are not making their required payments. Non-performing assets also include loans that have been restructured to permit the borrower to have smaller payments and real estate that has been acquired through foreclosure of unpaid loans. To the extent that our loan assets are non-performing, we will have less cash available for lending and other activities.

Our reserve for credit losses may not be sufficient to cover unexpected losses.

Our business depends on the behavior of our customers. We believe that our credit underwriting procedures are sufficient to protect us against all but the most unexpected events. In addition to our credit practices and procedures we maintain a reserve for credit losses on our SBA loans which management has judged to be adequate given the loans we make. We periodically review our reserve for adequacy considering current economic conditions and trends, collateral values, charge-off experience, levels of past due loans and non-performing assets and adjust our reserve accordingly. However, based on the increased volume in recent originated loans, along with changes in the credit quality of our customers, our reserves could materially be impacted thus affecting our financial condition and results of operations.

We compete with numerous financing sources.

We compete for our customers primarily on the basis of pricing, terms and service. Competition from both traditional lenders and new entrants is intense due to the recent strong economy and the ease with which the securitization process has increased the access to capital. While we have attempted to utilize our referral system as a means of obtaining customers at a low cost and processing the applications efficiently, there can be no assurance that we will be able to match the terms of our competitors without incurring losses. In addition, due to our relatively small size and capitalization, our larger competitors may be able to make loans when we are not due to our dependence on external warehouse financing.

19

Table of Contents

We could be adversely affected by weakness in the residential market.

Weakness in residential home values could impair our ability to collect on defaulted SBA loans as residential real estate is pledged in many of our SBA loans as part of the collateral package.

RISKS RELATING TO OUR ELECTRONIC PAYMENT PROCESSING BUSINESS

We rely currently on a single bank sponsor, which has substantial discretion with respect to certain elements of our business practices, in order to process bankcard transactions. If this sponsorship is terminated and we are not able to secure or migrate merchant portfolios to new bank sponsors, we will not be able to conduct our electronic payment processing business.

Because we are not a bank, we are unable to belong to and directly access the Visa and MasterCard bankcard associations. The Visa and MasterCard operating regulations require us to be sponsored by a bank in order to process bankcard transactions. We are currently registered with Visa and MasterCard through the sponsorship of one bank that is a member of the card associations. If this sponsorship is terminated and we are unable to secure a bank sponsor, we will not be able to process bankcard transactions. Furthermore, our agreement with our sponsoring bank gives the sponsoring bank substantial discretion in approving certain elements of our business practices, including our solicitation, application and qualification procedures for merchants, the terms of our agreements with merchants, the processing fees that we charge, our customer service levels and our use of independent sales organizations. We cannot guarantee that our sponsoring bank s actions under these agreements will not be detrimental to us.

If we or our processors or bank sponsor fail to adhere to the standards of the Visa and MasterCard bankcard associations, our registrations with these associations could be terminated and we could be required to stop providing payment processing services for Visa and MasterCard.

Substantially all of the transactions we process involve Visa or MasterCard. If we, our bank sponsor or our processors fail to comply with the applicable requirements of the Visa and MasterCard bankcard associations, Visa or MasterCard could suspend or terminate our registration. The termination of our registration or any changes in the Visa or MasterCard rules that would impair our registration could require us to stop providing payment processing services, which would have a material adverse effect on our business.

We and our electronic payment processing subsidiaries rely on other card payment processors and service providers. If they no longer agree, or are unable, to provide their services, our merchant relationships could be adversely affected and we could lose business.

Our electronic payment processing business relies on agreements with several other large payment processing organizations to enable us to provide card authorization, data capture, settlement and merchant accounting services and access to various reporting tools for the merchants we serve. We also rely on third parties to whom we outsource specific services, such as reorganizing and accumulating daily transaction data on a merchant-by-merchant and card issuer-by-card issuer basis and forwarding the accumulated data to the relevant bankcard associations. Many of these organizations and service providers are our competitors. The termination by our service providers of these arrangements with us or their failure to perform these services efficiently and effectively may adversely affect our relationships with the merchants whose accounts we serve and may cause those merchants to terminate their processing agreements with us.

On occasion, we experience increases in interchange and sponsorship fees. If we cannot pass these increases along to our merchants, our profit margins will be reduced.

Our electronic payment processing subsidiaries pay interchange fees or assessments to bankcard associations for each transaction we process using their credit, debit and gift cards. From time to time, the bankcard associations increase the interchange fees that they charge processors and the sponsoring banks. At their sole discretion, our sponsoring banks have the right to pass any increases in interchange fees on to us. In addition, our sponsoring banks may increase their Visa and MasterCard sponsorship fees, all of which are based upon the dollar amount of the payment transactions we process. If we are not able to pass these fee increases along to merchants through corresponding increases in our processing fees, our profit margins in this line of business will be reduced.

Unauthorized disclosure of merchant or cardholder data, whether through breach of our computer systems or otherwise, could expose us to liability and business losses.

Through our electronic payment processing subsidiaries, we collect and store sensitive data about merchants and cardholders and we maintain a database of cardholder data relating to specific transactions, including payment, card numbers

20

Table of Contents

and cardholder addresses, in order to process the transactions and for fraud prevention and other internal processes. If anyone penetrates our network security or otherwise misappropriates sensitive merchant or cardholder data, we could be subject to liability or business interruption. We cannot guarantee that our systems will not be penetrated in the future. If a breach of our system occurs, we may be subject to liability, including claims for unauthorized purchases with misappropriated card information, impersonation or other similar fraud claims. Similar risks exist with regard to the storage and transmission of such data by our processors.

We have potential liability if our merchants refuse or cannot reimburse charge-backs resolved in favor of their customers.

If a billing dispute between a merchant and a cardholder is not ultimately resolved in favor of the merchant, the disputed transaction is charged back to the merchant s bank and credited to the account of the cardholder. If we or our processing banks are unable to collect the charge-back from the merchant s account, or if the merchant refuses or is financially unable due to bankruptcy or other reasons to reimburse the merchant s bank for the charge-back, we bear the loss for the amount of the refund paid to the cardholder s bank.

We face potential liability for customer or merchant fraud.

Credit card fraud occurs when a merchant s customer uses a stolen card (or a stolen card number in a card-not-present transaction) to purchase merchandise or services. In a traditional card-present transaction, if the merchant swipes the card, receives authorization for the transaction from the card issuing bank and verifies the signature on the back of the card against the paper receipt signed by the customer, the card issuing bank remains liable for any loss. In a fraudulent card-not-present transaction, even if the merchant receives authorization for the transaction, the merchant is liable for any loss arising from the transaction. Many of our business customers are small and transact a substantial percentage of their sales over the Internet or by telephone or mail orders. Because their sales are card-not-present transactions, these merchants are more vulnerable to customer fraud than larger merchants and we could experience charge-backs arising from cardholder fraud more frequently with these merchants.

Merchant fraud occurs when a merchant, rather than a customer, knowingly uses a stolen or counterfeit card or card number to record a false sales transaction or intentionally fails to deliver the merchandise or services sold in an otherwise valid transaction. Anytime a merchant is unable to satisfy a charge-back, we are responsible for that charge-back. We have established systems and procedures to detect and reduce the impact of merchant fraud, but we cannot assure you that these measures are or will be effective. Failure to manage effectively risk and prevent fraud could increase our charge-back liability.

Our payment processing systems may fail due to factors beyond our control, which could interrupt our business or cause us to lose business and likely increase our costs.

We depend on the uninterrupted operations of our computer network systems, software and our processors data centers. Defects in these systems or damage to them due to factors beyond our control, and notwithstanding any redundant systems we develop and implement, could cause severe disruption to our business and other material adverse effects on our payment processing businesses.

RISKS RELATING TO OUR OPERATION OF A WEBSITE HOSTING BUSINESS

CrystalTech operates in a competitive industry where technological change can be rapid.

The website hosting business and its related technology involve a broad range of rapidly changing technologies. CrystalTech s equipment and the technologies on which it is based may not remain competitive over time, and others may develop superior technologies that render CrystalTech s products non-competitive without significant additional capital expenditures.

The website hosting industry is highly competitive and we may be unable to compete effectively.

The website hosting industry is highly competitive, rapidly evolving, and subject to intense marketing by providers with similar products and services. Some of our potential competitors are significantly larger and have substantially greater market presence as well as greater financial, technical, operational, marketing and other resources and experience than we do. In the event that such a competitor expends significant sales and marketing resources in one or several markets we may not be able to compete successfully in such markets. We believe that competition will continue to increase, placing downward pressure on prices. Such pressure could adversely affect our gross margins if we are not able to reduce our costs commensurate with such price reductions. In addition, some of our competitors may offer free or substantially reduced services. Although we believe that our customer and service and support will provided differentiation from any such free services, there can be no assurances that we will in fact be able to continue to be competitive.

21

Table of Contents

Our website hosting business depends on the efficient and uninterrupted operation of its computer and communications hardware systems and infrastructure.

Despite precautions taken by CrystalTech against possible failure of its systems, interruptions could result from natural disasters, power loss, the inability to acquire fuel for our backup generators, telecommunications failure, terrorist attacks and similar events. CrystalTech also leases telecommunications lines from local, regional and national carriers whose service may be interrupted. CrystalTech s business, financial condition and results of operations could be harmed by any damage or failure that interrupts or delays our operations and cash flows. CrystalTech currently does not have insurance covering such contingencies, although it is in the process of obtaining such coverage. There can be no assurance that CrystalTech will be able to obtain insurance to protect against such contingencies at reasonable prices, to cover all its losses or compensate CrystalTech for the possible loss of clients occurring during any period that CrystalTech is unable to provide service.

Service interruptions due to malicious attacks could result in a loss of revenues and harm CrystalTech s reputation.

Our networks have all the network infrastructure to mediate risks of unauthorized entry by malicious hackers. On occasion, hackers have managed to penetrate our network infrastructure for a short time before being detected. There can be no assurance that we will continue to be able to successfully address such threats. Any future network shut downs can have a significant negative impact on revenue and cash flows, as well as harm our reputation.

Of primary importance to our website hosting customers is the integrity of our infrastructure and the privacy of confidential information.

CrystalTech s infrastructure is potentially vulnerable to physical or electronic break-ins, viruses or similar problems. If a person circumvents CrystalTech s security measures, he or she could jeopardize the security of confidential information stored on CrystalTech s systems, misappropriate proprietary information or cause interruptions in CrystalTech s operations. We may be required to make significant additional investments and efforts to protect against or remedy security breaches. Security breaches that result in access to confidential information could damage our reputation and expose us to a risk of loss or liability. The security services that CrystalTech offers in connection with customers networks cannot assure complete protection from computer viruses, break-ins and other disruptive problems. Although CrystalTech attempts to limit contractually its liability in such instances, the occurrence of these problems may result in claims against CrystalTech or us or liability on our part. These claims, regardless of their ultimate outcome, could result in costly litigation and could harm our business and reputation and impair CrystalTech s ability to attract and retain customers.

Our business depends on Microsoft Corporation and others for the licenses to use software as well as other intellectual property in the website hosting business.

CrystalTech s website hosting business is built on a technological platform relying on the Microsoft Windows® products and other intellectual property that CrystalTech currently licenses. As a result, if we are unable to continue to have the benefit of those licensing arrangements or if the products upon which CrystalTech s platform is built become obsolete, our business could be materially and adversely affected.

We depend on the services of a few key personnel in managing its website hosting business, and the loss of one or more of them could materially impair its ability to maintain current levels of customer service and the proper technical operations of its business.

We depend upon the continued management of the operations of CrystalTech s website hosting business by its President and Chief Operating Officer, along with three or four other individuals to supervise CrystalTech s technical operations and the customer technical service response. If we were to lose the services of one or more of these persons and were unable to replace them expeditiously, our website hosting business could be significantly diminished.

RISKS RELATING TO OUR INSURANCE AGENCY BUSINESS

We cannot assure that the insurance services we plan to offer will be price competitive or accepted by our customers.

Despite our efforts to design, market and deliver integrated services to our customers, our proposed new services may not be widely accepted and we may not be able to compete with other larger and better capitalized providers of such services.

22

Table of Contents

We depend on third parties, particularly property and casualty insurance companies, to supply the products marketed by our agents.

Our contracts with property and casualty insurance companies typically provide that the contracts can be terminated by the supplier without cause. Our inability to enter into satisfactory arrangements with these suppliers or the loss of these relationships for any reason would adversely affect the results of our new insurance business.

Termination of our professional liability insurance policy may adversely impact our financial prospects and our ability to continue our relationships with insurance companies.

We must maintain professional liability insurance in connection with the operation of this business. If we lose this insurance, it is unlikely that our relationships with insurance companies would continue.

If we fail to comply with government regulations, our insurance agency business could be adversely affected.

Our insurance agency business is subject to comprehensive regulation in the various states in which we plan to conduct business. Our success will depend in part upon our ability to satisfy these regulations and to obtain and maintain all required licenses and permits. Our failure to comply with any statutes and regulations could have a material adverse effect on us. Furthermore, the adoption of additional statutes and regulations, changes in the interpretation and enforcement of current statutes and regulations or the expansion of our business into jurisdictions that have adopted more stringent regulatory requirements than those in which we currently conduct business could have a material adverse effect on us.

We do not have any control over the commissions our insurance agency expects to earn on the sale of insurance products which are based on premiums and commission rates set by insurers and the conditions prevalent in the insurance market.

Our insurance agency earns commissions on the sale of insurance products. Commission rates and premiums can change based on the prevailing economic and competitive factors that affect insurance underwriters. In addition, the insurance industry has been characterized by periods of intense price competition due to excessive underwriting capacity and periods of favorable premium levels due to shortages of capacity. We cannot predict the timing or extent of future changes in commission rates or premiums or the effect any of these changes will have on the operations of our insurance agency.

RISKS RELATED TO OUR CAPCO BUSINESS

Because our Capcos are subject to minimum investment and other requirements under state law, a failure of any of them to meet these requirements could subject the Capco and our shareholders to the loss of one or more Capcos.

Involuntary decertification of all or substantially all of our Capcos would result in material loss to us and our shareholders. A key requirement in order to maintain Capco certification is that a Capco must comply with minimum investment schedules that benchmark both the timing and type of required investments. Although to date we have met all applicable benchmarks, we may not do so in the future. A final involuntary loss of Capco status, referred to as a decertification as a Capco, will result in a loss of the tax credits for us and our insurance company investors; it would also enable the Capco insurer, which has the obligation to make compensatory payments to offset the lost tax credits, to take control of one or more Capcos and manage or liquidate the Capco investments to offset its losses. This would deprive us of the value of the investments and make participation in future Capco programs highly unlikely.

The Capco programs and the tax credits they provide are created by state legislation, and such laws are subject to possible action to repeal or retroactively revise the programs for political, economic or other reasons. Such an attempted repeal or revision would create substantial difficulty for the Capco programs and could, if ultimately successful, cause us material financial harm.

The tax credits associated with the Capco programs and provided to our Capcos investors are to be utilized by the investors over a period of time, typically ten years. Much can change during such a period and it is possible that one or more states may revise or eliminate the tax credits. Any such revision or repeal could have a material adverse economic impact on our Capcos, either directly or as a result of the Capco s insurer s actions. During 2002 a single legislator in Louisiana did introduce such a proposed bill, on which no action was taken, and in Colorado in 2003 and 2004 bills to modify (not repeal) its Capco program were introduced; the 2003 Colorado legislation was defeated in a legislative committee. The 2004 Colorado legislation was adopted and as a result, in 2004 our Colorado Capco initiated a lawsuit regarding some of the provisions of these amendments and the implementing regulations which we believe increased the cost of doing business by the Capco, but would have no further material effects. We reached a settlement with the State of Colorado in 2006 after incurring expenses in connection with such action. There can be no assurance that we will not be subject to further legislative action which might adversely impact our Capco business, or that we will be able to successfully challenge any such legislation.

Table of Contents

In the event of a threat of decertification by a state, the Capco insurer is authorized to assume partial or complete control of a Capco which would likely result in financial loss to the Capco and possibly us and our shareholders.

Under the terms of insurance policies purchased by all but one of our Capcos for the benefit of the investors, the Capco insurer is authorized, in the event of a formal written threat of decertification by a state and absent appropriate corrective action by the Capco, to assume partial or complete control of a Capco in order to avoid final decertification and the requirement to pay compensatory interest to the certified investors under the policies. While avoiding final decertification, control by the insurer would result in significant disruption of the Capco s business and likely result in financial loss to the Capco and our business.

The Capco programs and the tax credits they provide are created by state legislation, and such laws are subject to possible action to repeal or retroactively revise the programs for political, economic or other reasons. Such an attempted repeal or revision would create substantial difficulty for the Capco programs and could, if ultimately successful, cause us material financial harm.

The tax credits associated with the Capco programs and provided to our Capcos investors are to be utilized by the investors over a period of time, typically ten years. Much can change during such a period and it is possible that one or more states may revise or eliminate the tax credits. Any such revision or repeal could have a material adverse economic impact on our Capcos, either directly or as a result of the Capco s insurer s actions. During 2002 a single legislator in Louisiana did introduce such a proposed bill, on which no action was taken, and in Colorado in 2004 legislation was defeated in a legislative committee. The 2004 Colorado legislation and the implementing regulations were adopted, which we believe increased the cost of doing business by the Capco but would have no further material effects. We initiated a lawsuit but reached a settlement with the State of Colorado in 2006 after incurring expenses in connection with such action. There can be no assurance that we will not be subject to further legislative action which might adversely impact our Capco business, or that we will be able to successfully challenge any such legislation.

RISKS RELATING TO OUR COMMON SHARES

Two of our shareholders, both of whom are executive officers, beneficially own approximately 27% of our common shares, and are able to exercise significant influence over the outcome of most shareholder actions.

Because of their ownership of our shares, Messrs. Sloane and Rubin will be able to have significant influence over actions requiring shareholder approval, including the election of directors, the adoption of amendments to the certificate of incorporation, approval of stock incentive plans and approval of major transactions such as a merger or sale of assets. This could delay or prevent a change in control of our company, deprive our shareholders of an opportunity to receive a premium for their shares of common shares as part of a change in control and have a negative effect on the market price of our common shares.

Future issuances of our common shares or other securities, including preferred shares, may dilute the per share book value of our common shares or have other adverse consequences to our common shareholders.

Our board of directors has the authority, without the action or vote of our shareholders, to issue all or part of the approximately 19,000,000 authorized but unissued shares of our common shares. Our business strategy relies upon investment in and acquisition of businesses using the resources available to us, including our common shares. We have made acquisitions during each of the years from 2002 to 2005 involving the issuance of our common shares, and we expect to make additional acquisitions in the future using our common shares. Additionally, we anticipate granting additional options or restricted stock awards to our employees and directors in the future. We may also issue additional securities, through public or private offerings, in order to raise capital to support our growth, including in connection with possible acquisitions or in connection with purchases of minority interests in affiliated companies or Capcos. Future issuances of our common shares will dilute the percentage of ownership interest of current shareholders and could decrease the per share book value of our common shares. In addition, option holders may exercise their options at a time when we would otherwise be able to obtain additional equity capital on more favorable terms.

Pursuant to our certificate of incorporation, our board of directors is authorized to issue, without action or vote of our shareholders, up to 1,000,000 shares of blank check preferred shares, meaning that our board of directors may, in its discretion, cause the issuance of one or more series of preferred shares and fix the designations, preferences, powers and relative participating, optional and other rights, qualifications, limitations and restrictions thereof, including the dividend rate, conversion rights, voting rights, redemption rights and liquidation preference, and to fix the number of shares to be included

Table of Contents

in any such series. The preferred shares so issued may rank superior to the common shares with respect to the payment of dividends or amounts upon liquidation, dissolution or winding-up, or both. In addition, the shares of preferred shares may have class or series voting rights.

The authorization and issuance of blank check preferred shares could have an anti-takeover effect detrimental to the interests of our shareholders.

Our certificate of incorporation allows our board of directors to issue preferred shares with rights and preferences set by the board without further shareholder approval. The issuance of shares of this blank check preferred shares could have an anti-takeover effect detrimental to the interests of our shareholders. For example, in the event of a hostile takeover attempt, it may be possible for management and the board to impede the attempt by issuing the preferred shares, thereby diluting or impairing the voting power of the other outstanding common shares and increasing the potential costs to acquire control of us. Our board has the right to issue any new shares, including preferred shares, without first offering them to the holders of common shares as they have no preemptive rights.

We have adopted a classified board of directors that could have an anti-takeover effect detrimental to the interests of our shareholders.

In 2006, our shareholders approved an amendment to the Company s Certificate of Incorporation to provide for the classification of the Board of Directors into three classes. This makes removal of current management and members of the Board more difficult. It could also have the effect of deterring potential interested parties from initiating proxy contests or from acquiring substantial blocks of our Common Shares.

We know of no other publicly-held company that sponsors and operates Capcos as a material part of its business. As such, there are, to our knowledge, no other companies against which investors may compare our Capco business, operations, results of operations and financial and accounting structures.

In the absence of any meaningful peer group comparisons for our Capco business, investors may have a difficult time understanding and judging the strength of our business. This, in turn, may have a depressing effect on the value of our shares.

Provisions of our certificate of incorporation and New York law place restrictions on our shareholders ability to recover from our directors.

As permitted by New York law, our amended and restated certificate of incorporation limits the liability of our directors for monetary damages for breach of a director s fiduciary duty except for liability in certain instances. As a result of these provisions and New York law, shareholders have restrictions and limitations upon their rights to recover from directors for breaches of their duties. In addition, our certificate of incorporation provides that we must indemnify our directors and officers to the fullest extent permitted by law.

We may not be able to comply in a timely manner with all of the recently enacted or proposed corporate governance requirements.

Beginning with the enactment of the Sarbanes-Oxley Act of 2002, in July 2002, a significant number of new corporate governance requirements have been adopted or proposed by the SEC and the NASDAQ Stock Market. Although we currently expect to comply with all current and future requirements, we may not be successful in complying with these requirements in the future. In addition, certain of these requirements may require us to make changes to our corporate governance.

ITEM 2. PROPERTIES.

We conduct our principal business activities in facilities leased from unrelated parties at market rates. Our headquarters are located in New York, New York. Our operating subsidiaries have properties which are material to the conduct of their business as noted below. In addition, our Capcos maintain offices in each of the states in which they operate.

Below is a list of our leased offices and space as of December 31, 2006 which are material to the conduct of our business:

Table of Contents

Location	Lease expiration	Annual Rent	Purpose	Approx. sq. ft
1440 Broadway New York, New York 10018	October 2015	$195,000(1)	Principal executive offices and NSBF	23,000
1125 W. Pinnacle Peak Phoenix, AZ 85027	January 2012	$215,000(2)	CrystalTech offices	15,000
744 North 4th St. Milwaukee, WI 53203	February 2009	$145,000(3)	NMS-WI offices	3,600
1627 K Street Washington D.C. 20006	April 2013	$123,000(4)	Newtek Insurance Agency offices	3,800

(1) This lease includes a period of free rent in 2007. Annual rent in 2008 is equal to $802,000 and is subject to gradual increase to $913,000 from years 2009 to 2015.
(2) This lease is subject to gradual increases to $265,000 from years 2008 to 2011.
(3) This lease is subject to gradual increases to $156,000 in 2008.
(4) This lease is subject to gradual increases to $132,000 from years 2008 to 2013

We believe that our leased facilities are adequate to meet our current needs and that additional facilities are available to meet our development and expansion needs in existing and projected target markets.

ITEM 3. LEGAL PROCEEDINGS

We are not involved in any material pending litigation. We and/or one or more of our investee companies are involved in lawsuits regarding wrongful termination claims by employees or consultants, none of which are individually or in the aggregate material to Newtek. See Note 19 to Consolidated Financial Statements.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

Table of Contents

PART II

ITEM 5. MARKET FOR THE REGISTRANT S COMMON STOCK AND RELATED SHAREHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES.

(a) Market Information: Our common stock is traded on the NASDAQ National Stock Market under the symbol NEWT. High and low prices for the common stock over the previous two years are set forth below, based on the highest and lowest trading price during that period.

Period	High	Low
First Quarter: January 1, 2005 Through March 31, 2005	$ 4.33	$ 3.56
Second Quarter: April 1, 2005 Through June 30, 2005	$ 4.00	$ 2.12
Third Quarter: July 1, 2005 Through September 30, 2005	$ 2.84	$ 1.95
Fourth Quarter: October 1, 2005 Through December 31, 2005	$ 2.27	$ 1.47
First Quarter: January 1, 2006 Through March 31, 2006	$ 2.25	$ 1.65
Second Quarter: April 1, 2006 Through June 30, 2006	$ 2.75	$ 1.61
Third Quarter: July 1, 2006 Through September 30, 2006	$ 1.91	$ 1.44
Fourth Quarter: October 1, 2006 Through December 31, 2006	$ 2.27	$ 1.51

(b) Holders: As of December 31, 2006 there were approximately 268 holders of record of the common shares of Newtek.

(c) Dividends: We have never declared or paid any cash dividends on our common stock. We do not anticipate paying any cash dividends on our common stock in the foreseeable future. We currently intend to retain future earnings, if any, to finance our operations and to expand our business. Any future determination to pay cash dividends will be at the discretion of our board of directors and will be dependent upon our financial condition, operating results, capital requirements and other factors that our board of directors considers appropriate

(d) Securities Authorized for Issuance Under Equity Compensation Plans:

Plan Category	(a) Number of securities to be issued upon exercise of outstanding options, warrants and rights	(b) Weighted average exercise price of outstanding options, warrants and rights	(c) Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
Equity compensation plans approved by security holders	1,991,104 shares	$2.86/share (1)	2,362,985 shares
Equity compensation plans not approved by security holders	None	None	None

(1) Excludes 91,184 restricted shares rights which have a zero exercise price.

During the year ended December 31, 2006, we issued 89,936 shares of restricted securities, valued at $169,000, to our independent directors as compensation for director fees. These issuances were exempt from registration under the Securities Act in reliance on Section 4(2) of the Securities Act.

Performance Graph

The following chart and graph, which were prepared by management, compare the cumulative total return on our Common Shares over a measurement period beginning December 31, 2001 with (i) the cumulative total return on the securities included in the Russell 3000 Index and (ii) the cumulative total return on the stock of a company we have determined provides a peer comparison, CBIZ, Inc. (CBIZ). All of these cumulative returns are computed assuming the quarterly reinvestment of dividends paid during the applicable time period.

Table of Contents

Index	12/31/01	12/31/02	12/31/03	12/31/04	12/31/05	12/31/06
Newtek Business Services, Inc.	$ 100	$ 141.61	$ 223.87	$ 138.71	$ 62.26	$ 64.19
Russell 3000 Index	$ 100	$ 78.46	$ 102.83	$ 115.11	$ 122.16	$ 141.35
CBIZ, Inc.	$ 100	$ 115.22	$ 194.35	$ 189.57	$ 261.74	$ 303.04

We have used CBIZ as a peer comparison due to the fact that it is approximately the same in market capitalization and provides a variety of services to small and medium-sized businesses. However, as we are the only publicly traded company with a material portion of our business in the operation of certified capital companies, it may not be possible to make a direct comparison of us to any other company.

ITEM 6. SELECTED FINANCIAL DATA.

FIVE-YEAR HIGHLIGHTS

The following selected statements of operations and balance sheet data have been derived from the audited financial statements for each of the five years ended December 31, 2006. The Consolidated Financial Statements for the year ended December 31, 2006 have been audited by J.H. Cohn LLP, and the Consolidated Financial Statements for the four years ending December 31, 2005 have been audited by PricewaterhouseCoopers LLP, both independent registered public accounting firms. The comparability of the information below is affected by the acquisitions of CrystalTech Web Hosting, Inc. (CrystalTech) in July 2004, Vistar Insurance Agency, Inc., (Vistar or Keyosk) in July 2004 and Automated Merchant Services, Inc. (Automated Merchant Services or AMS) in August 2003. The selected financial data set forth below should be read in conjunction with, and is qualified by reference to, Management s Discussion and Analysis of Financial Condition and Results of Operations and our Consolidated Financial Statements, including the Notes thereto, appearing elsewhere in this report.

Table of Contents

	FISCAL YEARS ENDED Dec. 31 2006	Dec. 31 2005	Dec. 31 2004	Dec. 31 2003	Dec. 31 2002
	(In Thousands Except for Per Share Data)				
Revenue:					
Electronic payment processing	$ 43,341	$ 31,128	$ 18,131	$ 6,297	$ 1,585
Income from tax credits	15,607	36,669	33,565	44,933	30,603
Web hosting	13,535	10,627	4,428		
Interest income	6,237	4,844	3,834	4,059	900
Premium income	3,023	4,409	4,533	1,284	
Servicing fee	1,932	1,950	1,717	1,418	
Insurance commissions	916	1,203	560		
Other income	3,314	5,040	3,412	2,502	1,581
Total revenue	87,905	95,870	70,180	60,493	34,669
Expenses:					
Electronic payment processing costs	31,125	22,928	12,842	4,513	632
Consulting, payroll and benefits	16,986	16,184	10,843	8,407	4,565
Interest	16,281	15,997	14,039	13,879	11,485
Professional fees	6,302	7,802	5,183	4,500	3,145
Depreciation and amortization	6,148	4,508	2,459	504	148
Insurance	3,316	3,117	2,818	2,469	1,951
Provision for loan losses	405	2,258	205	473	
Goodwill impairment		878		1,435	
Other than temporary decline in value of investments		395		1,996	1,602
Equity in net losses of affiliates					729
Other general and administrative costs	10,986	8,626	5,599	4,247	2,895
Total expenses	91,549	82,693	53,988	42,423	27,152
(Loss) income from continuing operations before minority interest, benefit (provision) for income taxes and extraordinary items	(3,644)	13,177	16,192	18,070	7,517
Minority interest	435	792	890	(1,598)	(335)
(Loss) income from continuing operations before benefit (provision) for income taxes and extraordinary items	(3,209)	13,969	17,082	16,472	7,182
Benefit (provision) for income taxes	581	(6,548)	(6,467)	(7,090)	(2,657)
(Loss) income from continuing operations before discontinued operations and extraordinary items	(2,628)	7,421	10,615	9,382	4,525
Discontinued operations, net of tax	508	306			
(Loss) income before extraordinary items	(2,120)	7,727	10,615	9,382	4,525
Extraordinary gain on acquisition of minority interests					908
Extraordinary gain on acquisition of a business				187	2,735
Net (loss) income	$ (2,120)	$ 7,727	$ 10,615	$ 9,569	$ 8,168

Table of Contents

	FISCAL YEARS ENDED Dec. 31 2006	Dec. 31 2005	Dec. 31 2004	Dec. 31 2003	Dec. 31 2002
	(In Thousands Except for Per Share Data)				
Weighted average common shares outstanding					
Basic	34,875	34,241	30,068	25,777	24,184
Diluted	34,875	34,280	30,379	26,177	24,294
(Loss) income per share from continuing operations					
Basic and diluted	$ (0.08)	$ 0.22	$ 0.35	$ 0.36	$ 0.19
Income per share from discontinued operations					
Basic and diluted	$ 0.02	$ 0.01	$	$	$
Income per share from extraordinary items					
Basic and diluted	$	$	$	$ 0.01	$ 0.15
(Loss) income per share					
Basic and diluted	$ (0.06)	$ 0.23	$ 0.35	$ 0.37	$ 0.34
Balance Sheet Data (at end of period):					
Total assets	$ 240,737	$ 265,013	$ 228,398	$ 192,184	$ 169,055
Bank notes payable	$ 16,391	$ 21,287	$ 27,988	$ 51,990	$ 53,824
Notes payable in credits in lieu of cash	$ 86,332	$ 92,048	$ 76,259	$ 65,625	$ 65,196
Deferred tax liability	$ 24,428	$ 24,271	$ 16,617	$ 10,816	$ 3,726
Minority interest	$ 4,596	$ 5,033	$ 5,721	$ 8,393	$ 4,773
Shareholder s equity	$ 87,069	$ 87,525	$ 77,095	$ 40,248	$ 27,172
Common shares outstanding at year end	35,479	34,809	33,873	26,209	25,341
Shareholder s equity per share	$ 2.45	$ 2.51	$ 2.28	$ 1.54	$ 1.07

Table of Contents

ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF RESULTS OF OPERATIONS AND FINANCIAL CONDITION

Introduction and Certain Cautionary Statements

The following discussion and analysis of our financial condition and results of operations is intended to assist in the understanding and assessment of significant changes and trends related to the results of operations and financial position of the Company together with its subsidiaries. This discussion and analysis should be read in conjunction with the consolidated financial statements and the accompanying notes.

The statements in this Annual Report may contain forward-looking statements relating to such matters as anticipated future financial performance, business prospects, legislative developments and similar matters. The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements. In order to comply with the terms of the safe harbor, we note that a variety of factors could cause our actual results to differ materially from the anticipated results expressed in the forward looking statements such as intensified competition and/or operating problems on its operating business projects and their impact on revenues and profit margins or additional factors as described in Newtek Business Services previously filed registration statements.

We also need to point out that our Capcos operate under a different set of rules in each of the 8 jurisdictions and that these place varying requirements on the structure of our investments. In some cases, particularly in Louisiana, we don t control the equity or management of a qualified business but that cannot always be presented orally or in written presentations.

Executive Overview

We are a direct distributor of business services to the small and medium-sized business market. Our target market represents a very significant marketplace in the United States GDP. According to statistics published by the U.S. Small Business Administration, approximately 51% of the GDP in the United States comes from small-to medium-size businesses and 99% of businesses in the United States which have one or more employees fit into this market segment. As of December 31, 2006, we had over 75,000 business accounts. We use state of the art Web-based proprietary technology to be a low cost acquirer and provider of products and services to our small-and medium- size business clients. We partner with AIG, Merrill Lynch, Morgan Stanley, UBS, the Credit Union National Association with its 8,700 credit unions and 80 million members, the Navy Federal Credit Union with 2.7 million members, PSCU Financial Services, Inc., the nation s largest credit union service organization, General Motors Minority Dealers Association and Daimler Chrysler Minority Dealers Association, all of whom have elected to offer certain of our business services and financial products rather than provide some or all of them directly for their customers. We have deemphasized our Capco business in favor of growing our operating businesses and do not anticipate creating any new Capcos in the foreseeable future.

We have reported on our balance sheet at December 31, 2006 $43 million in aggregate of cash and cash equivalents, restricted cash and U.S. Treasuries, $87 million in shareholder equity, and $2.45 in net book value per share. Our shareholders equity has grown significantly through the years, from $22 million in 2002 to $87.1 million in 2006, even after the secondary stock offering completed in 2004, as our net book value per diluted share has grown from $1.07 in 2002 to $2.45 in 2006. Our debt is manageable and could be paid off without much difficulty. In 2006, we prepaid $7,000,000 of the $8,000,000 note payable to TICC, which was incurred in 2005 in conjunction with the purchase of CrystalTech Web Hosting, Inc. This prepayment was made primarily from CrystalTech s positive cash flow provided by operating activities.

As we continue to transition out of our Capco-dominated business model, our focus is on building the core businesses which provide services to small and medium- sized business customers and reducing the non-core businesses. Our client base is growing rapidly and, importantly, the proportion of our non-tax-credit revenue is growing significantly year after year. Revenue from our three major operating segments (electronic payment processing, web hosting and SBA lending) totaled $66,694,000 in 2006, a 23% increase as compared with $54,111,000 in 2005, and these segments represented 76% of total revenue in 2006 as compared to 56% in 2005. Our three major operating segments earned $7,022,000 in 2006, a 21% increase as compared with $5,823,000 in 2005. In addition, for the first time as a publicly traded company, we achieved consolidated positive cash flow provided by operating activities.

Table of Contents

Results of Operations

Consistent with management s focus, the revenue and expenses from the consolidated operating entities, specifically revenues related to the SBA lending, electronic payment processing and web hosting operations, continue to increase as a percentage of revenue, with a correlating decrease in revenues from Capco-related tax credits. The following table sets forth certain data from our statements of operations, expressed as a percentage of total revenues, for each of the periods presented.

	FISCAL YEARS ENDED		
	Dec. 31 2006	Dec. 31 2005	Dec. 31 2004
Revenues:			
Electronic payment processing	49.3%	32.5%	25.8%
Income from tax credits	17.8%	38.2%	47.9%
Web hosting	15.4%	11.1%	6.3%
Interest income	7.1%	5.1%	5.5%
Premium income	3.4%	4.6%	6.5%
Servicing fee	2.2%	2.0%	2.4%
Insurance commissions	1.0%	1.3%	0.8%
Other income	3.8%	5.2%	4.8%
Total revenues	100.0%	100.0%	100.0%
Expenses:			
Electronic payment processing costs	35.4%	23.9%	18.3%
Consulting, payroll and benefits	19.3%	16.9%	15.5%
Interest	18.5%	16.7%	20.0%
Professional fees	7.2%	8.1%	7.4%
Depreciation and amortization	7.0%	4.7%	3.5%
Insurance	3.8%	3.3%	4.0%
Provision for loan losses	0.5%	2.4%	0.3%
Goodwill impairment	0.0%	0.9%	0.0%
Other than temporary decline in value of investments	0.0%	0.4%	0.0%
Other general and administrative costs	12.5%	9.0%	8.0%
Total expenses	104.2%	86.3%	77.0%
(Loss) income from continuing operations before minority interest and benefit (provision) for income taxes	(4.2)%	13.7%	23.0%
Minority interest	0.5%	0.8%	1.3%
(Loss) income from continuing operations before benefit (provision) for income taxes	(3.7)%	14.5%	24.3%
Benefit (provision) for income taxes	0.7%	(6.8)%	(9.2)%
(Loss) income from continuing operations	(3.0)%	7.7%	15.1%
Discontinued operations, net of tax	.6%	0.3%	0.0%
Net (loss) income	(2.4)%	8.0%	15.1%

Comparison of the years ended December 31, 2006 and December 31, 2005

Total revenues decreased by $7,965,000, or 8%, to $87,905,000 for the year ended December 31, 2006, from $95,870,000 for the year ended December 31, 2005, predominately due to the decline in Capco revenues, or income from tax credits, as discussed below.

Electronic payment processing revenue increased by $12,213,000, or 39%, to $43,341,000 for the year ended December 31, 2006, from $31,128,000 for the year ended December 31, 2005, due to the increase in electronic payment processing customers as a result of our increased sales and marketing efforts. At December 31, 2006, we provided our payment services to over 12,350 small merchants across the United States, compared to 8,800 customers at December 31, 2005. Gross total processing volume increased to $2,056,959,000 from all merchant portfolios (of this amount, $375,155,000 of processing volume generated revenues that were recorded net of interchange fees) for the year ended December 31, 2006, from $1,465,227,000 of gross processing volume (of this amount, $295,591,000 of processing volume generated revenues that were recorded net of interchange fees) for the year ended December 31, 2005.

Income from tax credits decreased by $21,062,000, or 57%, to $15,607,000 for the year ended December 31, 2006 from $36,669,000 for the year ended December 31, 2005, due to a decrease of $21,909,000 in income from tax credits resulting from the satisfaction of investment benchmarks in 2005 versus 2006, offset by an increase of $847,000 in the amount recognized in 2006 from the accretion of tax credit income.

Web hosting revenue increased by $2,908,000, or 27%, to $13,535,000, for the year ended December 31, 2006 from $10,627,000 for the year ended December 31, 2005. At December 31, 2006 and 2005, CrystalTech was providing services to 58,000 and 46,000 client accounts respectively, an increase of 35%. The increase in revenue is due to the number of customers the Company provided services to and an increase in dedicated hosting customers which generates higher revenue per customer. The increase in revenue due to growth in customers was offset, in part, by a decrease in the revenue per shared web hosting customer due to competitive pricing.

Interest is generated from SBA lending activities, excess cash balances that are invested in money market accounts, U.S. Treasury notes, federal government backed securities mutual funds, etc., non-cash accretions on the structured insurance product, and on held to maturity investments. The following table details the changes in these different forms of interest income:

(In thousands)	2006	2005	Change
NSBF activities	$ 3,791	$ 3,490	$ 301
Non-cash accretions	204	175	29
Qualified investments	397	159	238
Treasury and other	1,845	1,020	825
	$ 6,237	$ 4,844	$ 1,393

The increase generated from Treasury and other investments is attributable to an increase in the average outstanding balances in cash and cash equivalents, US Treasury Notes and Short term investments during 2006, and increased interest rates (generally a 1-2% increase) on interest bearing accounts for the year ended December 31, 2006 as compared to the prior year.

Premium income decreased by $1,386,000, or 31%, to $3,023,000 for the year ended December 31, 2006 from $4,409,000 for the year ended December 31, 2005. The decrease in premium income was attributable to NSBF selling 130 guaranteed loans in the year ended December 31, 2006, aggregating $29,532,000 as compared to 166 loans sold aggregating $44,988,000 in the same period for the prior year. The premiums recognized in connection with these sales were $2,342,000 for the year ended December 31, 2006 as compared with $3,676,000 in the same period for the prior year. In addition, in the year ended December 31, 2006, NSBF sold to a financial institution $7,324,000 of loans previously classified as held for investment for aggregate proceeds of $7,649,000. The carrying value above the $7,324,000 of loans previously classified as held for investment of $325,000 was recorded as premium income. Also, in connection with this sale, included in premium income for the year ended December 31, 2006 is $355,000 representing the allocated portion of the remaining discount recorded at the time of loan origination. During the year ended December 31, 2005, NSBF sold to three financial institutions $8,522,000 of loans previously classified as held for investment for aggregate proceeds of $8,827,000. The carrying value above the $8,522,000 of loans previously classified as held for investment of $428,000 was recorded as premium income. Also, in connection with this sale, included in premium income for the year ended December 31, 2005 is $428,000 representing the allocated portion of the remaining discount recorded at the time of loan origination.

Servicing fee income related to SBA loans decreased by $18,000, or 0.9%, to $1,932,000 for the year ended December 31, 2006 from $1,950,000 for the year ended December 31, 2005. The lack of any material change in servicing fee income year over year was attributable to the servicing portfolio s consistent average base of approximately $142,500,000. The portfolio in which we earn servicing fee income at December 31, 2006 aggregated $139,900,000 as compared with $151,827,000 at December 31, 2005.

Insurance commissions decreased by $287,000, or 24%, to $916,000 for the year ended December 31, 2006 from $1,203,000 for the year ended December 31, 2005. The difference is due to the Company earning commissions from two large insurance policies in 2005 versus 2006.

Other income decreased by $1,726,000, or 34%, to $3,314,000 for the year ended December 31, 2006 from $5,040,000 for the year ended December 31, 2005. In 2006, other income was mainly comprised of a gain on the sale of an investment held by one of our Capcos of $1,706,000, and miscellaneous income and operating revenues (excluding insurance commissions) from companies that are included in the All other segment. In 2005, other income was primarily comprised of equity earnings of $993,000 in an investment, a $700,000 settlement from Citibank for the early termination of our contract with them, a $900,000 recovery of a Capco investment, and the balance relating to miscellaneous income and operating revenues (excluding insurance commissions) from companies that are included in the All other segment.

Table of Contents

Electronic payment processing direct costs increased by $8,197,000 to $31,125,000 for the year ended December 31, 2006 from $22,928,000 for the year ended December 31, 2005, an increase of 36%, which correlates to the significant increase in this business.

Consulting, payroll and benefits increased by $802,000 to $16,986,000 for the year ended December 31, 2006 from $16,184,000 for the year ended December 31, 2005. The increase was primarily due to the increased employee headcount from 360 to approximately 382 employees.

Changes in interest expense are summarized as follows:

(In thousands)	2006	2005	Change
Capco interest expense	$ 12,981	$ 12,684	$ 297
NSBF (SBA Lender) interest expense	2,093	2,012	81
Other interest expense	1,207	1,301	(94)
	$ 16,281	$ 15,997	$ 284

The increase in Capco interest expense in 2006 relates to the two new Capcos formed in June and December 2005 (WTX1 and WNYV), which had a full year of expense in 2006, compared to a partial year in 2005. The increase in SBA lender interest expense is attributable to the increase in the prime rate as well as an increase in the lending rate. Under the previous lines of credit with Deutsche Bank and Banco Popular, NSBF s lending rate was prime minus 50 basis points and prime, respectively. Under the Line of Credit Agreement with GE, the weighted average lending rate is prime plus 58 basis points or Base LIBOR plus 283 basis points. These increases were offset by the decrease in the average outstanding lines of credit from $30,236,000 during the year ended December 31, 2005 to $21,096,000 for the year ended December 31, 2006. The decrease in other interest expense was due to the Company paying down approximately $3,731,000 of it s notes payable AI Credit, and prepaying $7,000,000 of the note payable TICC.

Professional fees decreased by $1,500,000, or 19%, to $6,302,000 for the year ended December 31, 2006, from $7,802,000 for the year ended December 31, 2005. This decrease is primarily attributable to a decrease in audit and consulting fees in 2006.

Depreciation and amortization expense increased by approximately $1,640,000, or 36%, to $6,148,000 for the year ended December 31, 2006 from $4,508,000 for the year ended December 31, 2005. This is due to the acquisition of customer accounts and purchase of fixed assets in 2006 compared to 2005.

Insurance expense increased by $199,000, or 6%, to $3,316,000 for the year ended December 31, 2006, from $3,117,000 for the year ended December 31, 2005. This increase is due to the additional insurance relating to the two new Capcos in 2005 (Wilshire Texas Partners I, LLC, and Wilshire New York Partners, V, LLC), which had a full year of insurance expense amortization in 2006 compared to a partial year in 2005.

Provision for loan losses decreased by $1,853,000, or 82%, to $405,000 for the year ended December 31, 2006 from $2,258,000 for the year ended December 31, 2005. This large differential was attributable to management recording an additional $900,000 in reserves in 2005, of which $300,000 was associated with hurricane Katrina. The $300,000 reserve was established to cover known and probable future losses due to business interruptions and material property losses, as well as indirect economic effects outside of the hurricane region which could result in decreases in revenue to some of our other borrowers. The remaining $600,000 reserve was established due to then current economic conditions, specifically the rising interest rate environment and the high price of oil and gas, in addition to the potential economic impact to those small businesses in Louisiana, Alabama, Mississippi and other parts of the country that were not directly impacted by the storm as addressed in the reserves above. Consideration in this evaluation included past and then current loss experience, then current portfolio composition and the evaluation of real estate collateral as well as economic conditions in 2005. Management believed that such additional reserves would be adequate to absorb probable loan losses inherent in the Company s entire loan portfolio at December 31, 2005. Additionally, NSBF s charge-offs, in both the acquired CCC portfolio as well as newly originated loans, were significantly higher in 2005 ($1,914,000) as compared with 2006 ($465,000) due to the completion of the liquidation process on certain loans from the acquired CCC portfolio and unexpected credit events from the acquired portfolio and newly originated loans. These factors required management to establish an ad