NEWTEK BUSINESS SERVICES INC
Form 10-Q
May 13, 2008
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SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 31, 2008

OR

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from ______ to ______

Commission File Number: 001-16123

NEWTEK BUSINESS SERVICES, INC.

(Exact name of registrant as specified in its charter)

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

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

Indicate by checkmark whether the registrant has (1) filed all documents and reports required to be filed by Section 13 or 15(d) of the Exchange Act during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past ninety days. Yes x No ¨

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

Large Accelerated Filer ¨	Accelerated Filer ¨
Non-Accelerated Filer ¨	Smaller reporting company x

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

As of May 5, 2008, there 36,948,524 of the Company s Common Shares issued and outstanding.

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Item 1. Financial Statements

NEWTEK BUSINESS SERVICES, INC., AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

FOR THE THREE MONTHS ENDED MARCH 31, 2008 AND 2007

(In Thousands, except for Per Share Data)

	2008	2007
Operating revenues	$ 23,520	$ 21,809
Operating expenses:		
Electronic payment processing costs	12,225	9,865
Salaries and benefits	6,579	5,397
Interest	2,290	3,883
Depreciation and amortization	1,809	1,567
Other operating costs	4,652	5,287
Total operating expenses	27,555	25,999
Operating loss from continuing operations before minority interest, benefit for income taxes, and discontinued operations	(4,035)	(4,190)
Minority interest	102	124
Loss from continuing operations before benefit for income taxes and discontinued operations	(3,933)	(4,066)
Benefit for income taxes	1,238	1,372
Loss from continuing operations before discontinued operations	(2,695)	(2,694)
Discontinued operations, net of taxes		(205)
Net loss	$ (2,695)	$ (2,899)
Weighted average common shares outstanding:		
Basic and diluted	35,869	35,651
Loss per share from continuing operations:		
Basic and diluted	$ (0.08)	$ (0.07)
Loss per share from discontinued operations, net of taxes:		
Basic and diluted		(0.01)
Basic and diluted loss per share	$ (0.08)	$ (0.08)

See accompanying notes to these unaudited condensed consolidated financial statements.

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NEWTEK BUSINESS SERVICES, INC., AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

MARCH 31, 2008 AND DECEMBER 31, 2007

(In Thousands, except for Per Share Data)

	March 31, 2008 Unaudited	December 31, 2007 (Note 1)
ASSETS		
Cash and cash equivalents	$ 20,230	$ 25,372
Restricted cash	10,755	12,948
Credits in lieu of cash	86,186	92,781
SBA loans held for investment (net of reserve for loan losses of $2,226, and $2,196, respectively)	27,605	27,895
Accounts receivable (net of allowance of $442 and $321, respectively)	3,673	3,957
SBA loans held for sale	957	360
Prepaid and structured insurance	3,775	14,738
Prepaid expenses and other assets (net of accumulated amortization of deferred financing costs of $1,736 and $1,593, respectively)	10,607	9,789
Servicing asset (net of accumulated amortization and allowances of $3,432 and $3,160, respectively)	2,483	2,718
Fixed assets (net of accumulated depreciation and amortization of $7,339 and $6,616, respectively)	5,417	5,433
Intangible assets (net of accumulated amortization of $9,484 and $8,775, respectively)	8,316	8,829
Goodwill	12,996	12,996
Total assets	$ 193,000	$ 217,816
LIABILITIES AND SHAREHOLDERS EQUITY		
Liabilities:		
Accounts payable and accrued expenses	$ 8,606	$ 10,259
Notes payable	24,699	26,765
Deferred revenue	2,254	2,032
Notes payable in credits in lieu of cash	85,686	79,085
Deferred tax liability	7,038	17,880
Total liabilities	128,283	136,021
Minority interest	4,726	4,970
Commitments and contingencies		
Shareholders equity:		
Preferred stock (par value $0.02 per share; authorized 1,000 shares, no shares issued and outstanding)		
Common stock (par value $0.02 per share; authorized 54,000 shares, issued and outstanding 36,084 and 36,081, respectively, not including 474 and 583 shares held in escrow, respectively, and 473 held by an affiliate)	722	722
Additional paid-in capital	56,237	56,161
Retained earnings	3,223	20,245
Treasury stock, at cost (137 and 217 shares, respectively)	(191)	(303)
Total shareholders equity	59,991	76,825
Total liabilities and shareholders equity	$ 193,000	$ 217,816

See accompanying notes to these unaudited condensed consolidated financial statements.

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NEWTEK BUSINESS SERVICES, INC., AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

FOR THE THREE MONTHS ENDED MARCH 31, 2008 AND 2007

(In Thousands)

	2008	2007
Cash flows from operating activities:		
Net loss	$ (2,695)	$ (2,899)
Adjustments to reconcile net loss to net cash used in operating activities:		
Income from tax credits	(1,464)	(1,301)
Accretion of interest expense	1,749	3,063
Deferred income taxes	(1,290)	(1,589)
Depreciation and amortization	1,809	1,567
Provision for loan losses	409	167
Other, net	9	(319)
Changes in operating assets and liabilities :		
Originations of SBA loans held for sale	(3,068)	(9,116)
Proceeds from sale of SBA loans held for sale	2,471	6,594
Prepaid expenses and other assets, accounts receivable and accrued interest receivable	(692)	1,935
Accounts payable, accrued expenses and deferred revenue	(1,363)	(2,553)
Other, net	137	316
Net cash used in operating activities	(3,988)	(4,135)
Cash flows from investing activities:		
Investments in qualified businesses	(90)	
Return of investments in qualified businesses	174	570
Purchase of fixed assets and customer merchant accounts	(1,001)	(862)
SBA loans originated for investment, net	(994)	(2,686)
Payments received on SBA loans	903	1,744
Proceeds from sale of asset held for sale		1,572
Change in restricted cash	2,021	2,766
Other		578
Net cash provided by investing activities	1,013	3,682

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NEWTEK BUSINESS SERVICES, INC., AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

FOR THE THREE MONTHS ENDED MARCH 31, 2008 AND 2007 (CONTINUED)

	2008	2007
Cash flows from financing activities:		
Proceeds from notes payable		5,057
Repayments of notes payable		(4,266)
Change in restricted cash relating to CDS financing		2,050
Net proceeds (repayments) on bank notes payable	(2,026)	907
Other	(141)	(114)
Net cash (used in) provided by financing activities	(2,167)	3,634
Net (decrease) increase in cash and cash equivalents	(5,142)	3,181
Cash and cash equivalents - beginning of period	25,372	26,685
Cash and cash equivalents - end of period	$ 20,230	$ 29,866
Supplemental disclosure of cash flow activities:		
Reduction of credits in lieu of cash and notes payable in credits in lieu of cash balances due to delivery of tax credits to Certified Investors	$ 4,045	$ 3,828
Effects of CDS Business Services, Inc. consolidation (excludes intercompany balances):		
Additions to assets:		
Cash	$	$ 233
Accounts receivable		4,311
Prepaid expenses and other assets		94
Total assets	$	$ 4,638
Additions to liabilities:		
Accounts payable and accrued expenses	$	$ 3,127
Notes payable		3,259
Total liabilities		6,386
Goodwill recognized	$	$ 1,748

See accompanying notes to these unaudited condensed consolidated financial statements.

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NEWTEK BUSINESS SERVICES, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 DESCRIPTION OF BUSINESS AND BASIS OF PRESENTATION:

Newtek Business Services, Inc. (Newtek) is a holding company for several wholly- and majority-owned subsidiaries, including 15 certified capital companies which are referred to as Capcos, and several portfolio companies in which the Capcos own non-controlling or minority interests. The Company provides a one-stop-shop of business services to the small- and medium-sized business market and uses state of the art web-based proprietary technology to be a low-cost acquirer and provider of products and services. The Company partners with companies, credit unions, and associations to offer its services.

Effective January 1, 2008, the Company changed its basis of presentation for its business segments. For additional information see Note 11 to the Condensed Consolidated Financial Statements.

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.

Small Business Finance: Newtek Small Business Finance, Inc. (NSBF), a nationally licensed, U.S. Small Business Administration (SBA) lender that originates, sells and services loans to qualifying small businesses, which are partially guaranteed by the SBA. CDS Business Services, Inc, D/B/A Newtek Business Credit (NBC), provides financing to small- and medium-sized businesses by purchasing their receivables at a discounted rate. In addition, NBC provides billing and accounts receivable maintenance services to businesses.

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 other segments, including interest income, Capco management fee income and corporate 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 expense.

The condensed consolidated financial statements of Newtek Business Services, Inc., its subsidiaries and FIN 46 consolidated entities, (Financial Accounting Standards Board (FASB) issued Interpretation (FIN) No. 46 Consolidation of Variable Interest Entities), (the Company or Newtek included herein have been prepared by the Company in accordance with accounting principles generally accepted in the United States of America and include all wholly- and majority-owned subsidiaries, and those portfolio companies over which the Company has effective control but which the Capcos own non-controlling minority interest, or those of which Newtek is considered to be the primary beneficiary (as defined under FIN 46 and FIN 46R). All inter-company balances and transactions have been eliminated in consolidation. Currently, the Company is absorbing losses attributable to certain of its minority interest holders. Once these entities achieve profitability, the losses will be restored to the Company prior to allocation of profits to all minority holders.

The accompanying notes to condensed consolidated financial statements should be read in conjunction with Newtek s 2007 Annual Report on Form 10-K. These financial statements have been prepared in accordance with instructions to Form 10-Q and Article 10 of Regulations S-X and, therefore, omit or condense certain footnotes and other information normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States. The results of operations for an interim period may not give a true indication of the results for the entire year. The December 31, 2007 consolidated balance sheet has been derived from the audited financial statements of that date, but does not include all disclosures required by accounting principles generally accepted in the United States of America.

All financial information included in the tables in the following footnotes are stated in thousands, except per share data.

NOTE 2 SIGNIFICANT ACCOUNTING POLICIES:

Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenue and expense during the reporting period. The level of uncertainty in estimates and assumptions increases with the length of time until the underlying transactions are complete. The most significant estimates are with respect to valuation of investments in qualified businesses, asset impairment valuation, allowance for loan losses, valuation of servicing assets, chargeback reserves, tax valuation allowances and the fair value measurements used to value certain financial assets and financial liabilities. Actual results could differ from those estimates.

Change in Accounting Principle

During the first quarter of fiscal 2008, we elected to change our accounting principle to recognize the sale of guaranteed portions of SBA loans on the trade date. Prior to the first quarter of fiscal 2008, we recognized these transactions in our condensed consolidated financial statements on the settlement date. We concluded that use of the trade date was preferable to the settlement date as recognition of the sale at the trade date better reflects the risks and rewards of the transfer of ownership. In accordance with Statement of Financial Accounting Standards (SFAS) No. 154, Accounting Changes and Error Corrections, this change in accounting principle has been applied retrospectively to our condensed consolidated financial statements for all prior periods. As historically traded loans have settled in the same period, this change in accounting principle had no effect on previously reported operating income, net earnings, shareholders equity or cash flows.

Revenue Recognition

The Company operates in several different segments. Revenues are recognized as services are rendered and are summarized as follows:

Electronic payment processing revenue: Electronic payment processing income is derived from the electronic processing of credit and debit card transactions that are authorized and captured through third-party networks. Typically, merchants are charged for these processing services on a percentage of the dollar amount of each transaction plus a flat fee per transaction. Certain merchant customers are charged miscellaneous fees, including fees for handling chargebacks or returns, monthly minimum fees, statement fees and fees for other miscellaneous services. In accordance with Emerging Issues Task Force (EITF) 99-19, Reporting Revenue Gross as a Principal versus Net as an Agent , revenues derived from the electronic processing of MasterCard® and Visa® sourced credit and debit card transactions are reported gross of amounts paid to sponsor banks.

The Company also derives revenues from acting as independent sales offices (ISO) for third-party processors (residual revenue) and from the sale of credit and debit card devices. Residual revenue is recognized monthly, based on contractual agreements with such processors to share in the residual income derived from the underlying merchant agreements. Revenues derived from sales of equipment are recognized at the time of shipment to the merchant.

Web hosting revenue: Web hosting revenues are primarily derived from monthly recurring service fees for the use of our web hosting and software support services. Customer set-up fees are billed upon service initiation and are recognized as revenue over the estimated customer relationship period of 2.5 years. Payment for web hosting and related services is generally received one month to three years in advance. Deferred revenues represent customer prepayments for upcoming web hosting and related services.

Income from tax credits: Following an application process, a state will notify a company that it has been certified as a Capco. The state then allocates an aggregate dollar amount of tax credits to the Capco. However, such amount is neither recognized as income nor otherwise recorded in the financial statements since it has yet to be earned by the Capco. The Capco is legally entitled to earn tax credits upon satisfying defined investment percentage thresholds within specified time requirements and corresponding non-recapture percentages. At March 31, 2008, the Company had Capcos in seven states and the District of Columbia. Each state statute requires that the Capco invest a threshold percentage of Certified Capital in Qualified Businesses within the time frames specified. As the Capco meets these requirements, it avoids grounds under the statute for its disqualification for continued participation in the Capco program. Such a disqualification, or decertification as a Capco results in a recapture of all or a portion of the allocated tax credits; the proportion of the recapture is reduced over time as the Capco remains in general compliance with the program rules and meets the progressively increasing investment benchmarks.

As the Capco continues to make its investments in Qualified Businesses and, accordingly, places an increasing proportion of the tax credits beyond recapture, it earns an amount equal to the non-recapturable tax credits and records such amount as income from tax credits , with a corresponding asset called credits in lieu of cash , in the accompanying condensed

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consolidated balance sheets. The amount earned and recorded as income is determined by multiplying the total amount of tax credits allocated to the Capco by the percentage of tax credits immune from recapture (the earned income percentage) under the state statute. To the extent that the investment requirements are met ahead of schedule, and the percentage of non-recapturable tax credits is accelerated, the present value of the tax credit earned is recognized currently and the asset, credits in lieu of cash, is accreted up to the amount of tax credits available to the Certified Investors. If the tax credits are earned before the state is required to make delivery (i.e., investment requirements are met ahead of schedule, but credits can only be used by the certified investor in a future year), then the present value of the tax credits earned are recorded upon completion of the requirements, in accordance with Accounting Principles Board Opinion No. 21. The receivable (called credits in lieu of cash) is accreted to the annual deliverable amount which can then be delivered to the insurance company investors in lieu of cash interest. Delivery of the tax credits to the Certified Investors results in a decrease of the re