NEWTEK BUSINESS SERVICES INC
Form 10-Q
May 13, 2009

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, 2009

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

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

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

Large Accelerated Filer	¨	**Accelerated Filer**	¨
Non-Accelerated Filer	¨	**Smaller reporting company**	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 8, 2009, there were 37,031,656 of the Company s Common Shares issued and outstanding.

Table of Contents

CONTENTS

Table of Contents

Item 1. Financial Statements

NEWTEK BUSINESS SERVICES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

FOR THE THREE MONTHS ENDED MARCH 31, 2009 AND 2008

(In Thousands, except for Per Share Data)

	2009	2008
Operating revenues	$ 24,121	$ 23,520
Operating expenses:		
Electronic payment processing costs	12,944	12,225
Salaries and benefits	4,810	6,579
Interest	2,517	2,290
Depreciation and amortization	1,649	1,809
Provision for loan losses	424	439
Other general and administrative costs	4,392	4,213
Total operating expenses	26,736	27,555
Operating loss before fair market value adjustment and benefit for income taxes	(2,615)	(4,035)
Net change in fair market value of credits in lieu of cash and notes payable in credits in lieu of cash	537	
Loss before benefit for income taxes	(2,078)	(4,035)
Benefit for income taxes	1,014	1,238
Net loss	(1,064)	(2,797)
Net loss attributable to noncontrolling interests	88	102
Net loss attributable to Newtek Business Services, Inc.	$ (976)	$ (2,695)
Weighted average common shares outstanding - basic and diluted	35,625	35,869
Loss per share - basic and diluted	$ (0.03)	$ (0.08)

See accompanying notes to these unaudited condensed consolidated financial statements.

Table of Contents

NEWTEK BUSINESS SERVICES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

MARCH 31, 2009 AND DECEMBER 31, 2008

(In Thousands, except for Per Share Data)

	March 31, 2009 Unaudited	December 31, 2008 (Note 1)
ASSETS		
Cash and cash equivalents	$ 16,491	$ 16,852
Restricted cash	9,382	8,366
Credits in lieu of cash	46,260	70,559
SBA loans held for investment (net of reserve for loan losses of $3,592 and $3,420, respectively)	25,861	26,912
Accounts receivable (net of allowance of $269 and $192, respectively)	4,674	5,175
SBA loans held for sale		6,133
Prepaid expenses and other assets (net of accumulated amortization of deferred financing costs of $2,238 and $2,122, respectively)	8,194	9,998
Servicing asset (net of accumulated amortization and allowances of $3,948 and $3,756, respectively)	2,770	2,282
Fixed assets (net of accumulated depreciation and amortization of $10,229 and $9,477, respectively)	4,655	5,062
Intangible assets (net of accumulated amortization of $12,786 and $12,113, respectively)	5,546	6,096
Goodwill	12,092	12,092
Total assets	$ 135,925	$ 169,527
LIABILITIES AND EQUITY		
Liabilities:		
Accounts payable and accrued expenses	$ 8,082	$ 9,344
Notes payable	20,141	25,998
Deferred revenue	2,119	2,203
Notes payable in credits in lieu of cash	46,260	70,559
Deferred tax liability	4,275	5,344
Total liabilities	80,877	113,448
Commitments and contingencies		
Equity:		
Newtek Business Services, Inc. stockholders 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 36,650 and 36,667, respectively, not including 97 and 394 shares held in escrow, respectively)	733	733
Additional paid-in capital	58,267	58,232
Accumulated deficit	(5,521)	(4,545)
Treasury stock, at cost (1,026 shares)	(649)	(649)
Total Newtek Business Services, Inc. stockholders equity	52,830	53,771
Noncontrolling interests	2,218	2,308
Total equity	55,048	56,079
Total liabilities and equity	$ 135,925	$ 169,527

See accompanying notes to these unaudited condensed consolidated financial statements.

Table of Contents

NEWTEK BUSINESS SERVICES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

FOR THE THREE MONTHS ENDED MARCH 31, 2009 AND 2008

(In Thousands)

	2009	2008
Cash flows from operating activities:		
Net loss attributable to Newtek Business Services, Inc.	$ (976)	$ (2,695)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Income from tax credits	(1,536)	(1,464)
Accretion of interest expense	2,073	1,749
Fair market value adjustment	(537)	
Deferred income taxes	(1,069)	(1,290)
Depreciation and amortization	1,649	1,809
Provision for loan losses	424	439
Net loss attributable to noncontrolling interests	(90)	(102)
Other, net	140	81
Changes in operating assets and liabilities:		
Originations of SBA loans held for sale	(1,169)	(3,068)
Proceeds from sale of SBA loans held for sale	7,302	2,471
Prepaid expenses and other assets, accounts receivable and accrued interest receivable	1,347	(692)
Accounts payable, accrued expenses and deferred revenue	(1,346)	(1,363)
Other, net	(1,180)	137
Net cash provided by (used in) operating activities	5,032	(3,988)
Cash flows from investing activities:		
Investments in qualified businesses		(90)
Return of investments in qualified businesses	908	174
Purchase of fixed assets and customer merchant accounts	(500)	(1,001)
SBA loans originated for investment, net	(304)	(994)
Payments received on SBA loans	912	903
Change in restricted cash	(515)	2,021
Net cash provided by investing activities	501	1,013

See accompanying notes to these unaudited condensed consolidated financial statements.

Table of Contents

NEWTEK BUSINESS SERVICES, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

FOR THE THREE MONTHS ENDED MARCH 31, 2009 AND 2008 (CONTINUED)

	2009	2008
Cash flows from financing activities:		
Net repayments on bank notes payable	$ (5,857)	$ (2,026)
Other	(37)	(141)
Net cash used in financing activities	(5,894)	(2,167)
Net decrease in cash and cash equivalents	(361)	(5,142)
Cash and cash equivalents - beginning of period	16,852	25,372
Cash and cash equivalents - end of period	$ 16,491	$ 20,230
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	$ 12,730	$ 4,045

See accompanying notes to these unaudited condensed consolidated financial statements.

6

Table of Contents

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 fourteen 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 for 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.

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., d/b/a/ Newtek Technology Services, (NTS) which offers shared and dedicated web hosting and related services to the small- and medium-sized business market.

Small Business Finance: Primarily consists of 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; and CDS Business Services, Inc. d/b/a Newtek Business Credit (NBC) which provides receivable financing.

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: Corporate implements business strategy, directs marketing, provides technology oversight and guidance, coordinates and integrates activities of the segments, contracts with alliance partners, acquirers customer opportunities, and owns our proprietary NewTracker referral system. Revenue and expenses not allocated to 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.

The condensed consolidated financial statements of Newtek Business Services, Inc., its Subsidiaries and FIN 46 consolidated 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 several portfolio companies in which the Capcos own non-controlling minority interest in, or those which Newtek is considered to be the primary beneficiary of (as defined under FIN 46 and FIN 46R). All inter-company balances and transactions have been eliminated in consolidation. In accordance with the Company s fiscal 2009 adoption of SFAS No. 160, *Noncontrolling Interests in Consolidated Statements, an amendment of ARB No. 51* (SFAS 160), noncontrolling interests (previously shown as minority interest) are reported below net loss under the heading Net loss attributable to noncontrolling interests in the unaudited condensed consolidated statements of operations and shown as a component of equity in the condensed consolidated balance sheets. See New Accounting Pronouncements for further discussion.

The accompanying notes to unaudited condensed consolidated financial statements should be read in conjunction with Newtek s 2008 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, 2008 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.

Table of Contents

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.

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 charge-backs 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 its 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, 2009, the Company had Capcos in seven states and the District of Columbia. Each 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 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

8

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 receivable and the notes payable in credits in lieu of cash.

The allocation and utilization of Capco tax credits is controlled by the state law. In general, the Capco applies for tax credits from the state and is allocated a specific dollar amount of credits which are available to be earned. The Capco provides the state with a list of the Certified Investors, who have contractually agreed to accept the tax credits in lieu of cash interest payments on their notes. The tax credits are claimed by the Certified Investors on their state premium tax return as provided under each state Capco and tax law. State regulations specify the amount of tax credits a Certified Investor can claim and the period in which they can claim them. Each state periodically reviews the Capco s operations to verify the amount of tax credits earned. In addition, the state maintains a list of Certified Investors and therefore has the ability to determine whether the Certified Investor is allowed to claim this deduction.

Sales and Servicing of SBA Loans: NSBF originates loans to customers under the SBA program that generally provides for SBA guarantees of 50% to 90% of each loan, subject to a maximum guarantee amount. NSBF sells the guaranteed portion of each loan to a third party and retains the unguaranteed principal portion in its own portfolio. A gain is recognized on the guaranteed portions of these loans through collection on sale of a premium over the adjusted carrying value or a par sale with excess servicing. Commencing on January 1, 2008, the Company began to recognize the gain on sale of the guaranteed portion of the loans on the trade date rather than the date of settlement, under the terms of SFAS No. 156 Accounting for Servicing of Financial Assets an amendment of FASB Statement No. 140 for 2009 and 2008.

In each loan sale, the Company retains servicing responsibilities and receives servicing fees of a minimum of 1% of the guaranteed loan portion sold. The Company is required to estimate its adequate servicing compensation in the calculation of its servicing asset. The purchasers of the loans sold have no recourse to the Company for failure of customers to pay amounts contractually due.

In accordance with SFAS 156, upon sale of the loans to third parties, NSBF separately recognizes at fair value any servicing assets or servicing liabilities first, and then allocates the previous carrying amount between the assets sold and the interests that continue to be held by the transferor (the unguaranteed portion of the loan) based on their relative fair values at the date of transfer. The difference between the proceeds received and the allocated carrying value of the financial assets sold is recognized as a gain on sale of loans.

In accordance with SFAS 140, upon sale of the loans to third parties, the Company s investment in an SBA loan is allocated among the retained portion of the loan (unguaranteed), the sold portion of the loan (guaranteed) and the value of loan servicing retained, based on the relative estimated fair market values of each component at the sale date. The difference between the proceeds received and the allocated carrying value of the loan sold is recognized as a gain on sale of loans.

Each class of servicing assets and liabilities are subsequently measured under SFAS 156 using either the amortization method or the fair value measurement method. The amortization method, which NSBF has chosen to continue applying to its servicing asset, amortizes the asset in proportion to, and over the period of, the estimated future net servicing income on the underlying sold portion of the loans (guaranteed) and assesses the servicing asset for impairment based on fair value at each reporting date. In the event future prepayments are significant or impairments are incurred and future expected cash flows are inadequate to cover the unamortized servicing assets, additional amortization or impairment charges would be recognized. The Company uses an independent valuation specialist to estimate the fair value of the servicing asset.

In evaluating and measuring impairment of servicing assets, NSBF stratifies its servicing assets based on year of loan and loan term which are key risk characteristics of the underlying loan pools. The fair value of servicing assets is determined by calculating the present value of estimated future net servicing cash flows, using assumptions of prepayments, defaults, servicing costs and discount rates that NSBF believes market participants would use for similar assets.

If NSBF determines that the impairment for a stratum is temporary, a valuation allowance is recognized through a charge to current earnings for the amount the amortized balance exceeds the current fair value. If the fair value of the stratum were to later increase, the valuation allowance may be reduced as a recovery. However, if NSBF determines that an impairment for a stratum is other than temporary, the value of the servicing asset and any related valuation allowance is written-down.

Interest and Small Business Administration (SBA) Loan Fees SBA Loans: Interest income on loans is recognized as earned. Loans are placed on non-accrual status if they are 90 days past due with respect to principal or interest and, in the opinion of management, interest or principal on individual loans is not collectible, or at such earlier time as management determines that the collectibility of such principal or interest is unlikely. Such loans are designated as impaired non-accrual loans. All other loans are defined as performing loans. When a loan is designated as non-accrual, the accrual of interest is discontinued, and any accrued but uncollected interest income is reversed and charged against current operations. While a loan is classified as non-accrual and the future collectibility of the recorded loan balance is doubtful, collections of interest and principal are generally applied as a reduction to principal outstanding.

The Company passes certain expenditures it incurs to the borrower, such as forced placed insurance, insufficient funds fees, or fees it assesses, such as late fees, with respect to managing the loan. These expenditures are recorded when incurred. Due to the uncertainty with respect to collection of these passed through expenditures or assessed fees, any funds received to reimburse the Company are recorded on a cash basis as other income.

Insurance commissions: Revenues are comprised of commissions earned on premiums paid for insurance policies and are recognized at the time the commission is earned. At that date, the earnings process has been completed and the Company can estimate the impact of policy cancellations for refunds and establish reserves. The reserve for policy cancellations is based on historical cancellation experience adjusted by known circumstances.

Other income: Other income represents revenues generated by NBC, as well as revenues derived from operating units that cannot be aggregated with other business segments, and one-time recoveries or gains on qualified investments. Revenue is recorded when there is pervasive evidence of an agreement, the related fees are fixed, the service, and or product has been delivered, and the collection of the related receivable is assured. Other income particular to NBC include the following components:

Receivable fees: Receivable fees are derived from the funding (purchase) of receivables from finance clients. The percentage of fees is set when entered into an agreement with the client. The Company recognizes the revenue on the date the receivable is purchased. The Company does not take ownership of the receivables until funds are released which then constitutes a purchase of a client s asset. The Company also earns fees from certain clients based on the amount of funds provided to the client. The funds provided are collateralized by the receivables purchased. The fee is based on a specific interest rate which is set when entered into an agreement with the client. The Company recognizes the revenue as earned.

Late fees: Late fees are derived from receivables the Company has already purchased that have gone over a certain period (usually over 30 days) without payment. The client or the client s customer is charged a late fee according to the agreement with the client.

Billing fees: Billing fees are derived from billing-only (non-finance) clients. These fees are recorded when earned, which occurs when the service is rendered.

Other fees: These fees include annual fees, finance charges, supplies, shipping and handling, hardware repair, closing costs, NSF fees and termination fees that the Company charges either upon funding, takeovers or liquidation of finance clients. The Company also receives commission revenue from various sources.

The detail of total operating revenues included in the condensed consolidated s