NICHOLAS FINANCIAL INC
Form 10-Q
February 14, 2019
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE QUARTERLY PERIOD ENDED December 31, 2018

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: 0-26680

NICHOLAS FINANCIAL, INC.

(Exact Name of Registrant as Specified in its Charter)

British Columbia, Canada	**8736-3354**
(State or Other Jurisdiction of Incorporation or Organization)	**(I.R.S. Employer Identification No.)**
2454 McMullen Booth Road, Building C Clearwater, Florida	**33759**
(Address of Principal Executive Offices)	**(Zip Code)**

(727) 726-0763

(Registrant s telephone number, including area code)

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

Indicate by check mark whether the Registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T 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 definitions of large accelerated filer, accelerated filer, smaller reporting company and emerging growth company in Rule 12b-2 of the Exchange Act.

Large accelerated filer	Accelerated filer
Non-accelerated filer	Smaller reporting company
	Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by checkmark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act)

Yes No

As of February 7, 2019, 12,623,652 shares, no par value, of the Registrant were outstanding (of which 4,713,804 shares were held by the Registrant s principal operating subsidiary and pursuant to applicable law, not entitled to vote and 7,909,848 shares were entitled to vote).

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

Nicholas Financial, Inc. and Subsidiaries

Consolidated Balance Sheets

(In thousands)

	December 31, 2018 (Unaudited)	March 31, 2018
Assets		
Cash	**$ 4,252**	$ 2,626
Finance receivables, net	**219,210**	266,573
Assets held for resale	**1,902**	2,117
Income taxes receivable	**2,115**	1,505
Prepaid expenses and other assets	**987**	906
Property and equipment, net	**642**	843
Deferred income taxes	**5,438**	6,289
Total assets	**$ 234,546**	$ 280,859
Liabilities and shareholders equity		
Line of credit	**$ 120,000**	$ 165,750
Drafts payable	**1,345**	1,672
Accounts payable and accrued expenses	**3,610**	5,000
Total liabilities	**124,955**	172,422
Shareholders equity		
Preferred stock, no par: 5,000 shares authorized; none issued		
Common stock, no par: 50,000 shares authorized; 12,622 and 12,609 shares issued, respectively; and 7,908 and 7,895 shares outstanding, respectively	**34,621**	34,564
Treasury stock: 4,714 common shares, at cost	**(70,459)**	(70,459)
Retained earnings	**145,429**	144,332
Total shareholders equity	**109,591**	108,437
Total liabilities and shareholders equity	**$ 234,546**	$ 280,859

See Notes to the Consolidated Financial Statements.

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Nicholas Financial, Inc. and Subsidiaries

Consolidated Statements of Income

(Unaudited)

(In thousands, except per share amounts)

	Three months ended December 31, 2018	Three months ended December 31, 2017	Nine months ended December 31, 2018	Nine months ended December 31, 2017
Interest and fee income on finance receivables	**$ 16,740**	$ 20,526	**$ 54,903**	$ 64,062
Expenses:				
Marketing	**652**	351	**1,756**	1,095
Salaries and employee benefits	**4,575**	4,826	**14,182**	14,835
Administrative	**2,530**	2,845	**8,387**	8,698
Provision for credit losses	**7,870**	8,989	**21,670**	28,887
Depreciation	**91**	116	**290**	356
Interest expense	**2,303**	2,585	**7,228**	7,500
	18,021	**19,712**	**53,513**	**61,371**
Operating income (loss) before income taxes	**(1,281)**	814	**1,390**	2,691
Income tax expense (benefit)	**(376)**	3,712	**293**	4,432
Net income (loss)	**$ (905)**	$ (2,898)	**$ 1,097**	$ (1,741)
Earnings (loss) per share:				
Basic	**$ (0.12)**	$ (0.37)	**$ 0.14**	$ (0.22)
Diluted	**$ (0.12)**	$ (0.37)	**$ 0.14**	$ (0.22)

See Notes to the Consolidated Financial Statements.

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Nicholas Financial, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

(Unaudited)

(In thousands)

	Nine months ended December 31,	
	2018	2017
Cash flows from operating activities		
Net income (loss)	**$ 1,097**	$ (1,741)
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	**290**	356
Gain on sale of property and equipment	**(38)**	(22)
Provision for credit losses	**21,670**	28,887
Amortization of dealer discounts	**(8,140)**	(8,670)
Amortization of commission for products	**(1,508)**	(1,226)
Deferred income taxes	**851**	2,049
Share-based compensation	**41**	240
Change in fair value of interest rate swap agreements		17
Changes in operating assets and liabilities:		
Accrued interest receivable	**221**	149
Prepaid expenses and other assets	**319**	156
Accounts payable and accrued expenses	**(1,390)**	(938)
Income taxes receivable	**(610)**	99
Net cash provided by operating activities	**12,803**	19,356
Cash flows from investing activities		
Purchase and origination of finance receivables	**(56,266)**	(86,517)
Principal payments received	**91,386**	102,568
Decrease (increase) in assets held for resale	**215**	(522)
Purchase of property and equipment	**(113)**	(143)
Proceeds from sale of property and equipment	**62**	23
Net cash provided by investing activities	**35,284**	15,409
Cash flows from financing activities		
Repayments on line of credit	**(45,750)**	(35,000)
Change in drafts payable	**(327)**	335
Payment of loan origination fees	**(400)**	(211)
Proceeds from exercise of stock options	**16**	338

Net cash used in financing activities	**(46,461)**	(34,538)
Net increase in cash	**1,626**	227
Cash, beginning of period	**2,626**	2,855
Cash, end of period	**$ 4,252**	$ 3,082

See Notes to the Consolidated Financial Statements.

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1. Basis of Presentation

The accompanying consolidated balance sheet as of March 31, 2018, which has been derived from audited financial statements, and the accompanying unaudited interim consolidated financial statements of Nicholas Financial, Inc. (including its subsidiaries, the Company) have been prepared in accordance with accounting principles generally accepted in the United States (U.S. GAAP) for interim financial information, with the instructions to Form 10-Q pursuant to the Securities and Exchange Act of 1934, as amended, and with Article 8 of Regulation S-X thereunder. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete consolidated financial statements, although the Company believes that the disclosures made are adequate to ensure the information is not misleading. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for interim periods are not necessarily indicative of the results that may be expected for the year ending March 31, 2019. It is suggested that these consolidated financial statements be read in conjunction with the consolidated financial statements and accompanying notes thereto included in the Company s Annual Report on Form 10-K for the year ended March 31, 2018 as filed with the Securities and Exchange Commission on June 27, 2018. The March 31, 2018 consolidated balance sheet included herein has been derived from the March 31, 2018 audited consolidated balance sheet included in the aforementioned Form 10-K.

The preparation of consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for credit losses on finance receivables.

2. Revenue Recognition

Finance receivables consist of automobile finance installment contracts (Contracts) and direct consumer loans (Direct Loans). Interest income on finance receivables is recognized using the interest method. Accrual of interest income on finance receivables is suspended when a loan enters bankruptcy status, is contractually delinquent for 61 days or more, or the collateral is repossessed, whichever is earlier. We reverse finance charge amounts previously accrued upon suspension of accrual of finance charges. Chapter 13 bankruptcy accounts are accounted for under the cost-recovery method. Interest income on Chapter 13 bankruptcy accounts does not resume until all principal amounts are recovered (see Note 4).

A dealer discount represents the difference between the finance receivable of a Contract, and the amount of money the Company actually pays for the Contract. The discount negotiated by the Company is a function of the lender, the wholesale value of the vehicle and competition in any given market. In making decisions regarding the purchase of a particular Contract the Company considers the following factors related to the borrower: place and length of residence; current and prior job status; history in making installment payments for automobiles; current income; and credit history. In addition, the Company examines its prior experience with Contracts purchased from the dealer, and the value of the automobile in relation to the purchase price and the term of the Contract. The entire amount of discount is amortized as an adjustment to yield using the interest method over the life of the loan. The average dealer discount associated with new volume for the three-months ended December 31, 2018 and 2017 was 8.13% and 6.89%, respectively in relation to the total amount financed. The average dealer discount associated with new volume for the nine-months ended December 31, 2018 and 2017 was 8.29% and 7.23%, respectively.

Unearned insurance and fee commissions consist primarily of commissions received from the sale of ancillary products. These products include automobile warranties, roadside assistance programs, accident and health insurance, credit life insurance, involuntary unemployment insurance coverage, and forced placed automobile insurance. These commissions are amortized over the life of the contract using the interest method.

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3. Earnings Per Share

The Company has granted stock compensation awards with nonforfeitable dividend rights which are considered participating securities. Earnings per share is calculated using the two-class method, as such awards are more dilutive under this method than the treasury stock method. Basic earnings per share is calculated by dividing net income allocated to common shareholders by the weighted average number of common shares outstanding during the period, which excludes the participating securities. Diluted earnings per share includes the dilutive effect of additional potential common shares from stock compensation awards. Earnings per share have been computed based on the following weighted average number of common shares outstanding:

	Three months ended December 31, (In thousands, except per share amounts)		Nine months ended December 31, (In thousands, except per share amounts)	
	2018	2017	**2018**	2017
Numerator:				
Net income (loss)	**$ (905)**	$ (2,898)	**$ 1,097**	$ (1,741)
Less: Allocation of earnings to participating securities	**5**	40	**(10)**	23
Net income (loss) allocated to common stock	**$ (900)**	$ (2,858)	**$ 1,087**	$ (1,718)
Basic earnings (loss) per share computation:				
Net income (loss) allocated to common stock	**$ (900)**	$ (2,858)	**$ 1,087**	$ (1,718)
Weighted average common shares outstanding, including shares considered participating securities	**7,859**	7,910	**7,855**	7,876
Less: Weighted average participating securities outstanding	**(46)**	(110)	**(68)**	(102)
Weighted average shares of common stock	**7,813**	7,800	**7,787**	7,774
Basic earnings (loss) per share	**$ (0.12)**	$ (0.37)	**$ 0.14**	$ (0.22)
Diluted earnings (loss) per share computation:				
Net income (loss) allocated to common stock	**$ (900)**	$ (2,858)	**$ 1,087**	$ (1,718)
Undistributed earnings re-allocated to participating securities				
Numerator for diluted earnings (loss) per share	**$ (900)**	$ (2,858)	**$ 1,087**	$ (1,718)
Weighted average common shares outstanding for basic earnings per share	**7,813**	7,800	**7,787**	7,774
Incremental shares from stock options	**7**			

Weighted average shares and dilutive potential common shares	**7,820**	7,800	**7,787**	7,774
Diluted earnings (loss) per share	**$ (0.12)**	$ (0.37)	**$ 0.14**	$ (0.22)

Diluted earnings per share do not include the effect of certain stock options as their impact would be anti-dilutive. For the three-months ended December 31, 2018 and 2017, potential shares of common stock from stock options totaling 35,000 and 157,230, respectively, were not included in the diluted earnings per share calculation because their effect is anti-dilutive. For the nine-months ended December 31, 2018 and 2017, potential shares of common stock from stock options totaling 68,600 and 194,687, respectively, were not included in the diluted earnings per share calculation because their effect is anti-dilutive.

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4. Finance Receivables

Finance Receivables Portfolio

Finance receivables consist of Contracts and Direct Loans and are detailed as follows:

	(In thousands)		
	December 31, 2018	**March 31, 2018**	**December 31, 2017**
Finance receivables	**$ 250,279**	$ 301,155	$ 313,631
Accrued interest receivable	**2,421**	2,642	3,052
Unearned dealer discounts	**(10,757)**	(13,655)	(14,138)
Unearned insurance and fee commissions	**(2,758)**	(3,303)	(3,313)
Finance receivables, net of unearned	**239,185**	286,839	299,232
Allowance for credit losses	**(19,975)**	(20,266)	(21,187)
Finance receivables, net	**$ 219,210**	$ 266,573	$ 278,045

Contracts and Direct Loans each comprise a portfolio segment. The following tables present selected information on the entire portfolio of the Company:

	As of December 31,	
Contract Portfolio	**2018**	2017
Average APR	**22.68%**	22.21%
Average discount	**7.46%**	7.25%
Average term (months)	**53**	57
Number of active contracts	**29,061**	33,993

	As of December 31,	
Direct Loan Portfolio	**2018**	2017
Average APR	**25.97%**	25.18%
Average term (months)	**27**	33
Number of active contracts	**2,641**	2,718

The Company purchases Contracts from automobile dealers at a negotiated price that is less than the original principal amount being financed by the purchaser of the automobile. The Contracts are predominantly for used vehicles. As of December 31, 2018, the average model year of vehicles collateralizing the portfolio was a 2010 vehicle.

Direct Loans are typically for amounts ranging from $500 to $11,000 and are generally secured by a lien on an automobile, watercraft or other permissible tangible personal property. The majority of Direct Loans are originated with current or former customers under the Company s automobile financing program. The typical Direct Loan represents a better credit risk than typical Contracts due to the customer s prior payment history with the Company; however, the underlying collateral is less valuable. In deciding whether to make a loan, the Company considers the individual s credit history, job stability, income, and impressions created during a personal interview with a Company loan officer. Additionally, because most of the Direct Loans made by the Company to date have been made to current or former customers, the payment history of the borrower is a significant factor in making the loan decision. As of December 31, 2018, loans made by the Company pursuant to its Direct Loan program constituted approximately 3.4% of the aggregate principal amount of the Company s loan portfolio. Changes in the allowance for credit losses for both Contracts and Direct Loans were driven primarily by current economic conditions and credit loss trends over several reporting periods which are utilized in estimating future losses and overall portfolio performance.

Each portfolio segment consists of smaller balance homogeneous loans which are collectively evaluated for impairment.

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Allowance for Credit Losses

The following table sets forth a reconciliation of the changes in the allowance for credit losses on Contracts and Direct Loans for the three-months ended December 31, 2018 and 2017:

	Three months ended December 31, 2018		
	Contracts	Direct Loans	Consolidated
Balance at beginning of period	**$ 18,692**	**$ 484**	**$ 19,176**
Provision for credit losses	**7,743**	**127**	**7,870**
Charge-offs	**(7,337)**	**(103)**	**(7,440)**
Recoveries	**359**	**10**	**369**
Balance at December 31, 2018	**$ 19,457**	**$ 518**	**$ 19,975**

	Three months ended December 31, 2017		
	Contracts	Direct Loans	Consolidated
Balance at beginning of period	$ 19,967	$ 782	$ 20,749
Provision for credit losses	8,818	171	8,989
Charge-offs	(8,745)	(172)	(8,917)
Recoveries	360	6	366
Balance at December 31, 2017	$ 20,400	$ 787	$ 21,187

The following table sets forth a reconciliation of the changes in the allowance for credit losses on Contracts and Direct Loans for the nine-months ended December 31, 2018 and 2017:

	Nine months ended December 31, 2018		
	Contracts	Direct Loans	Consolidated
Balance at beginning of period	**$ 19,433**	**$ 833**	**$ 20,266**
Provision for credit losses	**21,655**	**15**	**21,670**
Charge-offs	**(22,965)**	**(357)**	**(23,322)**
Recoveries	**1,334**	**27**	**1,361**
Balance at December 31, 2018	**$ 19,457**	**$ 518**	**$ 19,975**

	Nine months ended December 31, 2017		
	Contracts	Direct Loans	Consolidated
Balance at beginning of period	$ 16,885	$ 773	$ 17,658
Provision for credit losses	28,498	389	28,887
Charge-offs	(26,372)	(395)	(26,767)
Recoveries	1,389	20	1,409
Balance at December 31, 2017	$ 20,400	$ 787	$ 21,187

During the first quarter of the fiscal year ending March 31, 2019, the Company began using the trailing six-month charge-offs, annualized, to calculate the allowance for credit losses. This change was made to reflect changes in the Company s lending policies and underwriting standards, which were a result of the Company changing its business strategies. The Company changed its focus to financing primary transportation to and from work for the subprime borrower. This change resulted in higher yielding loans, smaller amounts financed, and shorter monthly terms.

In addition, the Company takes into consideration the composition of the portfolio, current economic conditions, the estimated net realizable value of the underlying collateral, historical loan loss experience, delinquency, non-performing assets, and bankrupt accounts when determining management s estimate of probable credit losses and adequacy of the allowance for credit losses. If the allowance for credit losses is determined to be inadequate, then an additional charge to the provision would be recorded to maintain adequate reserves based on management s evaluation of the risk inherent in the loan portfolio.

Prior to June 30, 2018, the Company calculated the allowance for credit losses by reference to static pools, which each pool consisted of Contracts purchased during a three-month period for each branch location as management considers these pools to have similar risk characteristics and were considered smaller-balance homogenous loans. The Company analyzed each

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consolidated static pool at specific points in time to estimate losses that were probable of being incurred as of the reporting date. The Company maintained historical write-off information for over 10 years with respect to every consolidated static pool and segregated such static pool by liquidation, thereby creating snapshots or buckets of each pool s historical write-off-to liquidation ratio at five different points in each vintage pool s liquidation cycle. These snapshots were then used to assist in determining the allowance for credit losses. The five snapshots were tracked at liquidation levels of 20%, 40%, 60%, 80% and 100%.

The following table is an assessment of the credit quality by creditworthiness:

	(In thousands)					
	December 31, 2018			December 31, 2017		
	Contracts	Direct Loans	Total	Contracts	Direct Loans	Total
Performing accounts	**$ 225,110**	**$ 8,284**	**$ 233,394**	$ 283,340	$ 8,030	$ 291,370
Non-performing accounts	**13,073**	**186**	**13,259**	18,204	174	18,378
Total	**238,183**	**8,470**	**246,653**	301,544	8,204	309,748
Chapter 13 bankruptcy accounts	**3,564**	**62**	**3,626**	3,843	40	3,883
Finance receivables	**$ 241,747**	**$ 8,532**	**$ 250,279**	$ 305,387	$ 8,244	$ 313,631

A performing account is defined as an account that is less than 61 days past due. The Company defines an automobile contract as delinquent when more than 25% of a payment contractually due by a certain date has not been paid by the immediately following due date, which date may have been extended within limits specified in the servicing agreements or as a result of a deferral. The period of delinquency is based on the number of days payments are contractually past due, as extended where applicable.

In certain circumstances, the Company will grant obligors one-month payment extensions. The only modification of terms in those circumstances is to advance the obligor s next due date by one month and extend the maturity date of the receivable. There are no other concessions, such as a reduction in interest rate, or forgiveness of principal or of accrued interest. Accordingly, the Company considers such extensions to be insignificant delays in payments rather than troubled debt restructurings.

A non-performing account is defined as an account that is contractually delinquent for 61 days or more or is a Chapter 13 bankruptcy account, and on which the accrual of interest income is suspended, and any previously accrued interest is reversed. As of September 1, 2016, an account is written off when an account is 180 days contractually delinquent, which is consistent with practices within the subprime auto financing industry. Upon notification of a bankruptcy, an account is monitored for collection with other Chapter 13 bankruptcy accounts. In the event the debtors balance has been reduced by the bankruptcy court, the Company will record a loss equal to the amount of principal balance reduction. The remaining balance will be reduced as payments are received by the bankruptcy court. In the event an account is dismissed from bankruptcy, the Company will decide, based on several factors, whether to begin repossession proceedings or to allow the customer to begin making regularly scheduled payments. The Company does consider Chapter 13 bankruptcy accounts to be troubled debt restructurings and included in the Company s allowance for credit losses is a specific reserve of approximately $774,000 and $0 for these accounts as of December 31, 2018 and December 31, 2017, respectively.

The following tables present certain information regarding the delinquency rates experienced by the Company with respect to Contracts and Direct Loans, excluding Chapter 13 bankruptcy accounts:

		(In thousands, except percentages)				
Contracts	**Balance Outstanding**	**31 60 days**	**61 90 days**	**91 120 days**	**Over 120**	**Total**
December 31, 2018	**$ 238,183**	**$ 18,229**	**$ 6,897**	**$ 3,760**	**$ 2,416**	**$ 31,302**
		7.65%	**2.90%**	**1.58%**	**1.01%**	**13.14%**
December 31, 2017	$ 301,544	$ 22,583	$ 9,413	$ 5,320	$ 3,471	$ 40,787
		7.49%	3.12%	1.76%	1.15%	13.53%

Direct Loans	**Balance Outstanding**	**31 60 days**	**61 90 days**	**91 120 days**	**Over 120**	**Total**
December 31, 2018	**$ 8,470**	**$ 188**	**$ 88**	**$ 30**	**$ 68**	**$ 374**
		2.22%	**1.04%**	**0.35%**	**0.80%**	**4.42%**
December 31, 2017	$ 8,204	$ 204	$ 81	$ 26	$ 67	$ 378
		2.49%	0.99%	0.32%	0.82%	4.61%

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5. Line of Credit

The Company had a line of credit facility (the Line of Credit or the Line) up to $225 million during fiscal year 2018. On March 30, 2018, the Company executed Amendment No. 8 to the Second Amended and Restated Loan and Security Agreement, a one-year renewal extending the maturity date to March 31, 2019, reducing the Line of Credit to $200 million, and changing the minimum interest coverage ratio from a quarterly to monthly test. The pricing of the Line of Credit remained at 400 basis points above 30-day LIBOR, with a 1% floor on LIBOR and the beneficial ownership limit remained at 30%.

Pledged as collateral for this Line of Credit are all the assets of the Company.

The credit agreement requires compliance with certain financial ratios and covenants and satisfaction of specified financial tests, including maintenance of asset quality and performance tests. The Company s operating results over the past two years provide indicators that the Company may not be able to continue to comply with certain of the required financial ratios, covenants and financial tests prior to the maturity date of the Line of Credit in the absence of an amendment to the corresponding credit agreement or waiver. On November 2, 2018, the Company entered into a Waiver and Amendment No. 9 (Amendment No. 9) to the Second Amended and Restated Loan and Security Agreement governing the Line of Credit. Among other things, Amendment No. 9 waived compliance with the minimum interest coverage ratio and minimum loss reserve requirements for the measurement period ending August 31, 2018. On February 12, 2019, the Company entered into a Waiver and Amendment No. 10 (Amendment No. 10) to the Second Amended and Restated Loan and Security Agreement. Among other things, Amendment No. 10:

waived compliance with the minimum interest coverage ratio for the measurement period ended November 30, 2018; and

modifies the minimum interest coverage ratio to 0.44 to 1.0 for the measurement period ended on December 31, 2018, 0.20 to 1.0 for the measurement period ending January 31, 2019, and 1.0 to 1.0 for the measurement period ending February 28, 2019 and thereafter; and

reduced the Line of Credit to $140 million.

Only after giving effect to this amendment was the Company in compliance with all debt covenants as of December 31, 2018. See Note 10 Subsequent Events for further discussion of Amendment No. 10.

The Company s operating results over the past few years continue to provide indicators that the Company may not be able to continue to comply with certain of the required financial ratios, covenants and financial tests in the absence of amendments or waivers with respect to the corresponding credit agreement. Failure to meet any financial ratios, covenants or financial tests could result in the event of default under our Line of Credit. If an event of default occurs under the Line of Credit, the Company s lenders could increase the Company s borrowing costs, restrict the ability to obtain additional borrowings under the Line of Credit, accelerate all amounts outstanding, or enforce their interest against collateral pledged under the Line of Credit. There are no assurances that the lenders will approve a renewal or extension of the Line of Credit past the current maturity date of March 31, 2019, or, assuming that they will approve it, that the Line of Credit will not be on terms less favorable than the current agreement. In the event, the Company obtains information that the existing lenders do not intend to extend the relationship, the Company will seek alternative financing. The Company believes it is probable that it will be able to obtain financing from either its existing lenders or from other sources; however, it cannot provide any assurances that it will be successful in replacing the Line of Credit on reasonable terms or at all.

6. Income Taxes

The Company recorded an income tax benefit of approximately $376,000 for the three-months ended December 31, 2018 compared to income tax expense of approximately $3.7 million for the three-months ended December 31, 2017. The Company s effective tax rate decreased to 29.4% for the three-months ended December 31, 2018 from 456.0% for the three-months ended December 31, 2017. The income tax expense was approximately $293,000 for the nine-months ended December 31, 2018 and was approximately $4.4 million for the nine-months ended December 31, 2017. The Company s effective tax rate decreased to 21.1% for the nine-months ended December 31, 2018 from 164.7% for the nine-months ended December 31, 2017. The changes in the effective rates were attributable to a reduction in the current period operating income and the Tax Cuts and Jobs Act enacted in the prior year.

7. Fair Value Disclosures

The Company measures specific assets and liabilities at fair value, which is an exit price, representing the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. When applicable, the Company utilizes market data or assumptions that market participants would use in pricing the asset or liability under a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value. These tiers include: Level 1, defined as observable inputs such as quoted prices in active markets; Level 2, defined as inputs other than quoted prices in active markets that are either directly or indirectly observable; and Level 3, defined as unobservable inputs about which little or no market data exists, therefore requiring an entity to develop its own assumptions.

The Company s financial instruments consist of cash, finance receivables, repossessed assets, and the Line of Credit. For each of these financial instruments, the carrying value approximates fair value.

Finance receivables, net, approximates fair value based on the price paid to acquire Contracts. The price paid reflects competitive market interest rates and purchase discounts for the Company s chosen credit grade in the economic environment. This market is highly liquid as the Company acquires individual loans on a daily basis from dealers.

The initial terms of the Contracts generally range from 12 to 72 months. Beginning in December 2017, the maximum initial term of a Contract was reduced to 60 months. The initial terms of the Direct Loans generally range from 12 to 60 months. If liquidated outside of the normal course of business, the amount received may not be the carrying value.

Repossessed assets are valued at the lower of the finance receivable balance prior to repossession or the estimated net realizable value of the repossessed asset. The Company estimates the net realizable value using the projected cash value upon liquidation plus insurance claims outstanding, if any.

Based on current market conditions, any new or renewed credit facility would be expected to contain pricing that approximates the Company s current Line of Credit. Based on these market conditions, the fair value of the Line of Credit as of December 31, 2018 was estimated to be equal to the book value. The interest rate for the Line of Credit is a variable rate based on LIBOR pricing options.

			(In thousands)		
	Fair Value Measurement Using				
Description	**Level 1**	**Level 2**	**Level 3**	**Fair Value**	**Carrying Value**
Cash:					
December 31, 2018	**$ 4,252**	**$**	**$**	**$ 4,252**	**$ 4,252**
March 31, 2018	$ 2,626	$	$	$ 2,626	$ 2,626
Finance receivables:					
December 31, 2018	**$**	**$**	**$ 219,210**	**$ 219,210**	**$ 219,210**
March 31, 2018	$	$	$ 267,401	$ 267,401	$ 266,573

Repossessed assets:					
December 31, 2018	**$**	**$**	**$ 1,902**	**$ 1,902**	**$ 1,902**
March 31, 2018	$	$	$ 2,117	$ 2,117	$ 2,117
Line of credit:					
December 31, 2018	**$**	**$ 120,000**	**$**	**$ 120,000**	**$ 120,000**
March 31, 2018	$	$ 165,750	$	$ 165,750	$ 165,750

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The Company may be required, from time to time, to measure certain assets and liabilities at fair value on a nonrecurring basis. At each reporting period, all assets and liabilities for which the fair value measurement is based on significant unobservable inputs are classified as Level 3.

8. Contingencies

The Company currently is not a party to any pending legal proceedings other than ordinary routine litigation incidental to its business, none of which, if decided adversely to the Company, would, in the opinion of management, have a material adverse effect on the Company s financial condition or results of operations.

9. Summary of Significant Accounting Policies

Reclassifications

The Company made certain reclassifications to finance receivables, as a result of which it no longer reports a gross receivable and unearned interest balance. Therefore, the prior fiscal year balance sheet reflects a reclassification, to net the gross receivable and the unearned interest balance. The Company also reclassed the unearned insurance and fee commissions from a liability to net finance receivables, net of unearned discounts and insurance commissions. Net income and shareholders equity were not changed.

Recently Adopted Accounting Pronouncements

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606) . The ASU outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers. The guidance also requires disclosures regarding the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. Entities have the option to apply the new guidance under a retrospective approach to each prior reporting period presented or a modified retrospective approach with the cumulative effect of initially applying the new guidance recognized at the date of initial application within the Statement of Consolidated Financial Position. On July 9, 2015, the FASB approved the deferral of the effective date of ASU 2014-09 by one year. As a result, ASU 2014-09 is effective for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. On April 1, 2018, the Company adopted the new guidance utilizing the modified retrospective transition method. The adoption of this guidance did not have a material impact on the Company s consolidated financial statements.

In May 2017, the FASB issued ASU 2017-09, Compensation Stock Compensation (Topic 718). The guidance provides clarification on when modification accounting should be used for changes to the terms or conditions of a share-based payment award. This guidance is effective for fiscal years beginning after December 15, 2017 and for interim periods within those fiscal years, with early adoption permitted. The Company adopted the guidance on April 1, 2018, and it believes the adoption of this guidance did not have a material impact on its Consolidated Financial Statements and related disclosures.

In January 2017, the FASB issued ASU 2017-01, Business Combinations (Topic 805). The guidance clarifies the definition of a business, which assists entities when evaluating whether transactions should be accounted for as acquisitions of businesses or assets. This guidance is effective on a prospective basis for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company adopted the guidance on April 1, 2018 and it believes the adoption of this guidance did not have a material impact on its Consolidated Financial Statements.

In August 2016, the FASB issued the Accounting Standards Update (ASU) 2016-15 Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payment. The new guidance focuses on making the Statement of Cash Flows more uniform for companies. The amendments in this Update are effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. The Company adopted the guidance on April 1, 2018 and does not believe ASU 2016-15 had a material impact on its Consolidated Financial Statements.

Recent Accounting Pronouncements

In February 2018, the FASB issued Accounting Standards Update (ASU) No. 2018-02, Income Statement-Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income was issued to address a narrow-scope financial reporting issue that arose as a consequence of the change in the tax law. On December 22, 2017, the U.S. federal government enacted a tax bill, H.R.1, An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018 (Tax Cuts and Jobs Act of 2017). The ASU No. 2018-02 permits a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the newly enacted federal corporate income tax rate. The amount of the reclassification would be the difference between the historical corporate income tax rate of 35 percent and the newly enacted 21 percent corporate income tax rate. The ASU No. 2018-02 is effective for all entities for fiscal years beginning after

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December 15, 2018, and interim periods within those fiscal years with early adoption permitted, including adoption in any interim period, for (i) public business entities for reporting periods for which financial statements have not yet been issued and (ii) all other entities for reporting periods for which financial statements have not yet been made available for issuance. The adoption of this guidance will not impact the company s Consolidated Financial Statements or disclosures.

In August 2017, the Financial Accounting Standards Board (FASB) issued ASU 2017-12 Derivatives and Hedging (Topic 815). The guidance is intended to better align an entity s risk management activities and financial reporting for hedging relationships. This guidance is effective for fiscal years beginning after December 15, 2018 and for interim periods within those fiscal years, with early adoption permitted. The Company is currently evaluating impact of the adoption of this guidance on its Consolidated Financial Statements and related disclosures.

In June 2016, the FASB issued the ASU 2016-13 Financial Instruments Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. Among other things, the amendments in this ASU require the measurement of all expected credit losses for financial instruments held at the reporting date based on historical experience, current conditions and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. The ASU also requires additional disclosures related to estimates and judgments used to measure all expected credit losses. The new guidance is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Early application will be permitted for all organizations for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. The Company is currently evaluating the impact of the adoption of this ASU on the consolidated financial statements and is collecting and analyzing data that will be needed to produce historical inputs into any models created as a result of adopting this ASU. At this time, we believe the adoption of this ASU will likely have a material effect and is expected to increase the overall allowance for credit losses.

In February 2016, the FASB issued ASU No. 2016-02, Leases , intended to improve financial reporting about leasing transactions. The ASU affects all companies and other organizations that lease assets such as real estate, airplanes, and manufacturing equipment. The ASU will require organizations that lease assets referred to as lessees to recognize on the balance sheet the assets and liabilities for the rights and obligations created by those leases. The accounting by organizations that own the assets leased by the lessee also known as lessor accounting will remain largely unchanged from current U.S. GAAP. ASU 2016-02 is effective for annual periods beginning after December 15, 2018, including interim periods within those fiscal years. Early application is permitted. Upon adoption, the Company will add the impact of the full operating lease terms, using the present value of future minimum lease payments to the balance sheet. The Company will continue to evaluate the impact of the adoption of this ASU on the Consolidated Financial Statements.

The Company does not believe there are any other recently issued accounting standards that have not yet been adopted that will have a material impact on the Company s consolidated financial statements.

10. Subsequent Event

On February 12, 2019, the Company entered into an amendment to its existing loan and security agreement governing the terms and conditions of its Line of Credit. Such amendment:

waives compliance with the minimum interest coverage ratio requirement for the measurement period ended November 30, 2018;

modifies the minimum interest coverage ratio requirement to be 0.44 to 1.0 for the measurement period ended December 31, 2018, and 0.20 to 1.0 for the measurement period ending January 31, 2019, and 1.0 to 1.0 for the measurement period ending February 28, 2019 and thereafter; and

reduced the Line of Credit to $140 million.

After giving effect to such amendment, the interest coverage ratio is calculated as of each month end for the three-month period then ended as the ratio of (A) the Company s adjusted net earnings plus interest expense, waiver fees, and the provision for income tax for the applicable period to (B) the Company s interest expenses for such period and the minimum loss reserve amount is calculated as of each month for the three-month period then ended as (A) four times the net charge-offs divided by (B) the net balances due under all contracts divided by three. The interest rates for borrowings under the credit facility remain at base rate plus 3.0% or LIBOR plus 4.0%.

The Company s obligations under the loan and security agreement are secured by substantially all of the operating assets of the Company. The loan and security agreement contains other events of default and requires the Company to comply with certain other financial ratios and covenants and to satisfy specified financial tests, including maintenance of asset quality and portfolio performance tests. Unless waived by lender, failure to meet any required financial ratios, covenants or financial tests would result in an event of default under the loan and security agreement. If an event of default occurs, the

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Company s lenders could increase borrowing costs, restrict the Company s ability to obtain additional borrowings under the facility, accelerate all amounts outstanding under the facility, or enforce their interest against collateral pledged under the facility.

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

Forward-Looking Information

This Quarterly Report on Form 10-Q contains various forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Such statements are based on management s current beliefs and assumptions, as well as information currently available to management. When used in this document, the words anticipate , estimate , expect , will , may , plan, believe , intend and similar exp intended to identify forward-looking statements. Although Nicholas Financial, Inc., including its subsidiaries (collectively, the Company, we, us, or our) believes that the expectations reflected or implied in such forward-look statements are reasonable, it can give no assurance that such expectations will prove to be correct. Such statements are subject to certain risks, uncertainties and assumptions, including but not limited to the risk factors discussed under Item 1A Risk Factors in our Annual Report on Form 10-K, and our other filings made with the U.S. Securities and Exchange Commission (SEC). Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those anticipated, estimated or expected. Among the key factors that may cause actual results to differ materially from those projected in forward-looking statements include the availability of capital (including the ability to access bank financing), recently enacted, proposed or future legislation and the manner in which it is implemented, including the effect of changes in tax law, such as the effect of the Tax Cuts and Jobs Act, fluctuations in the economy, the degree and nature of competition and its effects on the Company s financial results, fluctuations in interest rates, the effectiveness of the Company s internal control over financial reporting and disclosure controls and procedures, demand for consumer financing in the markets served by the Company, the Company s products and services, increases in the default rates experienced on Contracts, adverse regulatory changes in the Company s existing and future markets, the Company s intentions regarding strategic alternatives, the Company s ability to expand its business, including its ability to complete acquisitions and integrate the operations of any acquired businesses and to expand into new markets, and the Company s ability to recruit and retain qualified employees. All forward-looking statements included in this Quarterly Report are based on information available to the Company as of the date of filing of this Quarterly Report, and the Company assumes no obligation to update any such forward-looking statement.

Litigation and Legal Matters

See Item 1. Legal Proceedings in Part II of this quarterly report below.

Regulatory Developments

As previously reported, Title X of the Dodd-Frank Act established the Consumer Financial Protection Bureau (CFPB), which became operational on July 21, 2011. Under the Dodd-Frank Act, the CFPB has regulatory, supervisory and enforcement powers over providers of consumer financial products, such as the Contracts and the Direct Loans that we offer, including explicit supervisory authority to examine, audit, and investigate companies offering a consumer financial product such as ourselves. Although the Dodd-Frank Act expressly provides that the CFPB has no authority to establish usury limits, efforts to create a federal usury cap, applicable to all consumer credit transactions and substantially below rates at which the Company could continue to operate profitably, are still ongoing. Any federal legislative or regulatory action that severely restricts or prohibits the provision of consumer credit and similar services on terms substantially similar to those we currently provide could if enacted have a material, adverse impact on our business, prospects, results of operations and financial condition. Some consumer advocacy groups have suggested that certain forms of alternative consumer finance products, such as installment loans, should be a regulatory priority and it is possible that at some time in the future the CFPB could propose and adopt rules making such lending or other products that we may offer materially less profitable or impractical. Further, the CFPB may target specific features of loans by rulemaking that could cause us to cease offering certain products. Any such rules could have a material adverse effect on our business, results of operations and financial condition. The CFPB could also adopt rules imposing new and potentially burdensome requirements and limitations with respect to any of our current or future lines of business, which could have a material adverse effect on our operations and financial performance. For example, the CFPB has stated that it expects to conduct separate rulemaking to identify larger participants in the installment lending market for purposes of its supervision program.

In June 2015, the CFPB published a rule expanding their supervision and examination of non-depository larger participants in the automobile finance business, including us. The CFPB s stated objectives of such examinations are: to assess the quality of a larger participant s compliance management systems for preventing violations of federal consumer financial laws; to identify acts or practices that materially increase the risk of violations of federal consumer finance laws and associated harm to consumers; and to gather facts that help determine whether the larger participant engages in acts or practices that are likely to violate federal consumer financial laws in connection with its automobile finance business. Thus, as a larger participant, we will be subject to examination by the CFPB for compliance with, among other Federal consumer financial laws, the applicable provisions of the Truth in Lending Act (TILA); Equal Credit Opportunity Act (ECOA); Fair Credit Reporting Act (FCRA); Electronic Fund Transfer Act (EFTA); Unfair, Deceptive or Abusive Acts or Practices (UDAAP); Gramm-Leach-Bliley Act (GLBA); Fair Debt Collection Practices Act (FDCPA); and, Military Lending Act (MLA), as well as, the adequacy of our compliance management system.

Critical Accounting Policy

The Company s critical accounting policy relates to the allowance for credit losses. It is based on management s opinion of an amount that is adequate to absorb losses incurred in the existing portfolio. Because of the nature of the customers under the Company s Contracts and its Direct Loan program, the Company considers the establishment of adequate reserves for credit losses to be imperative.

During the first quarter of fiscal year ending March 31, 2019, the Company began using the trailing six-month charge-offs, annualized, to calculate the allowance for credit losses. This change was made to reflect changes in the Company s lending policies and underwriting standards, which resulted from the Company changing its business strategies. The Company re-focused on financing primary transportation to and from work for the subprime borrower. This change resulted in purchasing higher yielding loans, smaller amounts financed and shorter monthly terms. A trailing six-month, annualized, is also more in line with the industry practice, which uses a trailing twelve-month. Management believes a trailing six-month will more quickly reflect changes in the portfolio.

In addition, the Company takes into consideration the composition of the portfolio, current economic conditions, the estimated net realizable value of the underlying collateral, historical loan loss experience, delinquency, non-performing assets, and bankrupt accounts when determining management s estimate of probable credit losses and adequacy of the allowance for credit losses. If the allowance for credit losses is determined to be inadequate, then an additional charge to the provision would be recorded to maintain adequate reserves based on management s evaluation of the risk inherent in the loan portfolio.

Prior to the first quarter of fiscal 2019, the Company calculated the allowance for credit losses by reference to static pools, with each pool consisting of Contracts purchased during a three-month period for a given branch location, as management considered the Contracts in those pools to have similar risk characteristics. The Company analyzed each consolidated static pool at specific points in time to estimate losses that were likely to be incurred as of the reporting date. The Company maintained historical write-off information for over 10 years with respect to every consolidated static pool and segregated each static pool by liquidation, thereby creating snapshots or buckets of each pool s historical write-off-to liquidation ratio at five different points in each pool s liquidation cycle. These snapshots were then used to assist in determining the allowance for credit losses. The five snapshots were tracked at liquidation levels of 20%, 40%, 60%, 80% and 100%.

Contracts are purchased from many different dealers and are all purchased on an individual Contract-by-Contract basis. Individual Contract pricing is determined by the automobile dealerships and is generally the lesser of the applicable state maximum interest rate, if any, or the maximum interest rate which the customer will accept. In most markets, competitive forces will drive down Contract rates from the maximum rate to a level where an individual competitor is willing to buy an individual Contract. The Company generally purchases Contracts on an individual basis.

The Company utilizes the branch model, which allows for Contract purchasing to be done at the branch level. The Company has detailed underwriting guidelines it utilizes to determine which Contracts to purchase. These guidelines are specific and are designed to provide reasonable assurance that the Contracts that the Company purchases have common risk characteristics. The Company utilizes its District Managers to evaluate their respective branch locations for adherence to these underwriting guidelines, as well as approve underwriting exceptions. The Company also utilizes internal audit (IA) to assure adherence to its underwriting guidelines. Any Contract that does not meet our underwriting guidelines can be submitted by a branch manager for approval from the Company s District Managers or senior management.

Introduction

For the three-months ended December 31, 2018, the net dilutive loss per share improved to $0.12 as compared to a dilutive loss per share of $0.37 for the three-months ended December 31, 2017. Net loss was $0.9 million for the three-months ended December 31, 2018 and $2.9 million for the three-months ended December 31, 2017. Revenue decreased 18.4% to $16.7 million for the three-months ended December 31, 2018 as compared to $20.5 million for the three-months ended December 31, 2017. The decrease in revenue was primarily due to a reduction in the aggregate dollar amount and volume of Contracts.

For the nine-months ended December 31, 2018, diluted net earnings per share increased to $0.14 as compared to a dilutive net loss per share of $0.22 for the nine-months ended December 31, 2017. Net income was $1.1 million for the nine-months

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ended December 31, 2018 compared to a $1.7 million net loss for the nine-months ended December 31, 2017. Revenue decreased 14.3% to $54.9 million for the nine-months ended December 31, 2018 as compared to $64.1 million for the nine-months ended December 31, 2017.

With the Company s regained focus on its core business of financing primary transportation to and from work for the subprime borrower, the Company was able to improve its financial results in the quarter ended December 31, 2018 compared to the prior year quarter. This resulted in an increase in the average yield of purchased Contracts to 23.5% from 21.7% for the three-months ended December 31, 2018 and 2017, respectively and an increase to 23.6% from 22.0% for the nine-months ended December 31, 2018 and 2017, respectively.

Aggressive competition had previously influenced the Company to purchase lower credit quality Contracts. Historically, the Company was able to expand its automobile finance business in the non-prime credit market by offering to purchase Contracts on terms that were competitive with those of other companies. However, it became increasingly difficult for the Company to match or exceed pricing of its competitors, which resulted in declining Contract acquisition rates during the 2016, 2017, and 2018 fiscal years. The Company expects this trend of declining acquisition rates to continue for the foreseeable future; however, the driver behind this trend is now expected to be the Company s intentional focus on pricing discipline**.** We remain cautious with respect to near-term losses as delinquency percentages remain elevated compared to historical levels.

	Three months ended December 31, (In thousands)		**Nine months ended December 31, (In thousands)**	
	2018	**2017**	**2018**	**2017**
Portfolio Summary				
Average finance receivables(1)	$ 261,036	$ 321,742	$ 279,023	$ 333,660
Average indebtedness(2)	$ 127,332	$ 183,615	$ 143,693	$ 196,619
Interest and fee income on finance receivables	$ 16,740	$ 20,526	$ 54,903	$ 64,062
Interest expense	2,303	2,585	7,228	7,500
Net interest and fee income on finance receivables	$ 14,437	$ 17,941	$ 47,675	$ 56,562
Gross portfolio yield(3)	25.65%	25.52%	26.24%	25.60%
Interest expense as a percentage of average finance receivables	3.53%	3.21%	3.45%	3.00%
Provision for credit losses as a percentage of average finance receivables	12.06%	11.18%	10.36%	11.54%
Net portfolio yield(3)	10.06%	11.13%	12.43%	11.06%
Operating expenses as a percentage of average finance receivables	12.03%	10.12%	11.76%	9.98%
	(1.96)%	1.01%	0.66%	1.08%

Pre-tax yield as a percentage of average finance receivables(4)				
Write-off to liquidation(5)	12.59%	13.66%	12.35%	13.00%
Net charge-off percentage(6)	10.84%	10.63%	10.49%	10.13%
Allowance percentage(7)	7.65%	6.59%	7.16%	6.35%

Note: All three-month and nine-month statement of income performance indicators expressed as percentages have been annualized.

(1) Average finance receivables represent the average of finance receivables throughout the period.
(2) Average indebtedness represents the average outstanding borrowings under the Line of Credit.

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(3) Gross portfolio yield represents interest and fee income on finance receivables as a percentage of average finance receivables. Net portfolio yield represents (a) interest and fee income on finance receivables minus (b) interest expense minus (c) the provision for credit losses, as a percentage of average finance receivables.
(4) Pre-tax yield represents net portfolio yield minus operating expenses (marketing, salaries, employee benefits, depreciation, and administrative), as a percentage of average finance receivables.
(5) Write-off to liquidation percentage is defined as net charge-offs divided by liquidation. Liquidation is defined as beginning receivable balance plus current period purchases and originations minus ending receivable balance.
(6) Net charge-off percentage represents net charge-offs (charge-offs less recoveries) divided by average finance receivables outstanding during the period.
(7) Allowance percentage represents the allowance for credit losses divided by average finance receivables outstanding during the period.

Operating Strategy

The Company previously announced that it was re-evaluating its operational strategy and structure. Under its new management team, however, the Company has elected to remain committed to its branch-based model and its core product of financing primary transportation to and from work for the subprime borrower. The Company will strategically employ the use of centralized servicing departments to supplement the branch operations and improve operational efficiencies, but its focus will be on its core business model of decentralized operations. The Company s strategy will also include pricing based on risk (rate, yield, advance, etc.) and a commitment to the underwriting discipline required for optimal portfolio performance.

The Company s principal goals are to increase its profitability and its long-term shareholder value through the measured acquisition of Contracts in existing markets and broadening the geographic area in which its current branches operate. The Company seeks to strengthen its automobile financing program in the seventeen states Alabama, Florida, Georgia, Illinois, Indiana, Kansas, Kentucky, Michigan, Missouri, North Carolina, Ohio, Pennsylvania, South Carolina, Tennessee, Texas, Virginia and Wisconsin in which it currently operates by employing its core branch-based business model in each market it services, while supporting its branch network with targeted centralized servicing departments. During fiscal 2019, the Company exited the Maryland market by closing its branch office located in Baltimore. The Company also consolidated offices in Florida (the Sunrise branch was consolidated with our Pompano branch) and in North Carolina (the Winston-Salem branch consolidated with our Greensboro branch). During fiscal 2017 and 2018, the Company also consolidated branch offices located in Sarasota, Florida, Toledo, Ohio, Troy, Michigan, Dayton, Ohio, Doral, Florida and Villa Park, Illinois with other branches in those markets. The Company will continue to evaluate any branch locations not meeting minimum profitability targets and may elect to close additional branches in the future.

During fiscal 2019 the Company also initiated expansion efforts in Houston, Texas and Milwaukee, Wisconsin. Currently these expansion efforts are supported virtually (Houston expansion through our existing Houston branch and Milwaukee expansion through our Corporate centralized funding and servicing department). Once receivables in each market reach an acceptable level, the Company intends to open physical brick-and-mortar locations in each of the respective areas. The Company also continues to look for expansion opportunities both in states in which it currently operates and in new states. Although the Company cannot assert how many new markets it will enter (if any) in the foreseeable future, it does remain focused on growing the branch network where conditions are favorable.

Although the Company has not made any bulk purchases of Contracts in over two decades, if the opportunity arises, the Company may consider possible acquisitions of portfolios of seasoned Contracts from dealers or lenders in bulk transactions as a means of further penetrating its existing markets or expanding its presence in targeted geographic locations.

The Company is currently licensed to provide Direct Loans in Florida, North Carolina, Ohio, and Georgia and has also started writing deregulated direct loans over $3,000 in Georgia. The Company solicits current and former customers in these states for the purpose of selling Direct Loans to such customers, and the expansion of its Direct Loan capabilities to the other states in which it acquires Contracts. Even with this targeted expansion, the Company expects its total Direct Loans portfolio to remain between 2% and 10% of its total portfolio for the foreseeable future. The Company cannot provide any assurances that it will be able to expand in either its current markets or any targeted new markets.

Analysis of Credit Losses

In December 2017, the Board appointed our new President and Chief Executive Officer. Under his leadership, the Company redefined its business strategy, which resulted in more restrictive lending policies and underwriting standards. On an aggregate basis, this change generally resulted in loans with higher yields, smaller amounts financed and shorter terms.

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Therefore, during the first quarter of fiscal 2019, the Company began using a trailing six-month charge-off analysis, annualized, to calculate the allowance for credit losses. Management believes that using the trailing six-month charge-off analysis, annualized, will more quickly reflect changes in the portfolio as compared to a trailing twelve months charge-off analysis that is a typical practice in the industry.

In addition, the Company takes into consideration the composition of the portfolio, current economic conditions, the estimated net realizable value of the underlying collateral, historical loan loss experience, delinquency, non-performing assets, and bankrupt accounts when determining management s estimate of probable credit losses and adequacy of the allowance for credit losses. If the allowance for credit losses is determined to be inadequate, then an additional charge to the provision would be recorded to maintain adequate reserves based on management s evaluation of the risk inherent in the loan portfolio.

Non-performing assets are defined as accounts that are contractually delinquent for 61 or more days past due or Chapter 13 bankruptcy account, and the accrual of interest income is suspended, and any previously accrued interest is reversed. Upon notification of a bankruptcy, an account is monitored for collection with other Chapter 13 accounts. In the event the debtors balance is reduced by the bankruptcy court, the Company will record a loss equal to the amount of principal balance reduction. The remaining balance will be reduced as payments are received by the bankruptcy court. In the event an account is dismissed from bankruptcy, the Company will decide based on several factors, whether to begin repossession proceedings or allow the customer to begin making regularly scheduled payments.

The Company defines a Chapter 13 bankruptcy account as a Troubled Debt Restructuring (TDR). As of March 31, 2018, the Company allocated a specific reserve using a look back method to calculate the estimated losses. The Company evaluated the performance as of December 31, 2018 of those accounts that had been classified as Chapter 13 bankruptcy accounts as of March 31, 2017. Based on this look back, management calculated a specific reserve of approximately $774,000.

The provision for credit losses decreased for the three and nine-months ended December 31, 2018 compared to the three and nine months ended December 31, 2017. The decreases were largely due to decreases in the average finance receivables balance partially offset by an increase in the net charge-off percentages (see note 6 in the Portfolio Summary table in the *Introduction* above for the definition of net charge-off percentage). The Company s net charge-off percentage increased because the decrease in average finance receivables, net of unearned dealer discounts, was disproportionately greater than the decrease in net charge-offs. The Company s allowance for credit losses also incorporates recent trends such as delinquency, non-performing assets, and bankruptcy. The Company believes that this approach reflects the current trends of incurred losses within the portfolio and better aligns the allowance for credit losses with the portfolio s performance indicators.

The delinquency percentage for Contracts more than thirty days past due, excluding Chapter 13 bankruptcy accounts, as of December 31, 2018 was 13.1%, a decrease from 13.5% as of December 31, 2017. The delinquency percentage for Direct Loans more than thirty days past due, excluding Chapter 13 bankruptcy accounts, as of December 31, 2018 was 4.4%, a decrease from 4.6% as of December 31, 2017. The decrease in delinquency percentage for both Contracts and Direct Loans was driven primarily by the Company s regained focus on local branch-based servicing. Beginning on September 1, 2016, when an account is 180 days contractually delinquent, the account is written off. Prior to September 2016, accounts that were 120 days contractually delinquent were written off.

The Company has continued to see a significant number of competitors with aggressive underwriting in its operating market. See *Note 4 Finance Receivables* for changes in allowance for credit losses, credit quality and delinquencies.

In accordance with our policies and procedures, certain borrowers qualify for, and the Company offers, one-month principal payment deferrals on Contracts and Direct Loans. For the three-months ended December 31, 2018 and December 31, 2017 the Company granted deferrals to approximately 2.38% and 7.47%, respectively, of total Contracts and Direct Loans. For the nine-months ended December 31, 2018 and December 31, 2017 the Company granted deferrals to approximately 9.37% and 30.34%, respectively, of total Contracts and Direct Loans. The decreases resulted from the Company s more disciplined approach with respect to granting deferrals. The number of deferrals is also influenced by portfolio performance, including but not limited to, inflation, credit quality of loans purchased, competition at the time of Contract acquisition, and general economic conditions.

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Three-months ended December 31, 2018 compared to three months ended December 31, 2017

Interest Income and Loan Portfolio

Interest and fee income on finance receivables, predominantly finance charge income, decreased 18.4% to $16.7 million for the three-month period ended December 31, 2018 from $20.5 million for the three-month period ended December 31, 2017. The decrease was primarily due to an 18.9 % decrease in average finance receivables to $261.0 million for the three-month period ended December 31, 2018 when compared to $321.7 million for the corresponding period ended December 31, 2017. This decrease in average finance receivables was primarily the result of a reduction in the aggregate dollar amount and volume of Contracts purchased, as the Company continued implementing its renewed strategic focus of financing primary transportation to and from work for the subprime borrower. This shift in focus also allowed us to acquire Contracts at higher yields during the three-month period ended December 31,2018 compared to acquisitions during the corresponding period ended December 31, 2017, although the increase in average yield could not entirely offset the reduction in the aggregate dollar amount of Contracts purchased.

The gross portfolio yield increased to 25.65% for the three-month period ended December 31, 2018 compared to 25.52% for the three-month period ended December 31, 2017. The net portfolio yield decreased to 10.06% for the three-month period ended December 31, 2018 from 11.13% for the corresponding period ended December 31, 2017. The net portfolio yield decreased due (i) to an increase in the provision for credit losses, as described under Analysis of Credit Losses , and (ii) an increase in interest expense as a percentage of average finance receivables (3.53% for the three-month period ended December 31, 2018 compared to 3.21% for the three-month period ended December 31, 2017).

Operating Expenses

Operating expenses decreased to approximately $7.8 million for the three-month period ended December 31, 2018 from approximately $8.1 million for the three-month period ended December 31, 2017. Operating expenses as a percentage of average finance receivables increased to 12.03% for the three-month period ended December 31, 2018 from 10.12% for the three-month period ended December 31, 2017. This increase was attributed to the decrease in the average finance receivables balance.

Provision Expense

The provision for credit losses decreased to $7.9 million for the three-months ended December 31, 2018 from $9.0 million for the three-months ended December 31, 2017, largely due to a 18.9 % decrease in the average finance receivables and by an increase in the net charge-offs percentage to 10.84% for the three-months ended December 31, 2018 from 10.63% for the three-months ended December 31, 2017. The Company s allowance for credit losses also incorporates recent trends such as delinquency, non-performing assets, and bankruptcy. The Company believes that this approach reflects the current trends of incurred losses within the portfolio and better aligns the allowance for credit losses with the portfolio s performance indicators.

Interest Expense

Interest expense was $2.3 million for the three-month period ended December 31, 2018 and $2.6 million for the three-month period ended December 31, 2017. The following table summarizes the Company s average cost of borrowed funds:

	Three months ended December 31,	
	2018	**2017**
Variable interest under the Line of Credit facility	**3.23%**	**0.63%**
Credit spread under the Line of Credit facility	**4.00%**	**5.00%**
Average cost of borrowed funds	**7.23%**	**5.63%**

LIBOR rates have increased (2.46% as of December 31, 2018 compared to 1.57 % as of December 31, 2017). During the three-months ended December 31, 2017 the Company s remaining interest rate swap expired. In addition, average cost of funds increased due to additional loan cost fees related to Amendment No. 9, which were amortized during the quarter ended December 31, 2018. For further discussions regarding interest rates see *Note 5 Line of Credit* .

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Income Taxes

The Company recorded an income tax benefit of approximately $376,000 for the three-months ended December 31, 2018 compared to income tax expense of approximately $3.7 million for the three-months ended December 31, 2017. The Company s effective tax rate decreased to 29.4% for the three-months ended December 31, 2018 from 456.0% for the three-months ended December 31, 2017. The change in the effective rate was attributable to a net operating loss for the three-month period ended December 31, 2018 and the Tax Cuts and Jobs Act, which was enacted in the prior year.

Nine-months ended December 31, 2018 compared to nine-months ended December 31, 2017

Interest Income and Loan Portfolio

Interest and fee income on finance receivables, predominantly finance charge income, decreased 14.3% to $54.9 million for the nine-month period ended December 31, 2018 from $64.1 million for the nine-month period ended December 31, 2017. The decrease in interest and fee income was primarily due to a 16.4% decrease in the average finance receivables to $279.0 million for the nine-month period ended December 31, 2018 when compared to $333.7 million for the nine-month period ended December 31, 2017. The decrease in average finance receivables was primarily the result of a reduction in the aggregate dollar amount and volume of Contracts, as the Company continued implementing its renewed strategic focus of financing primary transportation to and from work for the subprime borrower. This shift in focus also allowed us to acquire Contracts at higher yields during the nine-month period ended December 31, 2018 compared to acquisitions during the period ended December 31, 2017, although the increase in average yield could not entirely offset the reduction in the aggregate dollar amount of Contracts purchased.

The gross portfolio yield increased to 26.24% for the nine-month period ended December 31, 2018 compared to 25.60% for the nine-month period ended December 31, 2017. The net portfolio yield increased to 12.43% for the nine-month period ended December 31, 2018 from 11.06% for the corresponding period ended December 31, 2017. The net portfolio yield increased due to a decrease in the provision for credit losses, as described under Analysis of Credit Losses partially offset by an increase in the interest expense as a percentage of average finance receivables (3.45% for the nine-month period ended December 31, 2018 compared to 3.00% for the nine-month period ended December 31, 2017).

Operating Expenses

Operating expenses were approximately $24.6 million for the nine-month period ended December 31, 2018 and $25.0 for the nine-month period ended December 31, 2017. Operating expenses as a percentage of finance receivables increased to 11.8% for the nine-month period ended December 31, 2018 from 10.0% for the nine-month period ended December 31, 2017 primarily due to the lower average finance receivables.

Provision Expense

The provision for credit losses decreased to $21.7 million for the nine-months ended December 31, 2018 from $28.9 million for the nine-months ended December 31, 2017, largely due to a 16.4% decrease in the average finance receivables partially offset by an increase in the net charge-off percentage to 10.49% for the nine-months ended December 31, 2018 from 10.13% for the nine-months ended December 31, 2017. The Company s allowance for credit losses also incorporates recent trends such as delinquency, non-performing assets, and bankruptcy. The Company believes that this approach reflects the current trends of incurred losses within the portfolio and better aligns the allowance for credit losses with the portfolio s performance indicators.

Interest Expense

Interest expense decreased to $7.2 million for the nine-month period ended December 31, 2018 compared to $7.5 million for the nine-month period ended December 31, 2017. The following table summarizes the Company s average cost of borrowed funds:

	Nine months ended December 31,	
	2018	**2017**
Variable interest under the Line of Credit facility	**2.71%**	**0.08%**
Settlements under interest rate swap agreements		**(0.01)%**
Credit spread under the Line of Credit facility	**4.00%**	**5.00%**
Average cost of borrowed funds	**6.71%**	**5.07%**

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LIBOR rates have increased (2.46% as of December 31, 2018 compared to 1.57% as of December 31, 2017) In addition, there was an increase in the loan costs which were amortized during the nine-months ended December 31, 2018. For further discussions regarding interest rates, see *Note 5 Line of Credit* .

Income Taxes

Income tax expense was approximately $293,000 for the nine-months ended December 31, 2018 and $4.4 million for the nine-months ended December 31, 2017. The Company s effective tax rate decreased to 21.1% for the nine-months ended December 31, 2018 from 164.70% for the nine-months ended December 31, 2017. The change in the effective rate was attributed to a decrease in operating income during the nine months ended December 31, 2018 and the Tax Cuts and Jobs Act, which was enacted in the prior year.

Contract Procurement

The Company purchases Contracts in the eighteen states listed in the table below. The Contracts purchased by the Company are predominantly for used vehicles; for the three- and nine-month periods ended December 31, 2018 and 2017, less than 1% were for new vehicles.

The following tables present selected information on Contracts purchased by the Company.

State	As of December 31, 2018 Number of branches	Three months ended December 31, 2018 Net Purchases (In thousands)	Three months ended December 31, 2017	Nine months ended December 31, 2018 Net Purchases (In thousands)	Nine months ended December 31, 2017
FL	**17**	**$ 4,646**	$ 6,552	**$ 15,886**	$ 21,081
GA	**6**	**1,842**	3,000	**6,289**	8,270
NC	**5**	**1,419**	2,374	**5,352**	6,364
SC	**2**	**492**	1,088	**1,651**	3,040
OH	**6**	**2,498**	3,693	**8,371**	10,431
MI	**2**	**801**	1,286	**2,543**	3,685
VA	**2**	**275**	770	**1,484**	1,986
IN	**3**	**799**	1,776	**2,749**	4,975
KY	**3**	**863**	1,410	**2,826**	4,159
MD			244		886
AL	**2**	**227**	682	**966**	2,259
TN	**2**	**665**	982	**1,847**	2,304
IL	**1**	**181**	525	**545**	2,245
MO	**3**	**650**	1,153	**2,089**	3,615
KS	**1**	**259**	427	**813**	1,390
TX	**2**	**435**	739	**1,539**	1,859
PA	**1**	**424**	677	**1,316**	1,666
WI	**a**				106

Total	**59**	**$ 16,476**	$ 27,378	**$ 56,266**	$ 80,321

a. Purchases in the state of Wisconsin are currently being acquired and serviced through an Illinois branch.

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Contracts	Three months ended December 31, (Purchases in thousands) 2018	2017	Nine months ended December 31, (Purchases in thousands) 2018	2017
Purchases	**$ 16,476**	$ 27,378	**$ 56,266**	$ 80,321
Average APR	**23.45%**	21.68%	**23.56%**	21.99%
Average discount	**8.13%**	6.89%	**8.29%**	7.23%
Average term (months)	**47**	54	**47**	55
Average loan	**$ 10,139**	$ 11,577	**$ 10,169**	$ 11,552
Number of Contracts	**1,625**	2,365	**5,533**	6,953

Loan Origination

The following table presents selected information on Direct Loans originated by the Company.

Direct Loans Originated	Three months ended December 31, (Originations in thousands) 2018	2017	Nine months ended December 31, (Originations in thousands) 2018	2017
Originations	**$ 2,999**	$ 2,218	**$ 6,162**	$ 6,196
Average APR	**25.93%**	25.20%	**26.25%**	25.25%
Average term (months)	**25**	28	**25**	29
Average loan	**$ 4,063**	$ 3,566	**$ 3,963**	$ 3,742
Number of loans	**738**	622	**1,555**	1,656

Liquidity and Capital Resources

The Company s cash flows are summarized as follows:

	Nine months ended December 31, (In thousands) 2018	2017
Cash provided by (used in):		
Operating activities	**$ 12,803**	$ 19,356
Investing activities	**35,284**	15,409
Financing activities	**(46,461)**	(34,538)