

NICHOLAS FINANCIAL INC  
Form 10-Q  
February 09, 2018

**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, 2017**

**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**  
**(State or Other Jurisdiction of**

**8736-3354**  
**(I.R.S. Employer**

**Incorporation or Organization)**

**Identification No.)**

**2454 McMullen Booth Road, Building C**

**Clearwater, Florida**  
**(Address of Principal Executive Offices)**

**33759**  
**(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 1, 2018, 12,599,201 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 7,885,397 shares were entitled to vote).



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NICHOLAS FINANCIAL, INC.

FORM 10-Q

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**PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS**

Nicholas Financial, Inc. and Subsidiaries

**Consolidated Balance Sheets**

(In thousands)

|                                                                                                                                                     | <b>December 31,<br/>2017<br/>(Unaudited)</b> | <b>March 31,<br/>2017</b> |
|-----------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------|---------------------------|
| <b>Assets</b>                                                                                                                                       |                                              |                           |
| Cash                                                                                                                                                | \$ 3,082                                     | \$ 2,855                  |
| Finance receivables, net                                                                                                                            | 281,358                                      | 317,205                   |
| Assets held for resale                                                                                                                              | 2,975                                        | 2,453                     |
| Income taxes receivable                                                                                                                             | 620                                          | 719                       |
| Prepaid expenses and other assets                                                                                                                   | 729                                          | 674                       |
| Property and equipment, net                                                                                                                         | 970                                          | 1,184                     |
| Interest rate swap agreements                                                                                                                       |                                              | 17                        |
| Deferred income taxes                                                                                                                               | 6,456                                        | 8,505                     |
| <br>Total assets                                                                                                                                    | <br>\$ 296,190                               | <br>\$ 333,612            |
| <b>Liabilities and shareholders' equity</b>                                                                                                         |                                              |                           |
| Line of credit                                                                                                                                      | \$ 178,000                                   | \$ 213,000                |
| Drafts payable                                                                                                                                      | 2,186                                        | 1,851                     |
| Accounts payable and accrued expenses                                                                                                               | 4,994                                        | 5,932                     |
| Deferred revenues                                                                                                                                   | 3,313                                        | 3,969                     |
| <br>Total liabilities                                                                                                                               | <br>188,493                                  | <br>224,752               |
| <b>Shareholders' equity</b>                                                                                                                         |                                              |                           |
| Preferred stock, no par: 5,000 shares authorized; none issued                                                                                       |                                              |                           |
| Common stock, no par: 50,000 shares authorized; 12,599 and 12,524 shares issued, respectively; and 7,885 and 7,810 shares outstanding, respectively | 34,467                                       | 33,889                    |
| Treasury stock: 4,714 common shares, at cost                                                                                                        | (70,459)                                     | (70,459)                  |
| Retained earnings                                                                                                                                   | 143,689                                      | 145,430                   |
| <br>Total shareholders' equity                                                                                                                      | <br>107,697                                  | <br>108,860               |
| <br>Total liabilities and shareholders' equity                                                                                                      | <br>\$ 296,190                               | <br>\$ 333,612            |

*See accompanying notes.*



## Nicholas Financial, Inc. and Subsidiaries

## Consolidated Statements of Income (Loss)

(Unaudited)

(In thousands, except per share amounts)

|                                                       | Three months ended<br>December 31, |           | Nine months ended<br>December 31, |           |
|-------------------------------------------------------|------------------------------------|-----------|-----------------------------------|-----------|
|                                                       | 2017                               | 2016      | 2017                              | 2016      |
| Interest and fee income on finance receivables        | \$ 20,526                          | \$ 22,044 | \$ 64,062                         | \$ 67,606 |
| Expenses:                                             |                                    |           |                                   |           |
| Marketing                                             | 351                                | 369       | 1,095                             | 1,100     |
| Salaries and employee benefits                        | 4,826                              | 5,041     | 14,835                            | 16,363    |
| Administrative                                        | 2,845                              | 2,932     | 8,698                             | 8,752     |
| Provision for credit losses                           | 8,989                              | 8,796     | 28,887                            | 23,966    |
| Depreciation                                          | 116                                | 142       | 356                               | 413       |
| Interest expense                                      | 2,585                              | 2,258     | 7,483                             | 6,745     |
| Change in fair value of interest rate swap agreements |                                    | (81)      | 17                                | (184)     |
|                                                       | 19,712                             | 19,457    | 61,371                            | 57,155    |
| Operating income before income taxes                  | 814                                | 2,587     | 2,691                             | 10,451    |
| Income tax expense                                    | 3,712                              | 981       | 4,432                             | 3,972     |
| Net income (loss)                                     | \$ (2,898)                         | \$ 1,606  | \$ (1,741)                        | \$ 6,479  |
| Earnings (loss) per share:                            |                                    |           |                                   |           |
| Basic                                                 | \$ (0.37)                          | \$ 0.21   | \$ (0.22)                         | \$ 0.83   |
| Diluted                                               | \$ (0.37)                          | \$ 0.21   | \$ (0.22)                         | \$ 0.83   |

See accompanying notes.

## Nicholas Financial, Inc. and Subsidiaries

## Consolidated Statements of Cash Flows

(Unaudited)

(In thousands)

|                                                                                          | Nine months ended |           |
|------------------------------------------------------------------------------------------|-------------------|-----------|
|                                                                                          | December 31,      |           |
|                                                                                          | 2017              | 2016      |
| <b>Cash flows from operating activities</b>                                              |                   |           |
| Net income (loss)                                                                        | \$ (1,741)        | \$ 6,479  |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: |                   |           |
| Depreciation                                                                             | 356               | 413       |
| Gain on sale of property and equipment                                                   | (22)              | (13)      |
| Provision for credit losses                                                              | 28,887            | 23,966    |
| Amortization of dealer discounts                                                         | (8,670)           | (9,830)   |
| Amortization of commission for products                                                  | (1,226)           | (1,342)   |
| Deferred income taxes                                                                    | 2,049             | (626)     |
| Share-based compensation                                                                 | 240               | 474       |
| Change in fair value of interest rate swap agreements                                    | 17                | (184)     |
| Changes in operating assets and liabilities:                                             |                   |           |
| Prepaid expenses and other assets                                                        | 156               | 345       |
| Accounts payable and accrued expenses                                                    | (938)             | 1,552     |
| Income taxes receivable                                                                  | 99                | 1,198     |
| Deferred revenues                                                                        | (656)             | 86        |
| Net cash provided by operating activities                                                | 18,551            | 22,518    |
| <b>Cash flows from investing activities</b>                                              |                   |           |
| Purchase and origination of finance receivables                                          | (74,760)          | (118,276) |
| Principal payments received                                                              | 91,616            | 95,562    |
| Increase in assets held for resale                                                       | (522)             | (828)     |
| Purchase of property and equipment                                                       | (143)             | (728)     |
| Proceeds from sale of property and equipment                                             | 23                | 38        |
| Net cash provided by (used in) investing activities                                      | 16,214            | (24,232)  |
| <b>Cash flows from financing activities</b>                                              |                   |           |
| (Decrease) Increase on line of credit                                                    | (35,000)          | 3,340     |
| Change in drafts payable                                                                 | 335               | 188       |
| Payment of loan origination fees                                                         | (211)             |           |
| Proceeds from exercise of stock options                                                  | 338               | 1         |
| Net cash (used in) provided by financing activities                                      | (34,538)          | 3,529     |

|                           |          |          |
|---------------------------|----------|----------|
| Net increase in cash      | 227      | 1,815    |
| Cash, beginning of period | 2,855    | 1,849    |
| Cash, end of period       | \$ 3,082 | \$ 3,664 |

**Supplemental Disclosure of noncash investing and financing activities:**

|                                  |    |     |
|----------------------------------|----|-----|
| Tax deficiency from share awards | \$ | (9) |
|----------------------------------|----|-----|

*See accompanying notes.*

Nicholas Financial, Inc. and Subsidiaries

Notes to the Consolidated Financial Statements

(Unaudited)

## 1. Basis of Presentation

The accompanying consolidated balance sheet as of March 31, 2017, 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 and with the instructions to Form 10-Q pursuant to the Securities and Exchange Act of 1934, as amended in Article 10 of Regulation S-X. 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, 2018. 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, 2017 as filed with the Securities and Exchange Commission on June 14, 2017. The March 31, 2017 consolidated balance sheet included herein has been derived from the March 31, 2017 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 and the fair value of interest rate swap agreements.

## 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. 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, net of unearned interest, 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 from which the Company is purchasing the Contract, 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, 2017 and 2016 was 6.89% and 6.87%, respectively in relation to the total amount

financed. The average dealer discount associated with new volume for the nine months ended December 31, 2017 and 2016 was 7.23% and 7.00%, respectively.

The amount of future unearned income is computed as the product of the Contract rate, the Contract term and the Contract amount.

Deferred revenues 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.

## Nicholas Financial, Inc. and Subsidiaries

## Notes to the Consolidated Financial Statements (Continued)

(Unaudited)

**3. Earnings (Loss) Per Share**

The Company has granted stock compensation awards with nonforfeitable dividend rights which are considered participating securities. Earnings (loss) 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 (loss) per share is calculated by dividing net income (loss) allocated to common shareholders by the weighted average number of common shares outstanding during the period, which excludes the participating securities. Diluted earnings (loss) per share includes the dilutive effect of additional potential common shares from stock compensation awards. Earnings (loss) per share have been computed based on the following weighted average number of common shares outstanding:

|                                                                                                  | Three months ended<br>December 31,<br>(In thousands, except per<br>share amounts)<br>2017 |          | Nine months ended<br>December 31,<br>(In thousands, except per<br>share amounts)<br>2017 |          |
|--------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------|----------|------------------------------------------------------------------------------------------|----------|
|                                                                                                  | 2016                                                                                      |          | 2016                                                                                     |          |
| <b>Numerator:</b>                                                                                |                                                                                           |          |                                                                                          |          |
| Net income (loss)                                                                                | \$ (2,898)                                                                                | \$ 1,606 | \$ (1,741)                                                                               | \$ 6,479 |
| Less: Allocation of earnings (loss) to participating securities                                  | 40                                                                                        | (22)     | 23                                                                                       | (76)     |
| Net income (loss) allocated to common stock                                                      | (2,858)                                                                                   | 1,584    | (1,718)                                                                                  | 6,403    |
| <b>Basic earnings (loss) per share computation:</b>                                              |                                                                                           |          |                                                                                          |          |
| Net income (loss) allocated to common stock                                                      | \$ (2,858)                                                                                | \$ 1,584 | \$ (1,718)                                                                               | \$ 6,403 |
| Weighted average common shares outstanding, including shares considered participating securities | 7,910                                                                                     | 7,697    | 7,876                                                                                    | 7,763    |
| Less: Weighted average participating securities outstanding                                      | (110)                                                                                     | (107)    | (102)                                                                                    | (91)     |
| Weighted average shares of common stock                                                          | 7,800                                                                                     | 7,590    | 7,774                                                                                    | 7,672    |
| Basic earnings (loss) per share                                                                  | \$ (0.37)                                                                                 | \$ 0.21  | \$ (0.22)                                                                                | \$ 0.83  |
| <b>Diluted earnings (loss) per share computation:</b>                                            |                                                                                           |          |                                                                                          |          |
| Net income (loss) allocated to common stock                                                      | \$ (2,858)                                                                                | \$ 1,584 | \$ (1,718)                                                                               | \$ 6,403 |
| Undistributed earnings re-allocated to participating securities                                  |                                                                                           |          |                                                                                          |          |
| Numerator for diluted earnings (loss) per share                                                  | \$ (2,858)                                                                                | \$ 1,584 | \$ (1,718)                                                                               | \$ 6,403 |

|                                                                                |              |       |              |       |
|--------------------------------------------------------------------------------|--------------|-------|--------------|-------|
| Weighted average common shares outstanding for basic earnings (loss) per share | <b>7,800</b> | 7,590 | <b>7,774</b> | 7,672 |
| Incremental shares from stock options                                          |              | 60    |              | 60    |

|                                                              |              |       |              |       |
|--------------------------------------------------------------|--------------|-------|--------------|-------|
| Weighted average shares and dilutive potential common shares | <b>7,800</b> | 7,650 | <b>7,774</b> | 7,732 |
|--------------------------------------------------------------|--------------|-------|--------------|-------|

|                                   |                  |         |                  |         |
|-----------------------------------|------------------|---------|------------------|---------|
| Diluted earnings (loss) per share | <b>\$ (0.37)</b> | \$ 0.21 | <b>\$ (0.22)</b> | \$ 0.83 |
|-----------------------------------|------------------|---------|------------------|---------|

Diluted earnings (loss) per share do not include the effect of certain stock options as their impact would be anti-dilutive. The potential shares of common stock from stock options totaling 189,690 were excluded from the diluted earnings (loss) per share calculation for December 31, 2017 because the Company experienced a net loss for the period. The potential shares of common stock from stock options totaling 160,000 were excluded from the diluted earnings (loss) per share calculation for December 31, 2016 because their effect is anti-dilutive.

## Nicholas Financial, Inc. and Subsidiaries

## Notes to the Consolidated Financial Statements (Continued)

(Unaudited)

**4. Finance Receivables**

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

|                                                                                | (In thousands)       |                   |
|--------------------------------------------------------------------------------|----------------------|-------------------|
|                                                                                | December 31,<br>2017 | March 31,<br>2017 |
| Finance receivables, gross contract                                            | \$ 454,277           | \$ 512,720        |
| Unearned interest                                                              | (137,594)            | (160,853)         |
| Finance receivables, net of unearned interest                                  | 316,683              | 351,867           |
| Unearned dealer discounts                                                      | (14,138)             | (17,004)          |
| Finance receivables, net of unearned interest and<br>unearned dealer discounts | 302,545              | 334,863           |
| Allowance for credit losses                                                    | (21,187)             | (17,658)          |
| Finance receivables, net                                                       | \$ 281,358           | \$ 317,205        |

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

|                                | As of<br>December 31, |        |
|--------------------------------|-----------------------|--------|
|                                | 2017                  | 2016   |
| <b>Contract Portfolio</b>      |                       |        |
| Weighted APR                   | 22.21%                | 22.43% |
| Weighted average discount      | 7.25%                 | 7.48%  |
| Weighted average term (months) | 57                    | 57     |
| Number of active contracts     | 33,993                | 37,834 |

|                              | As of<br>December 31, |        |
|------------------------------|-----------------------|--------|
|                              | 2017                  | 2016   |
| <b>Direct Loan Portfolio</b> |                       |        |
| Weighted APR                 | 25.18%                | 25.69% |

|                                |              |       |
|--------------------------------|--------------|-------|
| Weighted average term (months) | <b>33</b>    | 33    |
| Number of active contracts     | <b>2,718</b> | 3,023 |

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

The following table sets forth a reconciliation of the changes in the allowance for credit losses on Contracts:

|                                | <b>Three months ended</b> |             | <b>Nine months ended</b> |             |
|--------------------------------|---------------------------|-------------|--------------------------|-------------|
|                                | <b>December 31,</b>       |             | <b>December 31,</b>      |             |
|                                | <b>(In thousands)</b>     |             | <b>(In thousands)</b>    |             |
|                                | <b>2017</b>               | <b>2016</b> | <b>2017</b>              | <b>2016</b> |
| Balance at beginning of period | <b>\$ 19,967</b>          | \$ 12,925   | <b>\$ 16,885</b>         | \$ 12,265   |
| Current period provision       | <b>8,818</b>              | 8,701       | <b>28,498</b>            | 23,723      |
| Losses absorbed                | <b>(8,745)</b>            | (8,247)     | <b>(26,372)</b>          | (23,815)    |
| Recoveries                     | <b>360</b>                | 570         | <b>1,389</b>             | 1,776       |
| Balance at end of period       | <b>\$ 20,400</b>          | \$ 13,949   | <b>\$ 20,400</b>         | \$ 13,949   |

The allowance for credit losses is increased by charges against earnings and decreased by charge-offs (net of recoveries). The Company aggregates Contracts into static pools consisting of Contracts purchased during a three-month period for each branch location as management considers these pools to have similar risk characteristics and are considered smaller-balance homogenous loans. The Company analyzes each consolidated static pool at specific points in time to estimate losses that are probable of being incurred as of the reporting date. It has maintained historical write-off information for over 10 years with respect to every consolidated static pool and segregates each static pool by liquidation which creates

## Nicholas Financial, Inc. and Subsidiaries

## Notes to the Consolidated Financial Statements (Continued)

(Unaudited)

**4. Finance Receivables (continued)**

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 are then used to assist in determining the allowance for credit losses. The five snapshots are tracked at liquidation levels of 20%, 40%, 60%, 80% and 100%. These snapshots help us in determining the appropriate allowance for credit losses.

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 predominately for used vehicles. As of December 31, 2017, the average model year of vehicles collateralizing the portfolio was a 2010 vehicle. The Company utilizes a static pool approach to track portfolio performance. If the allowance for credit losses is determined to be inadequate for a static pool, then an additional charge to income through the provision is used to maintain adequate reserves based on management's evaluation of the risk inherent in the loan portfolio, the composition of the portfolio, and current economic conditions. Such evaluation, considers among other matters, the estimated net realizable value of the underlying collateral, economic conditions, historical loan loss experience, management's estimate of probable credit losses and other factors that warrant recognition in providing for an adequate allowance for credit losses.

The following table sets forth a reconciliation of the changes in the allowance for credit losses on Direct Loans:

|                                | <b>Three months ended<br/>December 31,<br/>(In thousands)</b> |             | <b>Nine months ended<br/>December 31,<br/>(In thousands)</b> |             |
|--------------------------------|---------------------------------------------------------------|-------------|--------------------------------------------------------------|-------------|
|                                | <b>2017</b>                                                   | <b>2016</b> | <b>2017</b>                                                  | <b>2016</b> |
| Balance at beginning of period | \$ 782                                                        | \$ 774      | \$ 773                                                       | \$ 748      |
| Current period provision       | 171                                                           | 95          | 389                                                          | 243         |
| Losses absorbed                | (172)                                                         | (73)        | (395)                                                        | (217)       |
| Recoveries                     | 6                                                             | 3           | 20                                                           | 25          |
| Balance at end of period       | \$ 787                                                        | \$ 799      | \$ 787                                                       | \$ 799      |

Direct Loans are typically for amounts ranging from \$1,000 to \$11,000 and are generally secured by a lien on an automobile, watercraft or other permissible tangible personal property. Much 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 Contracts due to the customer's historical payment history with the Company; however, the underlying collateral is less valuable. In deciding if 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 borrowers under Contracts previously purchased by the Company, the payment history of the borrower under the Contract is a

significant factor in making the loan decision. As of December 31, 2017, loans made by the Company pursuant to its Direct Loan program constituted approximately 2% 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 by current economic conditions and credit loss trends over several reporting periods which are utilized in estimating future losses and overall portfolio performance.

A performing account is defined as an account that is less than 61 days past due. We define 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, we 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, forgiveness of principal or of accrued interest. Accordingly, we consider such extensions to be insignificant delays in payments rather than troubled debt restructurings.

## Nicholas Financial, Inc. and Subsidiaries

## Notes to the Consolidated Financial Statements (Continued)

(Unaudited)

**4. Finance Receivables (continued)**

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

|                                     | (In thousands)       |              |                      |              |
|-------------------------------------|----------------------|--------------|----------------------|--------------|
|                                     | December 31,<br>2017 |              | December 31,<br>2016 |              |
|                                     | Contracts            | Direct Loans | Contracts            | Direct Loans |
| Performing accounts                 | \$ 412,775           | \$ 10,349    | \$ 462,569           | \$ 11,231    |
| Non-performing accounts             | 27,053               | 217          | 36,980               | 280          |
| Total                               | \$ 439,828           | \$ 10,566    | \$ 499,549           | \$ 11,511    |
| Chapter 13 bankruptcy accounts      | 3,843                | 40           | 4,220                | 36           |
| Finance receivables, gross contract | \$ 443,671           | \$ 10,606    | \$ 503,769           | \$ 11,547    |

A non-performing account is defined as an account that is contractually delinquent for 61 days or more and the accrual of interest income is suspended. When an account is 180 days contractually delinquent, the account is written off. The delinquency table below represents both performing and non-performing accounts; however, it does not include Chapter 13 bankruptcy accounts. Upon notification of a Chapter 13 bankruptcy, the account is not modified to reflect the new repayment plan administered by a court-appointed trustee. The cost recovery method of accounting is used, and the accrual of interest income is suspended. The balance will be reduced as payments are received by the bankruptcy court. 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. In the event an account is dismissed from bankruptcy, the Company will decide, based on several factors, to begin repossession proceedings or to allow the customer to begin making regularly scheduled payments.

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

(In thousands, except percentages)

| Contracts         | Gross<br>Balance |           |           |          |          |    |          | Total     |
|-------------------|------------------|-----------|-----------|----------|----------|----|----------|-----------|
|                   | Outstanding      | 31        | 60days    | 61       | 90days   | 91 | 120 days | Over 120  |
| December 31, 2017 | \$ 439,828       | \$ 33,453 | \$ 14,039 | \$ 7,893 | \$ 5,121 |    |          | \$ 60,506 |

|                   |            |              |              |              |              |               |
|-------------------|------------|--------------|--------------|--------------|--------------|---------------|
|                   |            | <b>7.61%</b> | <b>3.19%</b> | <b>1.79%</b> | <b>1.16%</b> | <b>13.76%</b> |
| December 31, 2016 | \$ 499,549 | \$ 35,184    | \$ 17,263    | \$ 11,072    | \$ 8,645     | \$ 72,164     |
|                   |            | 7.04%        | 3.46%        | 2.22%        | 1.73%        | 14.45%        |

|                   | Gross Balance |        |        |       |        |       |          |          |       |       |    |       |
|-------------------|---------------|--------|--------|-------|--------|-------|----------|----------|-------|-------|----|-------|
| Direct Loans      | Outstanding   | 31     | 60days | 61    | 90days | 91    | 120 days | Over 120 | Total |       |    |       |
| December 31, 2017 | \$            | 10,566 | \$     | 254   | \$     | 102   | \$       | 32       | \$    | 83    | \$ | 471   |
|                   |               |        |        | 2.41% |        | 0.97% |          | 0.30%    |       | 0.78% |    | 4.46% |
| December 31, 2016 | \$            | 11,511 | \$     | 282   | \$     | 155   | \$       | 61       | \$    | 64    | \$ | 562   |
|                   |               |        |        | 2.45% |        | 1.34% |          | 0.53%    |       | 0.56% |    | 4.88% |

Nicholas Financial, Inc. and Subsidiaries

Notes to the Consolidated Financial Statements (Continued)

(Unaudited)

## 5. Line of Credit

The Company has a line of credit facility (the Line) up to \$225.0 million. On November 8, 2017, the Company executed amendment 7 to this existing Line which extended the maturity date to March 31, 2018 and increased the pricing of the Line to 400 basis points above 30 day LIBOR, while maintaining the 1% floor on LIBOR. The amendment also increased the beneficial ownership limit from 20% to 30% and revised the calculation of availability and the minimum interest coverage ratio. The threshold for the minimum interest coverage ratio was lowered for the period ending December 31, 2017.

On December 30, 2016, the Company executed an amendment which increased the pricing of the Line to 350 basis points above 30 day LIBOR while maintaining the 1% floor on LIBOR. Prior to December 30, 2016, the pricing on the Line was 300 basis points above 30 day LIBOR with a 1% floor on LIBOR.

Pledged as collateral for this Line are all the assets of the Company. The Line requires compliance with certain financial ratios and covenants and satisfaction of specified financial tests, including maintenance of asset quality and performance tests. As of December 31, 2017, the Company is in compliance with all debt covenants.

The Company has a longstanding relationship with its lenders and believes it is probable that it will be able to obtain financing from either its existing lenders or from other sources; however, we can provide no assurances that the lenders will approve the further renewal or extension of the Line past March 31, 2018 or, assuming that they will approve it, that the facility will not be on terms less favorable than the current agreement. The Company may also determine to seek alternative financing, including but not limited to, the issuance of equity or debt; however, we may not be able to raise additional funds on acceptable terms, or at all.

## 6. Interest Rate Swap Agreements

The Company previously utilized interest rate swap agreements to manage exposure to variability in expected cash flows attributable to interest rate risk. The interest rate swap agreements converted a portion of the floating rate debt to a fixed rate, more closely matching the interest rate characteristics of finance receivables.

During the nine months ended December 31, 2017, no new contracts were initiated and both interest rate swap contracts matured. During the nine months ended December 31, 2016, no new contracts were initiated and no contracts matured.

On June 13, 2017 an interest rate swap agreement with an effective date of June 13, 2012, a notional amount of \$25.0 million, and a fixed rate of interest of 1.00% expired.

On July 30, 2017 an interest rate swap agreement with an effective date of July 30, 2012, a notional amount of \$25.0 million, and a fixed rate of interest of 0.87% expired.



## Nicholas Financial, Inc. and Subsidiaries

## Notes to the Consolidated Financial Statements (Continued)

(Unaudited)

**6. Interest Rate Swap Agreements (continued)**

The locations and amounts of loss and gain in income are as follows:

|                                                                | <b>Three months ended</b> |             | <b>Nine months ended</b> |             |
|----------------------------------------------------------------|---------------------------|-------------|--------------------------|-------------|
|                                                                | <b>December 31,</b>       |             | <b>December 31,</b>      |             |
|                                                                | <b>(In thousands)</b>     |             | <b>(In thousands)</b>    |             |
|                                                                | <b>2017</b>               | <b>2016</b> | <b>2017</b>              | <b>2016</b> |
| Periodic change in fair value of interest rate swap agreements | \$                        | \$ (81)     | \$ 17                    | \$ (184)    |
| Periodic settlement differentials included in interest expense |                           | 45          | 18                       | 163         |
| Loss (gain) recognized in income                               | \$                        | \$ (36)     | \$ 35                    | \$ (21)     |

Net realized losses and gains from the interest rate swap agreements were recorded in the interest expense line item of the consolidated statements of income. The following table summarizes the average variable rates received and average fixed rates paid under the swap agreements.

|                        | <b>Three months ended</b> |             | <b>Nine months ended</b> |             |
|------------------------|---------------------------|-------------|--------------------------|-------------|
|                        | <b>December 31,</b>       |             | <b>December 31,</b>      |             |
|                        | <b>2017</b>               | <b>2016</b> | <b>2017</b>              | <b>2016</b> |
| Variable rate received |                           | 0.58%       | 1.05%                    | 0.51%       |
| Fixed rate paid        |                           | 0.94%       | 0.91%                    | 0.94%       |

**7. Income Taxes**

On December 22, 2017, the Tax Cuts and Jobs Act was passed into law ( TCJA ). The TCJA includes a broad range of tax reform including changes to tax rates and deductions that are effective January 1, 2018. The decrease in the enacted corporate tax rate expected to apply when our temporary differences are realized or settled ultimately resulted in a one-time revaluation of our net deferred tax asset of \$3.4 million in December 2017 with a corresponding charge to income tax expense. The tax effects of the TCJA increased income tax expense to a level that reduced net income to a net loss for both the three and nine-month periods ending December 31, 2017.

The provision for income taxes increased to approximately \$3.7 million for the three months ended December 31, 2017 from approximately \$1.0 million for the three months ended December 31, 2016. The Company's effective tax rate increased to 456.48% for the three months ended December 31, 2017 from 37.93% for the three months ended December 31, 2016. The provision for income taxes increased to approximately \$4.4 million for the nine months

ended December 31, 2017 from approximately \$4.0 million for the nine months ended December 31, 2016. The Company's effective tax rate increased to 164.70% for the nine months ended December 31, 2017 from 38.01% for the nine months ended December 31, 2016.

## **8. 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.

## Nicholas Financial, Inc. and Subsidiaries

## Notes to the Consolidated Financial Statements (Continued)

(Unaudited)

**8. Fair Value Disclosures (continued)**Assets and Liabilities Recorded at Fair Value on a Recurring Basis

The Company estimates the fair value of interest rate swap agreements based on the estimated net present value of the future cash flows using a forward interest rate yield curve in effect as of the measurement period, adjusted for nonperformance risk, if any, including a quantitative and qualitative evaluation of both the Company's credit risk and the counterparty's credit risk. Accordingly, the Company classifies interest rate swap agreements as Level 2.

| Description                      | Fair Value Measurement Using<br>(In thousands) |         |         |            |
|----------------------------------|------------------------------------------------|---------|---------|------------|
|                                  | Level 1                                        | Level 2 | Level 3 | Fair Value |
| Interest rate swap agreements:   |                                                |         |         |            |
| <b>December 31, 2017 assets:</b> | \$                                             | \$      | \$      | \$         |
| March 31, 2017 assets:           | \$                                             | \$ 17   | \$      | \$ 17      |

Financial Instruments Not Measured at Fair Value

The Company's financial instruments consist of cash, finance receivables and the Line. 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. The initial terms of the Direct Loans generally range from 12 to 72 months. If liquidated outside of the normal course of business, the amount received may not be the carrying value.

Based on current market conditions, any new or renewed credit facility would contain pricing that approximates the Company's current Line. Based on these market conditions, the fair value of the Line as of December 31, 2017 was estimated to be equal to the book value. The interest rate for the Line is a variable rate based on LIBOR pricing options.

## Nicholas Financial, Inc. and Subsidiaries

## Notes to the Consolidated Financial Statements (Continued)

(Unaudited)

**8. Fair Value Disclosures (continued)**

|                                                                       | (In thousands)         |            |            |            |                |
|-----------------------------------------------------------------------|------------------------|------------|------------|------------|----------------|
|                                                                       | Fair Value Measurement |            |            |            |                |
|                                                                       | Using                  |            |            |            |                |
| Description                                                           | Level 1                | Level 2    | Level 3    | Fair Value | Carrying Value |
| Cash:                                                                 |                        |            |            |            |                |
| December 31, 2017                                                     | \$ 3,082               | \$         | \$         | \$ 3,082   | \$ 3,082       |
| March 31, 2017                                                        | \$ 2,855               | \$         | \$         | \$ 2,855   | \$ 2,855       |
| Finance receivables:                                                  |                        |            |            |            |                |
| December 31, 2017                                                     | \$                     | \$         | \$ 281,358 | \$ 281,358 | \$ 281,358     |
| March 31, 2017                                                        | \$                     | \$         | \$ 317,205 | \$ 317,205 | \$ 317,205     |
| Line of credit:                                                       |                        |            |            |            |                |
| December 31, 2017                                                     | \$                     | \$ 178,000 | \$         | \$ 178,000 | \$ 178,000     |
| March 31, 2017                                                        | \$                     | \$ 213,000 | \$         | \$ 213,000 | \$ 213,000     |
| Assets and Liabilities Recorded at Fair Value on a Nonrecurring Basis |                        |            |            |            |                |

The Company may be required, from time to time, to measure certain assets and liabilities at fair value on a nonrecurring basis. The Company does not have any assets or liabilities measured at fair value on a nonrecurring basis as of December 31, 2017 and March 31, 2017.

**9. 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.

**10. Summary of Significant Accounting Policies****Reclassifications**

The Company made certain reclassifications to the 2016 statements of cash flows. The amortization of deferred revenues decreased cash flows from operating activities by \$1.342 million for 2016 and correspondingly increased cash flows from investing activities.

Nicholas Financial, Inc. and Subsidiaries

Notes to the Consolidated Financial Statements (Continued)

(Unaudited)

**10. Summary of Significant Accounting Policies (continued)**

**Recent Accounting Pronouncements**

In August 2016, the Financial Accounting Standards Board ( 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. Early adoption is permitted, including adoption in an interim period. The Company is currently evaluating the impact of the adoption of this ASU on the consolidated financial statements, and is in the process of analyzing its current presentation of the Consolidated Statements of Cash Flows. At this time, the Company does not believe ASU 2016-15 will have a material impact.

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 adverse effect on our consolidated financial statements.

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. While the Company has not specifically evaluated each lease agreement, we anticipate upon adoption, the Company will add the impact of the full operating lease terms that meets the scope, 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.

In January 2016, the FASB issued ASU No. 2016-01, Financial Instruments Recognition and Measurement of Financial Assets and Liabilities, which is intended to improve the recognition and measurement of financial instruments by requiring: equity investments (other than equity method or consolidation) to be measured at fair value with changes in fair value recognized in net income; public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (i.e., securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements; eliminating the requirement to disclose the fair value of financial instruments measured at amortized cost for organizations that are not public business entities; eliminating the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet; and requiring a reporting organization to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk (also referred to as own credit ) when the organization has elected to measure the liability at fair value in accordance with the fair value option for financial instruments. This ASU is effective for public companies for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. This ASU permits early adoption of the instrument-specific credit risk provision. While the Company is currently evaluating the impact of the pending adoption of this ASU on the Company's consolidated financial statements, the Company does not believe it will have a material impact on the consolidated financial statements.

Nicholas Financial, Inc. and Subsidiaries

Notes to the Consolidated Financial Statements (Continued)

(Unaudited)

**10. Summary of Significant Accounting Policies (continued)**

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606). The ASU requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The ASU, and all subsequently issued clarifying ASUs, will replace most existing revenue recognition guidance in U.S. GAAP when it becomes effective. The standard permits the use of either the retrospective or cumulative effect transition method. 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 will be effective for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. The ASU would permit public entities to adopt the ASU early, but not before the original effective date (i.e., annual periods beginning after December 15, 2016). The impact of the standard is limited to a large extent due to Topic 606 including a scope exception for finance receivables. Since substantially all of the Company's revenue streams are generated from activities that are outside the scope of the new standard, the Company does not believe that this standard will have a material impact on the Company's financials. The Company has begun analyzing in-scope contracts using the five-step process outlined in Topic 606 and expects to finalize our conclusion during the quarter ending March 31, 2018.

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.

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

### **Forward-Looking Information**

This report on Form 10-Q contains various statements, other than those concerning historical information, that are based on management's beliefs and assumptions, as well as information currently available to management, and should be considered forward-looking statements. This notice is intended to take advantage of the safe harbor provided by the Private Securities Litigation Reform Act of 1995 with respect to such forward-looking statements. When used in this document, the words anticipate, estimate, expect, will, may, plan, believe, intend and similar expressions are used to identify forward-looking statements. Although Nicholas Financial, Inc., including its subsidiaries (the Company, we, us, or our) believes that the expectations reflected in such forward-looking 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 Part II Item 1A Risk Factors in this Form 10-Q. 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 have a direct bearing on the Company's operating results are the availability of capital (including the ability to access bank financing) on favorable terms, 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 ( TCJA ) that was enacted on December 22, 2017, fluctuations in the economy, the degree and nature of competition and its effects on the Company's ability to maintain profit margins at acceptable levels or generate net income at all, fluctuations in interest rates, demand for consumer financing in the markets served by the Company, the Company's products and services, increases in the default rates experienced on automobile finance installment contracts ( Contracts ), adverse regulatory changes in the Company's existing and future markets, the Company's ability to expand its business, including its ability to complete acquisitions and integrate the operations of 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 report are based on information available to the Company on the date hereof, and the Company assumes no obligations to update any such forward looking statement. You should also consult factors described from time to time in the Company's other filings made with the Securities and Exchange Commission, including its reports on Forms 10-K, 10-Q, 8-K and annual reports to shareholders.

### **Litigation and Legal Matters**

See Item 1. Legal Proceedings in Part II of this Form 10-Q.

### **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.

The allowance for credit losses is established through a provision for credit losses based on management's evaluation of the risk inherent in the loan portfolio which includes the competitive environment that existed when the loan was acquired, the composition of the portfolio, and current economic conditions. Such evaluation considers, among other matters, the estimated net realizable value or the fair value of the underlying collateral, economic conditions, historical loan loss experience, management's estimate of probable credit losses and other factors that warrant recognition in providing for an adequate credit loss allowance.

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. The Company segregates its

Contracts into static pools for purposes of establishing reserves for losses. All Contracts purchased by a branch during a fiscal quarter comprise a static pool. The Company pools Contracts according to branch location because the branches purchase Contracts in different geographic markets. This method of pooling by branch and quarter allows the Company to evaluate the different markets where the branches operate. The pools also allow the Company to evaluate the different levels of customer income, stability and credit history, and the types of vehicles purchased, in each market. In analyzing a static pool, the Company considers the performance of prior static pools originated by the same branch office, the competition at time of acquisition, and current market and economic conditions. Each static pool is analyzed monthly to determine if the loss reserves are adequate, and adjustments are made if they are determined to be necessary. A consolidated static pool contains the static pools of all branches for a given quarter. The Company analyzes each consolidated static pool at specific points in time.

The Company has been maintaining historical write-off information for over 20 years with respect to every consolidated static pool, segregating each consolidated static pool by liquidation and in effect creating snapshots of a pool's write-off-to liquidation ratio at five different points in such pool's liquidation cycle. These snapshots help the Company in determining the appropriate provision for credit losses and subsequent allowance for credit losses. The five snapshots are taken when the liquidation levels are at 20%, 40%, 60%, 80% and 100%.

The Company's allowance for credit losses incorporates recent trends that include the acquisition of longer term contracts and increased delinquencies which the Company believes more closely depicts the amount of the allowance for credit losses needed to maintain an adequate reserve. Management evaluates each static pool on an independent basis each quarter and accounts for such pool's term, how far along the corresponding pool is in its liquidation cycle, late charges, the number of deferments, and delinquency. This information is based on the result each individual Contract. 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.

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 based on 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 does not anticipate any portfolio acquisitions in the near-term.

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 (the 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**

Pretax income for the three months ending December 31, 2017 was \$.8 million. In the month of December 2017, the Company had a one-time income tax expense adjustment of \$3.4 million relating to the Tax Cuts and Jobs Act ( TCJA ) which reduced net income to a net loss. The net loss for the three months ended December 31, 2017 was \$2.9 million.

For the three months ended December 31, 2016 the Company had pretax earnings of \$2.6 million and net earnings of \$1.6 million. Diluted net loss per share decreased to \$0.37 for the three months ended December 31, 2017 as compared to diluted earnings per share of \$0.21 for the three months ended December 31, 2016. Revenue decreased 7% to \$20.5 million for the three months ended December 31, 2017 as compared to \$22.0 million for the three months ended December 31, 2016.

The Company announced that its pretax income for the nine months ending December 31, 2017 was \$2.7 million. In the month of December 2017, the Company had a one-time income tax expense adjustment of \$3.4 million relating to the TCJA which reduced net income to a net loss. The net loss for the nine months ended December 31, 2017 was \$1.7 million.

For the nine months ended December 31, 2016 the Company had pretax earnings of \$10.5 million and net earnings of \$6.5 million. Diluted net loss per share decreased to \$0.22 for the nine months ended December 31, 2017 as compared to diluted earnings per share of \$0.83 for the nine months ended December 31, 2016. Revenue decreased 5% to

\$64.1 million for the nine months ended December 31, 2017 as compared to \$67.6 million for the nine months ended December 31, 2016.

On December 22, 2017, the Tax Cuts and Jobs Act was passed into law ( TCJA ). The TCJA includes a broad range of tax reform including changes to tax rates and deductions that are effective January 1, 2018. The decrease in the enacted corporate tax rate expected to apply when our temporary differences are realized or settled ultimately resulted in a one-time revaluation of our net deferred tax asset of \$3.4 million in December 2017 with a corresponding charge to income tax expense. The tax effects of the TCJA increased income tax expense to a level that reduced net income to a net loss for both the three and nine-month periods ending December 31, 2017.

|                                                                                                                                                            | Three months ended<br>December 31,<br>(In thousands) |            | Nine months ended<br>December 31,<br>(In thousands) |            |
|------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------|------------|-----------------------------------------------------|------------|
|                                                                                                                                                            | 2017                                                 | 2016       | 2017                                                | 2016       |
| <b>Portfolio Summary</b>                                                                                                                                   |                                                      |            |                                                     |            |
| Average finance receivables, net of unearned interest (1)                                                                                                  | \$ 321,742                                           | \$ 349,916 | \$ 333,660                                          | \$ 345,950 |
| Average indebtedness (2)                                                                                                                                   | \$ 183,615                                           | \$ 210,745 | \$ 196,619                                          | \$ 209,875 |
| Interest and fee income on finance receivables                                                                                                             | \$ 20,526                                            | \$ 22,044  | \$ 64,062                                           | \$ 67,606  |
| Interest expense                                                                                                                                           | 2,585                                                | 2,258      | 7,483                                               | 6,745      |
| Net interest and fee income on finance receivables                                                                                                         | \$ 17,941                                            | \$ 19,786  | \$ 56,579                                           | \$ 60,861  |
| Gross portfolio yield (3)                                                                                                                                  | 25.52%                                               | 25.20%     | 25.60%                                              | 26.06%     |
| Interest expense as a percentage of average finance receivables, net of unearned interest                                                                  | 3.21%                                                | 2.58%      | 2.99%                                               | 2.60%      |
| Provision for credit losses as a percentage of average finance receivables, net of unearned interest                                                       | 11.18%                                               | 10.05%     | 11.54%                                              | 9.24%      |
| Net portfolio yield (3)                                                                                                                                    | 11.13%                                               | 12.57%     | 11.07%                                              | 14.22%     |
| Marketing, salaries, employee benefits, depreciation, and administrative expenses as a percentage of average finance receivables, net of unearned interest | 10.12%                                               | 9.70%      | 9.98%                                               | 10.26%     |
| Pre-tax yield as a percentage of average finance receivables, net of unearned interest (4)                                                                 | 1.01%                                                | 2.87%      | 1.09%                                               | 3.96%      |
| Write-off to liquidation (5)                                                                                                                               | 13.66%                                               | 12.35%     | 13.00%                                              | 11.02%     |
| Net charge-off percentage (6)                                                                                                                              | 10.63%                                               | 8.86%      | 10.13%                                              | 8.57%      |
| Allowance percentage (7)                                                                                                                                   | 6.59%                                                | 4.21%      | 6.35%                                               | 4.26%      |

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

- (1) Average finance receivables, net of unearned interest, represents the average of gross finance receivables, less unearned interest throughout the period.
- (2) Average indebtedness represents the average outstanding borrowings under the Line
- (3)

Gross portfolio yield represents interest and fee income on finance receivables as a percentage of average finance receivables, net of unearned interest. 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, net of unearned interest.

- (4) Pre-tax yield represents net portfolio yield minus administrative expenses (marketing, salaries, employee benefits, depreciation, and administrative), as a percentage of average finance receivables, net of unearned interest.
- (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, net of unearned interest, outstanding during the period.
- (7) Allowance percentage represents the allowance for credit losses divided by average finance receivables, net of unearned interest, outstanding during the period.

**Three months ended December 31, 2017 compared to three months ended December 31, 2016****Interest Income and Loan Portfolio**

Interest and fee income on finance receivables, predominately finance charge income, decreased 7% to \$20.5 million for the three-month period ended December 31, 2017 from \$22.0 million for the three-month period ended December 31, 2016. The decrease was primarily due to a decrease in the average weighted APR of the portfolio, and a decrease in the volume of Contracts purchased.

Average finance receivables, net of unearned interest equaled approximately \$321.7 million for the three-month period ended December 31, 2017, a decrease of 8% from \$349.9 million for the corresponding period ended December 31, 2016. Our purchasing volume declined 39% quarter over quarter mainly as a result of the modification of our underwriting guidelines, including the use of alternative data provided by a third party service company beginning in March 2017, to improve pricing for proper risk. The decrease in average finance receivables, net of unearned interest was primarily due to this decrease in purchasing volume.

The gross portfolio yield increased to 25.52% for the three-month period ended December 31, 2017 compared to 25.20% for the three-month period ended December 31, 2016. The gross portfolio yield increased primarily due to the decrease in past-due accounts (see *Note 4- Finance Receivables* for further discussion). The net portfolio yield decreased to 11.13% for the three-month period ended December 31, 2017 from 12.57% for the corresponding period ended December 31, 2016. The net portfolio yield decreased due to an increase in interest expense, as described under *Interest Expense*, and an increase in the provision for credit losses, as described under *Analysis of Credit Losses*.

**Marketing, Salaries, Employee Benefits, Depreciation, and Administrative Expenses**

Marketing, salaries, employee benefits, depreciation, and administrative expenses decreased to approximately \$8.1 million for the three-month period ended December 31, 2017 from approximately \$8.5 million for the three-month period ended December 31, 2016. The decrease was primarily related to a decrease in bonuses related to the declining portfolio performance along with a decrease in administrative costs directly related to the volume of Contracts purchased. Marketing, salaries, employee benefits, depreciation, and administrative expenses as a percentage of finance receivables, net of unearned interest, increased to 10.12% for the three-month period ended December 31, 2017 from 9.70% for the three-month period ended December 31, 2016.

**Interest Expense**

Interest expense increased to approximately \$2.6 million for the three-month period ended December 31, 2017 as compared to \$2.3 million for the three-month period ended December 31, 2016. This increase was primarily due to the increase in the pricing to 400 basis points above 30 day LIBOR and an increase in 30 day LIBOR rates. Pricing prior to November 7, 2017 was 350 basis points above 30 day LIBOR. Pricing for the three-month period ended December 31, 2016 was 300 basis points above 30 day LIBOR until December 30, 2016, when it changed to 350 basis points above 30 day LIBOR. This change continued until the November 7, 2017 amendment. See below for more details. The following table summarizes the Company's average cost of borrowed funds:

|                                                     | <b>Three months ended December 31,</b> |             |
|-----------------------------------------------------|----------------------------------------|-------------|
|                                                     | <b>2017</b>                            | <b>2016</b> |
| Variable interest under the line of credit facility | <b>0.63%</b>                           | 0.21%       |
| Settlements under interest rate swap agreements     | <b>0.00%</b>                           | 0.09%       |
| Credit spread under the line of credit facility     | <b>5.00%</b>                           | 4.00%       |

|                                |              |       |
|--------------------------------|--------------|-------|
| Average cost of borrowed funds | <b>5.63%</b> | 4.30% |
|--------------------------------|--------------|-------|

LIBOR rates have increased (1.57% as of December 31, 2017 compared to .77% as of December 31, 2016) which caused an increase in variable interest for the amount that exceeded the 1% floor. Average cost of borrowed funds is greater than the highest 30 day LIBOR rate plus 400 basis points, or 5.57%, due to amortized loan costs. During the three months ended September 30, 2017, the Company's remaining interest rate swap expired (see *Note 6- Interest Rate Swap Agreements* for further discussion) but these did not have a significant effect on borrowing costs. For further discussions regarding interest rates see *Note 5 Line of Credit*.

**Nine months ended December 31, 2017 compared to nine months ended December 31, 2016****Interest Income and Loan Portfolio**

Interest and fee income on finance receivables, predominately finance charge income, decreased 5% to \$64.1 million for the nine-month period ended December 31, 2017 from \$67.6 million for the nine-month period ended December 31, 2016. The decrease was primarily due to a decrease in the average weighted APR of the portfolio, and a decrease in the volume of Contracts purchased.

Average finance receivables, net of unearned interest equaled approximately \$333.7 million for the nine-month period ended December 31, 2017, a decrease of 4% from \$346.0 million for the corresponding period ended December 31, 2016. Our purchasing volume declined 36% period over period mainly as a result of the modification of our underwriting guidelines, including the use of alternative data provided by a third party service company beginning in March 2017, to improve pricing for proper risk. The decrease in average finance receivables, net of unearned interest was primarily due to this decrease in purchasing volume.

The gross portfolio yield decreased to 25.60% for the nine-month period ended December 31, 2017 compared to 26.06% for the nine-month period ended December 31, 2016. The gross portfolio yield decreased primarily due to the decrease in the average weighted APR of the portfolio described above. The net portfolio yield decreased to 11.07% for the nine-month period ended December 31, 2017 from 14.22% for the corresponding period ended December 31, 2016. The net portfolio yield decreased due to a decrease in the gross portfolio yield, but primarily to an increase in the provision for credit losses, as described under Analysis of Credit Losses .

**Marketing, Salaries, Employee Benefits, Depreciation, and Administrative Expenses**

Marketing, salaries, employee benefits, depreciation, and administrative expenses decreased to approximately \$25.0 million for the nine-month period ended December 31, 2017 from approximately \$26.6 million for the nine-month period ended December 31, 2016. The decrease was primarily related to a decrease in the amount of Contracts purchased and a decrease in average headcount for the nine months ended December 31, 2017. The Company decreased average headcount to 305 for the nine-month period ended December 31, 2017 from 317 for the nine-month period ended December 31, 2016, mainly due to branch closures. Marketing, salaries, employee benefits, depreciation, and administrative expenses as a percentage of finance receivables, net of unearned interest, decreased to 9.98% for the nine-month period ended December 31, 2017 from 10.26% for the nine-month period ended December 31, 2016.

**Interest Expense**

Interest expense increased to approximately \$7.5 million for the nine-month period ended December 31, 2017 as compared to \$6.7 million for the nine-month period ended December 31, 2016. This increase was primarily due to the increase in the pricing to 400 basis points above 30 day LIBOR and an increase in 30 day LIBOR rates. Pricing prior to November 7, 2017 was 350 basis points above 30 day LIBOR. Pricing for the nine-month period ended December 31, 2016 was 300 basis points above 30 day LIBOR until December 30, 2016, when it changed to 350 basis points above 30 day LIBOR. This change continued until the November 7, 2017 amendment. See below for more details. The following table summarizes the Company's average cost of borrowed funds:

|                                                     | <b>Nine months ended December 31,</b> |              |
|-----------------------------------------------------|---------------------------------------|--------------|
|                                                     | <b>2017</b>                           | <b>2016</b>  |
| Variable interest under the line of credit facility | <b>0.08%</b>                          | <b>0.18%</b> |

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|                                                 |                |       |
|-------------------------------------------------|----------------|-------|
| Settlements under interest rate swap agreements | <b>(0.01)%</b> | 0.10% |
| Credit spread under the line of credit facility | <b>5.00%</b>   | 4.00% |
| Average cost of borrowed funds                  | <b>5.07%</b>   | 4.28% |

LIBOR rates have increased (1.57% as of December 31, 2017 compared to .77% as of December 31, 2016) which caused an increase in variable interest for the amount that exceeded the 1% floor. The increase in LIBOR rates also caused a decrease in expense related to our interest rate swap agreements. During the nine months ended December 31, 2017, both of the Company's interest rate swaps expired (see *Note 6- Interest Rate Swap Agreements* for further discussion) but these did not have a significant effect on borrowing costs. For further discussions regarding interest rates see *Note 5 Line of Credit*.

**Contract Procurement**

The Company purchases Contracts in the eighteen states listed in the table below. The Contracts purchased by the Company are predominately for used vehicles; for the three and nine month periods ended December 31, 2017 and 2016, less than 1% were for new vehicles.

The following tables present selected information on Contracts purchased by the Company, net of unearned interest.

| State | As of<br>December 31,<br>2017<br>Number<br>of<br>branches | Three months<br>ended<br>December 31,<br>2017      2016 |           | Nine months ended<br>December 31,<br>2017      2016 |            |
|-------|-----------------------------------------------------------|---------------------------------------------------------|-----------|-----------------------------------------------------|------------|
|       |                                                           | Net Purchases<br>(In thousands)                         |           | Net Purchases<br>(In thousands)                     |            |
| FL    | 19                                                        | \$ 6,552                                                | \$ 12,950 | \$ 21,081                                           | \$ 36,527  |
| GA    | 6                                                         | 3,000                                                   | 4,195     | 8,270                                               | 11,515     |
| NC    | 6                                                         | 2,374                                                   | 3,740     | 6,364                                               | 9,843      |
| SC    | 2                                                         | 1,088                                                   | 1,213     | 3,040                                               | 3,062      |
| OH    | 6                                                         | 3,693                                                   | 5,100     | 10,431                                              | 14,645     |
| MI    | 2                                                         | 1,286                                                   | 1,725     | 3,685                                               | 5,121      |
| VA    | 2                                                         | 770                                                     | 1,126     | 1,986                                               | 3,041      |
| IN    | 3                                                         | 1,776                                                   | 2,318     | 4,975                                               | 6,865      |
| KY    | 3                                                         | 1,410                                                   | 2,271     | 4,159                                               | 6,316      |
| MD    | 1                                                         | 244                                                     | 898       | 886                                                 | 2,056      |
| AL    | 2                                                         | 682                                                     | 1,138     | 2,259                                               | 3,699      |
| TN    | 2                                                         | 982                                                     | 1,426     | 2,304                                               | 3,858      |
| IL    | 3                                                         | 525                                                     | 2,004     | 2,245                                               | 5,570      |
| MO    | 3                                                         | 1,153                                                   | 2,383     | 3,615                                               | 5,997      |
| KS    | 1                                                         | 427                                                     | 926       | 1,390                                               | 2,274      |
| TX    | 2                                                         | 739                                                     | 1,578     | 1,859                                               | 5,239      |
| PA    | 1                                                         | 677                                                     | 748       | 1,666                                               | 1,878      |
| WI    | a                                                         |                                                         | 202       | 106                                                 | 806        |
| Total | 64                                                        | \$ 27,378                                               | \$ 45,941 | \$ 80,321                                           | \$ 128,312 |

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

| Contracts        | Three months ended<br>December 31,<br>(Purchases in thousands) |           | Nine months ended<br>December 31,<br>(Purchases in thousands) |            |
|------------------|----------------------------------------------------------------|-----------|---------------------------------------------------------------|------------|
|                  | 2017                                                           | 2016      | 2017                                                          | 2016       |
| Purchases        | \$ 27,378                                                      | \$ 45,941 | \$ 80,321                                                     | \$ 128,312 |
| Weighted APR     | 21.68%                                                         | 21.99%    | 21.99%                                                        | 22.20%     |
| Average discount | 6.89%                                                          | 6.87%     | 7.23%                                                         | 7.00%      |

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|                                |                  |           |                  |           |
|--------------------------------|------------------|-----------|------------------|-----------|
| Weighted average term (months) | <b>54</b>        | 57        | <b>55</b>        | 57        |
| Average loan                   | <b>\$ 11,577</b> | \$ 11,945 | <b>\$ 11,552</b> | \$ 11,727 |
| Number of Contracts            | <b>2,365</b>     | 3,846     | <b>6,953</b>     | 10,942    |

**Loan Origination**

The following table presents selected information on Direct Loans originated by the Company, net of unearned interest.

| Direct Loans Originated        | Three months ended<br>December 31,<br>(Originations in thousands) |          | Nine months ended<br>December 31,<br>(Originations in thousands) |          |
|--------------------------------|-------------------------------------------------------------------|----------|------------------------------------------------------------------|----------|
|                                | 2017                                                              | 2016     | 2017                                                             | 2016     |
| Originations                   | \$ 2,218                                                          | \$ 2,578 | \$ 6,196                                                         | \$ 7,109 |
| Weighted APR                   | 25.20%                                                            | 25.87%   | 25.25%                                                           | 26.03%   |
| Weighted average term (months) | 28                                                                | 29       | 29                                                               | 29       |
| Average loan                   | \$ 3,566                                                          | \$ 3,661 | \$ 3,742                                                         | \$ 3,563 |
| Number of loans                | 622                                                               | 704      | 1,656                                                            | 1,995    |

**Analysis of Credit Losses**

As of December 31, 2017, the Company had approximately 1,491 active static pools. The average pool upon inception consisted of 49 Contracts with aggregate finance receivables, net of unearned interest, of approximately \$570,000.

The provision for credit losses increased to \$9.0 million for the three months ended December 31, 2017 from \$8.8 million for the three months ended December 31, 2016, largely due to the net charge-off percentage (see note 6 in the Portfolio Summary table in the *Introduction* above for the definition of net charge-off percentage) increasing to 10.63% for the three months ended December 31, 2017 from 8.86% for the three months ended December 31, 2016 for the reasons described below. The provision for credit losses increased to approximately \$28.9 million for the nine months ended December 31, 2017 from approximately \$24.0 million for the nine months ended December 31, 2016. This increase is primarily a result of an increase in the net charge-off rate to 10.13% for the nine months ended December 31, 2017 from 8.57% for the nine months ended December 31, 2016 for the reasons described below.

The Company's allowance for credit losses incorporates recent trends that include increased delinquencies by analyzing the allowance on a loan by loan basis, which the Company believes more closely depicts the amount of the allowance for credit losses needed to maintain an adequate reserve within a static pool. 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 allowance for credit losses as a percentage of average net receivables (see note 7 in the Portfolio Summary table in the *Introduction* above for the definition of allowance percentage) increased to 6.59% for the three months ended December 31, 2017 from 4.21% for the three months ended December 31, 2016. The allowance for credit losses as a percentage of average net receivables increased to 6.35% for the nine months ended December 31, 2017 from 4.26% for the nine months ended December 31, 2016. The increase is primarily a result of an increase in write-off to liquidation to 13.66% for the three months ended December 31, 2017 from 12.35% for the three months ended December 31, 2016 and to 13.00% for the nine months ended December 31, 2017 from 11.02% for the nine months ended December 31, 2016.

The Company considers multiple factors to assist in determining appropriate loss reserve levels. The Company continues to evaluate reserve levels on a pool-by-pool basis during each reporting period. The longer-term outlook for portfolio performance will depend on overall economic conditions, the rational or irrational behavior of the Company's competitors, and the Company's ability to monitor, manage and implement its underwriting and collections philosophy in additional geographic areas as it strives to continue its expansion.

The Company's loan losses as a percentage of liquidation (see note 5 in the Portfolio Summary table in the *Introduction* above for the definition of write-off to liquidation) increased to 13.66% for the three months ended December 31, 2017 as compared to 12.35% for the three months ended December 31, 2016. The Company's losses as a percentage of liquidation increased to 13.00% for the nine months ended December 31, 2017 as compared to 11.02% for the nine months ended December 31, 2016.

The increases in the net charge-off percentage, write-off to liquidation percentage and allowance percentage for both the three-month and nine-month periods ended December 31, 2017 were primarily the result of the Company underestimating the competitiveness of the market in prior years and purchasing loans of lower credit quality in such years. As these loans move toward maturity, the actual losses do not occur evenly over their respective lives. Within both the three-month and nine-month periods ended December 31, 2017, the Company saw more charge-offs in these lower quality pools than it saw for the same pools during the three-month and nine-month periods ended December 31, 2016. At the beginning of 2016, the Company implemented measures to mitigate losses, identify fraud on the front end, and more accurately price

for risk. In January of 2016, the Company modified its underwriting policies, in March of 2017 the Company engaged a third party service company, to more accurately price risk, and in June of 2017, the Company created a centralized funding department to provide a final review of all Contracts prior to funding. The Company also continues to see decreased auction proceeds from repossessed vehicles, which increases the amount of write-offs which, in turn, increases the write-off to liquidation percentage, allowance percentage and net charge-off percentage. During the three months ended December 31, 2017 and 2016, auction proceeds from the sale of repossessed vehicles averaged approximately 36% and 37%, respectively, of the related principal balance. During the nine months ended December 31, 2017 and 2016, auction proceeds from the sale of repossessed vehicles averaged approximately 35% and 38%, respectively, of the related principal balance. Based on current market conditions, the Company does not expect auction proceeds to improve within the remaining quarters of the fiscal year.

Recoveries as a percentage of charge-offs were approximately 4.10% and 6.88% for the three months ended December 31, 2017 and 2016, respectively. Recoveries as a percentage of charge-offs were approximately 5.26% and 7.49% for the nine months ended December 31, 2017 and 2016, respectively. The Company attributes a large portion of this decrease simply to the increase in charge-offs for the 2017 periods, and to a lesser extent to the September 1, 2016, change in its accounting policy to write off accounts that are 180+ delinquent (from 120+ days delinquent). The Company periodically aggregates charge-off accounts it deems uncollectible and sells them to a third-party. For the nine months ended December 31, 2016 the Company received approximately \$225k from a third party sale, this has not occurred in the nine-months ended December 31, 2017.

The delinquency percentage for Contracts more than thirty days past due, excluding Chapter 13 bankruptcy accounts, as of December 31, 2017 was 13.76%, a decrease from 14.45% as of December 31, 2016. The delinquency percentage for Direct Loans more than thirty days past due, excluding Chapter 13 bankruptcy accounts, as of December 31, 2017 was 4.46%, a decrease from 4.88% as of December 31, 2016. The decrease in delinquency percentage for both Contracts and Direct Loans was driven primarily by portfolio improvement. The delinquency percentage for the period ended December 31, 2016 was exacerbated by greater than anticipated difficulties in implementing a centralized collection model in October 2016, after the Company moved all loan-servicing operations from branch locations to a centralized location within its corporate headquarters in Clearwater. The Company has since moved all of its collections back to the branches.

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, 2017 and December 31, 2016, the Company granted deferrals to approximately 7.47% and 11.84%, respectively, of total Contracts and Direct Loans. For the nine months ended December 31, 2017 and December 31, 2016, the Company granted deferrals to approximately 30.34% and 22.85%, respectively, of total Contracts and Direct Loans. The increase in the number of deferrals for the nine month period ended December 31, 2017 was mainly a result of the impact of Hurricane Irma and Hurricane Harvey, with 42% of our branch locations located in areas that were affected by these storms. The Company offered deferrals to those customers that were impacted to assist them during a time of crisis. Additionally, deferments are 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.

### **Income Taxes**

On December 22, 2017, the Tax Cuts and Jobs Act was passed into law ( TCJA ). The TCJA includes a broad range of tax reform including changes to tax rates and deductions that are effective January 1, 2018. The decrease in the enacted corporate tax rate expected to apply when our temporary differences are realized or settled ultimately resulted

in a one-time revaluation of our net deferred tax asset of \$3.4 million in December 2017 with a corresponding charge to income tax expense. The tax effects of the TCJA increased income tax expense to a level that reduced net income to a net loss for both the three and nine-month periods ending December 31, 2017.

The provision for income taxes increased to approximately \$3.7 million for the three months ended December 31, 2017 from approximately \$1.0 million for the three months ended December 31, 2016. The Company's effective tax rate increased to 456.48% for the three months ended December 31, 2017 from 37.93% for the three months ended December 31, 2016. The provision for income taxes increased to approximately \$4.4 million for the nine months ended December 31, 2017 from approximately \$4.0 million for the nine months ended December 31, 2016. The Company's effective tax rate increased to 164.70% for the nine months ended December 31, 2017 from 38.01% for the nine months ended December 31, 2016.

**Liquidity and Capital Resources**

The Company's cash flows are summarized as follows:

|                             | <b>Nine months ended<br/>December 31,<br/>(In thousands)</b> |             |
|-----------------------------|--------------------------------------------------------------|-------------|
|                             | <b>2017</b>                                                  | <b>2016</b> |
| Cash provided by (used in): |                                                              |             |
| Operating activities        | \$ 18,551                                                    | \$ 22,518   |
| Investing activities        | 16,214                                                       | (24,232)    |
| Financing activities        | (34,538)                                                     | 3,529       |
| Net increase in cash        | \$ 227                                                       | \$ 1,815    |

The Company's primary use of working capital for the nine months ended December 31, 2017 was funding the purchase of Contracts, which are financed substantially through cash from principal payments received, cash from operations and our line of credit (the Line). The Company may borrow up to \$225.0 million under the Line. Effective November 8, 2017, the Company executed amendment 7 to the Line which extended the maturity date to March 31, 2018 and increased the pricing of the Line to 400 basis points above 30 day LIBOR, while maintaining the 1% floor on LIBOR. The amendment also increased the voting stock ownership limit from 20% to 30% and revised the calculation of availability and the minimum interest coverage ratio. The threshold for the minimum interest coverage ratio was lowered for the period ending December 31, 2017.

On December 30, 2016, the Company had executed an amendment which increased the pricing of the Line to 350 basis points above 30 day LIBOR while maintaining the 1% floor on LIBOR. This pricing was maintained under a subsequent amendment effective June 30, 2017. Prior to December 30, 2016, the pricing on the Line was 300 basis points above 30 day LIBOR with a 1% floor on LIBOR.

Pledged as collateral for this Line are all the assets of the Company. The Line requires compliance with certain financial ratios and covenants and satisfaction of specified financial tests, including maintenance of asset quality and performance tests. As of December 31, 2017, the Company is in compliance with all debt covenants. Had the Company not entered into amendment 6 and amendment 7 to the credit agreement, the Company would not have been in compliance with the minimum interest coverage ratio of 1.5:1 as of June 30, 2017, September 30, 2017 and December 31, 2017, respectively.

As of December 31, 2017, the amount outstanding under the Line was \$178.0 million, while the average amount outstanding during the three and nine months ended December 31, 2017 was \$183.6 million and \$196.6 million, respectively. The exact amount that the Company may borrow under the Line at any given time is determined in accordance with the Second Amended and Restated Loan and Security Agreement, as subsequently amended.

The Company will continue to depend on the availability of the Line, together with cash from operations, to finance future operations. The availability of funds under the Line generally depends on availability calculations as defined in the corresponding credit agreement. In addition, our credit facility requires us to comply with certain financial ratios and covenants and to satisfy specified financial tests, including maintenance of asset quality and portfolio performance tests.

Since the borrowings available under the Line are calculated every month based on individual loan criteria as defined in the credit agreement, no assurances can be given that the Company will maintain sufficient availability.

As disclosed in Note 4 to the financial statements, the quality of the Company's loan portfolio has generally been deteriorating, which has resulted in an increase in non-performing loans, an increase in delinquencies (with a decrease limited to the quarter ended December 31, 2017) and other factors, which in turn has resulted in increased net charge-offs and an increase in the provision for credit losses. These conditions have resulted in a reduction in net earnings and have affected our borrowing capacity under the credit facility.

Failure to meet any financial ratios, covenants or financial tests could result in an event of default under our line of credit facility. If an event of default occurs under the credit facility, our lenders could increase our borrowing costs, restrict our 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.

The Company has a longstanding relationship with its lenders and believes it is probable that it will be able to obtain financing from either its existing lenders or from other sources. However, the Line currently matures on March 31, 2018. The Company can provide no assurances that the lenders will approve the further renewal or extension of the Line past its current maturity or, assuming that they will approve it, that the facility will not be on terms less favorable than the current agreement. The Company may also determine to seek alternative financing, including but not limited to, the issuance of equity or debt; however, we may not be able to raise additional funds on acceptable terms, or at all.

See also *Our business depends on our continued access to bank financing on acceptable terms* in *1A. Risk Factors* in this report, which is incorporated herein by reference.

### **Contractual Obligations**

The following table summarizes the Company's material obligations as of December 31, 2017.

|                               |    | Payments Due by Period<br>(In thousands) |                  |              |                                   |
|-------------------------------|----|------------------------------------------|------------------|--------------|-----------------------------------|
|                               |    | Total                                    | Less than 1 year | 1 to 3 years | 3 to 5 years<br>More than 5 years |
| Operating leases              | \$ | 4,153                                    | \$ 2,505         | \$ 1,578     | \$ 70                             |
| Line of credit <sup>1</sup>   |    | 178,000                                  | 178,000          |              |                                   |
| Interest on Line <sup>1</sup> |    | 2,479                                    | 2,479            |              |                                   |
| Total                         | \$ | 184,632                                  | \$ 182,984       | \$ 1,578     | \$ 70                             |

1. The Company's Line matures on March 31, 2018. Interest on outstanding borrowings under the Line as of December 31, 2017, is based on an effective interest rate of 5.57%. The effective interest rate used in the above table does not contemplate the possibility of entering into interest rate swap agreements in the future.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Market risks relating to the Company's operations result primarily from changes in interest rates. The Company does not engage in speculative or leveraged transactions, nor does it hold or issue financial instruments for trading purposes.

#### **Interest rate risk**

Management's objective is to minimize the cost of borrowing through an appropriate mix of fixed and floating rate debt. Derivative financial instruments, such as interest rate swap agreements, may be used to managing fluctuating interest rate exposures that exist from ongoing business operations. The Company does not use interest rate swap agreements for speculative purposes and does not currently have any active agreements.

As of December 31, 2017, \$178.0 million, or 100.00% of our total debt, was subject to floating interest rates. As a result, a hypothetical increase in LIBOR of 1% or 100 basis points (based on actual LIBOR rates of 1.57% as of December 31, 2017) would have resulted in an annual after-tax increase of interest expense of approximately \$1.2 million.

### **ITEM 4. CONTROLS AND PROCEDURES**

**Evaluation of disclosure controls and procedures.** In accordance with Rule 13a-15(b) of the Securities Exchange Act of 1934 (the "Exchange Act"), as of the end of the period covered by this Quarterly Report on Form 10-Q, the Company's management evaluated, with the participation of the Company's President and Chief Executive Officer and Principal Financial Officer, the effectiveness of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act). Based upon their evaluation of these disclosure controls and procedures, the

Principal Executive Officer and the Principal Financial Officer have concluded that the disclosure controls and procedures were effective as of the end of the period covered by this Quarterly Report on Form 10-Q.

Changes in internal control over financial reporting. There have been no changes in the Company's internal control over financial reporting that occurred during the Company's last fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## **PART II - OTHER INFORMATION**

### **ITEM 1. LEGAL PROCEEDINGS**

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.

### **ITEM 1A. RISK FACTORS**

In addition to the risk factors below and the other information set forth in this report, you should carefully consider the factors discussed in Part I Item 1A. Risk Factors in the Company's Annual Report on Form 10-K for the year ended March 31, 2017, which could materially affect our business, financial condition or future results. The risks described below, elsewhere in this report and in the Form 10-K are not the only risks facing the Company. Additional risks and uncertainties not currently known to the Company or that the Company currently deems to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

#### **Our business depends on our continued access to bank financing on acceptable terms.**

Our business is particularly dependent on our ability to access bank financing at competitive rates. We currently use a \$225.0 million line of credit facility (the "Line") with a consortium of lenders to finance a large portion of our Contract purchases and Direct Loans. This Line has a maturity date of March 31, 2018. Effective November 8, 2017, the Company executed amendment 7 to the Line, which extended the maturity date to March 31, 2018 and increased the pricing of the Line to 400 basis points above 30 day LIBOR, while maintaining the 1% floor on LIBOR. The amendment also increased the voting stock ownership limit from 20% to 30% and revised the calculation of availability and the minimum interest coverage ratio. The threshold for the minimum interest coverage ratio was lowered for the period ending December 31, 2017.

We can provide no assurances that the lenders will approve the further renewal or extension of the Line past March 31, 2018 or, assuming that they will approve it, that the facility will not be on terms less favorable than the current agreement. If the Company is unable to renew or replace the facility or find alternative financing, or to do so on acceptable terms, it will be unable to finance the same or similar level of Contract purchases or Direct Loans, and will likely be required to curtail portions of its strategic plan. This in turn would have a material adverse effect on its liquidity, capital resources and results of operations.

Pledged as collateral for the Line are substantially all of the assets of the Company. The Line requires compliance with certain financial ratios and covenants and satisfaction of specified financial tests, including maintenance of asset quality and performance tests. Had the Company not entered into amendment 6 and amendment 7 to the credit agreement, the Company would not have been in compliance with the minimum interest coverage ratio of 1.5:1 as of June 30, 2017, September 30, 2017 and December 31, 2017, respectively. Failure to meet any financial ratios, covenants or financial tests could result in an event of default under the Line. If an event of default occurs, our lenders could increase our borrowing costs, restrict our 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.

Since the borrowings available under the Line are calculated every month based on individual loan criteria as defined in the credit agreement, no assurances can be given that the Company will maintain sufficient availability. As disclosed in Note 4 to the financial statements, the quality of the Company's loan portfolio has generally been deteriorating, which has resulted in an increase in non-performing loans, an increase in delinquencies (with a decrease limited to the quarter ended December 31, 2017) and other factors, which in turn has resulted in increased net charge-offs and an increase in the provision for credit losses. These conditions have resulted in a reduction in net

earnings and have affected our borrowing capacity under the Line.

The Company may also determine to seek alternative financing, including but not limited through the issuance of equity or debt. We may not be able to raise additional funds on acceptable terms, or at all. If we are unable to secure sufficient capital to fund our operating activities, we may be required to curtail portions of our strategic plan. Any equity financings may cause substantial dilution to our stockholders and could involve the issuance of securities with rights senior to the common stock. Any allowed debt financings may require us to comply with onerous financial covenants and restrict our business operations. Our ability to complete additional financings is dependent on, among other things, the state of the capital markets at the time of any proposed offering, market reception of the Company and the likelihood of the success of our business model, and the offering terms, among other things.

**Changes in U.S. federal, state and local tax law or interpretations of existing tax law could increase our tax burden or otherwise adversely affect our financial condition or results of operations.**

We are subject to taxation at the federal, state and local levels in the United States. On December 22, 2017, the U.S. government enacted comprehensive tax legislation commonly referred to as the Tax Cuts and Jobs Act (the "TCJA"). The changes included in the TCJA are broad and complex. The final transition impacts of the TCJA may differ from the estimates provided elsewhere in this report, possibly materially, due to, among other things, changes in interpretations of the TCJA, any legislative action to address questions that arise because of the TCJA, any changes in accounting standards for income taxes or related interpretations in response to the TCJA, or any updates or changes to estimates the Company has utilized to calculate the transition impacts, including impacts from changes to current year earnings estimates. The estimated impact of the new law is based on management's current knowledge and assumptions and recognized impacts could be materially different from current estimates based on our actual results in the fourth quarter of fiscal 2018 and our further analysis of the new law.

**Item 6. EXHIBITS****Exhibit**

| <b>No.</b>        | <b>Description</b>                                                                                                                                                                                                                                                   |
|-------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 10.1              | <u>Employment Agreement, dated December 12, 2017, between Nicholas Financial, Inc. and Douglas Marohn, President and Chief Executive Officer (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on December 11, 2017)*</u> |
| 10.2              | <u>Form of Dealer Agreement and Schedule thereto listing dealers that are parties to such agreements</u>                                                                                                                                                             |
| 31.1              | <u>Certification of the Principal Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u>                                                                                                                                                    |
| 31.2              | <u>Certification of the Principal Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u>                                                                                                                                                    |
| 32.1 <sup>1</sup> | <u>Certification of the Principal Executive Officer Pursuant to 18 U.S.C. § 1350</u>                                                                                                                                                                                 |
| 32.2 <sup>1</sup> | <u>Certification of the Principal Financial Officer Pursuant to 18 U.S.C. § 1350</u>                                                                                                                                                                                 |
| 101.INS           | XBRL Instance Document                                                                                                                                                                                                                                               |
| 101.SCH           | XBRL Taxonomy Extension Schema Document                                                                                                                                                                                                                              |
| 101.CAL           | XBRL Taxonomy Extension Calculation Linkbase Document                                                                                                                                                                                                                |
| 101.DEF           | XBRL Taxonomy Extension Definition Linkbase Document                                                                                                                                                                                                                 |
| 101.LAB           | XBRL Taxonomy Extension Labels Linkbase Document                                                                                                                                                                                                                     |
| 101.PRE           | XBRL Taxonomy Extension Presentation Linkbase Document                                                                                                                                                                                                               |

\*Represents a management contract or compensatory plan, contract or arrangement in which a director or named executive officer of the Company participated

<sup>1</sup>This certification accompanies the Quarterly Report on Form 10-Q and is not filed as part of it.

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned thereunto duly authorized.

**NICHOLAS FINANCIAL, INC.**

(Registrant)

Date: February 09, 2018

/s/ Doug Marohn  
Doug Marohn  
President and Chief Executive Officer  
(Principal Executive Officer)

Date: February 09, 2018

/s/ Katie L. MacGillivray  
Katie L. MacGillivray  
Vice President and  
Chief Financial Officer  
(Principal Financial Officer)