

NICHOLAS FINANCIAL INC
Form 10-Q
November 14, 2006
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2006

.. **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

Incorporation or Organization)

2454 McMullen Booth Road, Building C

Clearwater, Florida
(Address of Principal Executive Offices)

8736-3354
(I.R.S. Employer

Identification No.)

33759
(Zip Code)

Edgar Filing: NICHOLAS FINANCIAL INC - Form 10-Q

(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 is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer

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

As of October 31, 2006, the registrant had 9,931,481 shares of common stock outstanding.

Table of Contents

NICHOLAS FINANCIAL, INC.

FORM 10-Q

TABLE OF CONTENTS

	Page
<u>Part I. Financial Information</u>	
Item 1. <u>Financial Statements (Unaudited)</u>	
<u>Condensed Consolidated Balance Sheets as of September 30, 2006 and as of March 31, 2006</u>	2
<u>Condensed Consolidated Statements of Income for the three and six months ended September 30, 2006 and 2005</u>	3
<u>Condensed Consolidated Statements of Cash Flows for the six months ended September 30, 2006 and 2005</u>	4
<u>Notes to the Condensed Consolidated Financial Statements</u>	5
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	12
Item 3. <u>Quantitative and Qualitative Disclosures about Market Risk</u>	23
Item 4. <u>Controls and Procedures</u>	23
<u>Part II. Other Information</u>	
Item 1A <u>Risk Factors</u>	23
Item 6. <u>Exhibits</u>	23

Table of Contents**PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS**

Nicholas Financial, Inc. and Subsidiaries

Condensed Consolidated Balance Sheets

	September 30, 2006 (Unaudited)	March 31, 2006
Assets		
Cash	\$ 1,732,922	\$ 1,729,057
Finance receivables, net	150,544,293	140,197,738
Accounts receivable	9,273	11,638
Assets held for resale	1,148,576	790,224
Prepaid expenses and other assets	1,037,777	570,723
Property and equipment, net	1,042,293	887,832
Derivatives	999,286	1,601,089
Deferred income taxes	3,879,078	3,706,642
 Total assets	 \$ 160,393,498	 \$ 149,494,943
Liabilities		
Line of credit	\$ 87,073,246	\$ 82,415,917
Drafts payable	1,001,182	992,171
Accounts payable and accrued expenses	6,867,658	6,064,734
Income taxes payable		177,557
Deferred revenues	1,540,204	1,595,389
 Total liabilities	 96,482,290	 91,245,768
Shareholders' equity		
Preferred stock, no par: 5,000,000 shares authorized; none issued and outstanding		
Common stock, no par: 50,000,000 shares authorized; 9,931,481 and 9,912,931 shares issued and outstanding, respectively	15,764,247	15,525,988
Accumulated other comprehensive income	618,582	992,675
Retained earnings	47,528,379	41,730,512
 Total shareholders' equity	 63,911,208	 58,249,175
 Total liabilities and shareholders' equity	 \$ 160,393,498	 \$ 149,494,943

See accompanying notes.

Table of Contents

Nicholas Financial, Inc. and Subsidiaries
Condensed Consolidated Statements of Income
(Unaudited)

	Three months ended September 30,		Six months ended September 30,	
	2006	2005	2006	2005
Revenue:				
Interest income on finance receivables	\$ 11,573,987	\$ 10,197,903	\$ 22,868,993	\$ 19,307,604
Sales	32,747	40,817	66,615	91,507
	11,606,734	10,238,720	22,935,608	19,399,111
Expenses:				
Cost of sales	4,385	9,913	5,402	22,284
Marketing	329,811	293,594	621,387	544,849
Salaries and employee benefits	3,067,434	2,678,672	5,809,519	5,312,970
Administrative	1,416,548	1,229,562	2,651,364	2,154,471
Provision for credit losses	852,451	832,009	1,662,453	1,260,034
Depreciation	91,953	82,595	178,942	156,259
Interest expense	1,362,691	1,058,479	2,622,894	2,039,032
	7,125,273	6,184,824	13,551,961	11,489,899
Operating income before income taxes	4,481,461	4,053,896	9,383,647	7,909,212
Income tax expense:				
Current	1,376,717	1,535,649	3,530,506	3,180,413
Deferred	336,320	9,071	55,274	(174,205)
	1,713,037	1,544,720	3,585,780	3,006,208
Net income	\$ 2,768,424	\$ 2,509,176	\$ 5,797,867	\$ 4,903,004
Earnings per share:				
Basic	\$ 0.28	\$ 0.25	\$ 0.58	\$ 0.50
Diluted	\$ 0.27	\$ 0.24	\$ 0.56	\$ 0.47

See accompanying notes.

Table of Contents

Nicholas Financial, Inc. and Subsidiaries
Condensed Consolidated Statements of Cash Flows
(Unaudited)

	Six months ended	
	2006	September 30, 2005
Cash flows from operating activities		
Net income	\$ 5,797,867	\$ 4,903,004
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	178,942	156,259
Gain on sale of property and equipment	(16,640)	(14,366)
Provision for credit losses	1,662,453	1,260,034
Deferred income taxes	55,274	(174,205)
Share-based compensation	122,801	
Changes in operating assets and liabilities:		
Accounts receivable	2,365	4,347
Prepaid expenses and other assets	(467,054)	(388,653)
Accounts payable and accrued expenses	802,924	599,463
Income taxes payable	(177,557)	(540,899)
Deferred revenues	(55,185)	148,904
Net cash provided by operating activities	7,906,190	5,953,888
Cash flows from investing activities		
Purchase and origination of finance contracts	(53,758,395)	(48,054,207)
Principal payments received	41,749,387	34,360,812
Increase in assets held for resale	(358,352)	(306,459)
Purchase of property and equipment	(333,403)	(245,610)
Proceeds from sale of property and equipment	16,640	38,000
Net cash used in investing activities	(12,684,123)	(14,207,464)
Cash flows from financing activities		
Repayment of notes payable related party		(400,000)
Net proceeds from line of credit	4,657,329	8,823,070
Increase in drafts payable	9,011	59,779
Proceeds from exercise of stock options and income tax benefit related thereto	115,458	159,660
Net cash provided by financing activities	4,781,798	8,642,509
Net increase in cash	3,865	388,933
Cash, beginning of period	1,729,057	853,494
Cash, end of period	\$ 1,732,922	\$ 1,242,427

See accompanying notes.

Table of Contents

Nicholas Financial, Inc. and Subsidiaries

Notes to the Condensed Consolidated Financial Statements

(Unaudited)

1. Basis of Presentation

The accompanying condensed consolidated balance sheet as of March 31, 2006, which has been derived from audited financial statements, and the accompanying unaudited interim condensed 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 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 accounting principles generally accepted in the United States for complete financial statements, although the Company believes that the disclosures made are adequate to make the information 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, 2007. It is suggested that these condensed 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, 2006 as filed with the Securities and Exchange Commission on June 29, 2006.

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

Certain amounts in our prior-period condensed consolidated financial statements and notes have been reclassified to conform to the current-period presentation.

2. Revenue Recognition

The Company is principally a specialized consumer finance company engaged primarily in acquiring and servicing retail installment sales Contracts (Contracts) for purchases of new and used automobiles and light trucks. To a lesser extent, the Company also makes direct loans and sells consumer-finance related products.

Interest income on finance receivables is recognized using the interest method. Accrual of interest income on finance receivables is suspended when a loan is contractually delinquent for 60 days or more or the collateral is repossessed, whichever is earlier.

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 entire amount of discount is related to credit quality and is considered to be part of the credit loss reserve. The Company receives a commission for selling add-on services to consumer borrowers and amortizes the commission, net of the related costs, over the term of the loan using the interest method. The Company's net fees charged for processing a loan are recognized as an adjustment to the yield and are amortized over the life of the loan using the interest method.

The amount of future unearned income is computed as the product of the Contract rate, the Contract term, and the Contract amount. The Company aggregates the Contracts purchased during a three-month period for each of its branch locations. After the analysis of purchase date accounting is complete, any uncollectable amounts would be contemplated in the allowance for credit losses.

Table of Contents

Nicholas Financial, Inc. and Subsidiaries

Notes to the Condensed Consolidated Financial Statements

(Unaudited)

3. Earnings Per Share

Basic earnings per share is calculated by dividing the reported net income for the period by the weighted average number of shares of common stock outstanding. Diluted earnings per share includes the effect of dilutive options and other share awards. Basic and diluted earnings per share have been computed as follows:

	Three months ended		Six months ended	
	September 30,		September 30,	
	2006	2005	2006	2005
Numerator for earnings per share net income	\$ 2,768,424	\$ 2,509,176	\$ 5,797,867	\$ 4,903,004
Denominator:				
Denominator for basic earnings per share weighted average shares	9,931,144	9,871,183	9,923,229	9,861,474
Effect of dilutive securities:				
Stock options and other share awards	362,248	595,428	365,970	612,941
Denominator for diluted earnings per share	10,293,392	10,466,611	10,289,199	10,474,415
Earnings per share basic	\$ 0.28	\$ 0.25	\$ 0.58	\$ 0.50
Earnings per share diluted	\$ 0.27	\$ 0.24	\$ 0.56	\$ 0.47

4. Finance Receivables

Finance receivables consist of automobile finance installment Contracts and direct consumer loans and are detailed as follows:

	September 30,	March 31,
	2006	2006
Finance receivables, gross contract	\$ 237,193,476	\$ 222,718,384
Unearned interest	(65,217,551)	(59,952,624)
Finance receivables, net of unearned interest	171,975,925	162,765,760
Dealer discounts	(11,559,119)	(13,629,445)
Allowance for credit losses	(9,872,513)	(8,938,577)
Finance receivables, net	\$ 150,544,293	\$ 140,197,738

The terms of the receivables range from 12 to 72 months and bear a weighted average interest rate of 24% for the three and six months ended September 30, 2006.

Table of Contents

Nicholas Financial, Inc. and Subsidiaries

Notes to the Condensed Consolidated Financial Statements

(Unaudited)

5. Line of Credit

At September 30, 2006 the Company had an \$100.0 million line of credit facility (the Line) expiring on November 30, 2008. The Company may borrow the lesser of \$100.0 million or amounts based upon formulas principally related to a percentage of eligible finance receivables, as defined. As of September 30, 2006, \$85.0 million of borrowings under the Line used LIBOR plus 175.0 basis points pricing options. The remainder of the borrowings under the Line used the prime rate plus 37.5 basis points pricing option. The prime rate based borrowings are generally less than \$5.0 million. The Company's cost of borrowed funds, which is based upon the interest rates charged under the Line, related party debt and the effect of the interest rate swap agreements (see note 7), amounted to 6.41% and 6.24% for the three and six months ended September 30, 2006, respectively, as compared to 5.90% and 5.84% for the three and six month period ended September 30, 2005, respectively. Pledged as collateral for this credit facility are all of the assets of the Company's subsidiary, Nicholas Financial, Inc. As of September 30, 2006, the amount outstanding under the Line was approximately \$87.1 million and the amount available under the Line was approximately \$12.9 million. The facility requires compliance with certain financial ratios and covenants and satisfaction of specified financial tests, including maintenance of asset quality and performance tests. Dividends require consent in writing by the agent and majority lenders under the facility. As of September 30, 2006, the Company was in full compliance with all debt covenants.

6. Notes Payable - Related Party

The Company had unsecured notes payable to the President and Chief Executive Officer at September 30, 2005 totaling \$600,000. For the three and six months ended September 30, 2005 the notes bore a variable interest rate equal to the average cost of borrowed funds for the Company plus 25.0 basis points, 6.11% at September 30, 2005. The Company incurred interest expense on the above notes of approximately \$9,300 and \$20,400 for the three and six months ended September 30, 2005, respectively. The interest rate was recalculated every three months and the notes were due upon thirty-day demand. The notes were called in on February 7, 2006 and paid in full on March 9, 2006.

Table of Contents

Nicholas Financial, Inc. and Subsidiaries

Notes to the Condensed Consolidated Financial Statements

(Unaudited)

7. Derivatives and Hedging

The Company utilizes interest rate swap agreements to manage interest rate exposure. The swaps effectively convert a portion of the Company's floating rate debt to a fixed rate, more closely matching the interest rate characteristics of the Company's finance receivables. At September 30, 2006, \$50,000,000 of the Company's borrowings have been designated as the hedged items to interest rate swap agreements which are detailed as follows:

Date Entered	Effective Date	Notional Amount	Fixed Rate	
			Of Interest	Maturity Date
January 6, 2003	April 2, 2003	\$ 10,000,000	3.35%	April 2, 2007
February 26, 2003	May 17, 2004	\$ 10,000,000	3.91%	May 19, 2008
March 11, 2004	October 5, 2004	\$ 10,000,000	3.64%	October 5, 2009
January 18, 2005	July 5, 2005	\$ 10,000,000	4.38%	July 2, 2010
September 9, 2005	September 13, 2005	\$ 10,000,000	4.46%	September 2, 2010

For derivative instruments that are designated and qualify as a cash flow hedge (i.e., hedging the exposure to variability in expected future cash flows that is attributable to a particular risk, such as interest rate risk), the effective portion of the gain or loss on the derivative instrument is reported as a component of comprehensive income and reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. The remaining gain or loss on the derivative instrument in excess of the cumulative change in the present value of the future cash flows of the hedged item, if any, is recognized in current earnings during the period of change.

Each swap agreement has identical terms to the critical terms of the hedged item and meets each condition in Statement of Financial Accounting Standards (SFAS) No.133 for utilization of the short-cut method to assess the effectiveness of the swap agreement in hedging the variability of interest payments on the floating rate borrowings under the Line. The short-cut method presumes there is no hedge ineffectiveness if all such applicable conditions are met and the critical terms of the hedge and the hedged item do not change. During the life of each hedge, the critical terms of the hedge and the hedged item did not change. Accordingly, the Company did not have any gain or loss from hedge ineffectiveness.

The Company records net gains and losses from the swap agreements into the interest expense line item of the consolidated statement of income. Under the swap agreements, the Company received an average variable rate of 5.36% and 3.53% for the three months ended September 30, 2006 and 2005, respectively. During the same period the Company paid an average fixed rate of 3.90% and 3.73%, respectively. Under the swap agreements, the Company received an average variable rate of 5.18% and 3.28% for the six months ended September 30, 2006 and 2005, respectively. During the same period the Company paid an average fixed rate of 3.86% and 3.66%, respectively. The interest rate swaps are recorded at fair value, approximately \$999,000 and \$1,601,000 as of September 30 and March 31, 2006, respectively, in the caption derivatives on the condensed consolidated balance sheet. Accumulated other comprehensive income at September 30 and March 31, 2006 of approximately \$619,000 and \$993,000, respectively, represents the after-tax effect of the derivative gains.

The following table reconciles net income with comprehensive income.

	Three months ended		Six months ended	
	September 30, 2006	September 30, 2005	September 30, 2006	September 30, 2005
Net Income	\$ 2,768,424	\$ 2,509,176	\$ 5,797,867	\$ 4,903,004
Mark to market interest rate swaps, net of tax benefit (expense) of \$305,950, (\$258,603), \$227,710 and (\$34,396), respectively	(496,221)	421,933	(374,093)	56,092

Edgar Filing: NICHOLAS FINANCIAL INC - Form 10-Q

Comprehensive income	\$ 2,272,203	\$ 2,931,109	\$ 5,423,774	\$ 4,959,096
----------------------	--------------	--------------	--------------	--------------

Table of Contents

Nicholas Financial, Inc. and Subsidiaries

Notes to the Condensed Consolidated Financial Statements

(Unaudited)

8. Share-Based Payments

The Company has share awards outstanding under three share-based compensation plans (the Equity Plans). Under the 1998 Employee Stock Option Plan and Non-Employee Director Stock Option Plan (collectively the 1998 Plans) the Board of Directors was authorized to grant option awards for up to 1,410,000 common shares to employees and directors. On August 9, 2006 the Company's shareholders approved the Nicholas Financial, Inc. Equity Incentive Plan (the 2006 Plan) for employees and non-employee directors. Under the 2006 Plan the Board of Directors is authorized to grant total share awards for up to 975,000 common shares. The 2006 Plan replaced the 1998 Plans; accordingly no additional option awards may be granted under the 1998 Plans. In addition to option awards, the 2006 Plan provides for restricted stock and performance share awards.

Option awards previously granted to employees and directors under the 1998 Plans generally vest ratably based on service over a five and three-year period, respectively and generally have a contractual term of 10 years. Dividends, if any, are not paid on unexercised options. Vesting and contractual terms for option awards under the 2006 Plan are essentially the same as those of the 1998 Plans. Restricted stock awards generally cliff vest over a three-year period based on service conditions. The vesting of performance share awards is contingent upon the attainment of company-wide performance goals including annual revenue growth and operating income targets. There are no post-vesting restrictions for share awards.

The Company funds share awards from authorized but unissued shares and does not purchase shares to fulfill the obligations of the plans. Dividends, if any, are not paid on unvested performance shares or unexercised options, but are paid on unvested restricted stock awards.

Effective April 1, 2006, the Company adopted SFAS No. 123 (revised 2004), Share-Based Payments , hereafter referred to as SFAS No. 123(R), which revises SFAS No. 123, Accounting for Stock Based Compensation, and supersedes Accounting Principles Board Opinion (APB) No. 25, Accounting for Stock Issued to Employees, and its related interpretations. SFAS No. 123(R) requires recognition of the cost of employee services received in exchange for an award of equity instruments in the consolidated financial statements over the period the employee is required to perform the services in exchange for the award (presumptively the vesting period). SFAS No. 123(R) also requires measurement of the cost of employee services received in exchange for an award based on the grant-date fair value of the award. SFAS No. 123(R) also amends SFAS No. 95 Statement of Cash Flows, to require that excess tax benefits be reported as financing cash inflows, rather than as a reduction of taxes paid, which is included within operating cash flows.

The Company adopted SFAS No. 123(R) using the modified prospective application. Accordingly, prior period amounts have not been restated. Under this application, the Company is required to record compensation expense for all awards granted after the date of adoption and for the unvested portion of previously granted awards that remain outstanding at the date of adoption. Prior to the adoption of SFAS No. 123(R), the Company used the intrinsic value method as prescribed by APB No. 25 and thus recognized no compensation expense for options granted with exercise prices equal to the fair market value of the Company's common stock on the date of grant.

The Company estimates the fair market value of each option award using the Black-Scholes option pricing model. The risk-free interest rate is based upon a U.S. Treasury instrument with a life that is similar to the expected term of the options. Expected volatility is based upon the historical volatility for the previous period equal to the expected term of the options. The expected term is based upon the average life of previously issued options. The expected dividend yield is based upon the current yield on date of grant.

Table of Contents

Nicholas Financial, Inc. and Subsidiaries

Notes to the Condensed Consolidated Financial Statements

(Unaudited)

8. Share-Based Payments (continued)

A summary of share award activity under the Equity Plans as of September 30, 2006, and changes during the six-month period then ended is presented below.

	Share Awards	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at March 31, 2006	756,200	\$ 2.78		
Granted	39,000	\$		
Exercised	(18,550)	\$ 1.85		
Forfeited	(10,700)	\$ 7.56		
Outstanding at September 30, 2006	765,950	\$ 2.59	3.82	\$ 8,600,749
Exercisable at September 30, 2006	629,350	\$ 2.02	3.30	\$ 7,424,445

The Company granted 39,000 and 48,000 share awards with a fair value of \$13.95 and \$4.84 during the six months ended September 30, 2006 and 2005, respectively. The total intrinsic value of options exercised during the six months ended September 30, 2006 and 2005 was approximately \$220,000 and \$337,000, respectively.

Cash received from options exercised during the six months ended September 30, 2006 and 2005 totaled approximately \$34,000 and \$37,000, respectively. Related income tax benefits during the same periods totaled approximately \$81,000 and \$122,000, respectively. Such amounts are included in proceeds from exercise of stock options and income tax benefit related thereto under cash flows from financing activities in the condensed consolidated statements of cash flows.

During the six months ended September 30, 2006, 10,700 options were forfeited at exercise prices ranging from \$2.20 to \$10.35 per share. During the same period 18,550 options were exercised at exercise prices ranging from \$1.13 to \$6.13 per share.

The following table presents a summary of the status of non-vested share awards under the Equity Plans as of September 30, 2006, and changes during the six-month period then ended.

	Share Awards	Weighted Average Grant Date Fair Value
Non-vested at March 31, 2006	151,850	\$ 2.80
Granted	39,000	\$ 13.95
Vested	(43,550)	\$ 2.19
Forfeited	(10,700)	\$ 3.45
Non-vested at September 30, 2006	136,600	\$ 6.12

Table of Contents

Nicholas Financial, Inc. and Subsidiaries

Notes to the Condensed Consolidated Financial Statements

(Unaudited)

8. Share-Based Payments (continued)

As of September 30, 2006 there was approximately \$686,000 of unrecognized compensation cost related to non-vested awards granted under the Equity Plans, which is expected to be recognized over a weighted-average period of approximately 3 years.

For purposes of disclosure pursuant to SFAS No. 123 and for recognition pursuant to SFAS No. 123(R) the estimated fair value of share awards is amortized over the awards requisite service period (the vesting period) using the straight line method. The adoption of SFAS No. 123(R) and its fair value compensation cost recognition provisions are different from the nonrecognition provisions under SFAS No. 123 and the intrinsic value method for compensation cost allowed by APB No. 25. For the six months ended September 30, 2006 total compensation cost for share-based payments recognized in income and the tax benefit related thereto were approximately \$123,000 and \$47,000, respectively. The adoption of SFAS No. 123(R) decreased reported amounts as follows for the six months ended September 30, 2006.

Operating income before income taxes	\$ (122,801)
Net income	\$ (75,875)
Earnings per share:	
Basic	\$ (0.01)
Diluted	\$ (0.01)

The following table illustrates the effect on net income and earning per share if the Company had applied the fair value recognition provision of SFAS No. 123(R) to options granted under the plans to the three and six-month periods ended September 30, 2005. For purposes of this pro forma disclosure, the value of the options is estimated using the Black-Scholes option pricing model and amortized to expense over the award's vesting period.

	Three months ended September 30, 2005	Six months ended September 30, 2005
Reported net income	\$ 2,509,176	\$ 4,903,004
Fair value impact of stock-based compensation not reported in net income, net of tax	13,183	27,186
Pro forma net income	\$ 2,495,993	\$ 4,875,818
Earnings per share:		
Reported basic	\$ 0.25	\$ 0.50
Pro forma basic	\$ 0.25	\$ 0.50
Reported diluted	\$ 0.24	\$ 0.47
Pro forma diluted	\$ 0.24	\$ 0.47

Table of Contents**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", and similar expressions are intended to identify forward-looking statements. Although the Company 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. 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 fluctuations in the economy, the degree and nature of competition, demand for consumer financing in the markets served by the Company, the Company's products and services, increases in the default rates experienced on Contracts, adverse regulatory changes in the Company's existing and future markets, the Company's ability to expand its business, including its ability to complete acquisitions and integrate the operations of acquired businesses, to recruit and retain qualified employees, to expand into new markets and to maintain profit margins in the face of increased pricing competition. 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 filings made with the Securities and Exchange Commission, including its reports on Form 10-K, 10-Q, 8-K and annual reports to shareholders.

Critical Accounting Policy

The Company's critical accounting policy relates to the allowance for losses on loans. It is based on management's opinion of an amount that is adequate to absorb losses in the existing portfolio. The allowance for credit losses is established through allocations of dealer discount and, for loans acquired prior to April 1, 2005, a portion of unearned income and a provision for loss based on management's evaluation of the risk inherent in the loan portfolio, the composition of the portfolio, specific impaired loans and current economic conditions. Such evaluation, which includes a review of all loans on which full collectibility may not be reasonably assured, 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, credit history, and the types of vehicles purchased in each market. Each such static pool consists of the Contracts purchased by a branch office during the fiscal quarter.

Contracts are purchased from many different dealers and are all purchased on an individual Contract by Contract basis. Individual Contract pricing is determined by the automobile dealerships and is generally the lesser of state maximum interest rates or the maximum interest rate at which the customer will accept. In certain 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 only buys Contracts on an individual basis and never purchases Contracts in batches, although the Company does consider portfolio acquisitions as part of its growth strategy.

The Company has detailed underwriting guidelines it utilizes to determine which Contracts to purchase. These guidelines are specific and are designed to cause all of the Contracts that the Company purchases to have common risk characteristics. The Company utilizes its District Managers to evaluate their respective branch locations for adherence to these underwriting guidelines. The Company also utilizes an internal audit department to assure adherence to its underwriting guidelines. The Company utilizes the branch model, which allows for Contract purchasing to be done on the branch level. Each Branch Manager may interpret the guidelines differently, and as a result, the common risk characteristics tend to be the same on an individual branch level but not necessarily compared to another branch.

Table of Contents

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 credit quality of the customer and the wholesale value of the vehicle. The automotive dealer accepts these terms by executing a dealer agreement with the Company. The entire amount of discount is related to credit quality and is considered to be part of the credit loss reserve. The Company utilizes a static pool approach to track portfolio performance. A static pool retains an amount equal to 100% of the discount as a reserve for credit losses.

Subsequent to the purchase, if the reserve for credit losses is determined to be inadequate for a static pool which is not fully liquidated, then an additional charge to income through the provision is used to reestablish adequate reserves. If a static pool is fully liquidated and has any remaining reserves, the excess discounts are immediately recognized into income and the excess provision is immediately reversed during the period. For static pools not fully liquidated that are determined to have excess discounts, such excess amounts are accreted into income over the remaining life of the static pool. For static pools not fully liquidated that are deemed to have excess reserves, such excess amounts are reversed against provision for credit losses during the period.

In analyzing a static pool, the Company considers the performance of prior static pools originated by the branch office, the performance of prior Contracts purchased from the dealers whose Contracts are included in the current static pool, the credit rating of the customers under the Contracts in the static pool, 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.

Introduction

Consolidated net income increased to \$2.8 million for the three-month period ended September 30, 2006 as compared to \$2.5 million for corresponding period ended September 30, 2005. Consolidated net income increased to \$5.8 million for the six-month period ended September 30, 2006 as compared to \$4.9 million for corresponding period ended September 30, 2005. Earnings were favorably impacted by an increase in the outstanding loan portfolio. The Company's software subsidiary, Nicholas Data Services (NDS), did not contribute significantly to consolidated operations in the three or six months ended September 30, 2006 or 2005.

Table of Contents

Portfolio Summary	Three months ended		Six months ended	
	September 30,		September 30,	
	2006	2005	2006	2005
Average finance receivables, net of unearned interest (1)	\$ 169,312,348	\$ 146,973,291	\$ 167,235,278	\$ 144,471,462
Average indebtedness (2)	\$ 85,041,313	\$ 71,747,445	\$ 84,098,632	\$ 69,843,069
Finance revenue (3)	\$ 11,573,987	\$ 10,197,903	\$ 22,868,993	\$ 19,307,604
Interest expense	1,362,691	1,058,479	2,622,894	2,039,032
Net finance revenue	\$ 10,211,296	\$ 9,139,424	\$ 20,246,099	\$ 17,268,572
Weighted average contractual rate (4)	23.92%	23.92%	24.03%	24.02%
Average cost of borrowed funds (2)	6.41%	5.90%	6.24%	5.84%
Gross portfolio yield (5)	27.34%	27.75%	27.35%	26.73%
Interest expense as a percentage of average finance receivables, net of unearned interest	3.22%	2.88%	3.14%	2.82%
Provision for credit losses as a percentage of average finance receivables, net of unearned interest	2.01%	2.26%	1.99%	1.74%
Net portfolio yield (5)	22.11%	22.61%	22.22%	22.17%
Operating expenses as a percentage of average finance receivables, net of unearned interest (6)	11.50%	11.46%	10.98%	11.10%
Pre-tax yield as a percentage of average finance receivables, net of unearned interest (7)	10.61%	11.15%	11.24%	11.07%
Write-off to liquidation (8)	7.65%	6.48%	6.37%	5.77%
Net charge-off percentage (9)	7.26%	5.83%	6.00%	5.13%

Note: All three-month key 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 and notes payable-related party. Average cost of borrowed funds represents interest expense as a percentage of average indebtedness.
- (3) Finance revenue does not include revenue generated by NDS. See Computer Software Business caption below for details on NDS revenue during the period.
- (4) Weighted average contractual rate represents the weighted average annual percentage rate (APR) of all Contracts purchased and direct loans originated during the period.
- (5) Gross portfolio yield represents finance revenues as a percentage of average finance receivables, net of unearned interest. Net portfolio yield represents finance revenue minus (a) interest expense and (b) the provision for credit losses as a percentage of average finance receivables, net of unearned interest.
- (6) Operating expenses represent total expenses, less interest expense, the provision for credit losses and operating costs associated with NDS. See Computer Software Business caption below for details on NDS operating expenses during the period.
- (7) Pre-tax yield represents net portfolio yield minus operating expenses as a percentage of average finance receivables, net of unearned interest.
- (8) 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 minus voids and refinances minus ending receivable balance.
- (9) Net charge-off percentage represents net charge-offs divided by average finance receivables, net of unearned interest, outstanding during the period.

Table of Contents

Three months ended September 30, 2006 compared to three months ended September 30, 2005

Interest Income and Loan Portfolio

Interest income on finance receivables, predominately finance charge income increased 13% to approximately \$11.6 million for the three-month period ended September 30, 2006, from \$10.2 million for the corresponding period ended September 30, 2005. Average finance receivables, net of unearned interest equaled approximately \$169.3 million for the three-month period ended September 30, 2006, an increase of 15% from \$147.0 million for the corresponding period ended September 30, 2005. The primary reason average finance receivables, net of unearned interest increased was the increase in the receivable base of several existing branches and the opening of additional branch locations. The gross finance receivable balance increased 18% to approximately \$237.2 million at September 30, 2006 from \$201.6 million at September 30, 2005. The primary reason interest income increased was the increase in the outstanding loan portfolio.

The gross portfolio yield was relatively constant at 27.34% for the three-month period ended September 30, 2006 as compared to 27.75% for the three-month period ended September 30, 2005. Reserves accreted into income for the three-month period ended September 30, 2006 were approximately \$1.1 million as compared to \$1.9 million for the corresponding period ended September 30, 2005.

The net portfolio yield decreased from 22.61% for the three-month period ended September 30, 2005 to 22.11% for the corresponding period ended September 30, 2006. The net portfolio yield decrease is primarily attributable to the decrease in the gross portfolio yield.

The provision increased from approximately \$832,000 for the three-month period ended September 30, 2005 to \$852,000 for the corresponding period ended September 30, 2006 for credit losses. The increase in the provision is net of provisions reversed for the three-month period ended September 30, 2006, which totaled approximately \$201,000. No provisions were reversed during the three months ended September 30, 2005. The reversal of provisions previously recorded was due to the charge-off performance of static pools originated from April 2005 thru September 2005.

Computer Software Business

Sales for the three-month period ended September 30, 2006 were approximately \$33,000 as compared to \$41,000 for the corresponding period ended September 30, 2005, a decrease of 20%. This decrease was primarily due to lower revenue from the existing customer base during the period ended September 30, 2006. Cost of sales and operating expenses decreased to approximately \$44,000 for the three-month period ended September 30, 2006 from \$84,000 for the three-month period ended September 30, 2005. The primary reason for the decrease was the reduction in the number of employees during the respective periods. Three of the remaining five employees of Nicholas Data Services were re-allocated to the Company's finance subsidiary, Nicholas Financial.

Operating Expenses

Operating expenses, excluding provision for credit losses and interest expense and costs associated with NDS, increased to approximately \$4.9 million for the three-month period ended September 30, 2006 from \$4.2 million for the corresponding period ended September 30, 2005. This increase of 16% was primarily attributable to the additional staffing of several existing branches, increased general operating expenses and the opening of additional branch offices. Operating expenses as a percentage of finance receivables, net of unearned interest increased to 11.50% for the three-month period ended September 30, 2006 from 11.46% for the three-month period ended September 30, 2005.

Interest Expense

Interest expense increased to approximately \$1,363,000 for the three-month period ended September 30, 2006 from \$1,058,000 for the three-month period ended September 30, 2005. The average indebtedness for the three-month period ended September 30, 2006 increased to approximately \$85.0 million as compared to \$71.7 million for the corresponding period ended September 30, 2005. The Company's average cost of borrowed funds increased to 6.41% for the three-month period ended September 30, 2006 as compared to 5.90% for the corresponding period ended September 30, 2005.

Table of Contents**Six months ended September 30, 2006 compared to three months ended September 30, 2005****Interest Income and Loan Portfolio**

Interest income on finance receivables, predominately finance charge income increased 18% to approximately \$22.9 million for the six-month period ended September 30, 2006, from \$19.3 million for the corresponding period ended September 30, 2005. Average finance receivables, net of unearned interest equaled approximately \$167.2 million for the six-month period ended September 30, 2006, an increase of 16% from \$144.5 million for the corresponding period ended September 30, 2005. The primary reason average finance receivables, net of unearned interest increased was the increase in the receivable base of several existing branches and the opening of additional branch locations. The gross finance receivable balance increased 18% to approximately \$237.2 million at September 30, 2006 from \$201.6 million at September 30, 2005. The primary reason interest income increased was the increase in the outstanding loan portfolio.

The gross portfolio yield increased from 26.73% for the six-month period ended September 30, 2005 to 27.35% for the six-month period ended September 30, 2006. The gross portfolio yield increased primarily due to a change to reflect interest earned on a contractual basis, as opposed to on the basis of expected yield (see discussion under Analysis of Credit Losses below), net of decreases in accretion of discounts. Reserves accreted into income for the six-month period ended September 30, 2006 were approximately \$2.4 million as compared to \$3.6 million for the corresponding period ended September 30, 2005.

The net portfolio yield increased from 22.17% for the six-month period ended September 30, 2005 to 22.22% for the corresponding period ended September 30, 2006. The net portfolio yield increased due to the above factors, net of additional provisions for credit losses required for the change in the recognition of interest (see discussion under Analysis of Credit Losses below) and the resulting affect on the provision for credit losses. The provision increased from approximately \$1,260,000 for the six-month period ended September 30, 2005 to \$1,662,000 for the corresponding period ended September 30, 2006 for credit losses. The increase in the provision is net of provisions reversed for the six-month period ended September 30, 2006, which totaled approximately \$617,000. No provisions were reversed during the six months ended September 30, 2005. The reversal of provisions previously recorded was due to the charge-off performance of static pools originated from April 2005 thru September 2005.

Computer Software Business

Sales for the six-month period ended September 30, 2006 were approximately \$67,000 as compared to \$92,000 for the corresponding period ended September 30, 2005, a decrease of 27%. This decrease was primarily due to lower revenue from the existing customer base during the period ended September 30, 2006. Cost of sales and operating expenses decreased to approximately \$86,000 for the six-month period ended September 30, 2006 from \$170,000 for the six-month period ended September 30, 2005. The primary reason for the decrease was the reduction in the number of employees during the respective periods. Three of the remaining five employees of Nicholas Data Services were re-allocated to the Company's finance subsidiary, Nicholas Financial.

Operating Expenses

Operating expenses, excluding provision for credit losses and interest expense and costs associated with NDS, increased to approximately \$9.2 million for the six-month period ended September 30, 2006 from \$8.0 million for the corresponding period ended September 30, 2005. This increase of 14% was primarily attributable to the additional staffing of several existing branches, increased general operating expenses and the opening of additional branch offices. Operating expenses as a percentage of finance receivables, net of unearned interest decreased to 10.98% for the six-month period ended September 30, 2006 from 11.10% for the six-month period ended September 30, 2005. The primary reason for the decrease was the increase in average finance receivables, net of unearned interest.

Interest Expense

Interest expense increased to approximately \$2,622,000 for the six-month period ended September 30, 2006 from \$2,039,000 for the six-month period ended September 30, 2005. The average indebtedness for the six-month period ended September 30, 2006 increased to approximately \$84.1 million as compared to \$69.8 million for the corresponding period ended September 30, 2005. The Company's average cost of borrowed funds increased to 6.24% for the six-month period ended September 30, 2006 as compared to 5.84% for the corresponding period ended September 30, 2005.

Table of Contents**Contract Procurement**

The Company purchases Contracts in the eleven states listed in the table below. The Company has been expanding its Contract procurement in Florida, Ohio, North Carolina, Georgia, Virginia, Kentucky, South Carolina, Maryland, Michigan, Indiana and Alabama. See Future Expansion below. The Contracts purchased by the Company are predominately for used vehicles; for the three-month periods ended September 30, 2006 and 2005, less than 3% were new. As of September 30, 2006, the average model year of vehicles collateralizing the portfolio was 2000.

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

State	Three months ended		Six months ended	
	September 30,		September 30,	
	2006	2005	2006	2005
FL	\$ 13,071,218	\$ 13,012,013	\$ 27,019,127	\$ 24,831,034
GA	2,966,613	2,819,508	5,117,852	4,752,551
NC	3,525,590	3,311,071	6,304,436	5,902,662
SC	942,504	1,049,646	1,678,383	1,865,373
OH	3,177,101	3,348,158	6,543,448	6,446,621
MI	367,756	642,702	822,192	1,000,078
VA	1,657,097	2,083,987	3,337,261	3,669,665
IN	647,973	739,087	1,062,127	1,252,205
KY	1,523,710	683,413	2,517,493	1,116,505
MD	956,585	375,913	1,839,643	650,716
AL	456,485		491,008	
Total	\$ 29,292,632	\$ 28,065,448	\$ 56,732,970	\$ 51,487,410

Contracts	Three months ended		Three months ended	
	September 30,		September 30,	
Purchases	2006	2005	2006	2006
Weighted APR	23.82%	23.79%	23.92%	23.88%
Average discount	8.32%	8.71%	8.43%	8.63%
Weighted average term (months)	46	46	46	45
Average loan	\$ 9,100	\$ 8,884	\$ 9,060	\$ 8,801
Number of Contracts	3,219	3,159	6,262	5,850

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		Six months ended	
	September 30,		September 30,	
	2006	2005	2006	2005

Edgar Filing: NICHOLAS FINANCIAL INC - Form 10-Q

Originations	\$ 2,232,781	\$ 1,835,145	\$ 4,641,687	\$ 3,749,776
Weighted APR	25.16%	26.02%	25.29%	25.88%
Weighted average term (months)	31	27	31	28
Average loan	\$ 3,467	\$ 3,275	\$ 3,487	\$ 3,347
Number of loans	644	561	1,331	1,121

Table of Contents**Analysis of Credit Losses**

As of September 30, 2006, the Company had 762 active static pools. The average pool upon inception consisted of 69 Contracts with aggregate finance receivables, net of unearned interest, of approximately \$609,000.

Prior to the April 1, 2005 in situations where, at the date of purchase, the dealer discount was determined to be insufficient to absorb all potential credit losses associated with a static pool, a portion of unearned income associated with the static pool was allocated to the reserve for dealer discounts. For loans purchased prior to April 1, 2005 the Company recognized revenue on the basis of interest expected to be collected, which was the gross contractual interest less amounts allocated to the reserve for dealer discounts.

Effective with loans purchased after March 31, 2005, the Company discontinued the practice of allocating a portion of unearned income to the reserve for dealer discounts. This change was made to reflect the predominate practice in the industry and improve comparability with other companies within the finance industry. Effective with loans purchased after March 31, 2005 the Company began recognizing interest income based upon the contractual rate of the loan. In situations where, at the date of purchase, the discount is determined to be insufficient to absorb all potential losses associated with the static pool, a charge to income is calculated and amortized into provision for credit losses over the life of the pool.

The change in the practice of allocating a portion of the unearned income to reserves for dealer discounts did not have a significant effect on the periodic net operating results, but rather resulted in differences in the classification of amounts within the statement of income. Both interest income and provisions for credit losses were higher for those pools acquired since March 31, 2005 than those pools previously acquired. In addition, while this change has not significantly changed the net finance receivables as reported, the components of net finance receivables have changed as unearned interest as a percentage of gross Contracts has increased as a result of the change and will be followed in subsequent periods by increases in the allowance for credit losses.

Certain tabular information and the discussions pertaining to credit losses presented herein address the change in the methodology. The table below, which is reflective of the change in allocation, presents net finance receivables as a percentage of gross Contracts as of September 30, 2006 and 2005.

	September 30, 2006		September 30, 2005	
	Amount	% of Gross Contracts	Amount	% of Gross Contracts
Finance receivables, gross contract	\$ 237,193,476	100.00	\$ 201,566,731	100.00
Unearned interest	(65,217,551)	(27.50)	(51,928,344)	(25.76)
Finance receivables, net of unearned interest	171,975,925	72.50	149,638,387	74.24
Dealer discounts	(11,559,119)	(4.87)	(16,355,319)	(8.11)
Allowance for credit losses	(9,872,513)	(4.16)	(7,141,586)	(3.54)
Finance receivables, net	\$ 150,544,293	63.47	\$ 126,141,482	62.59

Table of Contents

The following table sets forth a reconciliation of the changes in dealer discounts on Contracts.

	Three months ended September 30,		Six months ended September 30,	
	2006	2005	2006	2005
Balance at beginning of period	\$ 13,087,317	\$ 17,893,618	\$ 13,629,445	\$ 18,598,147
Discounts acquired on new volume	2,401,334	2,419,454	4,721,709	4,384,664
Losses absorbed	(3,245,232)	(2,351,280)	(5,227,679)	(3,751,255)
Recoveries	407,803	320,575	797,995	683,254
Discounts accreted	(1,092,103)	(1,927,048)	(2,362,351)	(3,559,491)
Balance at end of period	\$ 11,559,119	\$ 16,355,319	\$ 11,559,119	\$ 16,355,319

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

	Three months ended September 30,		Six months ended September 30,	
	2006	2005	2006	2005
Balance at beginning of period	\$ 9,023,826	\$ 6,288,330	\$ 8,644,810	\$ 6,448,790
Current period provision	791,997	771,025	1,528,776	1,152,632
Losses absorbed	(233,702)	(144,994)	(591,465)	(687,061)
Balance at end of period	\$ 9,582,121	\$ 6,914,361	\$ 9,582,121	\$ 6,914,361

The following table sets forth a reconciliation of the changes in the allowance for credit losses on direct loans.

	Three months ended September 30,		Six months ended September 30,	
	2006	2005	2006	2005
Balance at beginning of period	\$ 292,325	\$ 210,794	\$ 293,767	\$ 199,653
Current period provision	43,204	49,290	99,034	88,808
Losses absorbed	(48,949)	(39,468)	(115,334)	(76,362)
Recoveries	3,812	6,609	12,925	15,126
Balance at end of period	\$ 290,392	\$ 227,225	\$ 290,392	\$ 227,225

Reserves accreted into income for the three months ended September 30, 2006 and 2005, were approximately \$1.1 and \$1.9 million, respectively. Reserves accreted into income for the six months ended September 30, 2006 and 2005, were approximately \$2.4 and \$3.6 million, respectively. The amount and timing of reserves accreted into income is a function of individual static pool performance. The Company has seen deterioration in the performance of its Contract portfolio, more specifically, newer static pools have seen an increase in the default rate when compared to the preceding year pool performance during their same liquidation cycle. The Company attributes this increase to weakness in the consumer credit cycle and believes this trend will continue for the remainder of its fiscal year. Provisions reversed for the three-month period ended September 30, 2006 totaled approximately \$201,000. Provisions reversed for the six-month period ended September 30, 2006 totaled approximately \$617,000. No provisions were reversed during the three or six months ended September 30, 2005. The reversal of provisions previously recorded was due to the charge-off performance of static pools originated from April 2005 through September 2005.

The Company experienced a higher net charge-off percentage of 7.26% during the three-month period ended September 30, 2006 as compared to 5.83% for the three-month period ended September 30, 2005. The Company experienced a higher net charge-off percentage of 6.00% during

Edgar Filing: NICHOLAS FINANCIAL INC - Form 10-Q

the six-month period ended September 30, 2006 as compared to 5.13% for the six-month period ended September 30, 2005.

The average dealer discount associated with new volume for the three months ended September 30, 2006 and 2005 were 8.32% and 8.71%, respectively. The average dealer discount associated with new volume for the six months ended September 30, 2006 and 2005 were 8.43% and 8.63%, respectively. The Company believes the average dealer discount may continue to decrease as the result of competition in the markets the Company is currently operating in.

Table of Contents

The provision for credit losses increased from approximately \$832,000 for the three months ended September 30, 2005 to \$852,000 for the three months ended September 30, 2006. The provision for credit losses increased from approximately \$1,260,000 for the six months ended September 30, 2005 to \$1,662,000 for the six months ended September 30, 2006. The Company's losses as a percentage of liquidation increased from 6.48% for the three months ended September 30, 2005 to 7.65% for the three months ended September 30, 2006. The Company's losses as a percentage of liquidation increased from 5.77% for the six months ended September 30, 2005 to 6.37% for the six months ended September 30, 2006. The Company anticipates losses as a percentage of liquidation will be in the 6-9% range during the remainder of the current fiscal year. The longer term outlook for portfolio performance will depend on the overall economic conditions, the unemployment rate and the Company's ability to monitor, manage and implement its underwriting philosophy in additional geographic areas as it strives to continue its expansion. The Company does not believe there have been any significant changes in loan concentrations, terms or quality of Contracts purchased during the three or six months ended September 30, 2006 that would have contributed to the increase in losses.

Recoveries as a percentage of charge-offs were 13% and 16% for the three months ended September 30, 2006 and 2005, respectively. Recoveries as a percentage of charge-offs were 15% and 18% for the six months ended September 30, 2006 and 2005, respectively. The Company believes that as it continues to expand its operations, it will become more difficult to implement its loss recovery model in geographic areas further away from its Corporate headquarters, and as a result, the Company will likely experience declining recovery rates over the long term.

The Company believes there is a correlation between the unemployment rate and future portfolio performance. The Company does not expect the U.S. unemployment rate to rise or fall significantly in the foreseeable future. Therefore the Company does not plan on increasing or decreasing reserves based on the current U.S. unemployment rate. The number of bankruptcy filings by customers during the three and six months ended September 30, 2006 remained consistent with recent reporting periods.

The following tables present certain information regarding the delinquency rates experienced by the Company with respect to Contracts and under its direct consumer loan program:

	At September 30, 2006		At September 30, 2005	
Contracts				
Gross balance outstanding	\$ 227,429,864		\$ 194,489,189	
Delinquencies				
30 to 59 days	\$ 4,167,057	1.83%	\$ 2,793,371	1.44%
60 to 89 days	1,465,884	0.64%	707,902	0.36%
90 + days	563,469	0.25%	375,156	0.19%
Total delinquencies	\$ 6,196,410	2.72%	\$ 3,876,429	1.99%
Direct Loans				
Gross balance outstanding	\$ 9,724,049		\$ 7,077,542	
Delinquencies				
30 to 59 days	\$ 162,706	1.67%	\$ 42,556	0.60%
60 to 89 days	26,303	0.27%	21,067	0.30%
90 + days	25,178	0.26%	28,138	0.40%
Total delinquencies	\$ 214,187	2.20%	\$ 91,761	1.30%

The delinquency percentage for Contracts more than thirty days past at September 30, 2006 was 2.72% as compared to 1.99% at September 30, 2005. The delinquency percentage for direct loans more than thirty days past due at September 30, 2006 was 2.20% as compared to 1.30% at September 30, 2005.

The Company does not give significant consideration to short-term trends in delinquency percentages when evaluating reserve levels. However, the Company believes delinquency trends over several reporting periods are more useful in estimating future losses and overall portfolio performance. The Company also estimates future portfolio performance by considering various factors, the most significant of which are

Edgar Filing: NICHOLAS FINANCIAL INC - Form 10-Q

described as follows. The Company analyzes historical static pool performance for each branch location when determining appropriate reserve levels. The Company utilizes internal branch audits as an indication of future static pool performance. The Company also considers such things as the current unemployment rate in markets the Company operates in, the percentage of voluntary repossessions as compared to prior periods, the percentage of bankruptcy filings as compared to prior periods and other leading economic indicators.

Table of Contents**Income Taxes**

The provision for income taxes was approximately \$1.7 million and \$1.5 million for the three months ended September 30, 2006 and 2005, respectively. The provision for income taxes was approximately \$3.6 million and \$3.0 million for the six months ended September 30, 2006 and 2005, respectively. The Company's effective tax rate increased from 38.10% for the three months ended September 30, 2005 to 38.22% for the three months ended September 30, 2006. The Company's effective tax rate increased from 38.01% for the six months ended September 30, 2005 to 38.21% for the six months ended September 30, 2006.

Liquidity and Capital Resources

The Company's cash flows are summarized as follows:

	Six months ended	
	September 30,	
	2006	2005
Cash provided by (used in):		
Operating activities	\$ 7,906,190	\$ 5,953,888
Investing activities (primarily purchase of Contracts)	(12,684,123)	(14,207,464)
Financing activities	4,781,798	8,642,509
Net increase in cash	\$ 3,865	\$ 388,933

The Company's primary use of working capital for the three months ended September 30, 2006 was the funding of the purchase of Contracts. The Contracts were financed substantially through borrowings under the Company's \$100.0 million Line. The Line is secured by all of the assets of the Company's Nicholas Financial, Inc. subsidiary. At September 30, 2006 the Company could borrow the lesser of \$100.0 million or amounts based upon formulas principally related to a percentage of eligible finance receivables, as defined. Borrowings under the Line may be under various LIBOR pricing options plus 175.0 basis points or at the prime rate plus 37.5 basis points. Prime rate based borrowings are generally less than \$5.0 million. As of September 30, 2006, the amount outstanding under the Line was approximately \$87.0 million and the amount available under the Line was approximately \$13.0 million.

The Company has entered into interest rate swap agreements, each of which effectively converts a portion of the Company's floating-rate debt to a fixed-rate, thus reducing the impact of interest rate change on the Company's interest expense. At September 30, 2006, approximately 57% of the Company's borrowings under the Line were subject to interest rate swap agreements. These swap agreements have maturities ranging from April 2, 2007 through September 2, 2010.

The self-liquidating nature of Contracts and other loans enables the Company to assume a higher debt-to-equity ratio than in most businesses. The amount of debt the Company incurs from time to time under these financing mechanisms depends on the Company's need for cash and ability to borrow under the terms of the Line. The Company believes that borrowings available under the Line as well as cash flow from operations will be sufficient to meet its short-term funding needs.

Future Expansion

The Company currently operates a total of forty-five branch locations in ten states, including eighteen in Florida, five in Ohio, five in North Carolina, five in Georgia, three in Virginia, three in Kentucky, two in South Carolina, two in Maryland and one in each of Michigan and Indiana. Each office is budgeted (size of branch, number of employees and location) to handle up to 1,000 accounts and up to \$7.5 million in outstanding finance receivables, net of unearned interest. To date none of our branches has reached this capacity.

The Company currently intends to continue its expansion through the purchase of additional Contracts and the expansion of its direct consumer loan program. In order to increase the size of the Company's portfolio of Contracts, it will be necessary for the Company to open additional branch offices and increase the size of its Line, either with its current lender or another lender. The Company, from time to time, has and will meet with investment bankers and financial institutions discussing various strategies to meet the future needs of the Company. The Company believes opportunities for growth continue to exist in states where it currently operates branches and plans to continue its expansion activities in those states. No assurances can be given, however, that the Company will be able to continue to expand or, if it does continue to expand, that it

Edgar Filing: NICHOLAS FINANCIAL INC - Form 10-Q

will be able to do so profitably. The Company is also analyzing other markets in states the Company does not currently operate in, however, no assurance can be given that any expansion will occur in these new markets.

Table of Contents

Recently Issued Accounting Standards

In February 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 155, Accounting for Certain Hybrid Financial Instruments An Amendment of FASB Statements No. 133 and 140 . This statement amends SFAS No. 133 and SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities . SFAS No. 155 permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation. This statement also establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation. SFAS No. 155 is effective for fiscal years beginning after September 15, 2006. The adoption of SFAS No. 155 is not expected to have a significant impact on the consolidated financial statements.

In July 2006, FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN No. 48). FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS No. 109, Accounting for Income Taxes. This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN No. 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN No. 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the impact this interpretation will have on our consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements . This statement enhances existing guidance for measuring assets and liabilities using fair value. Prior to the issuance of SFAS No. 157, guidance for applying fair value was incorporated in several accounting pronouncements. This statement provides a single definition of fair value, together with a framework for measuring it, and requires additional disclosure about the use of fair value to measure assets and liabilities. SFAS No. 157 also emphasizes that fair value is a market-based measurement, not an entity-specific measurement, and sets out a fair value hierarchy with the highest priority being quoted prices in active markets. Under this statement, fair value measurements are disclosed by level within that hierarchy. While SFAS No. 157 does not add any new fair value measurements, it does change current practice. Changes to practice include: (1) a requirement for an entity to include its own credit standing in the measurement of its liabilities; (2) a modification of the transaction price presumption; (3) a prohibition on the use of block discounts when valuing large blocks of securities for broker-dealers and investment companies; and (4) a requirement to adjust the value of restricted stock for the effect of the restriction even if the restriction lapses within one year. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is currently evaluating the impact SFAS No. 157 will have on our consolidated financial statements.

Other recent accounting pronouncements issued by the FASB (including its Emerging Issues Task Force), the AICPA, and the SEC did not and are not believed by the Company to have a material impact on the Company s present or future consolidated financial statements.

Table of Contents

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 for the purpose of managing fluctuating interest rate exposures that exist from ongoing business operations. There was no ineffectiveness associated with the interest rate swap agreements during the periods ended September 30, 2006 and 2005.

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 Senior Vice President-Finance and Chief Financial Officer, the effectiveness of the design and operation 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 President and Chief Executive Officer and the Senior Vice President-Finance and Chief Financial Officer have concluded that the disclosure controls and procedures were effective as of the date of such evaluation to ensure that material information relating to the Company, including its consolidated subsidiaries, was made known to them by others within those entities, particularly during the period in which this Quarterly Report on Form 10-Q was being prepared.

Changes in internal controls. There was no change in the Company's internal control over financial reporting that occurred during the Company's last fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II - OTHER INFORMATION

ITEM 1A. RISK FACTORS

In addition to 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, 2006, which could materially affect our business, financial condition or future results. The risks described 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.

ITEM 6. EXHIBITS

See exhibit index following the signature page.

Table of Contents

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: November 14, 2006

/s/ Peter L. Vosotas
Peter L. Vosotas
Chairman of the Board, President,
Chief Executive Officer and Director

Date: November 14, 2006

/s/ Ralph T. Finkenbrink
Ralph T. Finkenbrink
Sr. Vice President -Finance
Chief Financial Officer and Director

Table of Contents

EXHIBIT INDEX

Exhibit No.	Description
31.1	Certification of President and Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Written Statement of the Chief Executive Officer Pursuant to 18 U.S.C. § 1350
32.2	Written Statement of the Chief Financial Officer Pursuant to 18 U.S.C. § 1350