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Business Development Companies

Fourth Quarter 2014

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BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES

Value Focus

Business Development Companies

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BDC Returns to Shareholders Tightly Correlated with HY Spreads

- BDC shareholders and managers will undoubtedly be glad to see 2014 recede in the rearview mirror, though 2015 is not off to a great start. As shown in Table 1, weak BDC investor returns continued in the fourth quarter, pushing the median annual total return for 2014 negative.

- On a relative basis, BDCs underperformed both the broader equity markets and the small-cap Russell 2000. In the first half of December, the overall market index was punished in the wake of Prospect Capital's announced 25% reduction in its monthly distribution.

- Dividend yields edged higher in the quarter, from a median level of 9.4% at September 30 to 9.7% at December 31. Among dividend payers, year-end yields ranged from 7.0% for internally-managed MAIN to 16.0% for MCC.

- The median price/NAV ratio for the group fell from 97% to 89% during the quarter. With twelve of the nineteen BDCs trading at a discount to NAV, asset growth for the group is likely to be constrained in the near-term as management teams are either unable or unwilling to raise equity capital at current stock prices.

- Credit spreads continued to widen during the quarter, in part due to deteriorating expectations for energy credits, which account for approximately 15% of the overall high-yield credit market (Chart 2).

- On a core operating basis, the financial performance of the BDCs held up in the fourth quarter as credit concerns remain subdued. On an aggregate basis, wider spreads on new originations nudged the effective gross asset yield to 10.9% from 10.8% during the prior quarter. Paired with modest operating expense reductions and incrementally higher leverage levels, the uptick in asset yield increased investment income ROE to 9.5% from 9.1% in 3Q14.

- Charts 2 and 4 depict the tight (negative) correlation between BDC returns and high-yield credit spreads. Unlike a depository institution, a BDC's entire portfolio is marked to market each quarter. As a result, even if credit losses remain mild, reported NAVs are likely to be under pressure due to widening credit spreads.

- As shown on Chart 5, we have tracked the fair value of a benchmark BDC loan on a quarterly basis over the past two years. The chart illustrates how common structural features of BDC loans and the overall credit markets can influence BDC loan marks.

    » Many floating-rate BDC loans have LIBOR floors. As evident from the chart, the favorable impact of rate floors

Table 1: Business Development Company Market Metrics

Company	Ticker	12/31/2014 Price	LTM Total Return	4Q14 Total Return	Assets ($millions)	Price / Net Asset Value	Dividend Yield	LTM ROAE
Ares Capital Corporation	ARCC	$15.61	-3.6%	-1.1%	9,203	93%	9.7%	11.7%
Prospect Capital Corporation	PSEC	$8.26	-16.2%	-13.5%	6,833	79%	12.1%	9.4%
FS Investment Corporation	FSIC	$9.93	NA	-4.9%	4,571	97%	8.9%	10.9%
Apollo Investment Corporation	AINV	$7.42	-3.5%	-6.7%	3,833	85%	10.8%	14.1%
Fifth Street Finance Corp.	FSC	$8.01	-3.2%	-9.9%	2,668	83%	13.8%	8.1%
Solar Capital Ltd.	SLRC	$18.01	-13.4%	-1.3%	1,717	81%	8.9%	7.5%
Main Street Capital Corporation	MAIN	$29.24	-3.0%	-2.0%	1,579	139%	7.0%	11.7%
Golub Capital BDC, Inc.	GBDC	$17.93	0.9%	14.5%	1,443	115%	7.1%	9.3%
PennantPark Investment Corporation	PNNT	$9.53	-8.7%	-9.9%	1,412	86%	11.8%	14.9%
New Mountain Finance Corporation	NMFC	$14.94	9.8%	4.1%	1,398	104%	9.1%	10.5%
Medley Capital Corporation	MCC	$9.24	-25.1%	-19.2%	1,324	74%	16.0%	8.8%
TPG Specialty Lending, Inc.	TSLX	$16.82	NA	7.5%	1,280	107%	9.0%	12.7%
Hercules Technology Growth Capital, Inc.	HTGC	$14.88	-1.6%	5.0%	1,199	146%	8.3%	11.6%
Blackrock Kelso Capital Corporation	BKCC	$8.20	-2.9%	-1.5%	1,151	82%	10.2%	15.9%
TCP Capital Corp.	TCPC	$16.78	9.5%	7.0%	1,120	109%	8.6%	13.0%
TICC Capital Corp.	TICC	$7.53	-17.4%	-11.5%	1,042	80%	15.4%	6.9%
Triangle Capital Corporation	TCAP	$20.29	-18.7%	-17.5%	942	122%	10.6%	10.0%
Capital Southwest Corporation	CSWC	$37.91	9.3%	6.3%	767	78%	0.5%	6.2%
THL Credit, Inc.	TCRD	$11.76	-21.0%	-6.2%	743	89%	11.6%	9.5%
Median			**-3.5%**	**-2.0%**	**1,398**	**89%**	**9.7%**	**10.5%**

Source: SNL Financial

on fair value is most pronounced when the forward yield curve is relatively flat (as was the case through much of 2013). Even though LIBOR at December 31, 2014, is essentially unchanged from December 31, 2012, the forward curve is markedly steeper, reducing the value increment associated with the LIBOR floor.

» Call provisions are common features of BDC loans. As a result, such loans often exhibit "negative convexity" – while widening spreads reduce loan values, the value benefit of spread tightening is constrained by the likelihood that the loan will be prepaid in such an environment. The dampening effect of the call provision on loan value was evident in the first half of 2014.

» Two additional factors which influence the fair value of actual BDC loans are not reflected in the benchmark loan modeled in Chart 5. First, the actual credit spread appropriate for a particular fair value measurement will reflect both changes in market spreads and borrower-specific factors (improving leverage ratios, changing industry outlook, acquisitions and other strategic changes). For example, the amount of spread widening appropriate to a borrower with no negative exposure to falling oil prices may well be less than that observed for the overall market. The calculations underlying Chart 5 do not include borrower-specific factors.

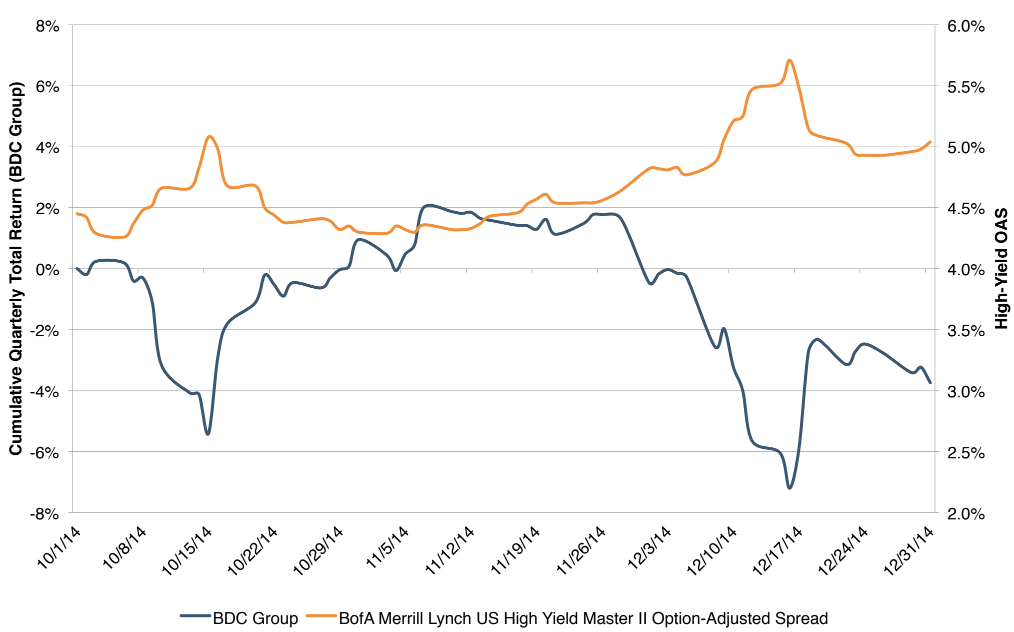
» Second, actual BDC loans have a fixed maturity date, and some have periodic amortization provisions. As a result, with the passage of time, the duration of the loan decreases, and the sensitivity of loan value to changes in interest rates diminishes. In contrast, the benchmark BDC loan depicted in Chart 5 is modeled with a constant maturity of four years, with no interim amortization of principal.

- As shown on Chart 6, the thinly-traded "baby bonds" issued by some BDCs largely escaped the carnage, as only a handful posted negative total returns during the fourth quarter.

Chart 1: Total Shareholder Returns (4Q14)

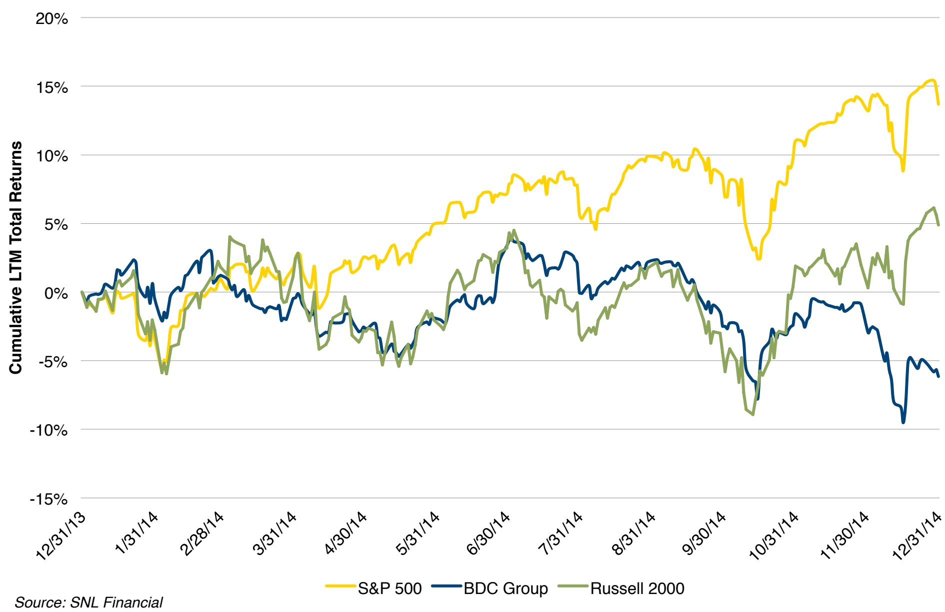
Source: SNL Financial

Chart 2: BDC Shareholder Returns vs. High-Yield Spreads (4Q14)



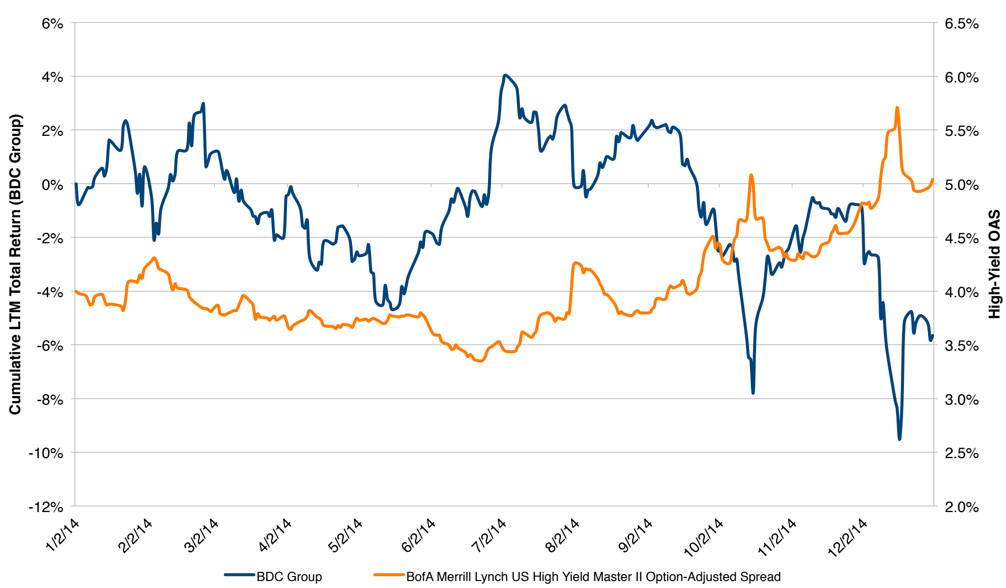
Source: SNL Financial and Federal Reserve Bank of St. Louis

Chart 3: Total Shareholder Returns (LTM)



Source: SNL Financial

Chart 4: BDC Shareholder Returns vs. High-Yield Spreads (LTM)



Source: SNL Financial and Federal Reserve Bank of St. Louis

Table 2: Business Development Company Performance Metrics (4Q14)

Company	Ticker	Gross Asset Yield	Operating Expenses	Net Asset Yield	Leverage (Liabilities / Assets)	Funding Cost	Leverage Carry	Leverage Multiplier	Investment Income ROE
Ares Capital Corporation	ARCC	11.4%	4.3%	7.1%	0.43x	5.5%	2.3%	1.74x	8.3%
Prospect Capital Corporation	PSEC	12.1%	4.0%	8.1%	0.45x	5.4%	2.5%	1.83x	10.4%
FS Investment Corporation	FSIC	10.1%	3.2%	6.9%	0.46x	3.6%	1.7%	1.86x	9.8%
Apollo Investment Corporation	AINV	12.4%	3.6%	8.9%	0.46x	4.3%	2.0%	1.85x	12.7%
Fifth Street Finance Corp.	FSC	11.3%	3.7%	7.6%	0.48x	4.2%	2.0%	1.91x	10.6%
Solar Capital Ltd.	SLRC	5.9%	2.0%	4.0%	0.44x	1.9%	0.8%	1.80x	5.6%
Main Street Capital Corporation	MAIN	7.1%	2.2%	4.9%	0.40x	3.9%	1.5%	1.65x	5.6%
Golub Capital BDC, Inc.	GBDC	8.5%	2.7%	5.8%	0.50x	3.3%	1.6%	1.99x	8.2%
PennantPark Investment Corporation	PNNT	11.9%	4.3%	7.6%	0.41x	4.0%	1.6%	1.71x	10.2%
New Mountain Finance Corporation	NMFC	10.1%	2.5%	7.6%	0.45x	3.4%	1.5%	1.83x	11.1%
Medley Capital Corporation	MCC	12.6%	4.4%	8.2%	0.43x	4.4%	1.9%	1.74x	11.0%
TPG Specialty Lending, Inc.	TSLX	13.1%	3.7%	9.4%	0.32x	3.9%	1.2%	1.47x	12.0%
Hercules Technology Growth Capital, Inc.	HTGC	12.6%	3.9%	8.7%	0.44x	5.0%	2.2%	1.79x	11.6%
Blackrock Kelso Capital Corporation	BKCC	11.6%	3.0%	8.6%	0.35x	5.2%	1.9%	1.55x	10.5%
TCP Capital Corp.	TCPC	10.5%	2.1%	8.4%	0.29x	3.4%	1.0%	1.40x	10.4%
TICC Capital Corp.	TICC	11.4%	2.9%	8.5%	0.45x	4.1%	1.9%	1.83x	12.2%
Triangle Capital Corporation	TCAP	11.2%	1.9%	9.3%	0.44x	5.4%	2.4%	1.78x	12.3%
Capital Southwest Corporation	CSWC	0.4%	1.0%	-0.6%	0.01x	0.0%	0.0%	1.01x	-0.6%
THL Credit, Inc.	TCRD	12.1%	4.5%	7.5%	0.41x	3.0%	1.2%	1.70x	10.7%
Median		**11.4%**	**3.2%**	**7.6%**	**0.44x**	**4.0%**	**1.7%**	**1.78x**	**10.5%**
Group Aggregate		**10.9%**	**3.5%**	**7.4%**	**0.43x**	**4.5%**	**1.9%**	**1.75x**	**9.5%**

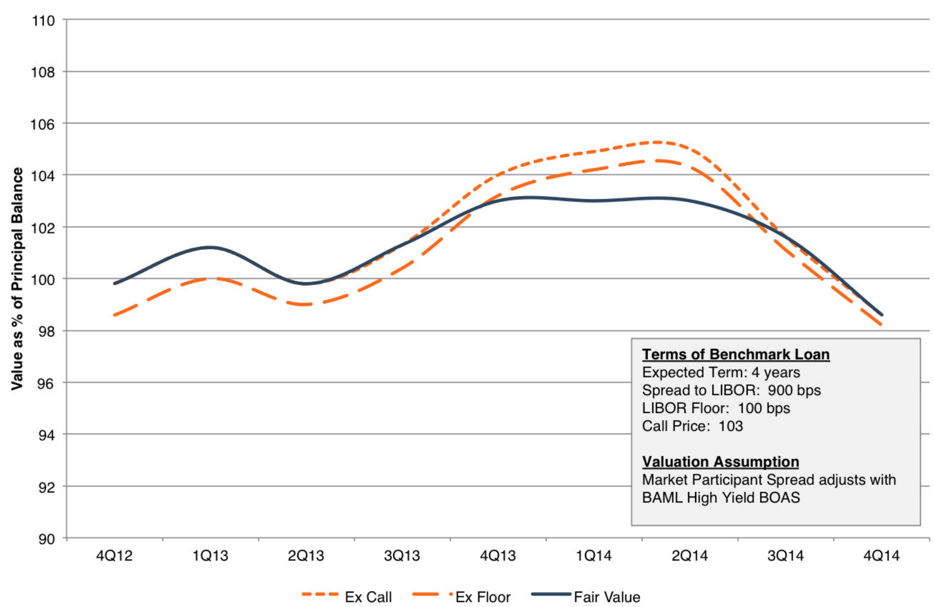
Source: SNL Financial, SEC Filings

Table 3: Trends in BDC Performance Metrics

	4Q14	3Q14	2Q14	1Q14	4Q13	Y-O-Y Change
Gross Asset Yield	10.9%	10.8%	11.0%	11.6%	12.0%	-110 bps
Operating Expenses	3.5%	3.6%	3.6%	3.9%	3.9%	-35 bps
Net Asset Yield	7.4%	7.2%	7.4%	7.7%	8.1%	-75 bps
Leverage (Liabilities/Assets)	0.43x	0.42x	0.40x	0.39x	0.39x	0.04x
times: Funding Cost	4.5%	4.5%	4.5%	4.6%	4.8%	-36 bps
Leverage Carry	1.9%	1.9%	1.8%	1.8%	1.9%	5 bps
Leverage Multiplier	1.75x	1.72x	1.67x	1.64x	1.63x	0.12x
Investment Income ROE	**9.5%**	**9.1%**	**9.4%**	**9.8%**	**10.2%**	**-63 bps**

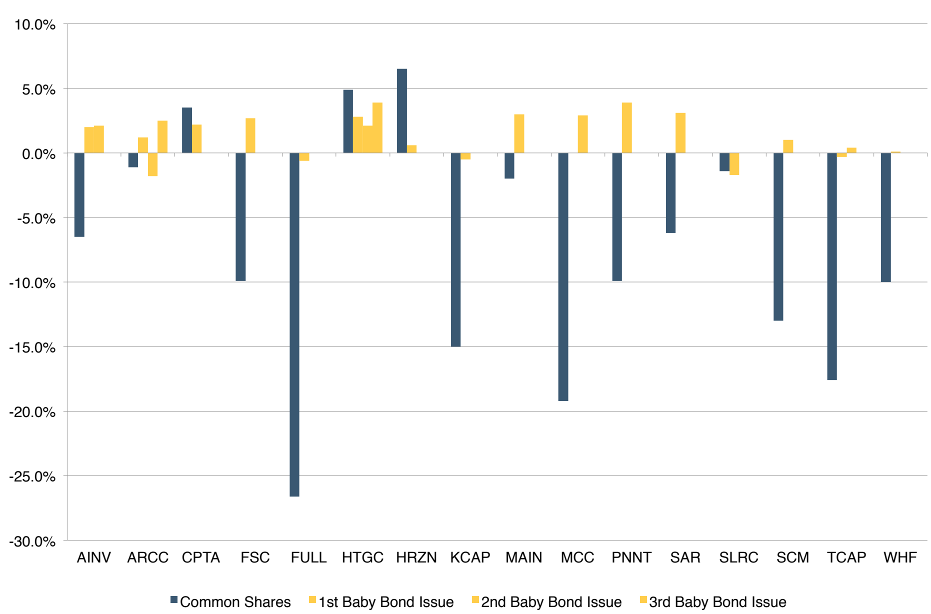
Source: SNL Financial. Aggregate measures for 19 BDCs with over $750 million in assets (ARCC, PSEC, FSIC, AINV, FSC, SLRC, MAIN, GBDC, NMFC, PNNT, TSLX, HTGC, BKCC, MCC, TICC, TCPC, TCAP, CSWC, TCRD)

Chart 5: Fair Value of Benchmark BDC Loan



Source: Bloomberg

Chart 6: Implied Yields for BDC Shares and Baby Bonds (Current)



Source: Bloomberg

Fairness Opinions

Evaluating a Buyer's Shares from the Seller's Perspective

M&A activity in the U.S. (and globally) has accelerated in 2014 after years of gradual improvement following the financial crisis. According to Dealogic, M&A volume where the target was a U.S. company totaled $1.4 trillion YTD through November 10, the highest YTD volume on record and up 43% from the same period last year. Excluding cross-border acquisitions, domestic-only M&A was $1.1 trillion, which represented the second highest YTD volume since 1999 and up 27% from last year. Healthcare and telecommunications were the first and second most targeted sectors.

The improvement has taken a long time even though corporate cash is high, financing costs are very low and organic revenue growth in most industries has been sluggish. Aside from improving confidence, another key foundation for increased M&A activity fell into place in 2013 when equity markets staged a strong rally as the S&P 500 rose 30% (32% with dividends) and the Russell 2000 increased 37% (39%). The absence of a meaningful pullback in 2014 and a 12% advance in the S&P 500 and 2% in the Russell 2000 have further supported activity.

The rally in equities, like low borrowing rates, has reduced the cost to finance acquisitions because the majority of stocks experienced multiple expansion rather than material growth in EPS. It is easier for a buyer to issue shares to finance an acquisition if the shares trade at rich valuation than issuing "cheap" shares. As of November 24, the S&P 500's P/E based upon trailing earnings (as reported) was 20.0x compared to 18.2x at year-end 2013, 17.0x at year-end 2012 and 14.9x at year-end 2011. The long-term average P/E since 1871 is 15.5x (Source: http://www.multpl.com).

High multiple stocks can be viewed as strong acquisition currencies for acquisitive companies because fewer shares have to be issued to achieve a targeted dollar value. As such, it is no surprise that the extended rally in equities has supported deal activity this year. However, high multiple stocks may represent an under-appreciated risk to sellers who receive the shares as consideration. Accepting the buyer's stock raises a number of questions, most which fall into the genre of: what are the investment merits of the buyer's shares? The answer may not be as obvious as it seems, even when the buyer's shares are actively traded.

Our experience is that some, if not most, members of a board weighing an acquisition proposal do not have the background to thoroughly evaluate the buyer's shares. Even when financial advisors are involved there still may not be a thorough vetting of the buyer's shares because there is too much focus on "price" instead of, or in addition to, "value."

A fairness opinion is more than a three or four page letter that opines as to the fairness from a financial point of a contemplated transaction; it should be backed by a robust analysis of all of the relevant factors considered in rendering the opinion, including an evaluation of the shares to be issued to the selling company's shareholders. The intent is not to express an opinion about where the shares may trade in the future, but rather to evaluate the investment merits of the shares before and after a transaction is consummated.

Key questions to ask about the buyer's shares include the following:

- **Liquidity of the Shares.** What is the capacity to sell the shares issued in the merger? SEC registration and even NASDAQ and NYSE listings do not guarantee that large blocks can be liquidated efficiently. Generally, the higher the institutional ownership, the better the liquidity. Also, liquidity may improve with an acquisition if the number of shares outstanding and shareholders increase sufficiently.

- **Profitability and Revenue Trends.** The analysis should consider the buyer's historical growth and projected growth in revenues, and operating earnings, (usually EBITDA or EBITDA less capital expenditures) in addition to EPS. Issues to be vetted include customer concentrations, the source of growth, the source of any margin pressure and the like. The quality of earnings and a comparison of core vs. reported earnings over a multi-year period should be evaluated.

- **Pro Forma Impact.** The analysis should consider the impact of a proposed transaction on revenues, EBITDA, margins, EPS and capital structure. The per share accretion and dilution analysis of such metrics as earnings, EBITDA and dividends should consider both the buyer's and seller's perspectives.

- **Dividends.** In a yield starved world, dividend paying stocks have greater attraction than in past years. Sellers should not be overly swayed by the pick-up in dividends from swapping into the buyer's shares; however, multiple studies have demonstrated that a sizable portion of an investor's return comes from dividends over long periods of time. If the dividend yield is notably above the peer average, the seller should ask why? Is it payout related, or are the shares depressed? Worse would be if the market expected a dividend cut. These same questions should also be asked in the context of the prospects for further increases.

- **Capital Structure.** Does the acquirer operate with an appropriate capital structure given industry norms, cyclicality of the business and investment needs to sustain operations? Will the proposed acquisition result in an over-leveraged company, which in turn may lead to pressure on the buyer's shares and/or a rating downgrade if the buyer has rated debt?

- **Balance Sheet Flexibility.** Related to the capital structure should be a detailed review of the buyer's balance sheet that examines such areas as liquidity, access to bank credit, and the carrying value of assets such as deferred tax assets.

- **Ability to Raise Cash to Close.** What is the source of funds for the buyer to fund the cash portion of consideration? If the buyer has to go to market to issue equity and/or debt, what is the contingency plan if unfavorable market conditions preclude floating an issue?

- **Consensus Analyst Estimates.** If the buyer is publicly traded and has analyst coverage, consideration should be given to Street expectations vs. what the diligence process determines. If Street expectations are too high, then the shares may be vulnerable once investors reassess their earnings and growth expectations.

- **Valuation.** Like profitability, valuation of the buyer's shares should be judged relative to its history and a peer group presently as well as relative to a peer group through time to examine how investors' views of the shares may have evolved through market and profit cycles.

- **Share Performance.** Sellers should understand the source of the buyer's shares performance over several multi-year holding periods. For example, if the shares have significantly outperformed an index over a given holding period, is it because earnings growth accelerated? Or, is it because the shares were depressed at the beginning of the measurement period? Likewise, underperformance may signal disappointing earnings, or it may reflect a starting point valuation that was unusually high.

- **Strategic Position.** Assuming an acquisition is material for the buyer, directors of the selling board should consider the strategic position of the buyer, asking such questions about the attractiveness of the pro forma company to other acquirers.

- **Contingent Liabilities.** Contingent liabilities are a standard item on the due diligence punch list for a buyer. Sellers should evaluate contingent liabilities too.

The list does not encompass every question that should be asked as part of the fairness analysis, but it does illustrate that a liquid market for a buyer's shares does not necessarily answer questions about value, growth potential and risk profile.

We at Mercer Capital have extensive experience in valuing and evaluating the shares (and debt) of financial and non-financial service companies garnered from over three decades of business. Feel free to contact us to discuss your situation in confidence.

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Valuation Services for BDCs & Other Investment Funds

Business development companies are an important and growing source of funding for middle market companies. Along with private equity and other investment funds, BDCs provide billions of dollars of investment capital to private companies in every segment of the economy. For over thirty years, Mercer Capital has met the valuation needs of the same middle market companies to which BDCs and other funds provide capital. We offer the following services for BDCs and other investment funds:

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- Solvency and fairness opinions
- Regulatory review and litigation support
- Purchase price allocation for portfolio companies
- Goodwill impairment testing for portfolio companies
- Equity compensation fair value measurement for portfolio companies
- Buy-sell agreement consulting and valuation dispute resolution

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