VALUE FOCUS

Business Development Companies

As of the First Quarter 2015, the Business Development Companies Industry Newsletter has rebranded as the *Portfolio Valuation: Private Equity Marks and Trends* Newsletter. You will receive a copy of it in the mail soon. This is the final issue of the Business Development Companies Newsletter. Archives of the Business Development Companies Newsletter can be found at www.mercercapital.com.

First Quarter 2015

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Value Focus

Business Development Companies

First Quarter 2015

- BDC returns outpaced broad market indices during the first quarter, which reflected some tightening in credit spreads after widening in 2H14 and perhaps enhanced disclosure to investors regarding exposure to energy credits that allayed some fears. During the second half of 2014 BDCs as a group performed poorly due to concerns about (a) exposure to the energy sector; (b) the potential for NAVs to decline due to lower fair value marks as a result of then widening credit spreads; and (c) expectations for dividend cuts—which we highlighted in our 4Q14 update on the sector.

- As shown in Table 1 on the next page, a group of the largest BDCs posted a median 4.6% total return in the first quarter, which pushed the median trailing twelve month return for the group to 2.1% from negative 3.5% in the twelve months ended December 31, 2014. The modestly positive performance over the trailing twelve months badly lags the broader market as represented by the S&P 500 (12.7%) and the Russell 2000 (8.2%).

- The returns for individual BDCs are primarily keyed to changes in dividend policy. Among the underperformers over the LTM period, Prospect Capital (-10.7%), Fifth Street Finance Corp (-14.3%), Medley Capital (-24.1%), and TICC Capital Corp (-19.1%) each announced dividend cuts. In our 4Q14 update, we questioned the sustainability of BDC dividends absent reductions in cost structures due to asset yields that seem destined to eventually decline absent Fed rate hikes and a limit on the amount of leverage BDCs can deploy.

- Indicated dividend yields declined during the quarter to a median of 9.3% at March 31 from 9.7% at year-end, which reflected price appreciation and in some instances dividend cuts. Among those that pay a material dividend, yields range from 6.8% for Main Street Capital to 15.6% for TICC Capital Corp. Main Street has been one of the strongest BDC performers over the past several years, generating attractive asset yields, producing favorable credit performance, and maintaining a low cost structure. On the other hand TICC's shares have been dogged by asset valuation/ credit concerns and uncertainty regarding the dividend in spite of a modest $0.02 per share reduction in the first quarter.

- Rising share prices pushed the median price/NAV ratio to 98% from 89% at December 31. Nine of the BDCs analyzed in Table 1 are trading at a premium to NAV, offering those management teams the ability to issue new shares on a non-dilutive basis to support portfolio growth. However, Bloomberg data reports that first-lien leveraged loan issuance across the market fell almost 65% on a year-over-year basis during the quarter. This suggests that loan demand at BDCs may have been muted thus far in 2015. Indeed, 1Q15 orginators are at bellweather ARCC lagged 1Q14 by 30%.

- Table 2 (on page 5) presents earnings and related measure for the same group of nineteen large BDCs, while Table 3 presents the aggregate performance metrics over the past five quarters. Interestingly, 4Q14 investment income ROE of 10.1% was the highest of the five quarters; however, Table 3 tells a story that we think will play out in the form of eventual pressure on ROE and therefore dividend payouts.

- Although the gross asset yield increased about 20bps from the prior quarter to 11.1%, the median asset yield declined 54bps from the year ago quarter. The pressure was offset by increasing operating leverage in the form of a 48bps reduction in operating expenses, which resulted in little change in the net asset yield of 7.7% on a Y-O-Y basis and 30bps improvement from the prior quarter. Funding costs were roughly unchanged, while slightly more leverage yielded the upward bias in investment income ROE to 10.1%

- A second area that impacts BDC share performance is changes in NAV per share from realized gains and losses and changes in fair value marks, which in turn are influenced by high yield credit spreads in addition to company specific factors. High yield credit spreads tightened modestly during the quarter due to stabilization in oil prices and an inflow of funds that were attracted to improved values. Nevertheless, high yield spreads were 110bps wider at March 31, 2015 compared to March 31, 2014.

- Charts 2 and 4 depict the tight (negative) correlation between BDC returns and high-yield credit spreads. Unlike a depository

Table 1: Business Development Company Market Metrics

Company	Ticker	3/31/2015 Price	LTM Total Return	1Q15 Total Return	Assets ($millions)	Price / Net Asset Value	Dividend Yield	LTM ROAE
Ares Capital Corporation	ARCC	$17.17	7.1%	12.8%	9,498	102%	8.9%	11.7%
Prospect Capital Corporation	PSEC	$8.45	-10.7%	5.7%	6,716	82%	11.8%	9.1%
FS Investment Corporation	FSIC	$10.14	NA	4.4%	4,355	103%	8.8%	7.7%
Apollo Investment Corporation	AINV	$7.68	2.1%	6.2%	3,701	91%	10.4%	7.7%
Fifth Street Finance Corp.	FSC	$7.30	-14.3%	-7.0%	2,950	80%	9.9%	3.4%
Solar Capital Ltd.	SLRC	$20.24	0.9%	14.7%	1,686	92%	7.9%	5.0%
Main Street Capital Corporation	MAIN	$30.90	2.3%	7.5%	1,694	148%	6.8%	11.4%
Golub Capital BDC, Inc.	GBDC	$17.55	6.0%	-0.3%	1,461	113%	7.3%	9.1%
New Mountain Finance Corporation	NMFC	$14.60	11.0%	0.0%	1,515	106%	9.3%	6.1%
PennantPark Investment Corporation	PNNT	$9.05	-8.5%	-2.1%	1,421	87%	12.4%	6.2%
TPG Specialty Lending, Inc.	TSLX	$17.21	13.1%	4.6%	1,304	111%	9.1%	10.7%
Hercules Technology Growth Capital, Inc.	HTGC	$13.48	4.1%	-7.4%	1,299	132%	9.2%	10.9%
BlackRock Capital Investment Corporation	BKCC	$9.06	8.7%	13.0%	1,302	86%	9.3%	18.7%
Medley Capital Corporation	MCC	$9.15	-24.1%	2.1%	1,298	78%	13.1%	3.0%
TICC Capital Corp.	TICC	$6.92	-19.1%	-4.6%	1,043	80%	15.6%	-0.6%
TCP Capital Corp.	TCPC	$16.02	6.1%	-2.4%	1,206	107%	9.0%	8.3%
Triangle Capital Corporation	TCAP	$22.81	-2.5%	15.2%	984	142%	10.3%	5.9%
Capital Southwest Corporation	CSWC	$46.42	34.4%	22.4%	796	98%	0.4%	2.4%
THL Credit, Inc.	TCRD	$12.29	-1.0%	7.5%	812	94%	11.1%	8.2%
Median			2.1%	4.6%	1,421	98%	9.3%	7.7%

Source: SNL Financial

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 should credit spreads begin to widen again.

- As shown on Chart 5 (on page 6), 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.

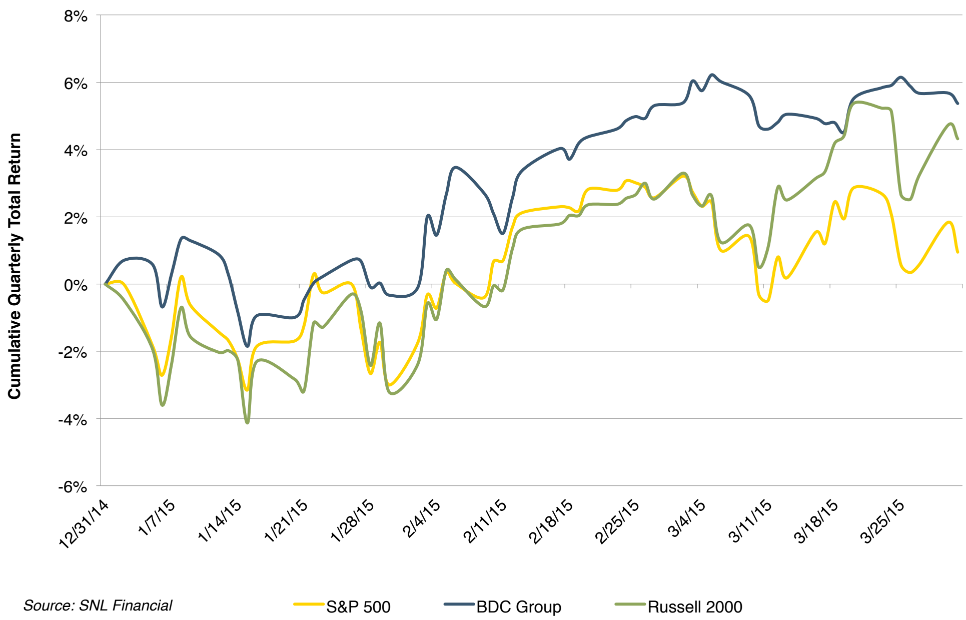
  » Many floating-rate BDC loans have LIBOR floors. As evident from the chart, the favorable impact of rate floors on fair value is most pronounced when the forward yield curve is relatively flat (as was the case through much of 2013). Even though LIBOR at March 31, 2015 is roughly unchanged from December 31, 2012, the forward curve is 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). The calculations underlying Chart 5 do not include borrower-specific factors.

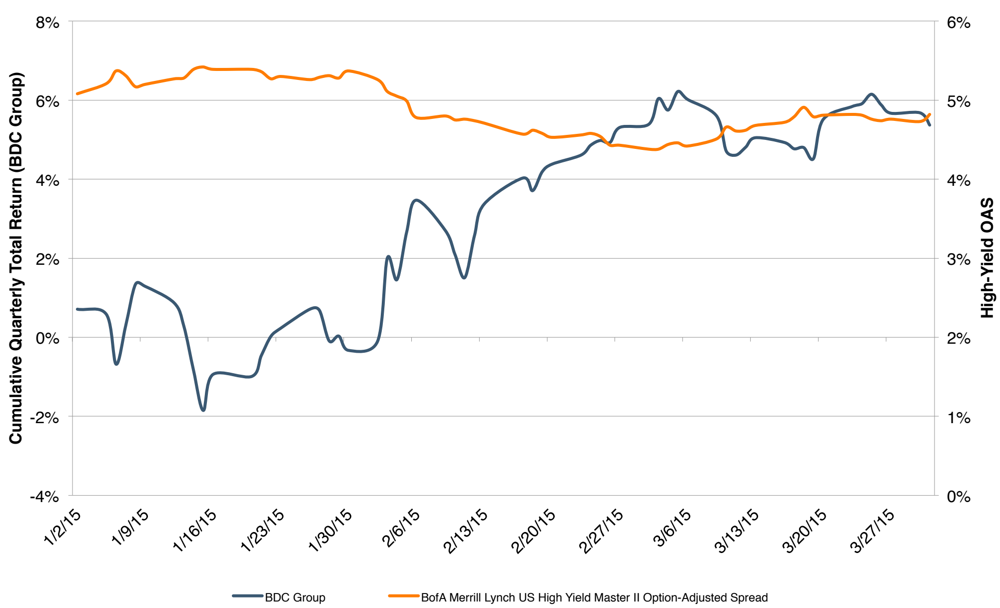
  » Second, actual BDC loans have a fixed maturity date, and some have periodic amortization provisions. As a result, with the passage of time, the duration of the loan decreases, and the sensitivity of loan value to changes in interest rates diminishes. In contrast, the benchmark BDC loan depicted in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

Chart 1: Total Shareholder Returns (1Q15)



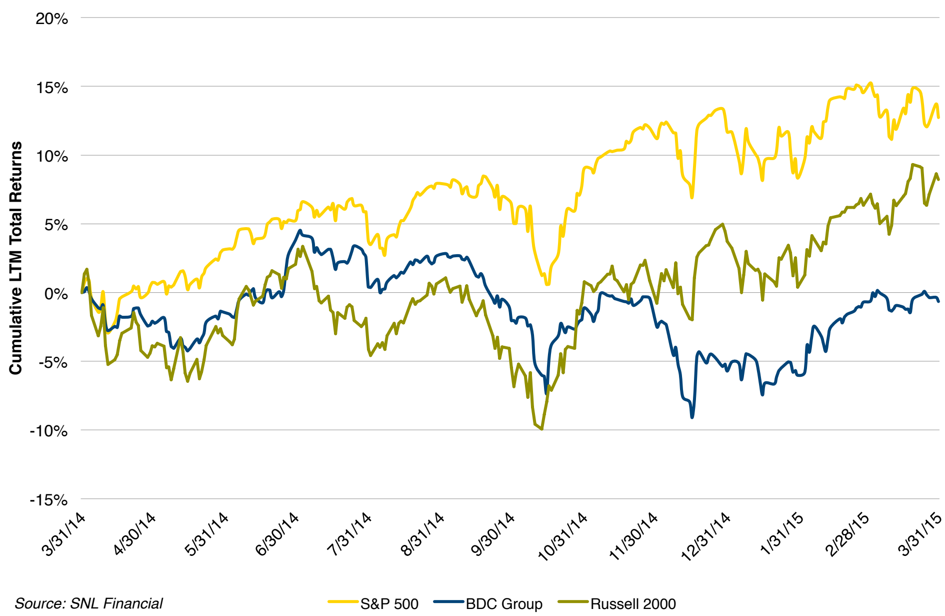
Source: SNL Financial

Chart 2: BDC Shareholder Returns vs. High-Yield Spreads (1Q15)



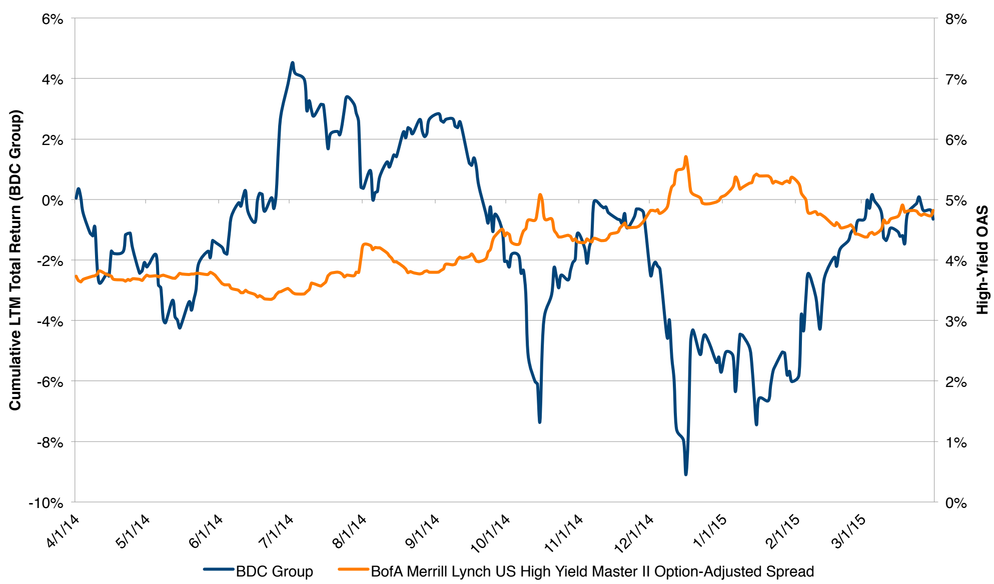
Source: SNL Financial and Federal Reserve Bank of St. Louis

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 (1Q15)

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	11.6%	3.6%	8.0%	0.44x	5.8%	2.5%	1.78x	1.78x
Prospect Capital Corporation	PSEC	11.7%	4.0%	7.8%	0.46x	5.2%	2.4%	1.84x	1.84x
FS Investment Corporation	FSIC	10.6%	2.4%	8.2%	0.46x	3.7%	1.7%	1.85x	1.85x
Apollo Investment Corporation	AINV	11.7%	3.5%	8.2%	0.46x	4.7%	2.2%	1.86x	1.86x
Fifth Street Finance Corp.	FSC	10.9%	3.8%	7.0%	0.49x	4.1%	2.0%	1.95x	1.95x
Solar Capital Ltd.	SLRC	7.7%	2.9%	4.8%	0.45x	1.9%	0.8%	1.81x	1.81x
Main Street Capital Corporation	MAIN	9.4%	0.8%	8.6%	0.42x	4.0%	1.7%	1.73x	1.73x
Golub Capital BDC, Inc.	GBDC	7.6%	2.0%	5.6%	0.50x	3.2%	1.6%	1.98x	1.98x
New Mountain Finance Corporation	NMFC	10.1%	1.5%	8.6%	0.47x	3.2%	1.5%	1.88x	1.88x
PennantPark Investment Corporation	PNNT	11.1%	3.7%	7.3%	0.43x	4.3%	1.8%	1.76x	1.76x
TPG Specialty Lending, Inc.	TSLX	15.9%	3.4%	12.5%	0.35x	3.5%	1.2%	1.54x	1.54x
Hercules Technology Growth Capital, Inc.	HTGC	11.8%	4.2%	7.6%	0.47x	5.3%	2.5%	1.90x	1.90x
Blackrock Kelso Capital Corporation	BKCC	12.4%	9.4%	3.0%	0.38x	4.8%	1.8%	1.61x	1.61x
Medley Capital Corporation	MCC	12.2%	3.9%	8.2%	0.46x	4.2%	1.9%	1.85x	1.85x
TICC Capital Corp.	TICC	11.0%	3.0%	8.0%	0.48x	6.5%	3.1%	1.92x	1.92x
TCP Capital Corp.	TCPC	11.1%	2.5%	8.6%	0.29x	3.6%	1.0%	1.40x	1.40x
Triangle Capital Corporation	TCAP	12.7%	3.8%	8.9%	0.44x	5.3%	2.3%	1.79x	1.79x
Capital Southwest Corporation	CSWC	3.9%	1.7%	2.3%	0.05x	0.0%	0.0%	1.05x	1.05x
THL Credit, Inc.	TCRD	12.4%	4.9%	7.5%	0.43x	3.9%	1.6%	1.74x	1.74x
Median		**11.1%**	**3.5%**	**8.0%**	**0.45x**	**4.1%**	**1.8%**	**1.81x**	**1.81x**
Group Aggregate		**11.1%**	**3.4%**	**7.7%**	**0.44x**	**4.6%**	**2.0%**	**1.78x**	**1.78x**

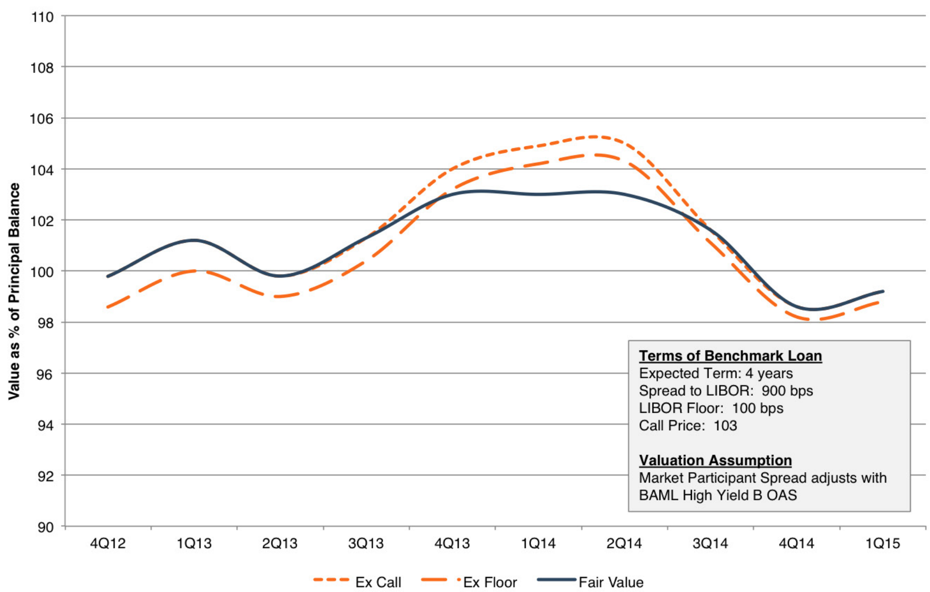
Source: SNL Financial, SEC Filings

Table 3: Trends in BDC Performance Metrics

	1Q15	4Q14	3Q14	2Q14	1Q14	Y-O-Y Change
Gross Asset Yield	11.1%	10.9%	10.8%	11.0%	11.6%	-54 bps
Operating Expenses	3.4%	3.5%	3.6%	3.6%	3.9%	-48 bps
Net Asset Yield	7.7%	7.4%	7.2%	7.4%	7.7%	-6 bps
Leverage (Liabilities/Assets)	0.44x	0.43x	0.42x	0.40x	0.39x	0.05x
times: Funding Cost	4.6%	4.5%	4.5%	4.5%	4.6%	1 bps
Leverage Carry	2.0%	1.9%	1.9%	1.8%	1.8%	22 bps
Leverage Multiplier	1.78x	1.75x	1.72x	1.67x	1.64x	0.14x
Investment Income ROE	10.1%	9.5%	9.1%	9.4%	9.8%	31 bps

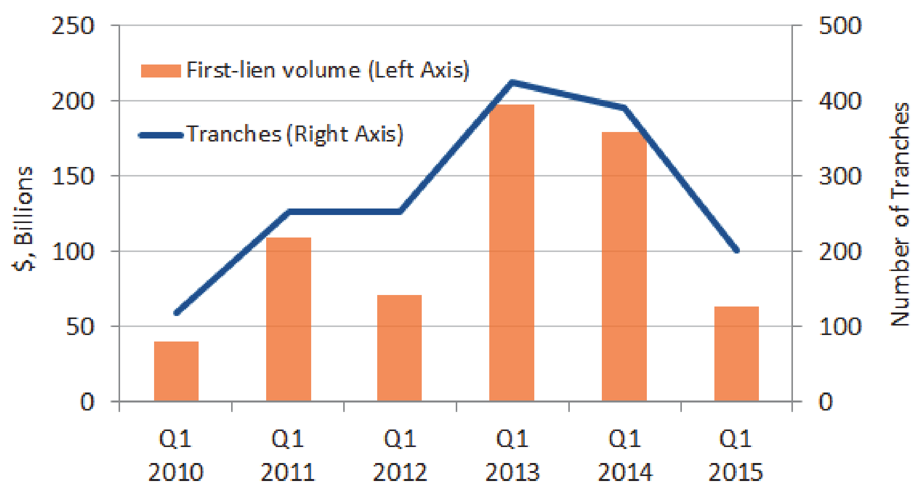
Source: SNL Financial. Aggregate measures for 19 BDCs with over $750 million in assets (ARCC, PSEC, FSIC, AINV, FSC, SLRC, MAIN, GBDC, NMFC, PNNT, TSLX, HTGC, BKCC, MCC, TICC, TCPC, TCAP, CSWC, TCRD)

Chart 5: Fair Value of Benchmark BDC Loan



Source: Mercer Capital analysis

Chart 6: BDC Shareholder Returns vs. High-Yield Spreads (LTM)



Source: Bloomberg LP BloombergBriefs.com

PFLT Announces Acquisition of MCGC

M&A has not been a common occurrence among BDCs. Under the external management model, the opportunity for material cost savings is limited, and prices at or near NAV indicate that investors assign little "franchise" value to the lending and origination platforms. The recently announced acquisition of MCG Capital (MCGC) by PennantPark Floating Rate Capital Ltd. (PFLT) is likely the exception that proves the rule. In the conference call describing the transaction, PFLT's chairman Arthur Penn aptly described the acquisition as a "synthetic equity" raise for PFLT.

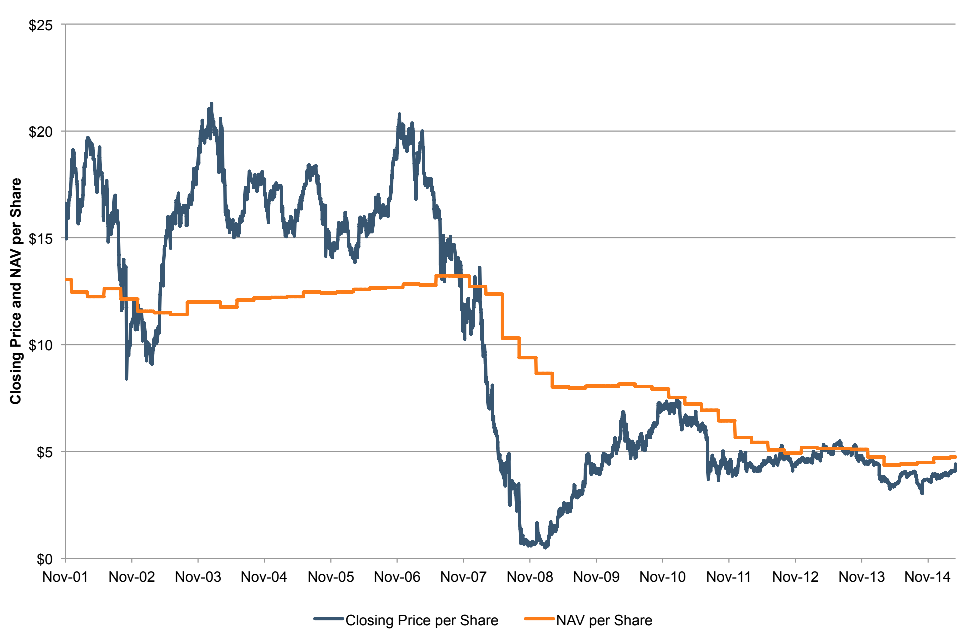
MCGC has experienced steady erosion in NAV per share since the beginning of the financial crisis due to substantial asset writedowns. Since that time, MCGC shares generally have traded at a discount – occasionally substantial – to reported NAV as shown in Figure 1.

The difficulty of operating a BDC that consistently trades below NAV became evident as MCG's balance sheet contracted steadily from approximately $1.6 billion in mid-2007 to approximately $580 million in mid-2013. MCGC did not originate new assets in 2014, and total assets decreased further to approximately $180 million as the company suspended dividend payments and commenced an aggressive share repurchase program (acquiring approximately 46% of outstanding shares during 2014).

As of March 31, 2015, only four investments remain on MCGC's balance sheet. Cash & equivalents represent approximately 64% of total assets at that date as shown in Figure 2; hence the description of the transaction as a "synthetic equity" raise for PFLT.

Total consideration to MCGC shareholders of approximately $4.75 per share is equal to reported NAV per share and represents a 15.8%

Figure 1: MCGC Shares Closing Price/NAV per Share



PFLT Announces Acquisition of MCGC (cont.)

premium to the prior trading price. The consideration consists of PFLT shares ($4.521) and cash ($0.226). Since the cash portion of the purchase consideration is payable from PFLT's investment advisor, the transaction should be modestly accretive to NAV per PFLT share. PFLT shares did not move on the announcement.

According to PFLT management, the principal strategic motivation for the transaction was the ability to increase the fund's size materially, allowing PFLT to capture a greater share of the middle market senior secured lending market and be able to provide financing for larger transactions.

PFLT completed two secondary offerings in 2013, yielding aggregate proceeds of approximately $113 million. The MCGC acquisition will provide PFLT with an additional $176 million of capital. At estimated transaction costs of $2 million, the relative cost of the MCGC acquisition will be comparable to the offering costs incurred in the 2013 secondary offerings.

Given the increase in the share count from the transaction (approximately 80%), prompt deployment of the new capital will be critical to maintain PFLT's monthly dividend of $0.095 per share. As with any capital raise – whether direct or "synthetic" – the ultimate success of the acquisition will depend on PFLT's ability to put the new capital to good use.

Figure 2: Pro Forma Balance Sheet

	3/31/15 MCGC	12/31/14 PFLT	Pro Forma
Cash & Equivalents	115,863	10,385	126,248
Investments	50,134	343,195	393,329
Other Assets	14,921	2,665	17,586
Total Assets	**$180,918**	**$356,246**	**$537,164**
Interest-Bearing Debt	0	136,008	136,008
Other Liabilities	4,780	9,294	14,074
Total Liabilities	4,780	145,302	150,082
Shareholders' Equity	176,138	210,943	387,081
Total Liabilities & Equity	**$180,918**	**$356,246**	**$537,164**
Shares Outstanding	37,074	14,898	26,743
NAV per Share	$4.75	$14.16	$14.47
Closing Price - April 28, 2015	$4.10	$14.15	

Source: SEC Filings, Mercer Capital analysis

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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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- Fair value measurement process consulting
- 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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