

VALUE FOCUS

Business Development Companies



Third Quarter 2014

In This Issue

Observations and Commentary	1
BDC Market Metrics	2
Shareholder Returns	3
BDC Performance Metrics	5
BDCs and Baby Bonds	6

About Mercer Capital	7
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Value Focus

Business Development Companies

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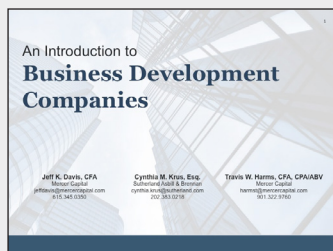
Observations and Commentary

- As shown in Table 1, BDC returns were under pressure during 3Q14, posting a negative 5.6% total return for the largest BDCs. On an LTM basis, the median total return fell to 1.9%.
- BDC returns lagged the S&P 500 as high-yield spreads widened nearly 100bps on the quarter (Chart 3). BDC total returns outpaced those of the small-cap Russell 2000 Index during this quarter.
- Share price declines during the quarter pushed the median price/NAV ratio to 97% from 103% at June 30. Stock prices below NAV can restrict the ability of BDCs to access incremental equity capital.
- The median dividend yield increased from 8.5% to 9.4% over the quarter, commensurate with the widening in high-yield spreads over the quarter.
- For the third quarter, the median net asset yield (after deducting operating expenses) for the group was 7.6%; including the effect of leverage, the investment income return on equity was 9.4%. Absent gains and losses on portfolio investments, investment income represents the principal dividend-paying capacity of a BDC.
- Table 3 summarizes trends in the aggregate ROE components over the past year. Gross asset yields have been under pressure, falling approximately 160bps from the prior-year quarter. Despite the near-term impact on stock prices, BDC managers may welcome the spread widening in their current underwriting efforts.
- Charts 5 and 6 summarize returns and yields for BDCs that have issued publicly traded “baby bonds.” Over the LTM period, bond investors have fared better than shareholders, with a median total return of 8.9%, compared to 2.1% for shareholders. The bonds are currently priced to yield 5.8%, compared to a coupon of 6.8%, suggesting companies will have some favorable refinancing opportunities at approaching call dates.

Table 1: Business Development Company Market Metrics

Company	Ticker	9/30/2014 Price	LTM Total Return	3Q14 Total Return	Assets (\$millions)	Price / Net Asset Value	Dividend Yield	LTM ROAE
Ares Capital Corporation	ARCC	\$16.16	2.6%	-7.5%	8,560	98%	9.4%	11.4%
Prospect Capital Corporation	PSEC	\$9.90	0.2%	-3.8%	6,477	94%	13.5%	9.9%
FS Investment Corporation	FSIC	\$10.77	NA	4.3%	4,572	105%	8.2%	11.0%
Apollo Investment Corporation	AINV	\$8.17	10.1%	-2.9%	3,812	93%	9.8%	16.3%
Fifth Street Finance Corp.	FSC	\$9.18	-1.0%	-4.1%	2,744	95%	12.0%	8.2%
Solar Capital Ltd.	SLRC	\$18.68	-9.2%	-10.4%	1,706	83%	8.6%	7.2%
Main Street Capital Corporation	MAIN	\$30.64	10.6%	-5.5%	1,549	146%	6.7%	13.3%
Golub Capital BDC, Inc.	GBDC	\$15.95	-1.1%	-8.2%	1,462	103%	8.0%	8.5%
New Mountain Finance Corporation	NMFC	\$14.69	12.6%	1.9%	1,358	100%	9.3%	12.9%
PennantPark Investment Corporation	PNNT	\$10.91	6.7%	-2.4%	1,290	96%	10.3%	18.7%
TPG Specialty Lending, Inc.	TS LX	\$16.01	NA	-25.0%	1,179	102%	9.5%	13.7%
Hercules Technology Growth Capital, Inc.	HTGC	\$14.46	2.8%	-8.8%	1,149	139%	8.6%	15.0%
Blackrock Kelso Capital Corporation	BKCC	\$8.54	-0.3%	-4.1%	1,131	87%	9.8%	14.8%
Medley Capital Corporation	MCC	\$11.81	-4.4%	-6.9%	1,101	93%	12.5%	10.9%
TICC Capital Corp.	TICC	\$8.83	1.9%	-8.1%	1,068	91%	13.1%	11.6%
TCP Capital Corp.	TCPC	\$16.07	8.4%	-9.9%	959	105%	9.0%	14.8%
Triangle Capital Corporation	TCAP	\$25.32	-5.5%	-8.8%	831	159%	8.5%	17.5%
Capital Southwest Corporation	CSWC	\$35.77	5.2%	-0.7%	797	70%	0.6%	16.4%
THL Credit, Inc.	TCRD	\$12.90	-9.2%	-5.6%	792	97%	10.5%	8.5%
Median			1.9%	-5.6%	1,290	97%	9.4%	12.9%

Source: SNL Financial

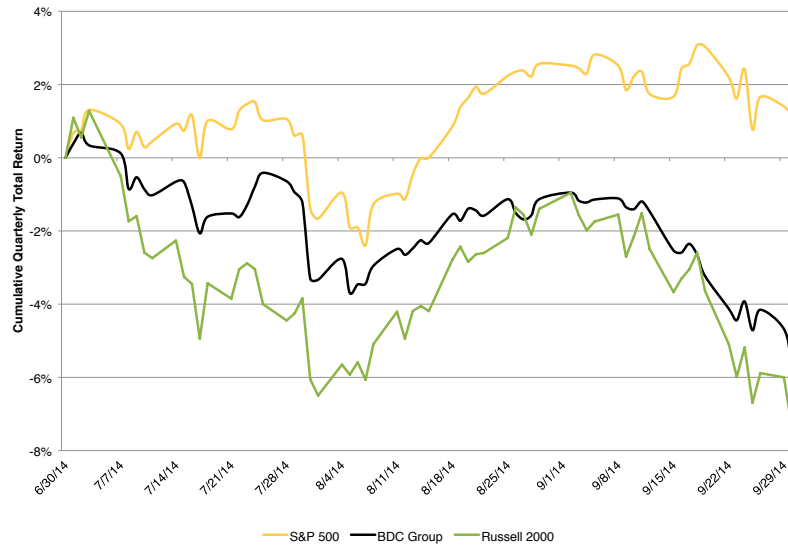
Recent Webinar: An Introduction to BDCs

On September 23, 2014, panelists from Mercer Capital and Sutherland Asbill & Brennan conducted a webinar sponsored by SNL Financial on the topic of “An Introduction to Business Development Companies.”

In the hunt for yield, investors are increasingly setting their sights on business development companies (BDCs), which offer stock market investors access to portfolios of private equity investments. This webinar explored the features that have contributed to the growth in BDCs, underlying asset classes to which BDCs offer investors exposure, and highlighted the key performance metrics for evaluating BDCs. Our panel discussed relevant regulatory developments affecting BDCs, reviewed the portfolio valuation procedures and assumptions that influence quarterly profits, and explored the performance of key market benchmarks.

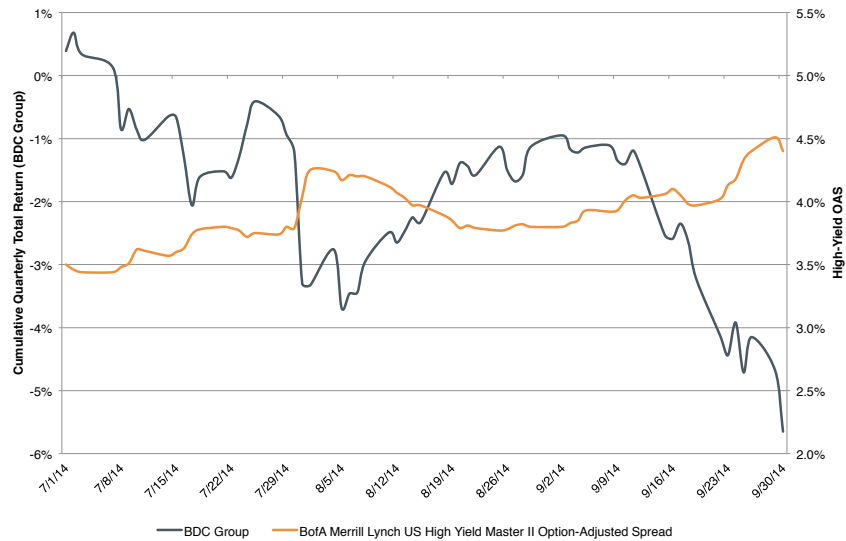
[Download the Slides at www.mercercapital.com.](http://www.mercercapital.com)

Chart 1: Total Shareholder Returns (3Q14)



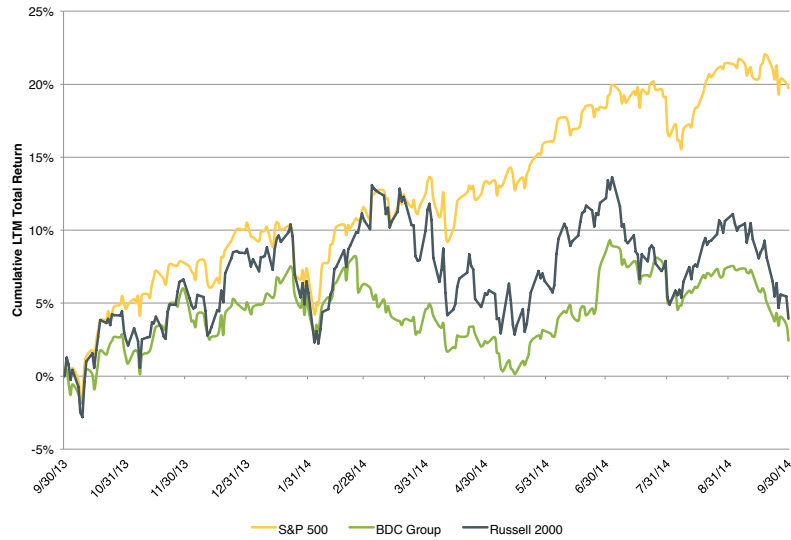
Source: SNL Financial

Chart 2: BDC Shareholder Returns vs. High-Yield Spreads (3Q14)



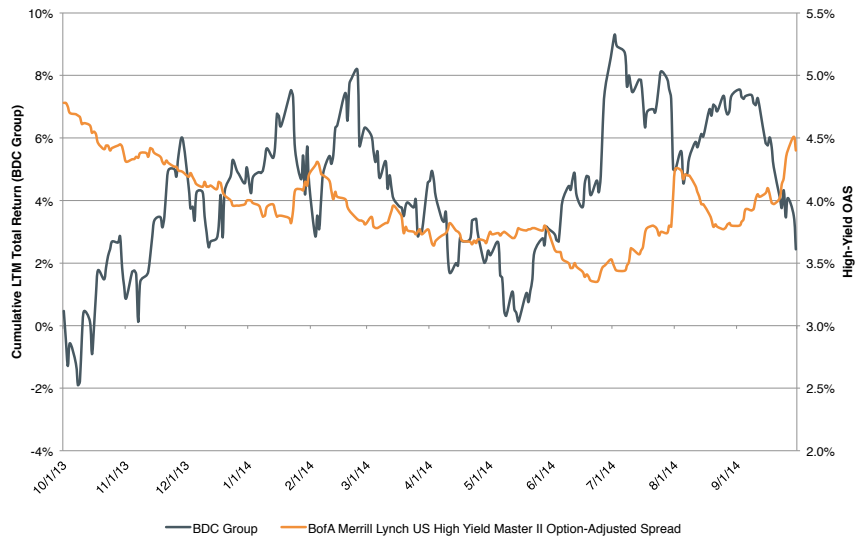
Source: SNL Financial and Federal Reserve Bank of St. Louis

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 (3Q14)

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	10.7%	3.9%	6.8%	0.41x	5.8%	2.4%	1.70x	7.5%
Prospect Capital Corporation	PSEC	11.3%	3.5%	7.8%	0.44x	5.9%	2.6%	1.79x	9.4%
FS Investment Corporation	FSIC	10.7%	4.3%	6.4%	0.43x	2.9%	1.2%	1.76x	9.1%
Apollo Investment Corporation	AINV	11.0%	3.2%	7.8%	0.45x	4.5%	2.0%	1.81x	10.4%
Fifth Street Finance Corp.	FSC	10.7%	3.6%	7.1%	0.51x	4.2%	2.1%	2.04x	10.2%
Solar Capital Ltd.	SLRC	6.6%	1.9%	4.6%	0.44x	1.9%	0.8%	1.77x	6.7%
Main Street Capital Corporation	MAIN	9.3%	2.6%	6.7%	0.40x	3.7%	1.5%	1.67x	8.7%
Golub Capital BDC, Inc.	GBDC	8.1%	2.1%	5.9%	0.48x	3.4%	1.6%	1.92x	8.3%
New Mountain Finance Corporation	NMFC	13.1%	5.5%	7.6%	0.29x	3.4%	1.0%	1.41x	9.3%
PennantPark Investment Corporation	PNNT	10.8%	5.3%	5.6%	0.43x	3.6%	1.5%	1.75x	7.1%
TPG Specialty Lending, Inc.	TSLX	15.6%	4.2%	11.4%	0.32x	3.5%	1.1%	1.48x	15.1%
Hercules Technology Growth Capital, Inc.	HTGC	11.8%	3.1%	8.7%	0.43x	5.2%	2.3%	1.76x	11.3%
Blackrock Kelso Capital Corporation	BKCC	11.4%	4.0%	7.4%	0.39x	4.9%	1.9%	1.64x	9.1%
Medley Capital Corporation	MCC	14.5%	4.6%	9.9%	0.41x	5.0%	2.0%	1.69x	13.2%
TICC Capital Corp.	TICC	11.1%	2.8%	8.3%	0.46x	4.0%	1.8%	1.84x	11.9%
TCP Capital Corp.	TCPC	10.8%	2.3%	8.6%	0.24x	1.9%	0.4%	1.31x	10.7%
Triangle Capital Corporation	TCAP	12.2%	2.8%	9.4%	0.46x	5.5%	2.5%	1.84x	12.7%
Capital Southwest Corporation	CSWC	0.4%	1.1%	-0.8%	0.01x	0.0%	0.0%	1.01x	-0.8%
THL Credit, Inc.	TCRD	12.2%	4.4%	7.8%	0.42x	3.0%	1.3%	1.73x	11.3%
Median		11.0%	3.5%	7.6%	0.43x	3.7%	1.6%	1.75x	9.4%
Group Aggregate		10.8%	3.6%	7.2%	0.42x	4.5%	1.9%	1.72x	9.1%

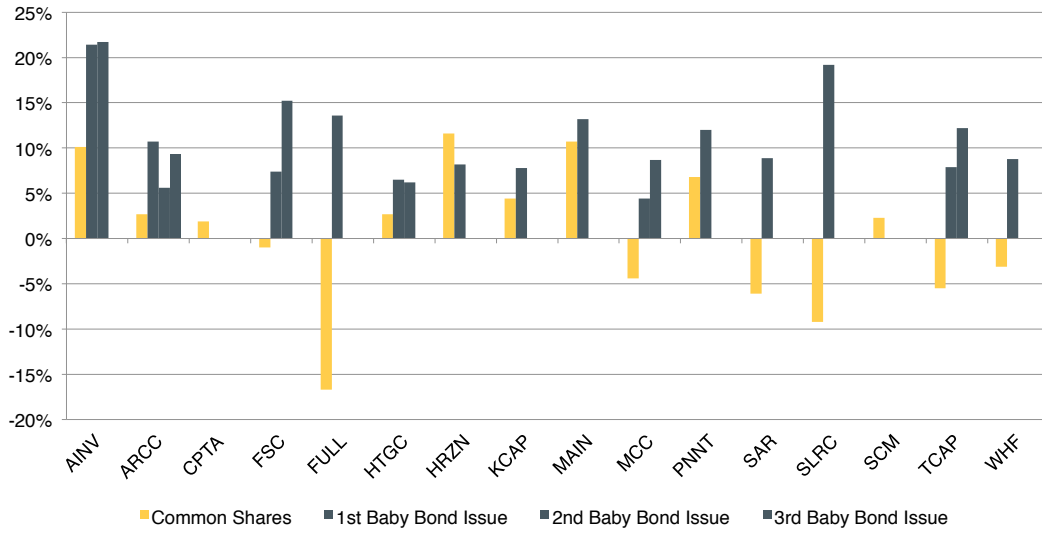
Source: SNL Financial, SEC Filings

Table 3: Trends in BDC Performance Metrics

	3Q14	2Q14	1Q14	4Q13	3Q13	Y-O-Y Change
Gross Asset Yield	10.8%	11.0%	11.6%	12.0%	12.3%	-1.6%
Operating Expenses	3.6%	3.6%	3.9%	3.9%	3.8%	-0.2%
Net Asset Yield	7.2%	7.4%	7.7%	8.1%	8.5%	-1.4%
Leverage (Liabilities/Assets)	0.42x	0.40x	0.39x	0.39x	0.38x	0.04x
times: Funding Cost	4.5%	4.5%	4.6%	4.8%	4.7%	-0.2%
Leverage Carry	1.9%	1.8%	1.8%	1.9%	1.8%	0.1%
Leverage Multiplier	1.72x	1.67x	1.64x	1.63x	1.62x	0.10x
Investment Income ROE	9.1%	9.4%	9.8%	10.2%	10.9%	-1.8%

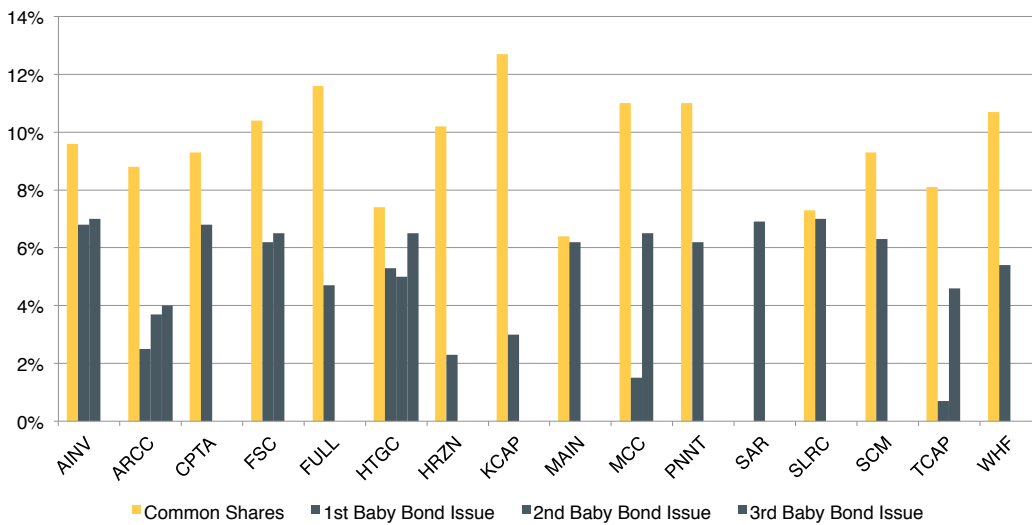
Source: SNL Financial. Aggregate measures for 19 BDCs with over \$750 million in assets (ARCC, PSEC, FSIC, AINV, FSC, SLRC, MAIN, GBDC, NMFC, PNNT, TSLX, HTGC, BKCC, MCC, TICC, TCPC, TCAP, CSWC, TCRD)

Chart 5: Total Returns for BDC Shares and Baby Bonds (LTM)



Source: Bloomberg

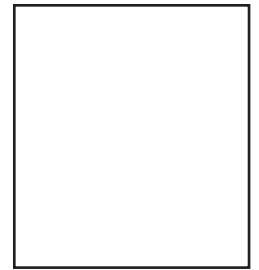
Chart 6: Implied Yields for BDC Shares and Baby Bonds (Current)



Source: Bloomberg



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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:

- Ongoing fair value measurement and review for portfolio investments
- 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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