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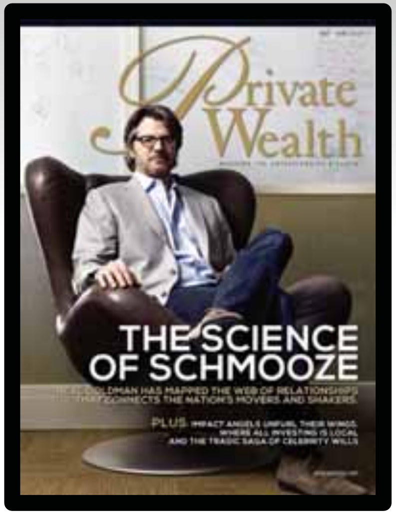

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Income Producing Alternatives:

Understanding Business Development Companies (BDCs)

June 18, 2014

Rich Petrocelli, Managing Director, Finance

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Today's Speaker

Rich Petrocelli, CPA

Managing Director, Finance
Fifth Street Management LLC

- Over 20 years of experience in investment management, private equity and corporate reorganizations
- Previously served as Chief Financial Officer, Chief Compliance Officer and Secretary at Saratoga Investment Corp., a publicly-traded BDC
- Received his B.S.B.A. from Georgetown University and an M.B.A. from New York University's Stern School of Business

About Fifth Street Management LLC

Lender Firm of the Year

KEY FACTS:

- Platform founded in 1998
- $4.5B+ in AUM with a core focus on credit strategies
- Headquartered in Greenwich, CT, with locations across the country
- ~80 professionals
- The investment adviser of two publicly-traded BDCs:
  - Fifth Street Finance Corp. (FSC), one of the largest BDCs in the country
  - Fifth Street Senior Floating Rate Corp. (FSFR), which focuses on 100% senior, floating rate securities

What is a BDC?

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What Do Your Clients Care About?

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What Do Your Clients Care About?

BDCs may be the answer.

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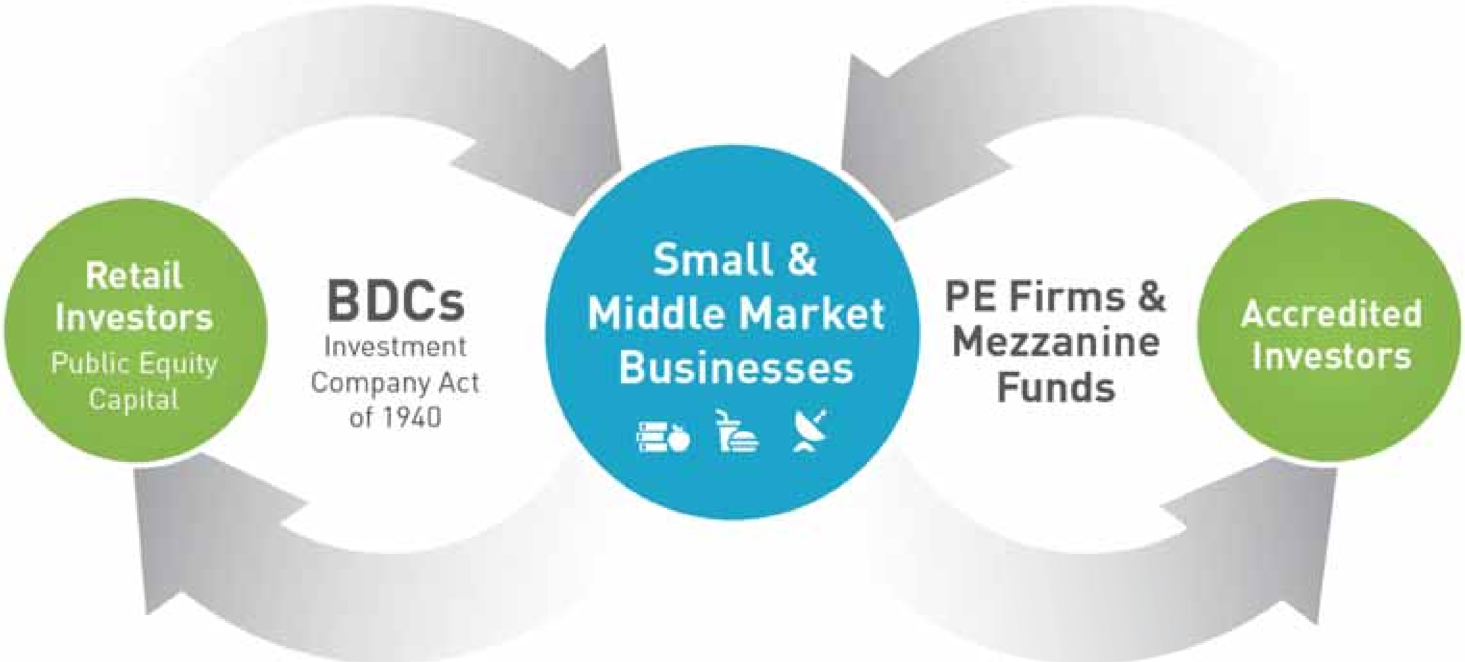
What is a BDC?

- Created by Congress in 1980 as a result of a lack of lending by banks to small and mid-sized businesses
- Regulated by the Investment Company Act of 1940
- Provided Regulated Investment Company (RIC) status in 1990
- A special type of closed-end fund that:
  - Provides growing, private companies access to capital
  - Enables private equity funds to access the public capital markets
  - Enables retail investors to participate in the upside of pre-IPO investing with complete liquidity*

* Note: Referring to publicly-traded BDCs.

What is a BDC?



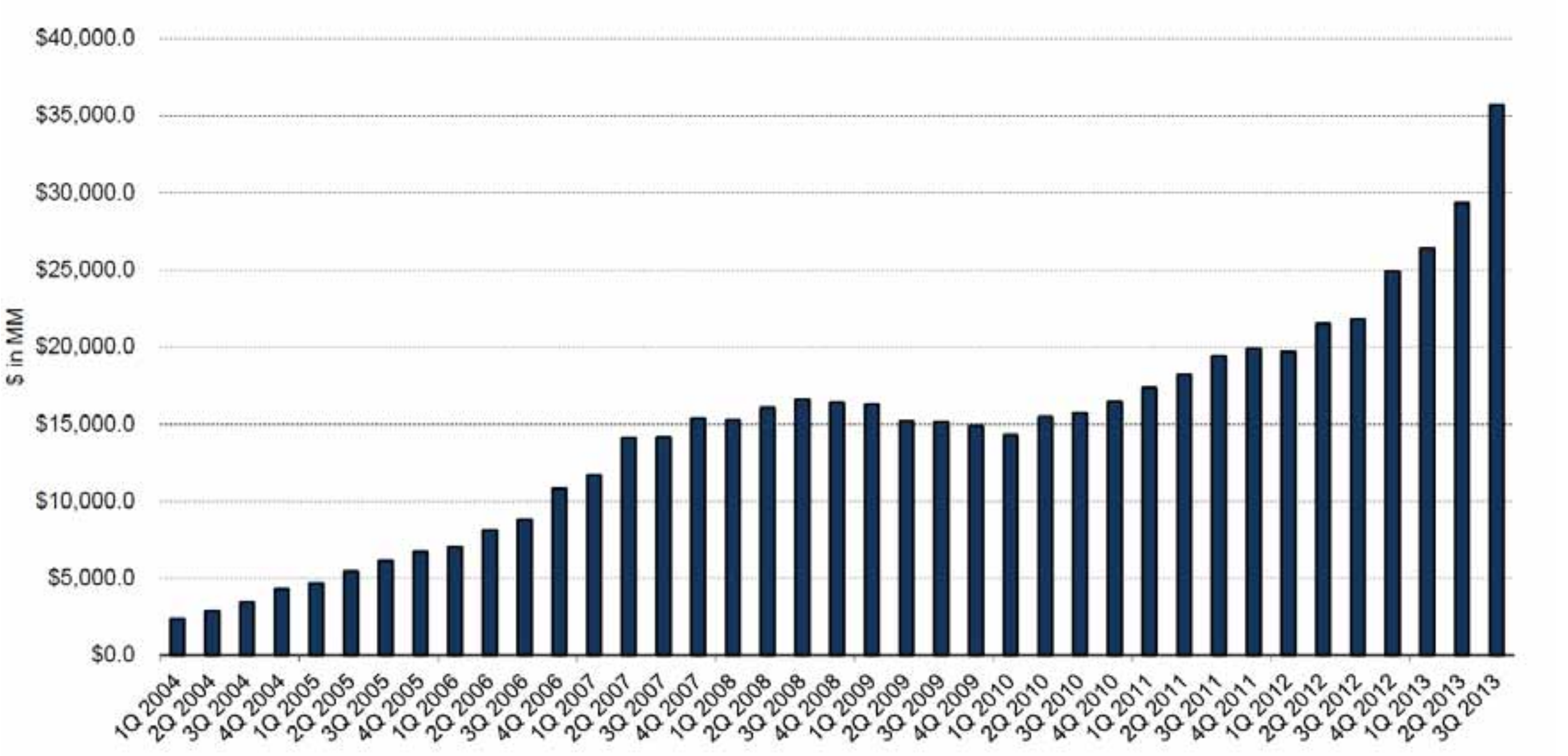
Note: PE stands for Private Equity.

How Did the BDC Industry Develop?

- In early 2002, there were 4 publicly-traded BDCs with assets of $4.2 billion
- In 2004, Apollo Investment Corporation raised $930 million in less than three months which ignited the growth of the BDC industry
- New and existing BDCs proliferated in the mid-2000s to help finance the rise in private equity M&A
- After the credit crisis, the industry continued to grow, as traditional banks pulled back from lending to non-investment grade companies and alternative lenders stepped in to fill the void
- Approximately 40 actively traded BDCs have over $30 billion in market capitalization (as of 3/31/14)

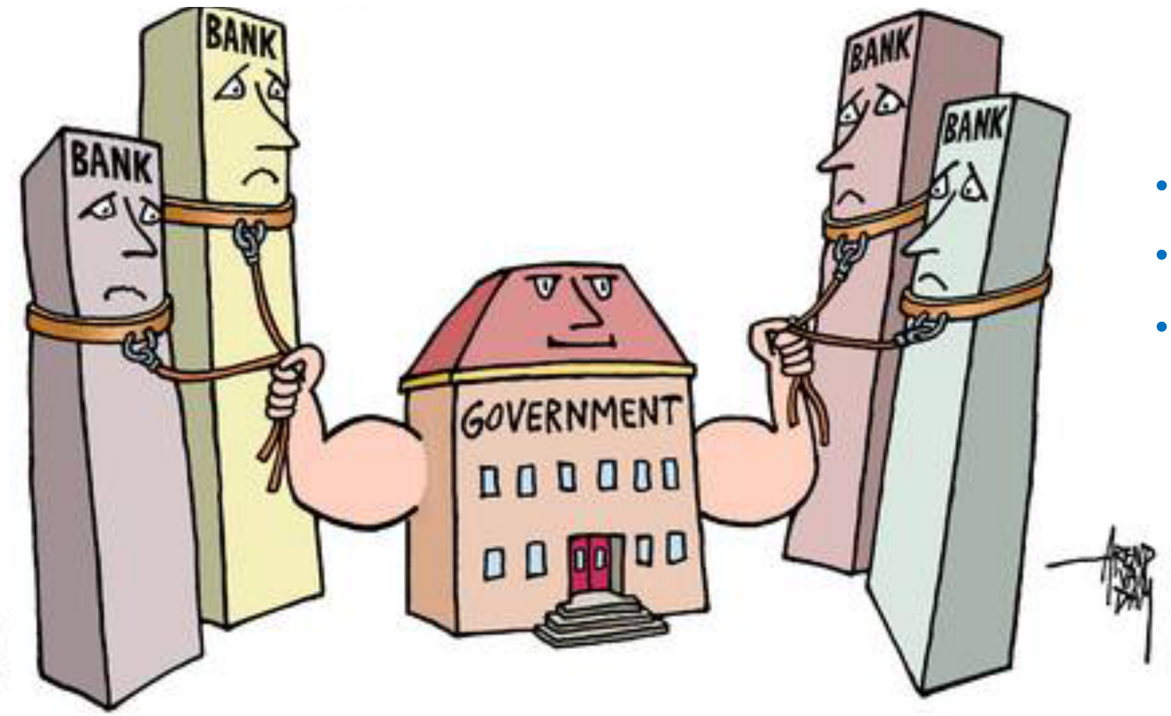
BDC Growth

Estimated Total BDC Loan Balances Since 2004[1]



[1] As of September 30, 2013; Source: Wells Fargo Securities, LLC Estimates.

Regulatory constraints and the long-term trend of bank consolidation have made lending to below investment grade private companies less profitable for banks.



- Basel III
- Volcker Rule
- FDIC Guidance on Leveraged Loans

Alternative Lenders Have Stepped in to Fill the Void

- Banks issued 73% of middle market loans in 2013 down from 81% in 2012[1]
- # of BDCs has doubled since 2008
- Banks now choose to lend to BDCs, who then source, underwrite and manage portfolios of ‘B’ or ‘BB’ rated middle market loans

[1] Source: Financial Times “Shadow banks step out to fund mid-market corporate America,” February 5, 2014.

BDC Qualifications

In order to become a BDC/RIC, a number of conditions must be met. The main ones include:

1. Income Distribution
2. Diversification
3. Leverage Constraints
4. Managerial Assistance

Income Distribution

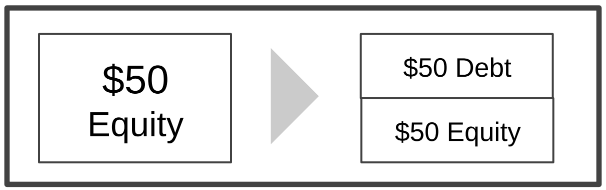
- A BDC may elect to be taxed as a Regulated Investment Company (RIC) under the Internal Revenue Code
- Taxation as a RIC allows for “pass through” tax treatment for income and capital gains that are distributed to shareholders
  - Structure similar to Real Estate Investment Trusts (REITs) and Master Limited Partnerships (MLPs)
- To maintain RIC status, a BDC must distribute at least 90% of its taxable annual net income to shareholders
- This structure enables BDCs to bypass corporate income taxes and pay shareholders dividends that are only taxed once instead of twice

Diversification

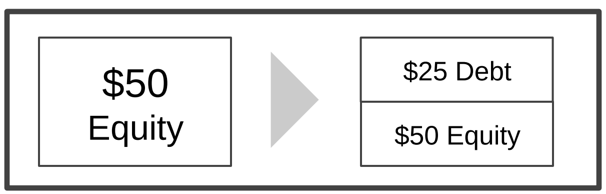
- Congress requires BDCs to remain sufficiently diversified in order to protect shareholders from excessive risks
  - More than half of a BDC's portfolio must be in investments that each represent less than 5% of total assets
  - BDCs must limit investment size so that no single investment exceeds 25% of assets
  - A BDC must have at least 70% of its investment portfolios in qualifying assets
    - Qualifying assets are defined as private debt or equity investment in private, or "thinly traded" companies (i.e. below $250 million market cap)
    - A BDC can generally invest with flexibility in non-qualifying assets that do not fall within the "70% basket"

Leverage Constraints

- A BDC's ratio of total debt to total equity cannot surpass a 1:1 level[1]
  - For example, a BDC with $50 in equity can borrow up to $50 of debt
  - A BDC would then be able to invest $100 in growing businesses



- Traditional closed-end funds' total leverage ratio cannot exceed a 1:3 threshold



- On a relative basis, BDCs employ much lower leverage than banks and agency mortgage REITs, which have exhibited average leverage ratios of 8:1 and 7:1, respectively[2]

[1] There are certain exceptions to this rule. For instance, BDCs may exclude leverage at the SBIC level if the SEC grants exceptive relief, which many have received; [2] Source: The BDC Almanac – Episode III; Wells Fargo (January 22, 2014).

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Managerial Assistance

- Unlike traditional investment managers that invest passively, BDCs must make significant managerial assistance available to portfolio companies
  - Often provided through board observer rights and active board participation
  - Allows BDCs to enhance investment returns, while ensuring protective measures can be taken to protect the value of BDCs' investments in private companies

Transparency: What are the Reporting Requirements?

- Form 10-K (Annual Report)
- Form 10-Q (Quarterly Report)
- Form 8-K (Current Report)
- Proxy Statements
- Sections 13 and 16 Filings
  - Forms 3, 4 or 5 for reporting beneficial ownership by insiders
  - Schedules 13D and 13G for reporting beneficial ownership by others
- Regulation G and Regulation FD
- Comply with the Sarbanes-Oxley Act of 2002
- Disclosure Controls and Procedures
- Internal Control over Financial Reporting/Attestation

How do BDCs Value Their Assets

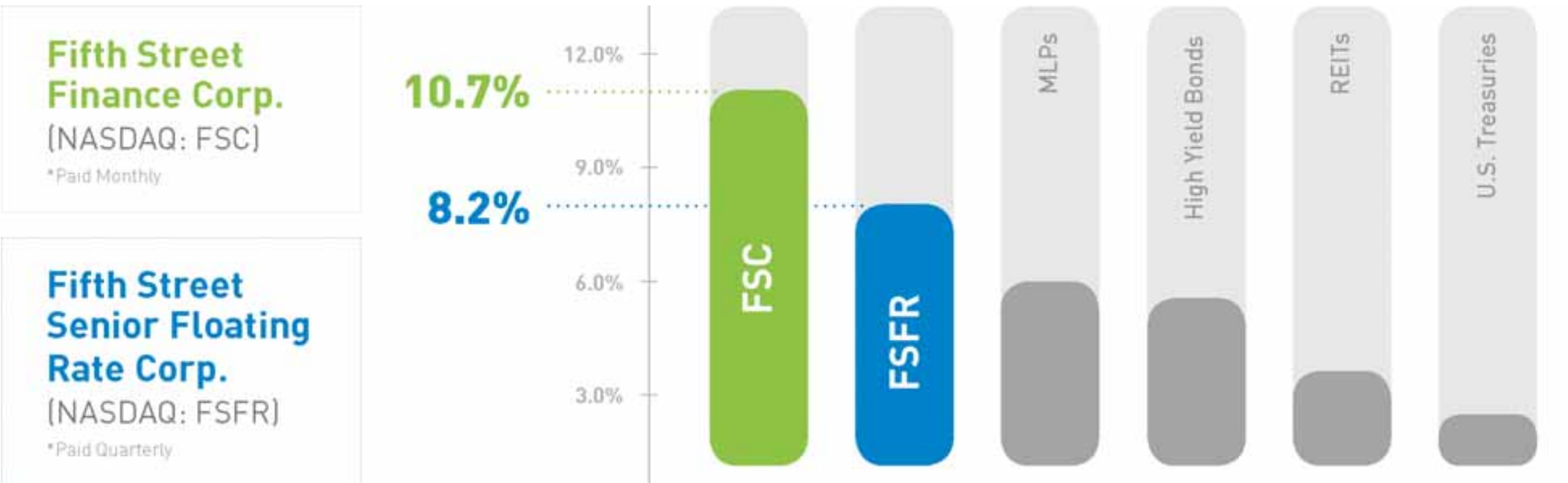
- Investments are reported at fair value
- FASB ASC 820 – *Fair Value Measurements and Disclosures*
- Fair Value – Price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at measurement date
- Regulated investment companies also governed by definition of "value" in Investment Company Act of 1940 further interpreted in SEC Codification of *Financial Reporting Policies* section 404.03 – "fair value as determined in good faith by the board of directors"

What are the Potential Benefits of Investing in BDCs?

- Attractive, Recurring Dividends
- Access to Private Middle Market Companies
- Built-In Liquidity
- All-in-One Diversification
- Position for Rising Interest Rates

Attractive, Recurring Dividends

Dividend Yield[1]



[1] FSC dividend yield as of June 5, 2014 based on annualized monthly dividend rate of $0.0833 per share declared by FSC's Board of Directors through August 2014. FSFR dividend yield as of June 5, 2014 based on annualized quarterly dividend rate of $0.30 per share declared by FSFR's Board of Directors through September 30, 2014. Twelve month trailing yields as of June 5, 2014 for Master Limited Partnerships (MLPs) are represented by the JPMorgan Alerian MLP ETN, high yield bonds by the iShares iBoxx USD High Yield Corporate Bond ETF, Real Estate Investment Trusts (REITs) by the iShares US Real Estate ETF and U.S. Treasuries by the 10-year U.S. Treasury Bond. Individuals cannot invest directly in an index.

Why is the yield so high?

Does this mean high risk?

Access to Middle Market Credits With Built-In Liquidity

ACCESS:

By investing in a BDC, your clients will gain exposure to private, growing small and mid-sized businesses – an opportunity typically only available to institutional investors like pensions and endowments through private funds.

LIQUIDITY:

When investing in a publicly-traded BDC, investors retain the flexibility to buy and sell. FSC, for instance, has a daily trading volume of 1.5M shares.

Note: Logos represent select FSC and FSFR portfolio debt & equity investments.

All-in-One Diversification

FSC's Portfolio at Fair Value as of March 31, 2014

BDCs are structured to act more like diversified mutual funds than single securities.

FSC's $2.7 billion portfolio is spread across 124 small and mid-sized companies in 35+ industries.

FSC PORTFOLIO MIX

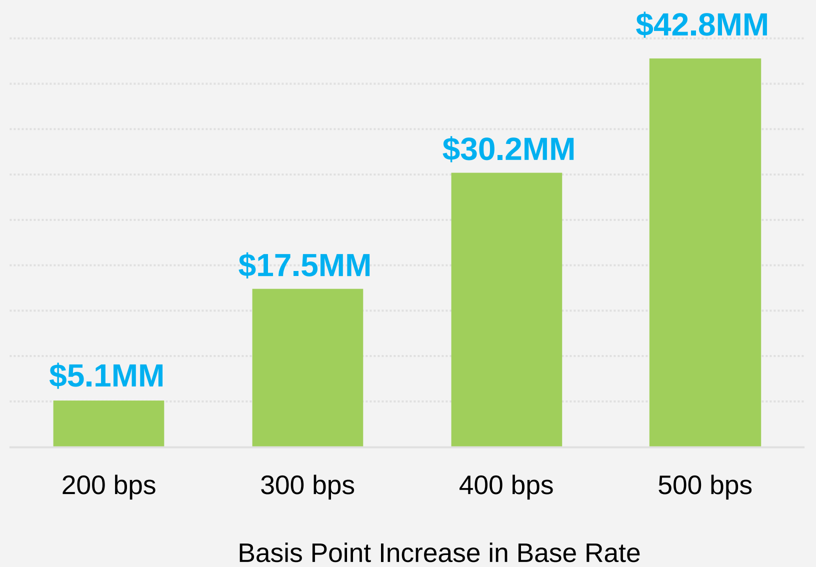
15%	Healthcare Services
13%	IT Services
12%	Commercial Services & Supplies
11%	Education Services
9%	Oil & Gas Equipment & Services
7%	Advertising
5%	Specialized Finance
4%	Specialty Retail
4%	Consumer Durables & Apparel
4%	Capital Goods
3%	Consumer Discretionary
3%	Healthcare Equipment & Technology
3%	Pharmaceuticals
3%	Aircrafts
5%	Other

Note: Numbers may not sum to 100% due to rounding.

Position for Rising Interest Rates

- Over half of FSC's borrowings are at fixed rates, **while ¾ of its lending is at floating rates**
- FSFR's portfolio consists of **100% senior, floating rate investments**

FSC's Annual Change in Net Spread Income from Interest Rate Changes[1]



[1] Net spread income calculated as the difference between the change in interest income and interest expense.
Note: As of March 31, 2014.

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How to Differentiate between BDCs

1. Management Team
2. Capital Structure Focus
3. Floating Rate vs. Fixed Rate Portfolio Composition
4. Origination Platform vs. Buying in Secondary Markets
5. Sponsored vs. Unsponsored Deals
6. Credit Quality
7. Quality of Earnings (Level of PIK Income)

"BDCs – The Equity REITS of the Future"[1]

Some industry analysts expect BDCs to follow a similar market capitalization growth trend to Equity REITs, due to similarities between the investment models

- Today, ~50 million Americans (16% of the U.S. population) own REITs in their 401(K)s and the industry's market capitalization has surpassed $600 billion

Similarities

- Strong returns relative to the market and peers
- Stable and consistent dividends
- Liquid access to an illiquid asset class
- BDCs offer significant portfolio diversification and access to active management
- Recession Tested

Differences

- BDCs are not yet institutionalized
- Funding costs are elevated
- Institutional ownership is lower than for REITs

[1] Source: Wells Fargo Report – BDCs: The Equity REITs of the Future; September 26, 2013


Q&A

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Thank you!

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