INVESTOR NEWSLETTER NOVEMBER 2009

SOUTHLAND CAPITAL MANAGEMENT

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BDC DIVIDENDS HOLD UP THROUGH RECESSION!

Notwithstanding the worst recession in memory, BDC dividend returns have held up remarkably well. That's the headline, but there are a couple of footnotes we should add. First of all, we're only talking about the 15 companies on our current Buy List, which leaves out several BDCs which have not yet solved their liquidity crisis stemming from the recession. Second, our list includes two Closed-end funds which invest in junk bonds and a grantor trust which is similar but not identical to a BDC. With all of that off our chests, we can tell you what we discovered on doing some data mining. We compared the 15 Buy List companies 2008 dividend levels with their annualized latest dividend. We found that 7 companies have had to cut their dividend. On the other hand, 2 held their pay-out unchanged and 6 actually increased. In aggregate terms we found that the overall dividend has dropped just 16% from 2008 amongst the 15 Buy List companies, which seems modest considering the market conditions.

INTERIM REPORT CARD

Here's an interim Report Card on SCM's Buy List as of November 8, 2009,and the results are encouraging. By this point, 10 of the 15 companies we are buying have reported their latest earnings and dividends. We're glad to report none of the Buy companies reduced their dividend. 8 have maintained the same dividend as the prior quarter and 2 increased their pay-out. Moreover many of the companies have announced their final dividends for the year (5), and 2 have announced dividends through November. Our only concern is that 5 of the 10 reporting companies are still setting dividend levels higher than the most recent Net Investment Income Per Share.

BDCs & THE CAPITAL MARKETS

What is better for the BDC industry: a shortage of debt capital from banks, finance companies, hedge funds, CLOs, bond financings, etc or the opposite? A number of BDCs which have raised new capital have been rubbing their hands about the paucity of capital in their respective segment of the debt markets. The argument is that the BDCs with ammunition will be able to pick and choose the very best new deals, and receive far higher pricing than was the case during the go-go days before the recession when financing was easy to obtain for borrowers. We don't agree with those who say the relative absence of capital is good for the health of the BDCs, and for two reasons. First, with so little capital around, and depressed earnings thanks to the recession, very few buy-outs are being contemplated, let alone closed. This applies in every segment of the market. The irony is that what with only a few good deals coming to market credit providers such as BDCs are having to compete at pre-recession levels to book new deals. Pricing and structure are better than just before the recession but are not outlandish, and are so few and far between to have only a minor impact on current earnings. Buy-out activity (which is a form of M&A) will only return when capital is more abundant, and until then BDCs and other credit providers will have a

HEADLINE NEWS

Fed Affirms Plan to Keep Rates Low

The Fed affirmed its intention to keep rates low for an "extended period" amid still high unemployment and low inflation but expressed growing confidence about an economic recovery. Why do we care? We borrow from Goldman Sachs at 1% above Fed Funds Rate, so this helps our 1-1 leverage for an "extended" period as well. With the unemployment rate is so high and other measures of slack in the economy -- such as unused factory capacity -- are so great that substantial downward pressure on inflation will linger even after a recovery takes hold.

hard time spending all their available funds.

The second reason that we need more debt capital flowing in the buy-out arena is that most BDCs do not provide all the financing for the buy-outs they participate in. Most BDCs are providing second lien senior debt or subordinated debt to borrowers. Other credit providers tend to lend the senior secured portion of financings, and the sponsor groups come up with the equity. In the last twelve months or more, both the senior lenders and (to a lesser degree) the sponsor groups have withdrawn both from new deals and existing transactions (wherever possible). As a result, borrowers are saddled both with declining earnings, muddied prospects and a dearth of lenders to provide refinancing or expansion capital. With all the goodwill in the world, BDCs cannot fill the gap left by the senior lenders (principally banks). Moreover, as principally subordinated debt providers, BDCs can often only sit and watch as banks re-structure borrowers or push them into bankruptcy.

Of course, BDCs have been adjusting their strategies to fit the new situation. Fifth Street Finance (FSC), for example, has been repositioning its portfolio from second lien to first lien senior debt, attracted both by higher margins than were previously possible and by the greater control over credits which a secured lien provides. Industry-wide, though, we don't see the BDC industry being able to reposition itself at the senior level of the buy-out market.

The best outcome is for senior debt capital to begin flowing again to the buy-out community from traditional and new sources. We've already witnessed during the summer the almost miraculous rebirth of the new issue junk bond market for larger issuers. This has helped some borrowers refinance their buy-out debt, though little new deal activity is underway. However, most of the borrowers that the BDC industry serves are medium to small sized companies who rely on loan financing. That market is just beginning to show signs of life. However, there's no doubt that many former participants in the senior loan market have gone away never to return. These include many banks, collateralized lenders and hedge funds. One of the key elements we're looking for to mark the "green shots" of a revival are new lenders into the buy-out world, or significant new commitments from existing players.

All of this is a long way round to noting that we were encouraged to hear that a Cincinnati Bank-Fifth Third Bancorp-has just launched a specialty group to provide financing for buy-outs. Here is the full press release:

"Fifth Third Bancorp has created a specialty lending group targeting private equity clients. The Cincinnati-based bank, Central Ohio's third-largest holder of deposits in Central Ohio, said its Fifth Third Sponsor Leveraged Finance would handle cash flow financing for a small group of private equity clients. Lending will be aimed at businesses with $10 million to $50 million in earnings before interest, taxes and other special items. Fifth Third (NASDAQ:FITB) said managing directors Brian Crabb and Josh VanManen will head the group. Crabb most recently worked for CapitalSource Finance and previously was with GE Capital. VanManen moves from Fifth Third's structured finance business in Denver, where he ran the unit's western region team. Crabb in a release called the team "a new foray into middle-market private equity lending for Fifth Third Bank." "At a time when sources of debt for private equity deals have been severely diminished, we are excited to enter this arena with a dedicated and focused effort," he said. Fifth Third had $111 billion in assets at the end of the quarter. In Central Ohio, the bank ran 60 branches and had $3.55 billion in deposits, representing about 10 percent of the market at midyear, according to the Federal Deposit Insurance Corp."

It's a drop in the ocean, but a good sign that the tide is turning. We scour industry publications, talk to lenders and attend private equity conferences and whenever we hear more news about debt flows in the senior market we'll provide an update.

BDC CONSOLIDATION

Ares Capital set to buy Allied Capital.

We were not shocked by the news that Ares Capital (ARCC) is set to acquire Allied Capital (ALD). There are half a dozen "zombie" BDCs which were over-leveraged during the recession and are in default with their unsympathetic lenders. For most of these BDCs, which cannot add new business and are just paying down debt as fast as possible, being acquired is a way out. Still, this is a gutsy move because Allied Capital used to be the second largest BDC. At June 30 2009, Allied still had $4.3bn in assets versus $2.3bn for its erstwhile acquiror. Allied Capital has both credit and financing problems, with 13.3% of yield assets (by our possibly flawed calculations) in the non-accrual category. The comparable number at Ares is only 7.2% (6.2% on all assets at cost). To date, Ares has cumulative Realized Losses of only $1mn on equity at original cost of nearly $1.4bn. We don't know what the comparable number is for ALD despite much harvesting of its portfolio as a number of deals have occurred in recent months which suggest there could be hundreds of millions in Realized Losses. On paper Ares looks like the better company.

Of course, liquidity is the most important element right now. We were concerned about Ares until just a few weeks ago. As late as the June 2009 10-Q, investments assets at fair market value covered net debt (which was $879mn) by only 223%. However, Ares did raise $110mn of new equity in August, which would take that coverage to 255%. Plus, it's likely that FMV has jumped in this quarter, so coverage may be up to 275% or higher. On a combined basis, we estimate the new ARCC will have over $6.6bn in assets at cost and about $2bn in debt. On a FMV basis,though, the assets might be initially worth $4.5bn. On those numbers asset coverage would be 225%. That's not a huge margin for error, but we're just making some very broad calculations.

Keeping with these same assumptions the implied equity value for the combined ARCC-ALD would be $2.5bn. Of that ARCC shareholders will keep 65%, which is about $1.6bn, or substantially higher than the current $1bn in market capitalization. ALD shareholders, whose market cap has been around $550mn would realize a value of $875mn, or a 56% increase on the current value. The theory is that the new Ares Capital will be able to hold on to Allied's assets long enough to fully realize their value, rather than be forced into unwarranted asset dispositions by ALD's unhappy lenders. On paper this could be a win-win, but it's too early to tell because we are just guessing at what Allied's assets might be written down to.

After Allied Capital Merger, Could American Capital Be Next?

American Capital has sold several portfolio companies over the last few months, largely in an effort to pay down debt. If the exits continue, American Capital may also reduce the size of its portfolio to a point that is more manageable for potential buyers. The asset sales can be a double edged sword, as the market believes that stronger companies will get sold first and assets that remain tend to be weaker ones - which could further turn off potential buyers. Much of American Capital's fate hinges on the outcome of its debt negotiations with their lenders.

NEWSLETTER

Keeping investors and prospective investors updated on the activities of Southland Capital Management and BDC Fund II

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