| Month | BDC Fund II* | S&P 500 TR | Nasdaq Comp | Dow Jones | Russell 2000 (DRI) |
|---|---|---|---|---|---|
| FYE — 2009 | 4.37% | 5.49% | 6.91% | 7.37% | 3.49% |
| FYE — 2010 | 73.04% | 15.07% | 16.91% | 11.02% | 26.85% |
| January — 2011 | 7.05% | 2.37% | 1.78% | 2.72% | -0.26% |
| February — 2011 | 8.08% | 3.43% | 3.04% | 2.81% | 5.48% |
| March — 2011 | -10.39% | 0.04% | -0.04% | 0.76% | 2.59% |
| April - 2011 | 6.18% | 2.96% | 3.32% | 3.98% | 2.64% |
| May - 2011 | --3.56% | -1.13% | -1.33% | -1.88% | -1.88% |
| June - 2011 | -7.17% | -1.67% | -2.18% | -1.24% | -2.31% |
| July - 2011 | -17.77% | -2.03% | -0.62% | -2.18% | -3.61% |
| August - 2011 | -11.59% | --5.43% | -6.42% | -4.36% | -8.70% |
| September - 2011 | -14.20 | -7.03 | -6.36 | -6.03 | -11.21% |
| Year to Date | -38.53% | -8.68% | -8.95% | -5.74% | -17.02% |
| Inception to Date | 11.01% | 11.43% | 13.80% | 12.36% | 9.34% |

* Fund's inception was October 1, 2009. Performance shown is net of all fees & expenses including management & performance fees. Past performance is not necessarily indicative of future performance. This material does not constitute an offer to sell (nor the solicitation of an offer to buy) interests in BDC Fund II, LP (the "Fund"). Offering is made by Private Placement Memorandum from a Principal only.

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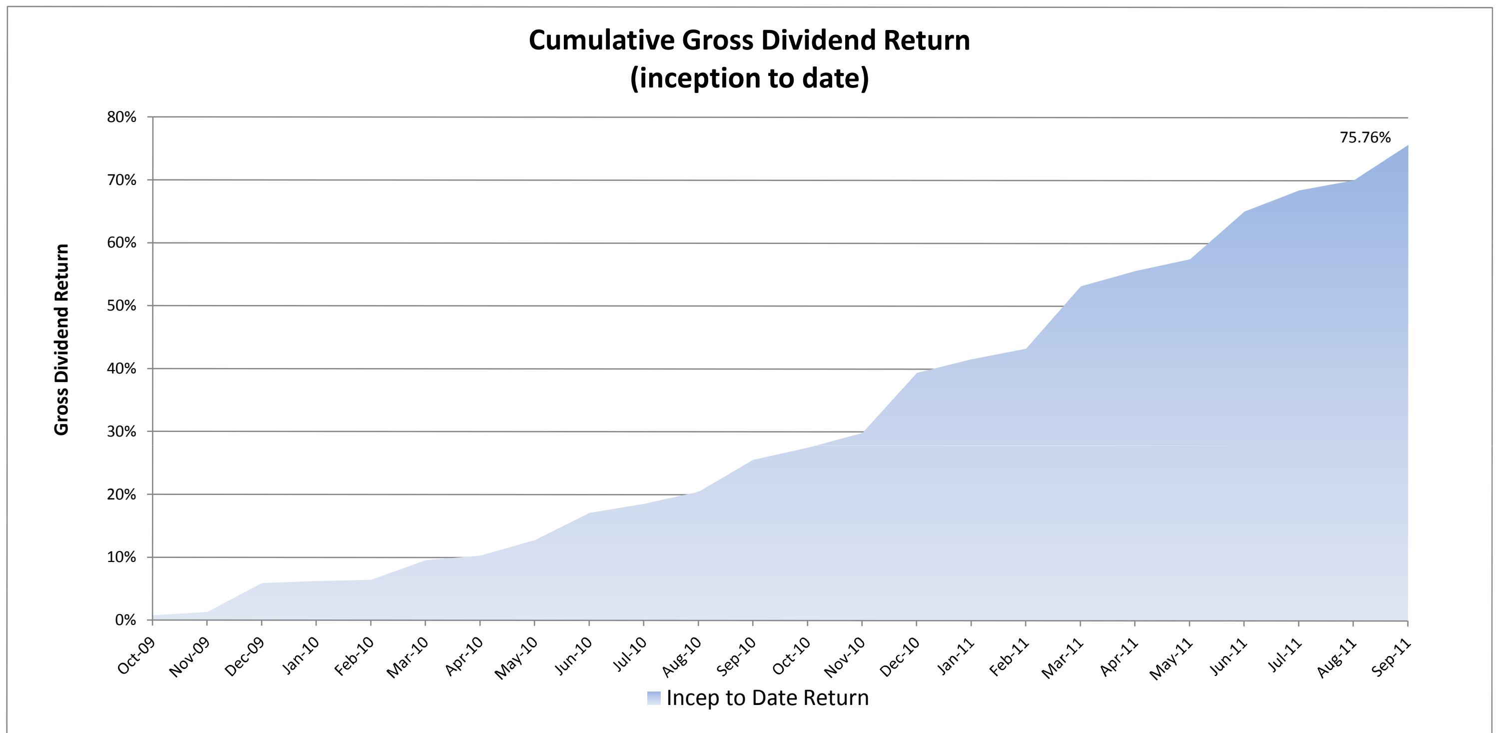
## SEPTEMBER 2011 RESULTS

September was a fifth down month in a row for BDC II, reflecting the pull back in stock prices over the same period for all the indices. We were down 14.2% for the month, principally because BDC stocks were down by 7% in the period. The general market remained transfixed about the prospects of a meltdown in the Eurozone.

All the indices were down in September, in a relatively tight range. Outside of BDC II, the poorest performing index was the Russell 2000 DRI (with reinvested dividends), down 11.21%. The "best" performing index was the Dow Jones, down 5.74% for the month. For the nine months year-to-date the Fund continued into negative territory: -38.5%. The other indices returns for the last nine months ranged from -5.7% (Dow Jones) to -17.0% (Russell 2000




DRI). The Fund's leverage continues to act as a double edged sword, multiplying returns on the upside and on the downside compared to the unleveraged indices.

The Fund's return since inception in October 2009 remains in the positive column, up 11.01%. That's slightly behind the S&P 500 TR, up 11.43%. At the back of the pack is the Russell 2000 DRI index, up 9.34% over the 23 months under discussion.

## CASH ON CASH RETURN

We have reached the second anniversary of the Fund's launch, and of our Cash On Cash feature. **We can report with some satisfaction that by the end of September 2011 the Fund reached a Cumulative Gross Dividend Return of 75.8%.**

### MORE ABOUT THE IMPORTANCE OF DIVIDEND INCOME

The above underscores our oft-repeated view that the Fund's income generating capacity is the key factor to be considered in evaluating our long term performance. Currently, the stock market is in turmoil due to concerns about the prospects of a second recession, and valuations are as much as 35% below the level of a few months ago. Six months from now valuations could be reversed even though the basic earnings could be unchanged, which means taking a snapshot of equity values at any one moment can be misleading.

### IT'S ABOUT THE INCOME NOT THE CAPITAL APPRECIATION

Conversely, the Fund's dividend income is a far more consistent and predictable contributor to the total return of the Fund. **In fact, we expect over a multi-year period virtually all an investor's net gains from investing in BDC II (and in BDCs generally) will be derived from dividend income received**. BDCs distribute all their earnings to shareholders, so investors cannot expect much, if any, appreciation in their asset values and stock prices over the long term. The tradeoff, though, is a very high level of current income from BDC distributions.

### COMPARING YIELDS

How high is high? At the moment, the BDC industry, partly because of its unusual tax structure and because it is still relatively not well known, generates the highest dividend yield of any sector. Let's compare:

* Investment grade bonds are yielding 4.0% (Wall Street Journal October 13, 2011)
* The average yield on Real Estate Investment Trusts ("REIT) is 4.3%. (REITs have the same earnings payout requirements as BDCs, but can use a greater amount of debt capital)
* Junk bond yields are averaging 9.6%. (Like BDC loans, junk bonds are targeted at below-investment grade borrowers, albeit usually larger in size.)
* Master Limited Partnerships ("MLP"), which involve investments in energy infrastructure, also pay-out all their earnings to their owners are yielding 6.5%.

**By comparison, the 22 companies on our Buy List are currently generating a yield of 12.5% per annum, substantially higher than all the other sectors just mentioned.** BDCs are yielding nearly 3 times what REITs are, although both sectors performed similarly in the last recession. Likewise, our BDCs are earning a 30% premium over junk bonds despite taking similar risks for similar periods. Moreover BDC investments are typically more diversified, more liquid and more transparent than owning junk bond loans or funds there

### THE BENEFIT OF CHEAP DEBT

The Fund also benefits from its ability to borrow $2 for every $1 of equity from our margin lender, and at very low rates (1.0% per annum). The combination of very high yields and the access to inexpensive margin borrowing has brought the Fund's current yields to record levels. **We calculate that BDC II is generating a 30.0%**

**distributable income yield on new investments, net of all expenses, interest expense and management fees.** The equivalent return on existing portfolio investments is 26.0%. Thank-you market slowdown.

**INCOME VERSUS CAPITAL APPRECIATION**

As the Cash on Cash return above demonstrates over time the constant dividend income stream the Fund generates overshadows the impact of any stock price appreciation or depreciation.

Let us illustrate using real life examples. If there is no recession, and current dividend levels remain unchanged, BDC II is projected to generate $11.0mn in net distributable income over the next 5 years. Distributable income is dividend income less interest expense, operating costs and the 2% management fee on portfolio assets. That's an average distribution to investors of $2.2mn a year.

Even if there is a recession and distributions are reduced by 20% (which is more than our own projections anticipate), total income during that period will be $8.8mn, or $1.75mn a year.

If the stock prices of the BDC II portfolio goes nowhere or even declines by 20%, a hypothetical investor with a long term outlook will still generate a superior return, unlikely to be equalled in any other sector After all, even in a recessionary environment and a 20% drop in portfolio values from here an investor would be doubling their investment over 5 years, before taxes.

**EVEN MORE DISTRIBUTIONS**

What's more, the Fund has the capacity to buy more assets and increase its income further should/when BDC stock prices rise again. As we discuss in much greater detail in the CIO Newsletter, this means that BDC II's cash flow could increase by up to 40% above the levels already discussed.

**WHAT'S WRONG WITH THIS PICTURE?**

Of course, the Fund faces risks in harvesting this dividend income over a multiyear period.

1. BDCs could cut their dividends more than we anticipate in the face of recession-driven losses or other pressures on their earnings. Commentators will mention that BDCs cut their dividends over 50% in the Great Recession. However, the top half performers only cut their distributions by 14%, including several who maintained or increased their distributions through the recession. Stock selection is important. (That's a plug for the Manager).

2. Earnings could be impacted by loan spreads narrowing if new competitors entered the market for middle market buy-out lending. However, the trend at the moment is in the opposite direction, and BDCs have the advantage of being able to raise public capital inexpensively, ready liquidity and organizations in place.

3. BDC stock prices could drop even further than the 30% off their 52 week highs that has already occurred. Stock price losses would eat into gains from dividend income when considering the total return over time. Certainly in the Great Recession some BDCs stock prices dropped up to 90% because of the crisis market conditions. However, all the stocks bounced back to multiples north of 10x earnings once the fears of a financial collapse dissipated. Currently for stock prices to drop permanently above their current level we would have to incur drops in income above 30%, which we consider unlikely.

4. The Fund's ability to borrow at very inexpensive rates to acquire high yielding assets could be impaired if interest rates rise sharply. However the Fed has promised to keep rates very low for at least two years. Thereafter rates would have to rise several points (probably above 6%) before the arbitrage benefit would be erased. The Fund is looking into entering into a long term interest rate cap to lock in the arbitrage.

**CONCLUSION**

Thanks to the favorable economics of the BDC model and the access to inexpensive margin debt, BDC II is a cash machine. Distributions over time should outstrip changes in portfolio value (if any) whatever the economic conditions we will face. We believe we can achieve returns similar to investing in private equity (15%-25% per annum) while having the benefit of being liquid, transparent and earning the return over time, rather than just at the end. Investing herein,though, requires a long term outlook and an ability to look beyond short term stock price volatility.

## NEWSLETTER

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

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