SCM SOUTHLAND Capital Management LLC

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%
FYE - 2011	-46.38%	2.11%	-1.80%	5.53%	-4.18%
FYE - 2012	28.21%	16.00%	15.19%	7.25%	16.34%
January - 2013	6.08%	5.18%	4.06%	5.77%	5.96%
February - 2013	1.45%	1.36%	0.57%	1.40%	1.33%
Year to Date	7.63%	6.61%	4.65%	7.25%	7.37%
Inception to Date	33.63%	54.09%	48.89%	44.69%	57.72%

* 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. The indices included above are presented only to provide a general indication of U.S. Stock market performance for the periods indicated and not as a standard of comparison because they are unmanaged, broadly based indices.

FEBRUARY 2013 RESULTS

The Fund was up again in February: 1.45%. After a continuing upward trend from January, the markets dropped on the Italian election results and concerns about the continuation of Quantitative Easing by the Fed, before reversing back at month-end. Once again, we managed to outperform the broad stock market indices we have been comparing ourselves since our launch. The closest index in the month was the Dow Jones, up 1.40%, with the S&P at 1.36%, and the NASDAQ at the back of the pack, up 0.57%.

Year-To-Date, the Fund is up 7.63%, nearly a full percentage point above the S&P 500 and slightly ahead of the Russell 2000 and the Dow Jones. Again, the Apple-heavy NASDAQ is the laggard: up “only” 4.65% in 2013.

Inception To Date returns continue to climb: up 33.63% over 41 months, after all fees and expenses, if you’d invested on Day One. We are still trailing the other indices (all of which have been zooming over this period). We are closest to the Dow Jones: up 44.69%. The leader is the smaller-cap Russell 2000, with dividends re-invested, up 57.72%.

As usual, the Fund out-performed the various hedge fund market indices for the month and YTD. One example will do: the HFRX Global Hedge Fund index was up 0.4% in February, and 2.4% YTD. Some simple math will show that the Fund out-performed those results by a factor of 3.

LOOKING BACKWARDS AND LOOKING FORWARD

We thought it might be interesting to share with both existing and prospective investors in the Fund our long-term outlook, but also review the initial assumptions on which we initially invested back in the dark days of 2009. As you’ll see some

assumptions have changed, but many have not. Now, as then, we believe the prospects for investing in the BDC sector, and Leveraged debt generally, are very encouraging.

FOUR MORE YEARS OF (TEPID) ECONOMIC GROWTH?

As you would expect, the performance of all categories of Leveraged Debt sectors correlates very closely with the health of the U.S. economy. When the U.S. economy is expanding, High Yield Bonds, Floating Rate Loans, and Business Development Companies all perform well: both in terms of returns and credit performance. Of course, as economic conditions deteriorate, so do Leveraged Debt prices and ultimately credit performance.

We launched the Fund in October 2009, only a few months after the official end of the Great Recession. At that time we anticipated the economic expansion that was just getting underway would last at least three to five years. That projection was based upon our own hard earned experience. We have been involved in the Leveraged Debt business through four boom-to-bust periods, and the expansion periods usually lasted around five years. Also, the National Bureau of Economic Research calculates that the average length of economic expansion in the US, using data going back to 1854, is 39 months.

We are now nearly four years into the economic expansion. As we all know, the “recovery” has been anemic and fitful. Even with the unemployment drop to 7.7% in February, there are still 12 million unemployed in the country, a level equal with the numbers in December 2008. GDP growth stalled in the fourth quarter of 2012, has picked up in the first quarter of 2013, but is expected to drop back again with the impact of reduced sequester-related government spending.

For the Fund that’s the good news. Leveraged Debt providers benefit in a slowly or fitfully expanding economic environment. Thankfully, we now foresee another 4 years of slow economic expansion. We use a variety of data points including the IMF, World Bank, U.S. Government and investment bank consensus projections. In 2013, the World Bank expects U.S. GDP to grow just 1.9%, versus a historical average. The Fed has-rightly or wrongly-decided to use the unemployment rate as the thermometer for monetary policy. The 6.5% unemployment target is not expected to be reached (according to the CBO and the IMF) until 2016. As a result, we don’t think it’s unreasonable to assume the U.S. economy will expand until 2017.

LOW INTEREST RATES

Back in October 2009, we were convinced that the Fed would keep interest rates low for several years, which is why we chose to use margin debt for the Fund. Our argument was that the opportunity existed to arbitrage the broad difference between BDC yields (north of 11.0% at the time) and the cost of borrowing (0.00%-0.5% from the Fed and about 1.0-1.25% for the Fund).

Back in 2009, our view that rates would stay down for several years was not common wisdom. That was then, and this is now. Like most everybody else, we are convinced that a low interest rate environment is here to stay for the next four years. Frankly, we don’t to expect see a return of the Fed Funds rate to the 5.5% level of 2006-2007 in the next four years. At worst, we’re expecting only a modest increase in rates, on the order of 1%-2%.

STABLE INCOME

Back in the autumn of 2009, we argued that investing in the BDC sector and other forms of Leveraged Debt (we were invested in both High Yield Bonds and Floating Rate Loans) would generate predictable, stable income from distributions.

At the time this was not obvious, as many market participants were still reeling from major reductions in distributions brought on by a combination of bad debts and lower rates. The BDC sector as a whole had seen distributions reduced by half within a 12-month period. Our analysis, though, indicated the reductions had run their course in the second quarter of 2009.

In fact, a review of the 21 dividend paying BDCs (including Kayne Anderson Energy and Compass Diversified-which are similar) that were in existence at October 2009 shows that three-quarters have increased their dividends in the past three and a half years, 10% are unchanged and only 15% have lowered their pay-outs. Even the 3 BDCs that have reduced their dividends (all due to troubled loans booked before the Great Recession), the reductions are modest, averaging 22%.

There has been a similar scenario played out in the Floating Rate Loan sector. Take, as an example, the Eaton Vance Senior Floating Rate Loan Closed End Fund. In October 2009, the monthly dividend was 7.3 cents a month. That level was 40% down from two years before. However, in the intervening three and half years Eaton Vance’s distribution has steadily risen. The current dividend is 9 cents a share, or a 23% increase.

Looking forward, we expect our Leveraged Debt investments to continue to generate a steady, predictable stream of income

throughout the period ahead for many of the reasons that have been in place for the past few years. First, virtually all the under-performing investments booked in the 2003-2007 expansion have been closed, sold or restructured in every Leveraged Debt sector. In the BDC sector, virtually without exception, under-performing and non-performing loans are at their lowest levels in 5 years. Likewise, Floating Rate Loans and High Yield Bonds are recording levels of defaulting (approximately 1.3% per annum) and "stressed loans" (borrowers not yet in default but with material financial problems) way below historical averages.

We have been tracking the performance of new loans underwritten since the Great Recession and found credit quality to be excellent. Amongst the BDCs, we are just closing out earnings season and have reviewed the earnings reports of over 30 players, with a couple of thousand loans booked since 2008. To date, we have identified less than 10 "troubled" loans therein. Likewise, published data about Floating Rate Loans and High Yield Bonds suggests this in an industry-wide phenomenon.

Even more importantly, the earnings reports we track (which also includes the results of other kinds of participants in leveraged finance including the major Private Equity Groups such as Blackstone, KKR, Carlyle Group etc. and commercial lenders) clearly show the underlying cash flow of borrowers (as measured by our industry's favorite acronym EBITDA: Earnings Before Interest, Depreciation and Amortization) continue to improve. Depending on the sector, we have seen data that suggests EBITDA growth ranges from modest (2-3% over 12 months earlier) to impressive (10% growth).

Cash flow growth amongst borrowers is occurring just as their debt service costs are reducing as most every able bodied company in America refinances higher priced debt on lower terms and for longer periods. An environment of broad cash flow growth, matched with lower debt service outgoings, and a moderately expanding economy (which keeps managers/owners from hibernating but also from excessive risk taking) is ideal for leveraged finance.

You'll be hearing in the media about how borrowers are able to get away with looser terms and easier covenants than they have in years. That is true up to a point. However, we believe the risk to be worried about is when the environment becomes so positive that a large number of companies that would previously have not been candidates for leveraged buy-outs are able to attract buyers and debt financing, as occurred in 2006-2007.

We have not witnessed any kind of repetition of the buy-out frenzy that set the stage for the losses that followed when the economy tanked. Although there is a very active financing market going on, most of the activity relates to refinancing existing companies with leveraged debt, rather than new players. Continued uncertainty about the future (listen to CNBC for a dose or watch the budget and sequester debates); company owners waiting for a more robust environment to sell and credit discipline amongst lenders has kept a reckless buy-out boom at bay.

What we have instead is a pressure on yields in certain of the Leveraged Debt segments (who has not heard about the record low rates on High Yield Bonds?) but continued strong credit quality. We should point out that the even the pressure on yields is not equal across the Leveraged Debt industry. Very large, liquid loans that borrowers can enter and exit very quickly are being bid up in the famous "search for yield" that the media like to report on. However, in the middle market (which principally involves BDCs) the smaller, less liquid loans continue to be made at relatively high yields.

PRICE APPRECIATION

Back in 2009, Leveraged Debt asset prices were just recovering from the biggest drop-off in valuation ever. High Yield Bonds and Floating Rate Loans dropped by 40% or more in 2008 (as did most other asset classes), as did BDCs. We believed in October 2009 that Leveraged Debt asset prices would recover, giving the Fund the opportunity to earn distributions and benefit from asset appreciation. At the time many BDCs were still in the process of re-structuring their balance sheets, raising capital and paying down debt. At least half of the BDCs we tracked had liquidity issues, and many had seen their stock prices drop to a fraction of their Net Asset Value due to the fear in the market.

What a difference three and a half years makes! Today, every BDC has all the liquidity they need, huge amounts of equity and debt has been raised. Notably two-thirds of the BDC communities have raised long-term debt capital on excellent terms from both the public market and from the Small Business Investment Corporation. Moreover, as we've discussed portfolios have been turned around and increased in size. The number of players in the industry has increased by one-third. Today, most BDCs are trading at or above their Net Asset Values.

A similar bounce-back has occurred in other forms of Leveraged Debt: High Yield Bonds may have dropped in 2008 but their total return in 2009 was 58% and continued up in every

subsequent year. Floating Rate Loans, which traded at a discount of 30 cents to par value in 2009, finally reverted back to par just a few weeks ago.

Going forward, we do not expect price appreciation to match the performance of the post-Great Recession years, but there will be major differences across the different sectors we invest in. Like everybody else in the financial community we expect very little if any price appreciation from High Yield Bonds. We have only modest expectations for BDC Notes, because of the fixed rate nature of the obligations, and the appreciation already achieved.

BACK TO THE FUTURE: BDC SECTOR TO APPRECIATE

We are more bullish about BDC common stocks, where our calculation of the Realizable Value of the investments we are in shows a 10% upside. Although BDC prices have been on the rise for months, 50% are still priced below the level they reached in February 2011 (just before the European crisis, when markets were optimistic). Moreover, many BDCs have considerable capital yet to spend, which means we expect distributions to increase even as distributions in other forms of dividend paying investments drop. The analyst community is projecting higher earnings in almost every case in 2013 and 2014 over 2012 results.

BDC price multiples, which historically trade in a relatively predictable range, are at relatively high levels, but the Fed induced low rate environment is resulting in some medium term multiple expansion as the sector provides the highest yield of any market segment except the highly leveraged mortgage segment.

Not baked into our assessment but worth mentioning are two potential developments that could push BDC prices even higher than we've calculated. First, the Financial Services Committee of the Congress is considering legislation which would allow BDCs to increase their leverage levels, which would boost earnings and valuations by as much as 20%. Secondly, the government is considering boosting the amount of SBIC debt borrowable by any single borrower to $350mn from $225mn currently, a 55% jump. With SBIC debt bearing a yield under 3.5% currently for 10 year borrowing, this long-term money would be a considerable fillip to the BDC sector, especially as nearly two-thirds of BDCs have accessed or plan to access the program.

OUTLOOK FOR FLOATING RATE LOANS: INSURANCE POLICY AGAINST HIGHER RATES

A special word about the Floating Rate sector: We began to make a major commitment to this sector last year. A little bit before the crowd, we recognized that with LIBOR rates bottoming out at 0.25%, Floating Rate Loan yields could not drop much further (unlike the situation with High Yield Bonds). Moreover, the floating rate nature of the loans makes this sector a good long term investment/hedge on higher interest rates, whether in the short term (which would surprise us), or in the long term (years three or four). Given that Floating Rate Loans are typically made to the largest borrowers and are secured, we see them as one of the safer investments to be made in Leveraged Debt investing, but with the added benefit of potentially providing outsized returns should interest rates rise sharply. (We have calculated that our Floating Rate investments could jump 20-30% in value should interest rates climb back to the levels of 2007).

VOLATILITY

Looking back in 2013 on the assumptions made in 2009 that has caused the Fund to be a success, the one area where we got it wrong was volatility management. Back in 2009-2011, we made the mistake of assuming the Fund could stay fully invested in the most volatile Leveraged Debt investments during market volatility without incurring any lasting damage to our capital. We were prepared to have relatively wide fluctuations in monthly results in return for maintaining stable distribution income, as long as we believed our fundamental assumptions about economic expansion, low interest rates, and steady leveraged debt distributions remained in place.

As we've discussed before, we did not anticipate that BDC common stock prices would drop for six consecutive months and (on average) in excess of 25% even as their fundamental performance improved. Since December 2011, we've addressed that issue by broadening our investment mix to include lower risk-lower volatility-lower return leveraged debt investments including BDC Notes, High Yield Bonds ETFs and Floating Rate Loan ETFs. We have also diversified the number of investments in the portfolio. Back in 2011 we had less than 20 investments in portfolio. Today we have 90 different investments, and no sector accounts for more than 100% of our capital. We're also prepared the portfolio to change from a bullish to a bearish stance by focusing on highly liquid investments that can be sold on short notice if market conditions suddenly deteriorate.

Ironically, though, we do not expect high levels of volatility going forward. Of course, four years is a very long time and we recognize that a "black swan" event could recur. Still, volatility was much lower in 2012 than in 2011, and the trend has continued in 2013. Currently the so-called "fear index" (the VIX) is at a low not seen since 2007. The markets have fluctuated somewhat with events such as the fiscal cliff irresolution, the failure to stop the Sequester and the deadlocked Italian elections. However, thanks to a combination of our portfolio mix, and lower market volatility, the Fund has not had to undertake a major U-turn in months. The last instance was in November 2012 when worries about the fiscal cliff and new tax rates caused a pull back. However the markets and the Funds changed course shortly thereafter and erased all those losses within weeks.

THE BOTTOM LINE

If the offset for lower price appreciation in the years ahead is lower market volatility, we'll be delighted. "Slow and steady wins the race" should be the Fund's motto. Thanks to our use of leverage, the Fund is generating a very high level of income, equal to about 20% of our equity. (We have half of our assets in the higher return-higher volatility investments, and the other half in the far less volatile, marginally lower yielding investments).

Our proprietary database calculates that should every investment in our portfolio reach the Realizable Value we have estimated, the Fund's equity value will increase by a further 20% in total.

In the most simplistic terms, if you assume we can maintain a 20% annual dividend income for the next 4 years and achieve another 20% gain from price appreciation, BDC II's gross gain could reach 100% before fees and expenses. As the calculations show, 80% of that potential and very hypothetical gain would be from the dividends received.

Of course, nobody knows what tomorrow will bring, and certainly not 4 years of tomorrows. Certainly, the Fund has the ability to adapt as circumstances change, as we have demonstrated in our history to date. Capital preservation is very important to us, and we will dial back risk when necessary, and we have many tools to do that. Nonetheless, we are very sanguine about current conditions-neither too hot nor too cold- which should allow the Fund to continue to achieve superior returns even as markets reach new heights. We might even pass the Inception To Date returns achieved by the other indices as we did in 2009-2010.

NEWSLETTER

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

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