Published by
Closed-End Fund Advisors

THE SCOTT LETTER:
CLOSED-END FUND REPORT

Vol. IX, No. 2 | *A Global View of the Closed-End Fund Industry* | March/April 2014

THE SCOTT LETTER is intended to educate global investors about closed-end funds. Closed-end funds can be a valuable and profitable investment tool. To learn about closed-end funds, visit our web site, www.CEFAdvisors.com, and in particular, read our article, What Are Closed-End Funds.

Feel free to forward this newsletter to anyone who you believe could benefit from information on closed-end funds or global portfolios.

– George Cole Scott, Editor-in-Chief

– John Cole Scott, Contributing Author

IN THIS ISSUE:

Prospect Capital: A Diversified and Investment Grade Yield Animal

CEFA's portfolio manager, John Cole Scott, interviewed Grier Eliasek on March 3, 2014 via phone to get a better understanding of his fund, Prospect Capital Corporation (NASDAQ:PSEC), and to learn more about the business development company ("BDC") sector of closed-end funds ("CEFs").

Established by Congress in 1980, BDCs are "closed-end investment companies for the purpose of making capital more readily available to small, developing and financially troubled companies that do not have ready access to the public capital markets or other forms of conventional financing" (Source: U.S. Securities and Exchange Commission, October 2006).

PSEC is the third largest BDC CEF by assets with market capitalization of $3.4 billion and is also the most liquid BDC CEF on a 90-day average trade volume basis with $49.6 million in share liquidity (Source: CEF Universe, CEFA, March 14, 2014).

M. Grier Eliasek

In addition to serving as President and Chief Operating Officer of PSEC and Managing Director of Prospect Capital Management and Prospect Administration, M. Grier Eliasek also serves on PSEC's Board of Directors.

"At Prospect Capital, Eliasek is responsible for leading the Prospect team of professionals in the origination and assessment of investments. Prior to Prospect Capital, Eliasek served as a Managing Director with Prospect Street Ventures, an investment management firm which, together with its predecessors, has invested in excess of $1.5 billion in senior loan, mezzanine, bridge loan, private equity and venture capital structures through publicly traded closed-end funds and private limited partnerships.

"Prior to joining Prospect, Eliasek served as a consultant with Bain & Company, a global strategy consulting firm. At Bain, Eliasek analyzed new lines of businesses, developed market strategies, revamped sales organizations, and improved operational performance (Excerpt: Team, Prospect Capital).

SL: Good morning, Grier. Thank you for spending time with me today to learn more about your Fund and the BDC sector of closed-ended management companies. To start, what are the similarities and differences in a traditional CEF and a BDC CEF? Can you give me a good overview on the structure?

Eliasek: BDCs are required to invest at least 70% of assets in qualified investments, which generally are private U.S. non-financial companies. They are also required to offer managerial assistance to portfolio companies. BDCs can obtain up to 1.0x debt-to-equity, compared to CEFs that are capped at 0.5x debt-to-equity. BDCs file 10-Qs and 10-Ks like typical non-fund stocks. Both BDCs and CEFs are regulated by the Investment Company Act of 1940 with reporting transparency and SEC oversight.

Both BDCs and CEFs are required to distribute at least 90% of their income to shareholders and to meet certain diversity and portfolio control requirements in order to avoid corporate taxation. Because BDCs focus on private companies and can obtain more leverage, BDCs produce typical dividend yields of 8%-12%, which are several hundred basis points above yields offered by CEFs (as well as MLPs, REITs, and utilities).

[**Editors Note:** Traditional equity CEFs are showing an average yield of 6.7%, but those that pay monthly or quarterly dividends are averaging about 8% per year. Taxable bond CEFs average 7.4% and municipal bond CEFs currently average a 6.3% yield (Source: CEF Universe, CEFA, March 14, 2014).]

BDCs have both individual and institutional investors compared to CEFs that tend to be much more individual investor-focused. However, in the eyes of the SEC, BDCs are essentially closed-end funds, which the SEC has made clear with their stance on items like the Acquired Fund Fees and Expenses ("AFFE") issue that caused the S&P and Russell to remove BDCs from their primary equity indices. This index change is a big buying opportunity for investors because of the short-term, downward dislocation in BDC valuations that has occurred.

SL: Could you explain the basic differences between a large U.S. bank and a large lending-based BDC?

Eliasek: Banks are typically leveraged about 10.0x debt-to-equity compared to BDCs at less than 1.0x. Banks obtain leverage by accepting deposits from customers, thereby creating significant regulatory oversight from numerous governmental entities. Banks generally must make loans fully collateralized by assets like receivables and inventory.

BDCs have far more flexibility on how they can invest than banks. For example, leveraged lending guidelines restrict banks to term loans that must amortize at least 50% of principal within five to seven years, which limits the amount of term debt banks can advance to companies. BDCs have no such regulatory restriction, which has resulted in BDCs taking market share away from banks for financings related to acquisitions and recapitalizations. Banks are tax-paying corporations without distribution requirements, while BDCs are non-tax-paying entities with the requirement to pay out at least 90% of income to shareholders.

SL: Why did you IPO Prospect Capital? What was the initial strategy and has it changed over time?

Eliasek: Prospect Capital Corporation went public in 2004, so we are pleased to be celebrating our 10-year anniversary as a public company this year. We launched with less than $100 million of capital that was initially invested in energy and industrial companies and have grown the business to a market capitalization of about $3.4 billion over the past decade.

In the beginning we primarily made loans to and acquired controlling interests in closely held companies. Over the last several years we have expanded the business to include investments in all industries and a variety of origination strategies, including private equity sponsor lending, direct non-sponsor lending, operating buyouts, financial buyouts, structured credit, real estate and syndicated debt investing. We now have over 130 portfolio companies and over $6 billion of funded and revolving capital.

SL: How is your background helpful in managing the portfolio, and how do you organize the 50 or so investment-oriented employees? Also, seeing that your average deal is $46 million, can you talk about having smaller deals as a start to longer term relationships?

Eliasek: I'm the co-founder and President of Prospect Capital Corporation and have worked at Prospect for approximately 15 years. With a B.S. degree in Chemical Engineering from the University of Virginia, an MBA from Harvard Business School, and an earlier career in strategy consulting at Bain & Company, I've been trained to think analytically and scientifically in approaching business and investment problems. We organize our investment team in a matrix fashion by both origination strategy and industry expertise, which gives us flexibility to address a wide variety of investment types.

Deal leads have a plethora of standardized screening memo templates, term sheets and legal documents to draw upon, to ensure consistency and quality. We focus more heavily on quantitative and fact-based memo writing with iterative question-and-answer communications than in-person meetings. Investments must first be approved by the relevant subcommittee and then the overall credit committee which includes the requirement for approximately 20 blue ink signatures.

Deal teams are responsible for the lifecycle of an investment from beginning to end, including working through any issues that might emerge. This creates a powerful incentive to avoid making credit mistakes on the front-end.

On the deal size question, Progrexion is a good example of one of our portfolio companies. As of December 2013, we had approximately $300 million invested in that company. Progrexion started as a smaller deal (about $35 million) several years ago, and the company has grown like a rocket ship, with the possibility of a future IPO. The firm is owned by a private equity firm that we've done lots of repeat business with, making this investment an efficient place for us to spend time.

There's often an exception to every rule, but below a $10 million deal size we start saying, "Gosh, that is awfully small," especially with agent-based deals where we're the ones that put out the term sheets, negotiate the documents, lead the diligence, etc. You will see us occasionally do smaller deals in the syndicated or club lender markets. Those deals can generally be a little more time efficient because much of the information we're seeking has often been previously assembled.

Our deal sizes are increasing, and we win a significant amount of business because of scale. For smaller deals, one can attend a lender meeting, and there might be 20 competing lenders who can write such smaller checks for these deals. By comparison, for a $200-$300 million dollar deal, I can probably count on one hand the number of firms that can hold such capital in one spot, and PSEC is one of those few companies.

SL: What do you like about the BDC CEF structure to carry out your work in the portfolio?

Eliasek: The permanent capital nature of the BDC structure gives us a long-term perspective when investing, compared to a private partnership that must exit each investment within a few years. Our portfolio company CEOs like that we can hold our control investments potentially forever, which makes that part of our business similar to Berkshire Hathaway.

PSEC is one of the few BDCs with an investment grade rating, which gives us access to diversified credit markets. This prudent leverage allows us to provide efficient financing to our counterparties, which unlevered partnerships would not be able to match.

Our transparency and liquidity as a public stock have allowed us to scale the business over the past decade, thereby providing us with a scaled balance sheet that can deploy capital in increasingly larger situations with a wide variety of origination strategy approaches. Investors can take a sizeable position in PSEC relatively quickly versus the vast bulk of closed-end funds that are highly illiquid.

SL: How would you classify the Fund's management style? What changes, if any, have you made to the Fund in the past year?

Eliasek: Our style is a multi-line, diversified strategy that focuses on (1) preserving capital, (2) providing double-digit current yields and (3) delivering capital gains as icing on the cake.

We're really a "yield animal," and our approximate 12% dividend yield reflects success in originating and closing attractively yielding investments. We've delivered those results with sterling credit quality, given that no loans in our book originated in over six years have gone on non-accrual.

Our objective has not changed in the past year, but we have continued to expand our multi-line approach to include other origination strategies, such as multi-family real estate acquisitions through our private REIT portfolio companies.

SL: Where do you spend the most money? Where do you spend the least that might surprise you? You're a large company with a large revenue stream. Has that always been the case?

Eliasek: Beyond our investments, we spend a significant amount of money recruiting and retaining one of the best teams in the industry. We have approximately 100 professionals, making us the largest dedicated middle-market team in the industry. This is important because we need a lot of bodies to screen through more than 4,000 investment opportunities per annum to select the 1%-2% percent that make it into our portfolio.

Our team includes significant staffing of internal tax professionals, lawyers and CPAs, which help create competitive advantages in our responsiveness and capabilities. We don't spend a lot of money on fancy offices and other corporate waste. Our philosophy is an old-fashioned value orientation in which we view "a penny saved is a penny earned." We abhor waste as a team and organization and are focused on maximizing return for our shareholders.

SL: How do you define "unencumbered assets" in your portfolio?

Eliasek: Our unencumbered assets are about 80% of our portfolio. This means that of our more than $5 billion of funded assets, we only obtain secured financing on just over $1 billion of those assets. This liability approach is a significant differentiator and risk reduction aspect of our business. Our secured facility with 23 banks resides in a special purpose vehicle structure, and those banks cannot go after the other $4 billion of assets on our balance sheet should we experience a problem.

We use unsecured term debt with no financial covenants and no cross defaults with the revolver for the bulk of our financing. This reduces risk for our shareholders. We keep our powder dry in our revolver so that we can go on offense during dislocation and recessionary periods, when other players lack capital. For example, we completed the first acquisition of another BDC back in 2009 when we bought Patriot Capital for 50 cents on the dollar, and we've reaped realized unlevered IRRs in excess of 40% from that portfolio acquisition.

SL: In what types of companies, sectors or regions do you prefer to invest?

Eliasek: We don't tend to redline particular industries. We adjust the capital structure for cyclicality, growth stage and performance. Capital structure selection is just as important as company selection in how we underwrite deals. If we stick to the mantra of "thou shalt not over-lever nor overpay," then we'll do just fine. We prefer to invest in businesses with recurring revenues, barriers to entry and stable management that co-invests to align incentives. We invest throughout the middle market, which we define as companies with $5-$100 million earnings before interest, taxes, depreciation and amortization ("EBITDA").

SL: Are there any other investments that are similar to BDC CEFs?

Eliasek: BDCs sometimes get compared to other dividend-paying vehicles, including CEFs, MLPs, property REITs, and mortgage REITs. BDCs offer higher yields than all of these, except mortgage REITs, with far less macro interest-rate risk than mortgage REITs. Unlike REITs, BDCs have leverage restrictions to protect investors and lenders.

SL: What are the best indices to track your Fund's relative performance?

Eliasek: Wells Fargo has a BDC index. Over the past several years, we've outperformed that index as well as many equity indices, including the S&P 500 and multiple financial indices. Despite that outperformance, we're still an undervalued company. If our company were to trade in-line over the next year with the industry average on a forward consensus earnings multiple basis, that snapback plus our dividend would result in a more than 60% return, creating an attractive entry point for investors at the current price.

SL: How have BDCs performed as an industry?

Eliasek: Over the past five years, the BDC index has delivered a 213% total return compared to 138% for investment grade bonds, 135% for high yield bonds, 128% for the S&P 500 index, 117% for equity REITs, 96% for leveraged loans and 75% for the S&P 500 Financial index. As a group, BDCs have also outperformed the S&P 500 on a current yield and total return basis since the first publicly traded BDC completed its IPO in 1960.

SL: Please explain the differences in the seven yield-oriented origination strategies. What is your outlook for impact of each on the portfolio? Where are you seeing the most attractive deals and what drove you into real estate?

Eliasek: Sponsor financing (about 45%) is our largest segment. This business involves lending money to companies owned by third party private equity funds. Direct lending, i.e., lending money to closely held companies, is about 10% of our business. We originate many of our direct loans, as well as our control deals, through proprietary deal sourcing through our call center. There are fewer competitors in this segment, and we can often capture higher returns with less risk.

Buyouts are another 15% of our assets and include both operating and financial buyouts as additional strategies. Two of our operating buyouts are Gas Solutions and NRG, where we reaped 50%+ IRRs monetizations.

With financial buyouts, we achieve significant tax efficiency because we can hold these companies as partnerships with no taxes paid downstairs or upstairs, resulting in 20%+ yields out of that segment. Structured credit is another 15% of our assets. We purchase control stakes in the equity tranche of new issue collateralized loan obligations ("CLOs"), working with top tier collateral managers and enjoying 15%+ yields. Real estate, our newest vertical investment, is about 5% of our assets which has a focus on multi-family properties with tenant diversity and rent growth prospects. Finally, syndicated debt investing is about 10% of our assets. This is where we pursue opportunistic anchor investing in the syndicated markets. Since we have so many choices in where we invest across these origination strategies, we can afford to be disciplined with how we deploy capital.

Multi-family real estate has so far been the best fit for our capital because of tenant diversity. If, in buying these properties, one can purchase stabilized yields, acquire attractive locations and obtain long-dated financing, one can achieve a double-digit yield out of the box. We've observed that public apartment REITs tend to focus on new development assets. As investors, we don't care if a property is brand-spanking new – we just want to earn a good return, although we do like to see additional upside through a renovation program that results in rent bumps.

Our real estate investing has tended to focus on the Southeast because that's where population growth is occurring in our country. We also like having some equity upside in our portfolio. Real estate is one example of this upside, and our operating and financial buyouts are other examples.

While we've been deploying capital across all of our strategies, of late we've been particularly active with our control strategies. We have a number of operating buyouts in our advanced pipeline right now. On the financial buyout front, we've announced that we are acquiring a publicly traded auto finance company called Nicholas Financial.

Our CLO business continues to be quite active. We like our buyout and CLO businesses because we can earn greater returns with greater barriers to entry with those deals compared to our straight lending businesses. Our financial buyout book is yielding 20%-30%, and our CLO business is yielding 15%-20%. These are very attractive yields in this yield-starved market.

SL: How does the current Federal Reserve policy of tapering impact the portfolio? As we've discussed, a good part of what you have is floating assets, and your liabilities are all fixed. Are you looking forward to a rise in rates?

Eliasek: Our business has 91% floating rate assets and nearly 100% fixed rate liabilities, so we expect to benefit from rising interest rates in the future. When rates move, it might be a surprising and sharply upward event. History has shown this time and time again. We're ready for that possibility, and we've modeled out a 500 basis point move in the LIBOR. You can see the positive earnings impact of such increase in our corporate presentation on our website. Many investors have piled into floating rate CEFs, but those yields are going down as more money goes into that liquid market. BDCs lend to the private markets with higher barriers to entry than the liquid syndicated markets.

SL: What is your approach on keeping the portfolio diversified but not over-diversified? What is considered "too many positions" for a fund of your focus and size?

Eliasek: We like diversity and view it as a significant risk reduction for our business. If we should ever experience a credit issue with one position, we prefer that position to be a small percentage of our portfolio.

Excess concentration and over-leverage are two big risks for lending platforms, and we are mindful of each by having more than 130 portfolio companies and a prudent debt-to-equity level. We do need to hire additional professionals as we grow our number of portfolio companies, but our scientific systems and processes scale well.

During the last cycle, we and the vast bulk of other BDCs were quite concentrated with a small number of lender relationships. Going into the last recession, we had one lender that held all of our debt. When we applied the same lens from company underwriting to our own business, we said, "Wow, we're not very diversified with our lending relationships."

A business benefits from diversified suppliers, and capital is our supply. Today we have 23 banks in our credit facility, and we sleep very well at night knowing that if one bank needs to drop from our revolving credit facility, we can replace it without a problem. As a major differentiator for our business, the only secured debt we use is this revolving facility, which only encumbers 20% of our assets. If we ever have a problem with our secured funding, the banks can only grab that 20% and not touch the other 80%. This benefits our bondholders and shareholders.

SL: What is one item advisers and investors always seem to misunderstand about your Fund or BDCs?

Eliasek: The biggest misconception people have is that our 12% dividend yield means we are somehow riskier than other BDCs with 8%-10% dividend yields. Our credit track record has been sterling, with a low non-accrual rate over our company's history. We've more than covered our dividend, with excess income available for future distributions.

Compared to mortgage REITs, we're not sitting here making beta macro bets on interest rates and other factors completely outside of our company's control. We can and do control our own underwriting on a bottoms-up basis.

SL: Please put the Fund's use of leverage into perspective and how it has changed over time. Do I understand the reports correctly that you have about 50% leverage? If so, give us a breakdown of the types of leverage you employ.

Eliasek: Our debt-to-equity level has been in the approximate 0.5x range for several quarters now, which is a level similar to other BDCs. We have more diversified access to financing than any other BDC. We have raised financing through our 23-bank secured revolver, convertible bonds, institutional bonds, traded baby bonds and weekly program notes.

As previously discussed, all of our term debt is unsecured with no financial covenants. We run a matched book where our 5-year assets are matched by similar maturity liabilities, and a significant portion of our debt is callable, giving us the ability to prepay such debt without penalty.

Due to our scale, diversity, longevity and track record, we are one of the only BDCs with an investment grade rating, which is BBB on an unsecured basis and Aa3 on a secured basis. These favorable ratings allow us to access multiple debt capital markets in an efficient manner. With favorable feedback from rating agencies, we're exploring an increase in our debt-to-equity from 0.5x to 0.75x, which is still a low leverage figure and allows us to drive accretive earnings growth for our shareholders.

SL: How does the board of directors set dividend policy, and what is your input on this?

Eliasek: Our Board declares dividends each quarter around the time of our earnings release. The Board consists of a majority of independent directors as well as two management directors (which includes me). We switched from quarterly to monthly dividends several years ago and received strong, positive investor feedback from that change.

We also have been declaring forward dividends several months into the future to increase confidence in the recurring nature of our dividends. We've declared forward our dividends through September 2014. We do like signaling to investors that our objective is to increase the dividend over time. This is not set policy and, of course, the future is uncertain, but we have a strong track record with our historical dividends, which have been more than covered by our net investment income since inception.

SL: What drove the large dividend increase in 2012?

Eliasek: We had a couple of significant controlled portfolio company exits in 2012, including Gas Solutions and NRG Manufacturing. We made 6x-8x our money on each of these investments, driving our earnings and boosting the dividend by 8% at the end of 2012.

SL: Looks like your 2013 average deal size was $50 million with a range of $2-$200 million. How can you make any real returns on deals under $25 million in size?

Eliasek: Attractive returns can be found with both smaller transaction sizes as well as larger ones. In many cases, we start with a smaller investment and then provide add-on capital to such companies as they make additional acquisitions or require capital for growth.

SL: Give us a quick overview on earnings per share, price-to-earnings ratios and price-to-book ratios for the Fund and BDCs in general.

Eliasek: Our stock has traded in recent months at a slight premium to net asset value, but this is not unusual because we've traded at a premium-to-book for most of our 10-year history as a public company.

We and other BDCs tend to trade between 1.0x and 1.1x book, with the opportunity for multiple expansions beyond that based on performance. Our stock trades at about 9x forward earnings compared to about 11x for the BDC market in general. Our net investment income per share has generally been in the range of our dividends of $0.33/share per quarter.

SL: What is the biggest strength of your board of directors? How have you used them to help fuel the company's growth? Is there a situation where the board solved a problem that in hindsight you go, "Gosh, that almost took us out, but we handled it well?"

Eliasek: We have a world class board with accomplished independent directors. I saw that you interviewed our Audit Committee Chairman and valuation expert, Eugene Stark, as part of his CFO responsibilities at General American. Bill Gremp has significant financial expertise due to a career in corporate finance, and Andy Cooper has been a serial entrepreneur with significant operational contacts and ideas to help the portfolio.

When our company went public in 2004, we focused exclusively on energy and industrial businesses, where we made a number of strong performing investments. Heading into 2007 with the economy roaring along, there was a credit bubble and a related commodity bubble (natural gas). As true believers of value investing, we said, "This is not sustainable." We adjusted our risk and changed the name of the company from Prospect Energy to Prospect Capital. If we had continued doing what we were doing, we probably would not have had a horrible result because of our focus on debt more than equity, but positions declined in value as natural gas prices subsided. That decision to diversify was a momentous one in our company's history.

SL: Please help us understand how the Fund monitors its net investment income ("NII") and portfolio company value over time.

Eliasek: We produce net investment income primarily through interest on loans, structuring fees, prepayment premiums and equity dividends from our portfolio. Increasing NII while preserving capital is the most important focus of our investment team. All of our portfolio investments are Level 3 assets because they are illiquid, so our Board hires a third party, independent valuation firm to fairly value all of our investments each quarter. These valuations are approved by the independent directors on our Audit Committee, and those numbers go into our financial statements each quarter.

SL: As portfolio manager, how do you balance the need for NAV performance with payments of dividends to shareholders? How about income versus total return growth?

Eliasek: Because our investments are in private, illiquid companies, we are far more concerned with net investment income than unrealized quarterly mark-to-market valuation changes.

Cash is king, so our desire is to drive recurring cashflow out of our portfolio so we can service and increase our dividends to our shareholders. We are happy to achieve capital gains and NAV growth as icing on the cake beyond our dividend, and our controlled portfolio grants us equity upside too, ... BUT the dividend is the largest and most important component of our return.

SL: With CEFs known for yield, how do you compete against other BDC funds? What type of environment would lead you to a more capital appreciation focus versus income payouts?

Eliasek: Our scale is an enormous competitive advantage. While there are approximately 40 listed BDCs with a combined market cap of about $30 billion, the handful with a market cap above $1 billion comprise two-thirds of the industry. We can hold larger deal sizes, pursue controlled buyouts and evaluate many different opportunities across our multi-line origination approach.

SL: Why do you make changes in the portfolio, portfolio companies, allocation or sector changes?

Eliasek: We do not set top-down targets on our asset mix. Instead, we let every opportunity stand alone in a bottoms-up fashion. The diversity you see in our business is a natural diversity that has arisen from evaluating thousands of deals each year and letting the best ones fight for space on our shelf.

We have over 130 portfolio companies with no one industry representing more than 5%-10% of our total assets. This allows us to sleep well at night and not worry about excess industry concentration.

SL: Please talk about private REITs and how you use them to benefit shareholders.

Eliasek: We own multiple private REITs as a tax-advantaged way for us to invest in real estate. Our focus has been on multi-family, garden style properties in southeastern suburbs with barriers to entry for new development.

We've found compelling values with A-/B+ properties that are 10-20 years old with upside through a capital improvement program that results in rent increases. We work with multiple property managers and want to grow this business. Real estate represents about 5% of our portfolio today.

SL: Have there been defaults in the portfolio? How do you model the risk/reward?

Eliasek: Our non-accrual rate, which means a company has been in payment default for at least 60 days, stands on a cumulative basis at only 0.3%. While that rate is low, we are staffed up and prepared to roll up our sleeves to work through potential issues in the portfolio. Because we have equity upside through our buyouts and real estate, we believe we can more than offset potential loan losses with capital gains elsewhere in the portfolio.

SL: Is a $3.5 billion portfolio too big to keep growing the company?

Eliasek: We do not set growth targets for our company and view such targets as potentially unhealthy forces. We're in a credit business and only want to do deals that meet our risk/reward requirements.

We have experienced significant growth because of our success in driving originations through proactive outreach. We have approximately 100 people with offices in New York, Chicago, Houston, San Francisco and Westport, making us the largest middle market origination team in the industry.

SL: Define for us what a "non-accrual" would look like. We recall Allied Capital having low non-accruals and still blowing up. What has changed since then?

Eliasek: A non-accrual means a loan that has not met its debt service requirements for 60 days. Allied Capital failed its investors by over-leveraging its balance sheet and tripping its financial covenants. Remember that we keep our leverage modest and issue term debt with no financial covenants. We view today's BDCs as more responsible stewards of capital than historical companies like Allied. Long-term loss rates on BDC assets have averaged only 0.5% per year, compared to 2.5% for banks.

SL: What is next for PSEC?

Eliasek: In 2014, look for more of the same from us in terms of closing profitable originations. We are studying a prudent increase in our leverage to drive accretive earnings growth while still maintaining a healthy cushion versus our regulatory limit of 1.0x debt-to-equity. We also may sell some of our controlled investments due to the robustness of the M&A market, if we can fetch attractive prices for those assets.

SL: How often do you update investors on the Fund's financials and holdings? What is your investor relations/public relations strategy? How have you set your future plans to interact with more financial advisors or individual investors versus institutions or family offices?

Eliasek: We file our 10-Qs, 10-Ks and earnings release on a quarterly basis as well as hold a quarterly earnings call. Our next cycle (associated with the March 2014 quarter) for this will occur in early May. We have increased our investor relations and public relations outreach, including appearances at conferences and speaking to journalists, because so many investors have never heard of our $3.5 billion market cap company that is yielding 12%. We want to change that and to see our stock price go up. We've also doubled the number of research analysts that cover our stock in the past year, and our institutional ownership has been increasing.

We're about six months into a more intense effort to enhance understanding and education. We've also been hosting a series of introductory webinars that offer 20-minute overview presentations about our company and invite questions. We've also hired a group called Four Woods to educate the financial advisor community about our company.

Many of our investors are "smart money" financial advisors and individuals. Many of them are self-directed and have found us through screens and word-of-mouth. Nearly 50% of our stock is owned by self-directed high net worth individuals at discount brokerage firms. Other investors include wirehouses, regionals, independents and institutional accounts.

A significant amount of this smart money finds us, and I consider your investors to be smart money too, John. Hopefully they'll find us too.

SL: Thank you. As you know, this interview is part of our due diligence process for our clients, and we are breaking into the BDC world this year. This interview is proving very helpful to our process. When looking over the tax treatments of dividends, 96% was non-qualified in 2013, but in 2012 it was much lower at 43%. What trends impact this component of your yield and after-tax return to investors?

Eliasek: The biggest driver of our tax treatment is the amount of our revenue that comes from equity dividends from C-corporations. In 2012, we experienced such significant dividends due to our sale of Gas Solutions, which boosted our qualified dividend mix. Investors should expect a majority of non-qualified income in a typical year.

SL: Talk about why you brought out the convertible bonds, senior loans and baby bonds.

Eliasek: We were the first BDC to issue many of these term debt products. Before we pioneered such usage, the industry was relegated to just obtaining financing from the bank market, typically in a concentrated fashion. We didn't like the risk profile that secured bank debt represented, so we created new debt capital markets, and today we enjoy more access to diversified debt markets than any other BDC. This reduces our risk and allows us to cherry-pick the optimal places to issue.

On a daily basis, we examine the costs and terms of issuing in each market. In 2014 you'll likely see us interested in a shorter term institutional bond as a potential place to issue, as more investor interest and liquidity come to that format.

SL: Do you see any conflicts of interest with PSEC being externally managed? It seems to add higher cost to shareholders.

Eliasek: Our interests are aligned with our investors because we managers have made significant cash equity investments into PSEC stock along with other shareholders. Every employee at PSEC is also a shareholder. The external structure has a profit-sharing component that provides significant motivation for our team to produce increased net investment income and total return results. In our war for talent on the recruiting front, we typically compete with hedge funds and private equity funds for the best people, so having an external structure is important for that reason too.

SL: How have you been able to accomplish a successful track record?

Eliasek: One reason is a careful credit culture. We're now going on more than six years without originating a deal in our book that has gone on non-accrual. We're very proud of the long list of firsts we've achieved in the industry, including the first BDC acquisition, the first convertible bond, the first institutional bond, the first and only weekly bond program, the first tax-efficient financial buyout, the first ATM program, the first call center, etc.

SL: Tell us how you acquired Patriot Capital.

Eliasek: We got to know Patriot about a year before the deal was announced. We didn't know the company beforehand, but we saw that the business was having some issues. After I met Rich Buckanavage, CEO of Patriot, I noticed their capitalization was quite risky. Patriot was using a 1-year revolver with significant lender concentration to finance 5-year illiquid private middle market loans, which is another way of saying the bank decides what happens to them every year.

I remember talking to Patriot in the fall of 2008, about a bank facility being due in March 2009. I said to the company, "Well, what are you guys going to do if the bank doesn't extend? What is your plan B?" Patriot had no plan B. When the revolver was pulled, for which Patriot had many months of advanced notice, Patriot panicked and hired an investment bank to sell the company.

We had already done a significant amount of work to understand Patriot's business. When Patriot ran a competitive auction, we had a huge head start over others. We were able to come in, become the plan B and buy that business for around 50¢ on the dollar. As of today (March 3, 2014), we have reaped from the Patriot deal more than 40% unlevered returns that have been nearly fully realized.

SL: As you talk about the many unique things that you've done as a company, one that strikes me is your call center. When was that built and has it really been as successful as I sense from this conversation?

Eliasek: We began building our call center about 18 months ago, and we developed it because we recognized there is a significant premium on originations in this business. Companies do best when they go out and source their own flow, resulting in a large array of opportunities from which to select. We see more than 4,000 opportunities per annum. This is a needle in a haystack business, and one must see excellent quantity in order to find excellent quality.

A small percentage of private equity firms use call centers to source deals. To my knowledge, no one before us has ever employed a call center in the BDC industry. We have a dozen professionals in our call center who make hundreds of calls per week focused on 4,000+ smaller intermediaries in our database. Our call center also calls companies directly, often where there is a pre-existing industry thesis.

For example, recently I asked our team to provide to our call center specific subsector industry ideas where we think it would be interesting to look at more deal flow. When the call center identifies an actionable opportunity, that's when the call center waves in an investment professional, sort of like someone fishing might ask for help to land a big catch into the boat. Our deal teams get involved to assess if the opportunity is a good deal or not. We've closed multiple deals from these efforts, and we expect to have more such activity in the future.

SL: Grier, thank you for your time. I have learned much about your business and the BDC structure and expect our readers will be able to understand your Fund better going forward. We suggest people visit www.prospectstreet.com to learn more about the Fund or watch one of your many investment presentations. ■

Disclosure: Clients and employees of CEFA as well as its family members did not own shares of PSEC at the time of this interview or publication. We will wait three business days after publication before making any purchases in the position.

Portfolio Managers' Review

BDCs came on the investment scene in 1980. They are structured like CEF's, but they do not invest in securities. Instead they make high yield loans to small, sometimes struggling companies. We asked General American Investors CFO and PSEC Board member Eugene Stark to describe the differences between old-line CEF's and the new BDCs.

Stark said, "BDC's are a unique subset of closed-end funds created by Congress in 1980 to provide capital to smaller, non-public companies. By regulation, the preponderance of BDC investments are oriented toward private loans and equity. BDCs are also allowed to leverage their assets to a greater extent than typical closed-end funds. Asset coverage of only 200% is required for a BDC versus 300% asset coverage in a single class of debt for a closed-end."

Stark also said, "BDCs can provide smaller companies additional access to capital and provide investors with access to an asset class generally unavailable through typical closed-end funds, albeit with a sometimes higher risk-return profile than that offered by the typical investment grade, income-producing CEF."

As of March 21, 2014, there were 595 traditional closed-end funds totaling $260 billion in net assets and 47 BDC CEFs with $30.6 billion in market capitalization. CEFA has recently added coverage of BDCs to its Daily CEF News and CEF Universe systems.

CEFA expects to invest in BDCs over time. We are also utilizing our extensive and sensitive data on municipal bond CEFs to launch National, New York and California Municipal portfolio models. The replay of a webinar we conducted on the municipal sector and our models may be found on our blog (www.CEF-Blog.com).

Equity discounts have narrowed to -7.8% on average, and average bond discounts have been rather stable at -6.0%. CEF yields have been trending higher for U.S. and non-U.S. equity funds, while trending lower for specialty equity funds. On average, taxable bond CEFs yield is 7.4%; national muni bond funds, 6.4% and equity CEFs, 7.9%. The average BDC yields 9.3% (Source: CEF Universe, CEFA, March 21, 2014).

Most municipal bond CEFs show good fundamentals and earnings coverage as well as relative UNII balances. Now that investors are about to pay their 2013 tax bills, we think more high income earners will shift assets to the municipal bond sector. This, in addition to stronger revenue from many state and local governments, is a positive for municipals. The muni CEF sector has the highest exposure to duration sensitive bonds. Investors should consider this risk before purchasing these funds.

We believe investors need to be careful in choosing taxable bond CEFs, as there has been a recent flurry of dividend cuts across a few of the subsectors. Taxable bond CEFs are, however, the only major CEF group to show a significant increase in return of capital over the past nine months. The subsectors we like best in this area are loan participation funds, high yield funds and convertible funds.

We also like equity U.S.-focused funds with modest dividend policies and discounts wider than -10%. The foreign fund sectors are starting to perform better. There is a good chance that the non-U.S. equity CEFs will outperform U.S. equities in 2014. Additional equity subsectors that we favor includes MLP funds, REIT funds and covered call/option funds. ■

George Cole Scott

George Cole Scott
Founder and Editor-in-Chief
Senior Portfolio Manager

John Cole Scott
Contributing Author
Portfolio Manager

Leslie Jane Daniels
Copy Editor

Mamie Woo McNeal
Production Editor

The Scott Letter Online
is published by

Closed-End Fund Advisors
Global Investment Counsel
7204 Glen Forest Avenue, Suite 105
Richmond, Virginia 23226
(804) 288-2482
www.CEFAdvisors.com