

MONROE CAPITAL Corp  
Form 10-K  
March 05, 2019

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**FORM 10-K**

**(Mark One)**

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the fiscal year ended December 31, 2018**

**OR**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**Commission file number: 814-00866**

**MONROE CAPITAL CORPORATION**

**(Exact Name of Registrant as Specified in its Charter)**

**Maryland** **27-4895840**  
**(State or Other Jurisdiction of (I.R.S. Employer**  
**Incorporation or Organization) Identification No.)**

**311 South Wacker Drive, Suite 6400** **60606**  
**Chicago, Illinois**  
**(Address of Principal Executive Office) (Zip Code)**

**(312) 258-8300**

**(Registrant's Telephone Number, Including Area Code)**

**Securities registered pursuant to Section 12(b) of the Act:**

<b>Title of Each Class</b>	<b>Name of Each Exchange on Which Registered</b>
<b>Common Stock, par value \$0.001 per share</b>	<b>The Nasdaq Global Select Market</b>
<b>5.75% Notes due 2023</b>	<b>The Nasdaq Global Select Market</b>

**Securities registered pursuant to Section 12(g) of the Act: None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.  
Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes  No

Edgar Filing: MONROE CAPITAL Corp - Form 10-K

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.  x

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer       Accelerated filer                       x  
Non-accelerated filer       "Smaller reporting company"        
Emerging growth company     

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.     

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes  No  x

The aggregate market value of outstanding common stock held by non-affiliates of the registrant was \$267.7 million based on the number of shares held by non-affiliates of the registrant as of June 29, 2018, which is the last business day of the registrant's most recently completed second fiscal quarter.

As of March 4, 2019, the registrant had 20,444,564 shares of common stock, \$0.001 par value, outstanding.

### **Documents Incorporated by Reference**

Portions of the registrant's definitive proxy statement to be filed with the Securities and Exchange Commission pursuant to Regulation 14A relating to the registrant's 2019 Annual Meeting of Stockholders, to be filed with the Securities and Exchange Commission within 120 days following the end of the Company's fiscal year, are incorporated by reference in Part III of this Annual Report on Form 10-K as indicated herein.



**TABLE OF CONTENTS**

	<b>PAGE</b>
<u>PART I</u>	<u>1</u>
<u>Item 1. Business</u>	<u>1</u>
<u>Item 1A. Risk Factors</u>	<u>24</u>
<u>Item 1B. Unresolved Staff Comments</u>	<u>45</u>
<u>Item 2. Properties</u>	<u>45</u>
<u>Item 3. Legal Proceedings</u>	<u>45</u>
<u>Item 4. Mine Safety Disclosures</u>	<u>45</u>
<u>PART II</u>	<u>46</u>
<u>Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	<u>46</u>
<u>Item 6. Selected Consolidated Financial Data</u>	<u>47</u>
<u>Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>49</u>
<u>Item 7A. Quantitative and Qualitative Disclosures About Market Risk</u>	<u>68</u>
<u>Item 8. Consolidated Financial Statements and Supplementary Data</u>	<u>69</u>
<u>Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	<u>69</u>
<u>Item 9A. Controls and Procedures</u>	<u>69</u>
<u>Item 9B. Other Information</u>	<u>69</u>
<u>PART III</u>	<u>70</u>
<u>Item 10. Directors, Executive Officers and Corporate Governance</u>	<u>70</u>
<u>Item 11. Executive Compensation</u>	<u>70</u>
<u>Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	<u>70</u>
<u>Item 13. Certain Relationships and Related Transactions, and Director Independence</u>	<u>70</u>
<u>Item 14. Principal Accountant Fees and Services</u>	<u>70</u>
<u>PART IV</u>	<u>71</u>
<u>Item 15. Exhibits and Consolidated Financial Statement Schedules</u>	<u>71</u>
<u>Item 16. Form 10-K Summary</u>	<u>73</u>
<u>Signatures</u>	<u>74</u>

## CERTAIN DEFINITIONS

Except as otherwise specified in this Annual Report on Form 10-K (“Annual Report”), the terms:

• “we,” “us,” “our” and the “Company” refer to Monroe Capital Corporation, a Maryland corporation, and its consolidated subsidiaries;

• MC Advisors refers to Monroe Capital BDC Advisors, LLC, our investment adviser and a Delaware limited liability company;

• MC Management refers to Monroe Capital Management Advisors, LLC, our administrator and a Delaware limited liability company;

• Monroe Capital refers to Monroe Capital LLC, a Delaware limited liability company, and its subsidiaries and affiliates; and

• SLF refers to MRCC Senior Loan Fund I, LLC, an unconsolidated Delaware limited liability company, in which we co-invest with NLV Financial Corporation (“NLV”) primarily in senior secured loans.

## FORWARD-LOOKING STATEMENTS

This Annual Report contains statements that constitute forward-looking statements which are subject to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Statements that are not historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Some of the statements in this Annual Report constitute forward-looking statements because they relate to future events or our future performance or future financial condition. These forward-looking statements are not historical facts, but rather are based on current expectations, estimates and projections about our company, our industry, our beliefs and our assumptions. The forward-looking statements contained in this Annual Report involve risks and uncertainties, including statements as to:

- our future operating results;
- our business prospects and the prospects of our portfolio companies;
- the dependence of our future success on the general economy and its impact on the industries in which we invest;
- the impact of a protracted decline in the liquidity of credit markets on our business;
- the impact of increased competition;
- the impact of fluctuations in interest rates on our business and our portfolio companies;
- our contractual arrangements and relationships with third parties;
- the valuation of our investments in portfolio companies, particularly those having no liquid trading market;
- actual and potential conflicts of interest with MC Advisors, MC Management and other affiliates of Monroe Capital;
- the ability of our portfolio companies to achieve their objectives;
- the use of borrowed money to finance a portion of our investments;

- the adequacy of our financing sources and working capital;
- the timing of cash flows, if any, from the operations of our portfolio companies;
- the ability of MC Advisors to locate suitable investments for us and to monitor and administer our investments;
- the ability of MC Advisors or its affiliates to attract and retain highly talented professionals;
- our ability to qualify and maintain our qualification as a RIC and as a business development company; and
- the impact of future legislation and regulation on our business and our portfolio companies.

We use words such as “anticipates,” “believes,” “expects,” “intends,” “seeks,” “plans,” “estimates,” “targets” and similar expressions to identify forward-looking statements. The forward-looking statements contained in this Annual Report involve risks and uncertainties. Our actual results could differ materially from those implied or expressed in the forward-looking statements for any reason, including the factors set forth in “Part I — Item 1A. Risk Factors” in this Annual Report.

Although we believe that the assumptions on which these forward-looking statements are based are reasonable, any of those assumptions could prove to be inaccurate, and as a result, the forward-looking statements based on those assumptions also could be inaccurate. Important assumptions include our ability to originate new loans and investments, certain margins and levels of profitability and the availability of additional capital. In light of these and other uncertainties, the inclusion of a projection or forward-looking statement in this Annual Report should not be regarded as a representation by us that our plans and objectives will be achieved.

We have based the forward-looking statements included in this Annual Report on information available to us on the date of this Annual Report, and we assume no obligation to update any such forward-looking statements. Although we undertake no obligation to revise or update any forward-looking statements in this Annual Report, whether as a result of new information, future events or otherwise, you are advised to consult any additional disclosures that we may make directly to you or through reports that we in the future may file with the Securities and Exchange Commission (the “SEC”), including annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K.



## **PART I**

### **ITEM 1. BUSINESS**

#### **FORMATION OF OUR COMPANY**

We are a Maryland corporation, formed February 9, 2011, for the purpose of purchasing an initial portfolio of loans from two funds managed by Monroe Capital, raising capital in our initial public offering, which was completed in October 2012 (the “Initial Public Offering”), and thereafter operating as an externally managed business development company (“BDC”) under the Investment Company Act of 1940 (the “1940 Act”), as amended. We are a closed-end, non-diversified investment company that has elected to be treated as a BDC under the 1940 Act. In addition, for tax purposes we have elected to be treated as a regulated investment company (“RIC”) under the U.S. Internal Revenue Code of 1986, as amended (the “Code”), commencing with our taxable year ended December 31, 2012.

Prior to the closing of the Initial Public Offering, we purchased our initial portfolio of loans for \$67.5 million from two funds managed by Monroe Capital, which was comprised of 16 loans that were either senior secured debt, junior secured debt or unitranche secured debt (a combination of senior secured debt and junior secured debt under the same facility) obligations of companies that we believe provided us with a sound foundation for our business. Our board of directors (the “Board”) determined the purchase price for our initial portfolio based on the aggregate fair value of the assets in the initial portfolio and the disinterested members of our Board approved the transaction as being fair to us.

#### *Public Offerings of Common Stock*

The Initial Public Offering consisted of the sale of 5,750,000 shares of our common stock at a price of \$15.00 per share, resulting in net proceeds to us, net of underwriting discounts and commissions, of approximately \$84.6 million. On July 22, 2013, we completed a public offering of an additional 4,000,000 shares of our common stock at a price of \$14.05 per share. On August 20, 2013, we also sold an additional 225,000 shares of our common stock at a price of \$14.05 per share pursuant to the underwriters’ partial exercise of the over-allotment option. These issuances during the year ended December 31, 2013 provided us with proceeds, net of offering and underwriting costs, of \$56.0 million.

On April 20, 2015, we closed a public offering of 2,450,000 shares of our common stock at a public offering price of \$14.85 per share, raising approximately \$36.4 million in gross proceeds. On May 18, 2015, we completed the sale of an additional 367,500 shares of our common stock, at a public offering price of \$14.85 per share, raising approximately \$5.5 million in gross proceeds pursuant to the underwriters’ exercise of the over-allotment option. Aggregate underwriters discounts and commissions were \$1.7 million and offering costs were \$0.3 million, resulting in net proceeds of approximately \$39.9 million.

On July 25, 2016, we closed a public offering of 3,100,000 shares of our common stock at a public offering price of \$15.50 per share, raising approximately \$48.1 million in gross proceeds. On August 3, 2016, we sold an additional 465,000 shares of our common stock, at a public offering price of \$15.50 per share, raising approximately \$7.2 million in gross proceeds pursuant to the underwriters' exercise of the over-allotment option. Aggregate underwriters' discounts and commissions were \$2.2 million and offering costs were \$0.5 million, resulting in net proceeds of approximately \$52.5 million.

On June 9, 2017, we closed a public offering of 3,000,000 shares of our common stock at a public offering price of \$15.00 per share, raising approximately \$45.0 million in gross proceeds. On June 14, 2017, pursuant to the underwriters' exercise of the over-allotment option, we sold an additional 450,000 shares of our common stock, at a public offering price of \$15.00 per share, raising an additional \$6.8 million in gross proceeds for a total of approximately \$51.8 million. Aggregate underwriters' discounts and commissions were \$2.1 million and offering costs were \$0.1 million, resulting in net proceeds of approximately \$49.6 million.

#### *At-the-market Securities Offering Program*

On February 6, 2015, we entered into an at-the-market ("ATM") securities offering program with MLV & Co. LLC ("MLV") and JMP Securities LLC ("JMP") (the "Initial ATM Program") through which we could sell, by means of ATM offerings from time to time, up to \$50.0 million of our common stock. During the year ended December 31, 2015, we sold 672,597 shares at an average price of \$14.88 per share for gross proceeds of approximately \$10.0 million under the Initial ATM Program. Aggregate underwriters' discounts and commissions were \$0.2 million and offering costs were \$83 thousand, resulting in net proceeds of approximately \$9.8 million.

On July 1, 2016, we amended the Initial ATM Program with MLV and JMP to replace MLV with FBR Capital Markets & Co. ("FBR"), an affiliate of MLV. On May 12, 2017, we entered into new equity distribution agreements with each of FBR and JMP (the "ATM Program"). All other material terms of the Initial ATM Program remain unchanged under the ATM Program. During the year ended December 31, 2017, we sold 173,939 shares at an average price of \$15.71 per share for gross proceeds of \$2.7 million under the Initial ATM Program and no shares were sold under the ATM Program. Aggregate underwriters' discounts and commissions were \$41 thousand and offering costs were \$23 thousand, resulting in net proceeds of approximately \$2.7 million. During the year ended December 31, 2018, we sold 182,299 shares at an average price of \$13.82 per share for gross proceeds of approximately \$2.5 million under the ATM Program. Aggregate underwriters' discounts and commissions were \$38 thousand and offering costs were \$79 thousand, resulting in net proceeds of approximately \$2.4 million.

#### *Small Business Administration Subsidiary*

Edgar Filing: MONROE CAPITAL Corp - Form 10-K

On February 28, 2014, our wholly-owned subsidiary, Monroe Capital Corporation SBIC, LP (“MRCC SBIC”), a Delaware limited partnership, received a license from the Small Business Administration (“SBA”) to operate as a Small Business Investment Company (“SBIC”) under Section 301(c) of the Small Business Investment Act of 1958. MRCC SBIC commenced operations on September 16, 2013. On April 13, 2016, MRCC SBIC was approved by the SBA for an additional \$75.0 million in SBA debentures for a total of \$115.0 million in available SBA debentures.

## OVERVIEW OF OUR BUSINESS

We are a specialty finance company focused on providing financing solutions primarily to lower middle-market companies in the United States and Canada. We provide customized financing solutions focused primarily on senior secured, junior secured and unitranche secured (a combination of senior secured and junior secured debt in the same facility in which we syndicate a “first out” portion of the loan to an investor and retain a “last out” portion of the loan) debt and, to a lesser extent, unsecured subordinated debt and equity, including equity co-investments in preferred and common stock and warrants.

Our investment objective is to maximize the total return to our stockholders in the form of current income and capital appreciation through investment in senior secured, unitranche secured and junior secured debt and, to a lesser extent, unsecured subordinated debt and equity investments. We seek to use our extensive leveraged finance origination infrastructure and broad expertise in sourcing loans to invest in primarily senior secured, unitranche secured and junior secured debt of middle-market companies. We believe that our primary focus on lending to lower middle-market companies offers several advantages as compared to lending to larger companies, including more attractive economics, lower leverage, more comprehensive and restrictive covenants, more expansive events of default, relatively small debt facilities that provide us with enhanced influence over our borrowers, direct access to borrower management and improved information flow.

Since the consummation of the Initial Public Offering, we have grown the fair value of our portfolio of investments to approximately \$553.6 million at December 31, 2018. Our portfolio at December 31, 2018 consists of 74 different portfolio companies and holdings include senior secured, junior secured and unitranche secured debt and equity investments. As of December 31, 2018, we have borrowed \$136.0 million under our revolving credit facility, we have \$69.0 million in aggregate principal amount of senior unsecured notes (“2023 Notes”) outstanding and we have drawn \$115.0 million in SBA debentures to finance the purchase of our assets.

Our investments will generally range between \$2.0 million and \$18.0 million each, although this investment size may vary proportionately with the size of our capital base. As of December 31, 2018, our portfolio included approximately 79.3% senior secured debt, 10.6% unitranche secured debt, 3.8% junior secured debt and 6.3% equity securities. We expect that the companies in which we invest may be leveraged, often as a result of leveraged buy-outs or other recapitalization transactions, and, in certain cases, will not be rated by national ratings agencies. If such companies were rated, we believe that they would typically receive a rating below investment grade (between BB and CCC under the Standard & Poor’s system) from the national rating agencies.

While our primary focus is to maximize current income and capital appreciation through debt investments in thinly traded or private U.S. companies, we may invest a portion of the portfolio in opportunistic investments in order to seek to enhance returns to stockholders. Such investments may include investments in high-yield bonds, distressed

debt, private equity or securities of public companies that are not thinly traded and securities of middle-market companies located outside of the United States. We expect that these public companies generally will have debt securities that are non-investment grade.

## **OUR INVESTMENT ADVISOR**

Our investment activities are managed by our investment advisor, MC Advisors. MC Advisors is responsible for sourcing potential investments, conducting research and due diligence on prospective investments and their private equity sponsors, analyzing investment opportunities, structuring our investments and managing our investments and portfolio companies on an ongoing basis. MC Advisors was organized in February 2011 and is a registered investment adviser under the Investment Advisers Act of 1940, as amended (the “Advisers Act”).

Under our Investment Advisory and Management Agreement with MC Advisors, we pay MC Advisors a base management fee and an incentive fee for its services. While not expected to review or approve each investment, our independent directors periodically review MC Advisors’ services and fees as well as its portfolio management decisions and portfolio performance. In connection with these reviews, our independent directors consider whether our fees and expenses (including those related to leverage) remain appropriate.

MC Advisors seeks to capitalize on the significant deal origination, credit underwriting, due diligence, investment structuring, execution, portfolio management and monitoring experience of Monroe Capital’s investment professionals. The senior management team of Monroe Capital, including Theodore L. Koenig and Aaron D. Peck, provides investment services to MC Advisors pursuant to a staffing agreement, or the Staffing Agreement, between MC Management, an affiliate of Monroe Capital, and MC Advisors. Messrs. Koenig and Peck have developed a broad network of contacts within the investment community and average more than 30 years of experience investing in debt and equity securities of lower middle-market companies. In addition, Messrs. Koenig and Peck have extensive experience investing in assets that constitute our primary focus and have expertise in investing throughout all periods of the economic cycle. MC Advisors is an affiliate of Monroe Capital and is supported by experienced investment professionals of Monroe Capital under the terms of the Staffing Agreement. Monroe Capital’s core team of investment professionals has an established track record in sourcing, underwriting, executing and monitoring transactions. From Monroe Capital’s formation in 2004 through December 31, 2018, Monroe Capital’s investment professionals invested in over 1,275 loan and related investments with an aggregate principal value of over \$10.5 billion.

In addition to their roles with Monroe Capital and MC Advisors, Messrs. Koenig and Peck serve as interested directors. Mr. Koenig has more than 30 years of experience in structuring, negotiating and closing transactions on behalf of asset-backed lenders, commercial finance companies, financial institutions and private equity investors at organizations including Monroe Capital, which Mr. Koenig founded in 2004, and Hilco Capital LP, where he led investments in over 20 companies in the lower middle-market. Mr. Peck has more than 25 years of public company management, leveraged finance and commercial lending experience at organizations including Deerfield Capital Management LLC, Black Diamond Capital Management LLC and Salomon Smith Barney Inc. Messrs. Koenig and Peck are joined on the investment committee of MC Advisors by Michael J. Egan and Jeremy T. VanDerMeid, each of whom is a senior investment professional at Monroe Capital. Mr. Egan has more than 30 years of experience in commercial finance, credit administration and banking at organizations including Hilco Capital, The CIT Group/Business Credit, Inc., The National Community Bank of New Jersey (The Bank of New York) and KeyCorp. Mr. VanDerMeid has more than 20 years of lending and corporate finance experience at organizations including Morgan Stanley Investment Management, Dymas Capital Management Company, LLC and Heller Financial.

## **ABOUT MONROE CAPITAL**

Monroe Capital, a Delaware limited liability company that was founded in 2004, is a leading lender to middle-market companies. As of December 31, 2018, Monroe Capital had approximately \$7.0 billion in assets under management. Monroe Capital has maintained a continued lending presence in the lower middle-market throughout the most recent economic downturn. The result is an established lending platform that we believe generates consistent primary and secondary deal flow from a network of proprietary relationships and additional deal flow from a diverse portfolio of over 500 current investments. From Monroe Capital's formation in 2004 through December 31, 2018, Monroe Capital's investment professionals invested in over 1,275 loans and related investments with an aggregate principal value of over \$10.5 billion. The senior investment team of Monroe Capital averages more than 25 years of experience and has developed a proven investment and portfolio management process that has performed through multiple market cycles. In addition, Monroe Capital's investment professionals are supported by administrative and back-office personnel focused on operations, finance, legal and compliance, accounting and reporting, marketing, information technology and office management.

## **INVESTMENT STRATEGY**

Our investment objective is to maximize the total return to our stockholders in the form of current income and capital appreciation primarily through investments in senior, unitranche and junior secured debt and, to a lesser extent, unsecured subordinated debt and equity. We also seek to invest opportunistically in attractively priced, broadly syndicated loans, which should enhance our geographic and industry portfolio diversification and increase our portfolio's liquidity. We do not target any specific industry, however, as of December 31, 2018, our investments in the High Tech Industries, Services: Business, and Banking, Finance, Insurance & Real Estate industries represented approximately 16.9%, 10.4%, and 10.1% respectively, of the fair value of our portfolio. To achieve our investment objective, we utilize the following investment strategy:

***Attractive Current Yield on Investment Portfolio.*** We believe our sourcing network allows us to enter into transactions with attractive yields and investment structures. Based on current market conditions and our pipeline of new investments, we expect our target directly originated senior and unitranche secured debt will have an average maturity of three to seven years and interest rates of 7% to 13%, and we expect our target directly originated junior secured debt and unsecured subordinated debt will have an average maturity of four to seven years and interest rates of 8% to 15%. In addition, based on current market conditions and our pipeline of new investments, we expect that our target debt investments will typically have a variable coupon (with a LIBOR floor), may include payment-in-kind (“PIK”) interest (interest that is not received in cash, but added to the principal balance of the loan), and that we will typically receive upfront closing fees of 1% to 4%. We may also receive warrants or other forms of upside equity participation. Our transactions are generally secured and supported by a lien on all assets and/or a pledge of company stock in order to provide priority of return and to influence any corporate actions. Although we will target investments with the characteristics described in this paragraph, we cannot provide assurance that our new investments will have these characteristics and we may enter into investments with different characteristics as the market dictates. For a description of the characteristics of our current investment portfolio, see “Management’s Discussion and Analysis of Financial Condition and Results of Operations — Portfolio and Investment Activity.” Until investment opportunities can be found, we may invest our undeployed capital in cash, cash equivalents, U.S. government securities and high-quality debt investments that mature in one year or less from the date of investment. These temporary investments may have lower yields than our other investments and, accordingly, may result in lower distributions, if any, during such period.

***Sound Portfolio Construction.*** We strive to exercise discipline in portfolio creation and management and to implement effective governance throughout our business. Monroe Capital and MC Advisors, which is comprised of substantially the same investment professionals who have operated Monroe Capital, have been, and we believe will continue to be, conservative in the underwriting and structuring of covenant packages in order to enable early intervention in the event of weak financial performance by a portfolio company. We seek to pursue lending opportunities selectively and to maintain a diversified portfolio. We believe that exercising disciplined portfolio management through continued intensive account monitoring and timely and relevant management reporting allows us to mitigate risks in our debt investments. In addition, we have implemented rigorous governance processes through segregation of duties, documented policies and procedures and independent oversight and review of transactions, which we believe helps us to maintain a low level of non-performing loans. We believe that Monroe Capital’s proven process of thorough origination, conservative underwriting, due diligence and structuring, combined with careful account management and diversification, enabled it to protect investor capital, and we believe MC Advisors follows the same philosophy and processes in originating, structuring and managing our portfolio investments.

***Predictability of Returns.*** Beyond conservative structuring and protection of capital, we seek a predictable exit from our investments. We seek to invest in situations where there are a number of potential exit options that can result in full repayment or a modest refinance of our investment. We seek to structure the majority of our transactions as secured loans with a covenant package that provides for full or partial repayment upon the completion of asset sales and restructurings. Because we seek to structure these transactions to provide for contractually determined, periodic payments of principal and interest, we are less likely to depend on merger and acquisition activity or public equity markets to exit our debt investments. As a result, we believe that we can achieve our target returns even in a period when public markets are depressed.

## **BUSINESS STRATEGY**

We believe that we represent an attractive investment opportunity for the following reasons:

***Deep, Experienced Management Team.*** We are managed by MC Advisors, which has access through the Staffing Agreement to Monroe Capital's experienced team comprised of over 100 professionals, including seven senior partners that average more than 25 years of direct lending experience. We are led by our Chairman and Chief Executive Officer, Theodore L. Koenig, and Aaron D. Peck, our Chief Financial Officer and Chief Investment Officer. This extensive experience includes the management of investments with borrowers of varying credit profiles and transactions completed in all phases of the credit cycle. Monroe Capital's senior investment professionals provide us with a difficult-to-replicate sourcing network and a broad range of transactional, financial, managerial and investment skills. This expertise and experience is supported by administrative and back office personnel focused on operations, finance, legal and compliance, accounting and reporting, marketing, information technology and office management. From Monroe Capital's formation in 2004 through December 31, 2018, Monroe Capital's investment professionals invested in more than 1,275 loan and related investments with an aggregate principal value of over \$10.5 billion.

***Differentiated Relationship-Based Sourcing Network.*** We believe Monroe Capital's senior investment professionals benefit from extensive relationships with commercial banks, private equity firms, financial intermediaries, management teams and turn-around advisors. We believe that this broad sourcing network differentiates us from our competitors and offers us a diversified origination approach that does not rely on a single channel and offers us consistent deal flow throughout the economic cycle. We also believe that this broad network allows us to originate a substantial number of non-private equity-sponsored investments.

***Extensive Institutional Platform for Originating Middle-Market Deal Flow.*** Monroe Capital's broad network of relationships and significant origination resources enable us to review numerous lending opportunities, permitting us to exercise a high degree of selectivity in terms of loans to which we ultimately commit. Monroe Capital estimates that it reviewed approximately 2,000 investment opportunities during 2018. Monroe Capital's over 1,275 previously executed transactions, over 500 of which are with current borrowers, offer us another source of deal flow, as these



debt investments reach maturity or seek refinancing. We are also positioned to benefit from Monroe Capital's established brand name, strong track record in partnering with industry participants and reputation for closing deals on time and as committed. Monroe Capital's senior investment professionals are complemented by extensive experience in capital markets transactions, risk management and portfolio monitoring.

***Disciplined, "Credit-First" Underwriting Process.*** Monroe Capital has developed a systematic underwriting process that applies a consistent approach to credit review and approval, with a focus on evaluating credit first and then appropriately assessing the risk-reward profile of each loan. MC Advisors' assessment of credit outweighs pricing and other considerations, as we seek to minimize potential credit losses through effective due diligence, structuring and covenant design. MC Advisors seeks to customize each transaction structure and financial covenant to reflect risks identified through the underwriting and due diligence process. We also seek to actively manage our origination and credit underwriting activities through personal visits and calls on all parties involved with an investment, including the management team, private equity sponsors, if any, or other lenders.

***Established Credit Risk Management Framework.*** We seek to manage our credit risk through a well-defined portfolio strategy and credit policy. In terms of credit monitoring, MC Advisors assigns each loan to a particular portfolio management professional and maintains an internal credit rating analysis for all loans. MC Advisors then employs ongoing review and analysis, together with regular investment committee meetings to review the status of certain complex and challenging loans and a comprehensive quarterly review of all loan transactions. MC Advisors' investment professionals also have significant turnaround and debt work-out experience, which gives them perspective on the risks and possibilities throughout the entire credit cycle. We believe this careful approach to investment and monitoring enables us to identify problems early and gives us an opportunity to assist borrowers before they face difficult liquidity constraints. By anticipating possible negative contingencies and preparing for them, we believe that we diminish the probability of underperforming assets and loan losses.

## INVESTMENTS

### ***Investment Structure***

We structure our investments, which typically have maturities of three to seven years, as follows:

***Senior Secured Loans.*** We structure senior secured loans to obtain security interests in the assets of the portfolio company borrowers that serve as collateral in support of the repayment of such loans. This collateral may take the form of first-priority liens on the assets of the portfolio company borrower. Our senior secured loans may provide for moderate loan amortization in the early years of the loan, with the majority of the amortization deferred until loan maturity.



*Unitranche Secured Loans.* We structure our unitranche loans as senior secured loans. We obtain security interests in the assets of these portfolio companies that serve as collateral in support of the repayment of these loans. This collateral may take the form of first-priority liens on the assets of a portfolio company. Generally, we syndicate a “first out” portion of the loan to an investor and retain a “last out” portion of the loan, in which case the “first out” portion of the loan will generally receive priority with respect to payments of principal, interest and any other amounts due thereunder. Unitranche structures combine characteristics of traditional first lien senior secured as well as second lien and subordinated loans and our unitranche loans will expose us to the risks associated with second lien and subordinated loans and may limit our recourse or ability to recover collateral upon a portfolio company’s bankruptcy. Unitranche loans typically provide for moderate loan amortization in the initial years of the facility, with the majority of the amortization deferred until loan maturity. Unitranche loans generally allow the borrower to make a large lump sum payment of principal at the end of the loan term, and there is a risk of loss if the borrower is unable to pay the lump sum or refinance the amount owed at maturity. In many cases we, together with our affiliates, are the sole or majority lender of our unitranche loans, which can afford us additional influence with a borrower in terms of monitoring and, if necessary, remediation in the event of underperformance.

*Junior Secured Loans.* We structure junior secured loans to obtain a security interest in the assets of these portfolio companies that serves as collateral in support of the repayment of such loans. This collateral may take the form of second priority liens on the assets of a portfolio company. These loans typically provide for moderate loan amortization in the initial years of the facility, with the majority of the amortization deferred until loan maturity.

*Preferred Equity.* We generally structure preferred equity investments to combine features of equity and debt. We may obtain a security interest in the assets of these portfolio companies that serves as collateral in support of the repayment of such preferred equity, which takes a priority to common shareholders. Preferred equity interests generally have a stated dividend rate and may not have a fixed maturity date.

*Warrants and Equity Co-Investment Securities.* In some cases, we may also receive nominally priced warrants or options to buy a minority equity interest in the portfolio company in connection with a loan. As a result, as a portfolio company appreciates in value, we may achieve additional investment return from this equity interest. We may structure such warrants to include provisions protecting our rights as a minority-interest holder, as well as a “put,” or right to sell such securities back to the issuer, upon the occurrence of specified events. In other cases, we may make a minority equity co-investment in the portfolio company in connection with a loan. Additionally, we may receive equity in our distressed portfolio companies in conjunction with amendments or additional debt fundings.

We tailor the terms of each investment to the facts and circumstances of the transaction and the prospective portfolio company, negotiating a structure that protects our rights and manages our risk while creating incentives for the portfolio company to achieve its business plan and improve its operating results. We seek to limit the downside potential of our investments by:

• selecting investments that we believe have a very low probability of loss;

• requiring a total return on our investments (including both interest and potential equity appreciation) that we believe will compensate us appropriately for credit risk; and

• negotiating covenants in connection with our investments that afford our portfolio companies as much flexibility in managing their businesses as possible, consistent with the preservation of our capital. Such restrictions may include affirmative and negative covenants, default penalties, lien protection, change of control provisions and board rights, including either observation or rights to a seat on the board of directors under some circumstances.

We expect to hold most of our investments to maturity or repayment, but we may sell some of our investments earlier if a liquidity event occurs, such as a sale, recapitalization or worsening of the credit quality of the portfolio company.

*Senior Loan Fund.* We have invested in SLF, which as of December 31, 2018, consisted of loans to different borrowers in industries similar to the companies in our portfolio. SLF invests primarily in senior secured loans of middle market companies. These senior secured loans are generally similar to our senior secured loans, which are secured by a first lien on some or all of the issuer's assets and include traditional senior debt and any related revolving or similar credit facility. SLF may also invest in more liquid senior secured loans.

**Investments**

We seek to create a diverse portfolio that includes senior secured, unitranche secured, junior secured loans and warrants and equity co-investment securities by investing approximately \$2.0 million to \$18.0 million of capital, on average, in the securities of middle-market companies. This investment size may vary proportionately with the size of our capital base. Set forth below is a list of our ten largest portfolio company investments as of December 31, 2018, as well as the top ten industries in which we were invested as of December 31, 2018, in each case excluding SLF, calculated as a percentage of our total investments at fair value as of such date (in thousands):

Portfolio Company	Fair Value of Investments	Percentage of Total Investments	
TRG, LLC	\$ 20,264	3.7	%
Mid-West Wholesale Hardware Co.	20,079	3.6	
Incipio, LLC	19,181	3.5	
HFZ Capital Group LLC	18,009	3.3	
Rockdale Blackhawk, LLC	17,770	3.2	
Echelon Funding I, LLC	15,146	2.7	
Newforma, Inc.	14,961	2.7	
Inland Pipe Rehabilitation LLC	14,509	2.6	
First Call Resolution, LLC	14,111	2.5	
RPL Bidco Limited	13,912	2.5	
	\$ 167,942	30.3	%

Industry	Fair Value of Investments	Percentage of Total Investments	
High Tech Industries	\$ 93,698	16.9	%
Services: Business	57,592	10.4	
Banking, Finance, Insurance & Real Estate	55,839	10.1	
Healthcare & Pharmaceuticals	52,769	9.5	
Retail	33,863	6.1	
Wholesale	27,740	5.0	
Construction & Building	24,942	4.5	
Media: Advertising, Printing & Publishing	21,908	4.0	
Hotels, Gaming & Leisure	20,264	3.7	
Consumer Goods: Non-Durable	19,181	3.5	
	\$ 407,796	73.7	%

**INVESTMENT PROCESS OVERVIEW**

We view our investment process as consisting of four distinct phases described below:

**Origination.** MC Advisors seeks to develop investment opportunities through extensive relationships with regional banks, private equity firms, financial intermediaries, management teams and other turn-around advisors. Monroe Capital has developed this network since its formation in 2004. MC Advisors manages these leads through personal visits and calls by its senior deal professionals. It is these professionals' responsibility to identify specific opportunities, refine opportunities through due diligence regarding the underlying facts and circumstances and utilize innovative thinking and flexible terms to solve the financing issues of prospective clients. Monroe Capital's origination professionals are broadly dispersed throughout North America, with six offices in the United States. Certain of Monroe Capital's originators are responsible for covering a specified target market based on geography and others focus on specialized industry verticals. We believe Monroe Capital's origination professionals' experience is vital to enable us to provide our borrowers with innovative financing solutions. We further believe that their strength and breadth of relationships across a wide range of markets will generate numerous financing opportunities and enable us to be highly selective in our lending activities. In sourcing new transactions, MC Advisors seeks opportunities to work with borrowers domiciled in the United States and Canada and typically focuses on industries in which Monroe Capital has previous lending experience.

**Due Diligence.** For each of our investments, MC Advisors prepares a comprehensive new business presentation, which summarizes the investment opportunity and its due diligence and risk analysis, all from the perspective of strengths, weaknesses, opportunities and threats presented by the opportunity. This presentation assesses the borrower and its management, including products and services offered, market position, sales and marketing capabilities and distribution channels; key contracts, customers and suppliers, meetings with management and facility tours; background checks on key executives; customer calls; and an evaluation of exit strategies. MC Advisors' presentation typically evaluates historical financial performance of the borrower and includes projections, including operating trends, an assessment of the quality of financial information, capitalization and liquidity measures and debt service capacity. The financial analysis also includes sensitivity analysis against management projections and an analysis of potential downside scenarios, particularly for cyclical businesses. MC Advisors seeks to also review the dynamics of the borrowers' industry and assess the maturity, market size, competition, technology and regulatory issues confronted by the industry. Finally, MC Advisors' new business presentation includes all relevant third-party reports and assessments, including, as applicable, analyses of the quality of earnings of the prospective borrower, a review of the business by industry experts and third-party valuations. MC Advisors also includes in this due diligence, if relevant, field exams, collateral appraisals and environmental reviews, as well as a review of comparable private and public transactions.

***Underwriting.*** MC Advisors uses the systematic, consistent approach to credit evaluation developed in house by Monroe Capital with a particular focus on determining the value of a business in a downside scenario. In this process, the senior investment professionals at MC Advisors bring to bear extensive lending experience with emphasis on lessons learned from the past two credit cycles. We believe that the extensive credit and debt work-out experience of Monroe Capital's senior management enables us to anticipate problems and minimize risks. Monroe Capital's underwriting professionals work closely with its origination professionals to identify individual deal strengths, risks and any risk mitigants. MC Advisors preliminarily screens transactions based on cash flow, enterprise value and asset-based characteristics, and each of these measures is developed on a proprietary basis using thorough credit analysis focused on sustainability and predictability of cash flow to support enterprise value, barriers to entry, market position, competition, customer and supplier relationships, management strength, private equity sponsor track record and industry dynamics. For asset-based transactions, MC Advisors seeks to understand current and future collateral value, opening availability and ongoing liquidity. MC Advisors documents this preliminary analysis which is thoroughly reviewed by at least one member of its investment committee prior to proposing a formal term sheet. We believe this early involvement of the investment committee ensures that our resources and those of third parties are deployed appropriately and efficiently during the investment process and lowers execution risk for our clients. With respect to transactions reviewed by MC Advisors, we expect that only approximately 10% of our sourced deals will reach the formal term sheet stage.

***Credit Approval/Investment Committee Review.*** MC Advisors employs a standardized, structured process developed by Monroe Capital when evaluating and underwriting new investments for our portfolio. MC Advisors' investment committee considers its comprehensive new business presentation to approve or decline each investment. This committee includes Messrs. Koenig, Peck, Egan and VanDerMeid. The committee is committed to providing a prompt turnaround on investment decisions. Each meeting to approve an investment requires a quorum of at least three members of the investment committee, and each investment must receive unanimous approval by such members of the investment committee.

The following chart illustrates the stages of MC Advisors' evaluation process:

## **Evaluation Process**

***Execution.*** We believe Monroe Capital has developed a strong reputation for closing deals as proposed, and we intend to continue this tradition. Through MC Advisors' consistent approach to credit evaluation and underwriting, we seek to close deals as fast or faster than competitive financing providers while maintaining the discipline with respect to credit, pricing and structure necessary to ensure the ultimate success of the financing.

**Monitoring.** We benefit from the portfolio management system already in place at Monroe Capital. This monitoring includes regular meetings between the responsible analyst and our portfolio company to discuss market activity and current events. MC Advisors' portfolio management staff closely monitors all credits, with senior portfolio managers covering agented and more complex investments. MC Advisors segregates our capital markets investments by industry. MC Advisors' monitoring process, developed by Monroe Capital, has daily, weekly, monthly and quarterly components and related reports, each to evaluate performance against historical, budget and underwriting expectations. MC Advisors' analysts monitor performance using standard industry software tools to provide consistent disclosure of performance. When necessary, MC Advisors updates our internal risk ratings, borrowing base criteria and covenant compliance reports.



As part of the monitoring process, MC Advisors regularly assesses the risk profile of each of our investments and rates each of them based on an internal proprietary system that uses the following categories, which we refer to as MC Advisors' investment performance rating. For any investment rated in grades 3, 4 or 5, MC Advisors, through its internal Portfolio Management Group ("PMG"), will increase its monitoring intensity and prepare regular updates for the investment committee, summarizing current operating results and material impending events and suggesting recommended actions. The PMG is responsible for oversight and management of any investments rated in grades 3, 4 or 5. MC Advisors monitors and, when appropriate, changes the investment ratings assigned to each investment in our portfolio. In connection with our valuation process, MC Advisors reviews these investment ratings on a quarterly basis, and our Board reviews and affirms such ratings. A definition of the rating system follows:

<b>Investment Performance Risk Rating</b>	<b>Summary Description</b>
Grade 1	Includes investments exhibiting the least amount of risk in our portfolio. The issuer is performing above expectations or the issuer's operating trends and risk factors are generally positive.
Grade 2	Includes investments exhibiting an acceptable level of risk that is similar to the risk at the time of origination. The issuer is generally performing as expected or the risk factors are neutral to positive.
Grade 3	Includes investments performing below expectations and indicates that the investment's risk has increased somewhat since origination. The issuer may be out of compliance with debt covenants; however, scheduled loan payments are generally not past due.
Grade 4	Includes an issuer performing materially below expectations and indicates that the issuer's risk has increased materially since origination. In addition to the issuer being generally out of compliance with debt covenants, scheduled loan payments may be past due (but generally not more than six months past due).
Grade 5	Indicates that the issuer is performing substantially below expectations and the investment risk has substantially increased since origination. Most or all of the debt covenants are out of compliance or payments are substantially delinquent. Investments graded 5 are not anticipated to be repaid in full, and we will reduce the fair market value of the loan to the amount we expect to recover.

Our investment performance ratings do not constitute any ratings of investments by a nationally recognized statistical rating organization or represent or reflect any third-party assessment of any of our investments.

In the event of a delinquency or a decision to rate a loan grade 4 or grade 5, the PMG, in consultation with the investment committee, will develop an action plan. Such a plan may require a meeting with the borrower's management or the lender group to discuss reasons for the default and the steps management is undertaking to address the under-performance, as well as required amendments and waivers that may be required. In the event of a dramatic deterioration of a credit, MC Advisors and the PMG form a team or engage outside advisors to analyze, evaluate and take further steps to preserve our value in the credit. In this regard, we would expect to explore all options, including

Edgar Filing: MONROE CAPITAL Corp - Form 10-K

in a private equity sponsored investment, assuming certain responsibilities for the private equity sponsor or a formal sale of the business with oversight of the sale process by us. The PMG and the investment committee have extensive experience in running debt work-out transactions and bankruptcies.

The following table shows the distribution of our investments on the 1 to 5 investment performance rating scale at fair value as of December 31, 2018 (in thousands):

Investment Performance Rating	Investments at Fair Value	Percentage of Total Investments	
1	\$ —	—	%
2	452,549	81.8	
3	57,741	10.4	
4	43,331	7.8	
5	—	—	
Total	\$ 553,621	100.0	%

The following table shows the distribution of our investments on the 1 to 5 investment performance rating scale at fair value as of December 31, 2017 (in thousands):

Investment Performance Rating	Investments at Fair Value	Percentage of Total Investments	
1	\$ 3,445	0.7	%
2	415,094	84.0	
3	57,547	11.6	
4	18,052	3.7	
5	—	—	
Total	\$ 494,138	100.0	%

## MANAGEMENT AND OTHER AGREEMENTS

MC Advisors is located at 311 South Wacker Drive, Suite 6400, Chicago, Illinois 60606. MC Advisors is a registered investment adviser under the Advisers Act. Subject to the overall supervision of our Board and in accordance with the 1940 Act, MC Advisors manages our day-to-day operations and provides investment advisory services to us. Under the terms of the Investment Advisory and Management Agreement, MC Advisors:

determines the composition of our portfolio, the nature and timing of the changes to our portfolio and the manner of implementing such changes;

assists us in determining what securities we purchase, retain or sell;

identifies, evaluates and negotiates the structure of the investments we make (including performing due diligence on our prospective portfolio companies); and

executes, closes, services and monitors the investments we make.

MC Advisors' services under the Investment Advisory and Management Agreement are not exclusive, and it is free to furnish similar services to other entities so long as its services to us are not impaired.

### *Management and Incentive Fee*

Under the Investment Advisory and Management Agreement with MC Advisors and subject to the overall supervision of our Board, MC Advisors provides investment advisory services to us. For providing these services, MC Advisors receives a fee from us, consisting of two components — a base management fee and an incentive fee. The base management fee is calculated at an annual rate of 1.75% of average invested assets (calculated as total assets excluding cash, which includes assets financed using leverage) and is payable quarterly in arrears.

The incentive fee consists of two parts. The first part is calculated and payable quarterly in arrears based on our pre-incentive fee net investment income for the preceding quarter subject to a total return requirement. Pre-incentive fee net investment income means interest income, dividend income and any other income (including any other fees such as commitment, origination, structuring, diligence and consulting fees or other fees that we receive from portfolio companies but excluding fees for providing managerial assistance) accrued during the calendar quarter,

minus operating expenses for the quarter (including the base management fee, any expenses payable under our administration agreement between an affiliate of Monroe Capital and MC Advisors (the “Administration Agreement”) and any interest expense and dividends paid on any outstanding preferred stock, but excluding the incentive fee). Pre-incentive fee net investment income includes, in the case of investments with a deferred interest feature such as market discount, debt instruments with PIK interest, preferred stock with PIK dividends and zero-coupon securities, accrued income that we have not yet received in cash. MC Advisors is not under any obligation to reimburse us for any part of the incentive fee it received that was based on accrued interest that we never actually receive.

The foregoing incentive fee is subject to a total return requirement, which provides that no incentive fee in respect of our pre-incentive fee net investment income will be payable except to the extent 20.0% of the cumulative net increase in net assets resulting from operations over the then-current and 11 preceding quarters exceeds the cumulative incentive fees accrued and/or paid for the 11 preceding quarters (the “Incentive Fee Limitation”). Therefore, any ordinary income incentive fee that is payable in a calendar quarter will be limited to the lesser of (i) 20% of the amount by which our pre-incentive fee net investment income for such calendar quarter exceeds the 2% hurdle described below, subject to the “catch-up” provision, and (ii) (x) 20% of the cumulative net increase in net assets resulting from operations for the then current and 11 preceding calendar quarters minus (y) the cumulative incentive fees accrued and/or paid for the 11 preceding calendar quarters. For the foregoing purpose, the “cumulative net increase in net assets resulting from operations” is the amount, if positive, of the sum of our pre-incentive fee net investment income, base management fees, realized gains and losses and unrealized gains and losses for the then-current and 11 preceding calendar quarters.

Pre-incentive fee net investment income does not include any realized capital gains, realized capital losses or unrealized capital gains or losses. If any distributions from portfolio companies are characterized as a return of capital, such returns of capital would affect the capital gains incentive fee to the extent a gain or loss is realized. Because of the structure of the incentive fee, it is possible that we may pay an incentive fee in a quarter where we incur a loss. For example, if we receive pre-incentive fee net investment income in excess of the hurdle rate (as defined below) for a quarter, we will pay the applicable incentive fee even if we have incurred a loss in that quarter due to realized and unrealized capital losses.

Pre-incentive fee net investment income, expressed as a rate of return on the value of our net assets (defined as total assets less indebtedness and before taking into account any incentive fees payable during the period) at the end of the immediately preceding calendar quarter, is compared to a fixed “hurdle rate” of 2% per quarter (8% annually). If market interest rates rise, we may be able to invest our funds in debt instruments that provide for a higher return, which would increase our pre-incentive fee net investment income and make it easier for MC Advisors to surpass the fixed hurdle rate and receive an incentive fee based on such net investment income.

We pay MC Advisors an incentive fee with respect to our pre-incentive fee net investment income in each calendar quarter as follows:

• no incentive fee in any calendar quarter in which the pre-incentive fee net investment income does not exceed the hurdle rate of 2% (8% annually);

100% of our pre-incentive fee net investment income with respect to that portion of such pre-incentive fee net investment income, if any, that exceeds the hurdle rate but is less than 2.5% in any calendar quarter. We refer to this portion of our pre-incentive fee net investment income (which exceeds the hurdle rate but is less than 2.5%) as the “catch-up” provision. The catch-up is meant to provide MC Advisors with 20% of the pre-incentive fee net investment income as if a hurdle rate did not apply if this net investment income exceeds 2.5% in any calendar quarter; and

20% of the amount of our pre-incentive fee net investment income, if any, that exceeds 2.5% in any calendar quarter.

These calculations are adjusted for any share issuances or repurchases during the quarter.

The following is a graphical representation of the calculation of the income-related portion of the incentive fee:

### **Quarterly Incentive Fee Based on Pre-Incentive Fee Net Investment Income**

**Pre-incentive fee net investment income (expressed as a percentage of the value of net assets)**

#### **Percentage of pre-incentive fee net investment income allocated to income-related portion of incentive fee**

These calculations will be appropriately prorated for any period of less than three months and adjusted for any share issuances or repurchases during the current quarter.

The second part of the incentive fee is a capital gains incentive fee that is determined and payable in arrears as of the end of each fiscal year (or upon termination of the investment advisory and management agreement, as of the termination date), and equals 20% of our realized capital gains as of the end of the fiscal year. In determining the capital gains incentive fee payable to MC Advisors, we calculate the cumulative aggregate realized capital gains and cumulative aggregate realized capital losses since our inception, and the aggregate unrealized capital depreciation as of the date of the calculation, as applicable, with respect to each of the investments in our portfolio. For this purpose, cumulative aggregate realized capital gains, if any, equals the sum of the differences between the net sales price of each investment, when sold, and the amortized cost of such investment. Cumulative aggregate realized capital losses equals the sum of the amounts by which the net sales price of each investment, when sold, is less than the amortized cost of such investment since our inception. Aggregate unrealized capital depreciation equals the sum of the difference, if negative, between the valuation of each investment as of the applicable calculation date and the amortized cost of such investment. At the end of the applicable year, the amount of capital gains that serves as the basis for our calculation of the capital gains incentive fee equals the cumulative aggregate realized capital gains less cumulative aggregate realized capital losses, less aggregate unrealized capital depreciation, with respect to our portfolio of investments. If this number is positive at the end of such year, then the capital gains incentive fee for such year equals 20% of such amount, less the aggregate amount of any capital gains incentive fees paid in respect of our

portfolio in all prior years.

### Examples of Quarterly Incentive Fee Calculation

#### Example 1: Income Related Portion of Incentive Fee before Total Return Requirement Calculation

##### *Alternative 1*

###### *Assumptions*

Investment income (including interest, dividends, fees, etc.) = 1.25%

Hurdle rate <sup>(1)</sup> = 2%

Management fee <sup>(2)</sup> = 0.4375%

Other expenses (legal, accounting, custodian, transfer agent, etc.) = 0.2%

Pre-incentive fee net investment income

(investment income – (management fee + other expenses)) = 0.6125%

Pre-incentive fee net investment income does not exceed hurdle rate, therefore there is no income-related incentive fee.

##### *Alternative 2*

###### *Assumptions*

Investment income (including interest, dividends, fees, etc.) = 3.0%

Hurdle rate <sup>(1)</sup> = 2%

Management fee <sup>(2)</sup> = 0.4375%

Other expenses (legal, accounting, custodian, transfer agent, etc.) = 0.2%

Pre-incentive fee net investment income

(investment income – (management fee + other expenses)) = 2.3625%

Incentive fee = 100% × Pre-incentive fee net investment income (subject to “catch-up”<sup>(3)</sup>)

= 100% × (2.3625% – 2%)

= 0.3625%

Pre-incentive fee net investment income exceeds the hurdle rate, but does not fully satisfy the “catch-up” provision, therefore the income-related portion of the incentive fee is 0.3625%.

**Alternative 3**

*Assumptions*

Investment income (including interest, dividends, fees, etc.) = 3.5%

Hurdle rate <sup>(1)</sup> = 2%

Management fee <sup>(2)</sup> = 0.4375%

Other expenses (legal, accounting, custodian, transfer agent, etc.) = 0.2%

Pre-incentive fee net investment income

(investment income – (management fee + other expenses)) = 2.8625%

Incentive fee = 100% × Pre-incentive fee net investment income (subject to “catch-up”<sup>(3)</sup>)

Incentive fee = 100% × “catch-up” + (20% × (Pre-incentive fee net investment income – 2.5%))

“Catch-up” = 2.5% – 2%

= 0.5%

Incentive fee = (100% × 0.5%) + (20% × (2.8625% – 2.5%))

= 0.5% + (20% × 0.3625%)

= 0.5% + 0.0725%

= 0.5725%

Pre-incentive fee net investment income exceeds the hurdle rate, and fully satisfies the “catch-up” provision, therefore the income related portion of the incentive fee is 0.5725%.

(1) Represents 8.0% annualized hurdle rate.

(2) Represents 1.75% annualized base management fee.

The “catch-up” provision is intended to provide our investment advisor with an incentive fee of 20% on all (3) pre-incentive fee net investment income as if a hurdle rate did not apply when our net investment income exceeds 2.5% in any fiscal quarter.

**Example 2: Income Portion of Incentive Fee with Total Return Requirement Calculation:**

*Assumptions*

Hurdle rate <sup>(1)</sup> = 2%

Management fee <sup>(2)</sup> = 0.4375%

Other expenses (legal, accounting, transfer agent, etc.) = 0.2%



Cumulative incentive compensation accrued and/or paid for preceding 11 calendar quarters = \$9 million

***Alternative 1***

*Additional Assumptions*

Investment income (including interest, dividends, fees, etc.) = 3.50%

Pre-incentive fee net investment income

(investment income – (management fee + other expenses)) = 2.8625%

20.0% of cumulative net increase in net assets resulting from operations over current and preceding 11 calendar quarters = \$8 million

Although our pre-incentive fee net investment income exceeds the hurdle rate of 2.0% (as shown in Alternative 3 of Example 1 above), no incentive fee is payable because 20.0% of the cumulative net increase in net assets resulting from operations over the then current and 11 preceding calendar quarters did not exceed the cumulative income and capital gains incentive fees accrued and/or paid for the preceding 11 calendar quarters.

***Alternative 2***

*Additional Assumptions*

Investment Income (including interest, dividends, fees, etc.) = 3.50%

Pre-incentive fee net investment income

(investment income – (management fee + other expenses)) = 2.8625%.

20% of cumulative net increase in net assets resulting from operations over current and preceding 11 calendar quarters = \$10 million

Because our pre-incentive fee net investment income exceeds the hurdle rate of 2.0% and because 20.0% of the cumulative net increase in net assets resulting from operations over the then current and 11 preceding calendar quarters exceeds the cumulative income and capital gains incentive fees accrued and/or paid for the preceding 11 calendar quarters, an incentive fee would be payable, as shown in Alternative 3 of Example 1 above.

(1) Represents 8.0% annualized hurdle rate.

(2) Represents 1.75% annualized management fee.



**Example 3: Capital Gains Portion of Incentive Fee (\*):**

*Alternative 1:*

*Assumptions*

Year 1: \$20 million investment made in Company A (“Investment A”), and \$30 million investment made in Company B (“Investment B”)

Year 2: Investment A sold for \$50 million and fair market value (“FMV”) of Investment B determined to be \$32 million

Year 3: FMV of Investment B determined to be \$25 million

Year 4: Investment B sold for \$31 million

The capital gains portion of the incentive fee would be:

Year 1: None

Year 2: Capital gains incentive fee of \$6 million — (\$30 million realized capital gains on sale of Investment A multiplied by 20%)

Year 3: None — \$5 million (20% multiplied by (\$30 million cumulative capital gains less \$5 million cumulative capital depreciation)) less \$6 million (previous capital gains fee paid in Year 2)

Year 4: Capital gains incentive fee of \$200,000 — \$6.2 million (\$31 million cumulative realized capital gains multiplied by 20%) less \$6 million (capital gains incentive fee taken in Year 2)

*Alternative 2*

*Assumptions*

Year 1: \$20 million investment made in Company A (“Investment A”), \$30 million investment made in Company B (“Investment B”) and \$25 million investment made in Company C (“Investment C”)

Year 2: Investment A sold for \$50 million, FMV of Investment B determined to be \$25 million and FMV of Investment C determined to be \$25 million

Year 3: FMV of Investment B determined to be \$27 million and Investment C sold for \$30 million

Year 4: FMV of Investment B determined to be \$35 million

Year 5: Investment B sold for \$20 million

The capital gains incentive fee, if any, would be:

Year 1: None

Year 2: \$5 million capital gains incentive fee — 20% multiplied by \$25 million (\$30 million realized capital gains on Investment A less unrealized capital depreciation on Investment B)

Year 3: \$1.4 million capital gains incentive fee <sup>(1)</sup> — \$6.4 million (20% multiplied by \$32 million (\$35 million cumulative realized capital gains less \$3 million unrealized capital depreciation)) less \$5 million capital gains incentive fee received in Year 2

Year 4: None

Year 5: None — \$5 million (20% multiplied by \$25 million (cumulative realized capital gains of \$35 million less realized capital losses of \$10 million)) less \$6.4 million cumulative capital gains incentive fee paid in Year 2 and Year

3 (2)

The hypothetical amounts of returns shown are based on a percentage of our total net assets and assume no leverage.  
\*There is no guarantee that positive returns will be realized and actual returns may vary from those shown in this example.

As illustrated in Year 3 of Alternative 1 above, if we were to be wound up on a date other than our fiscal year end (1) of any year, we may have paid aggregate capital gains incentive fees that are more than the amount of such fees that would be payable if we had been wound up on the fiscal year end of such year.

As noted above, it is possible that the cumulative aggregate capital gains fee received by our investment advisor (2) (\$6.4 million) is effectively greater than \$5 million (20% of cumulative aggregate realized capital gains less net realized capital losses or net unrealized depreciation (\$25 million)).

12

*Payment of Our Expenses*

All investment professionals of MC Advisors and/or its affiliates, when and to the extent engaged in providing investment advisory and management services to us, and the compensation and routine overhead expenses of personnel allocable to these services to us, are provided and paid for by MC Advisors and not by us. We bear all other out-of-pocket costs and expenses of our operations and transactions, including, without limitation:

- organization and offering;

- calculating our net asset value (including the cost and expenses of any independent valuation firm);

- fees and expenses incurred by MC Advisors payable to third parties, including agents, consultants or other advisors, in monitoring financial and legal affairs for us and in conducting research and due diligence on prospective investments and equity sponsors, analyzing investment opportunities, structuring our investment and monitoring our investments and portfolio companies on an ongoing basis (although none of MC Advisors' duties will be subcontracted to sub-advisors);

- interest payable on debt, if any, incurred to finance our investments;

- offerings of our common stock and other securities;

- investment advisory fees;

- administration fees and expenses, if any, payable under the Administration Agreement (including payments under the Administration Agreement between us and MC Management based upon our allocable portion of MC Management's overhead in performing its obligations under the Administration Agreement, including rent and the allocable portion of the cost of our chief financial officer and chief compliance officer, and their respective staffs);

- transfer agent, dividend agent and custodial fees and expenses;

- federal and state registration fees;

- all costs of registration and listing our shares on any securities exchange;

federal, state and local taxes;

independent directors' fees and expenses;

costs of preparing and filing reports or other documents required by the SEC or other regulators;

costs of any reports, proxy statements or other notices to stockholders, including printing costs;

fidelity bond, directors and officers/errors and omissions liability insurance, and any other insurance premiums;

direct costs and expenses of administration, including printing, mailing, long distance telephone, copying, secretarial and other staff, independent auditors and outside legal costs;

proxy voting expenses; and

all other expenses incurred by us or MC Management in connection with administering our business.

### ***Duration and Termination***

Unless terminated earlier as described below, the Investment Advisory and Management Agreement will continue in effect from year to year if approved annually by our Board or by the affirmative vote of the holders of a majority of our outstanding voting securities, and, in either case, if also approved by a majority of our directors who are not “interested persons.” The Investment Advisory and Management Agreement automatically terminates in the event of its assignment, as defined in the 1940 Act, by MC Advisors and may be terminated by either party without penalty upon not less than 60 days’ written notice to the other. The holders of a majority of our outstanding voting securities may also terminate the Investment Advisory and Management Agreement without penalty. See “Risk Factors — Risks Relating to Our Business and Structure — We depend upon MC Advisors’ senior management for our success, and upon its access to the investment professionals of Monroe Capital and its affiliates” and “Risk Factors — Risks Relating to Our Business and Structure — MC Advisors can resign on 60 days’ notice, and we may not be able to find a suitable replacement within that time, resulting in a disruption in our operations that could adversely affect our financial condition, business and results of operations.”

### ***Indemnification***

The Investment Advisory and Management Agreement provides that, absent willful misfeasance, bad faith or gross negligence in the performance of its duties or by reason of the reckless disregard of its duties and obligations, MC Advisors and its affiliates’ respective officers, directors, members, managers, stockholders and employees are entitled to indemnification from us from and against any claims or liabilities, including reasonable legal fees and other expenses reasonably incurred, arising out of or in connection with our business and operations or any action taken or omitted on our behalf pursuant to authority granted by the Investment Advisory and Management Agreement, except where attributable to gross negligence, willful misconduct, bad faith or reckless disregard of such person’s duties under the Investment Advisory and Management Agreement.

### **Administration Agreement**

Pursuant to an Administration Agreement, MC Management furnishes us with office facilities and equipment and provides us clerical, bookkeeping and record keeping and other administrative services at such facilities. Under the Administration Agreement, MC Management performs, or oversees the performance of, our required administrative services, which include, among other things, being responsible for the financial records that we are required to maintain and preparing reports to our stockholders and reports filed with the SEC. MC Management also assists us in determining and publishing our net asset value, oversees the preparation and filing of our tax returns, prints and disseminates reports to our stockholders and generally oversees the payment of our expenses and the performance of administrative and professional services rendered to us by others. Under the Administration Agreement, MC Management also provides managerial assistance on our behalf to those portfolio companies that have accepted our



offer to provide such assistance.

Payments under the Administration Agreement are equal to an amount based upon our allocable portion (subject to the review and approval of our Board) of MC Management's overhead in performing its obligations under the Administration Agreement, including rent and our allocable portion of the cost of our officers, including our chief financial officer and chief compliance officer and their respective staffs. Unless terminated earlier as described below, the Administration Agreement will continue in effect from year to year with the approval of our Board. The Administration Agreement may be terminated by either party without penalty upon 60 days' written notice to the other party.

MC Management may retain third parties to assist in providing administrative services to us. To the extent that MC Management outsources any of its functions, we pay the fees associated with such functions on a direct basis without profit to MC Management. We reimburse MC Management for the allocable portion (subject to the review and approval of our Board) of MC Management's overhead and other expenses incurred by it in performing its obligations under the Administration Agreement, including rent, the fees and expenses associated with performing compliance functions, and our allocable portion of the cost of our chief financial officer and chief compliance officer and their respective staffs. For the years ended December 31, 2018, 2017 and 2016, we incurred \$3.4 million, \$3.4 million and \$3.1 million in administrative expenses (included within Professional fees, Administrative service fees and General and administrative expenses on the consolidated statements of operations) under the Administration Agreement, respectively, of which \$1.3 million, \$1.2 million and \$1.3 million, respectively, was related to MC Management overhead and salary allocation and paid directly to MC Management.

### ***Indemnification***

The Administration Agreement provides that, absent willful misfeasance, bad faith or gross negligence in the performance of its duties or by reason of the reckless disregard of its duties and obligations, MC Management and its affiliates' respective officers, directors, members, managers, stockholders and employees are entitled to indemnification from us from and against any claims or liabilities, including reasonable legal fees and other expenses reasonably incurred, arising out of or in connection with our business and operations or any action taken or omitted on our behalf pursuant to authority granted by the Administration Agreement, except where attributable to gross negligence, willful misconduct, bad faith or reckless disregard of such person's duties under the Administration Agreement.

### **License Agreement**

We have entered into a license agreement with Monroe Capital under which Monroe Capital has agreed to grant us a non-exclusive, royalty-free license to use the name "Monroe Capital." Under this agreement, we have a right to use the "Monroe Capital" name for so long as MC Advisors or one of its affiliates remains our investment advisor. Other than with respect to this limited license, we have no legal right to the "Monroe Capital" name. This license agreement will remain in effect for so long as the Investment Advisory and Management Agreement with MC Advisors is in effect.

### **Staffing Agreement**

We do not have any internal employees. We depend on the diligence, skill and network of business contacts of the senior investment professionals of MC Advisors to achieve our investment objective. MC Advisors is an affiliate of Monroe Capital and depends upon access to the investment professionals and other resources of Monroe Capital and Monroe Capital's affiliates to fulfill its obligations to us under the Investment Advisory and Management Agreement. MC Advisors also depends upon Monroe Capital to obtain access to deal flow generated by the professionals of Monroe Capital and its affiliates. Under the Staffing Agreement, MC Management provides MC Advisors with the resources necessary to fulfill these obligations. The Staffing Agreement provides that MC Management will make available to MC Advisors experienced investment professionals and access to the senior investment personnel of Monroe Capital for purposes of evaluating, negotiating, structuring, closing and monitoring our investments. The Staffing Agreement also includes a commitment that the members of MC Advisors' investment committee serve in such capacity. The Staffing Agreement remains in effect until terminated and may be terminated by either party without penalty upon 60 days' written notice to the other party. Services under the Staffing Agreement are provided to MC Advisors on a direct cost reimbursement basis, and such fees are not our obligation.

## **Board Approval of the Investment Advisory and Management Agreement and Staffing Agreement**

At a meeting of our Board held on August 2, 2018, our Board, including directors who are not “interested persons” as defined in the 1940 Act, voted unanimously to approve and continue the Investment Advisory and Management Agreement for another annual period in accordance with the requirements of the 1940 Act. The approval included consideration and approval of the specific individuals provided through the Staffing Agreement between MC Advisors and MC Management that comprise our investment committee. In reaching a decision to approve and continue the investment advisory agreement and investment committee, the Board reviewed a significant amount of information and considered, among other things:

*Nature, Quality and Extent of Services.* Our Board reviewed information about the services to be performed and the personnel performing such services under the Investment Advisory Agreement and Staffing Agreement, including the specific approval of the members of the investment committee to be provided pursuant to the Staffing Agreement. Our board of directors considered the nature, extent and quality of the investment selection process employed by MC Advisors and the experience of the members of the investment committee. Our Board concluded that the services to be provided under the Investment Advisory Agreement are consistent with those of comparable business development companies described in the available market data.

*The reasonableness of the fees paid to MC Advisors.* Our Board considered comparative data based on publicly available information on other business development companies with respect to services rendered and the advisory fees (including the management fees and incentive fees) of other business development companies as well as our projected operating expenses and expense ratio compared to other business development companies. Our Board also considered the profitability of MC Advisors. Based upon its review, our board of directors concluded that the fees to be paid under the Investment Advisory Agreement are reasonable compared to other business development companies.

*Investment Performance.* Our Board reviewed our investment performance as well as comparative data with respect to the investment performance of other externally managed business development companies. Our Board concluded that MC Advisors was delivering results consistent with our investment objective over the most recently completed period.

*Economies of Scale.* Our Board addressed the potential for MC Advisors to realize economies of scale in managing our assets, and determined that at this time they did not expect economies of scale to be realized by MC Advisors.

Based on the information reviewed and the discussions detailed above, our Board, including all of the directors who are not “interested persons” as defined in the 1940 Act, concluded that the investment advisory fee rates and terms are fair and reasonable in relation to the services provided and approved the investment advisory agreement and its continuation as being in the best interests of our stockholders. MC Advisors bears all expenses related to the services and personnel provided pursuant to the Staffing Agreement.

## VALUATION PROCESS AND DETERMINATION OF NET ASSET VALUE

The net asset value per share of our outstanding shares of common stock is determined quarterly by dividing the value of total assets minus liabilities by the total number of shares outstanding. We calculate the value of our total assets in accordance with the following procedures.

Investments for which market quotations are readily available and within a recent date are valued at such market quotations. We may also obtain indicative prices with respect to certain of our investments from pricing services or brokers or dealers in order to value such investments. We expect that there will not be a readily available market value within a recent date for many of our investments; those debt and equity securities that are not publicly traded or whose market prices are not readily available are valued at fair value as determined in good faith by our Board using a documented valuation policy and a consistently applied valuation process.

Our Board is ultimately and solely responsible for determining the fair value of the portfolio investments that are not publicly traded, whose market prices are not readily available on a quarterly basis in good faith or any other situation where portfolio investments require a fair value determination.

With respect to investments for which market quotations are not readily available or for which no indicative prices from pricing services or brokers or dealers have been received, our Board undertakes a multi-step valuation process each quarter, as described below:

- the quarterly valuation process begins with each portfolio company or investment being initially evaluated and rated by the investment professionals responsible for the credit monitoring of the portfolio investment;

- our Board engages one or more independent valuation firm(s) to conduct fair value appraisals of material investments for which market quotations are not readily available. These fair value appraisals for material investments are received at least once in every calendar year for each portfolio company investment, but are generally received quarterly;

- to the extent an independent valuation firm is not engaged to conduct an investment appraisal on an investment for which market quotations are not readily available, the investment will be valued by the MC Advisors investment professional responsible for the credit monitoring;

- preliminary valuation conclusions are then documented and discussed with the investment committee;

our audit committee of the Board reviews the preliminary valuations of MC Advisors and of the independent valuation firm(s) and responds and supplements the valuation recommendations to reflect any comments; and

our Board discusses these valuations and determines the fair value of each investment in the portfolio in good faith, based on the input of MC Advisors, the independent valuation firm(s) and the audit committee.

The valuation technique utilized in the determination of fair value is affected by a wide variety of factors including the type of investment, whether the investment is new and not yet established in the marketplace, and other characteristics particular to the transaction. The Board generally uses the income approach to determine fair value, as long as it is appropriate. If there is deterioration in credit quality or a debt investment is in workout status, we may consider other factors in determining the fair value, including the value attributable to the debt investment from the enterprise value of the portfolio company or the proceeds that would be received in a liquidation analysis. This liquidation analysis may also include probability weighting of alternative outcomes. We generally consider our debt to be performing loans if the borrower is not in default, the borrower is remitting payments in a timely manner, the loan is in covenant compliance and is otherwise not deemed to be impaired. In determining the fair value of the performing debt, we consider fluctuations in current interest rates, trends in yields of debt instruments with similar credit ratings, financial condition of the borrower, economic conditions and other relevant factors, both qualitative and quantitative. In the event that a debt instrument is not performing, as defined above, we will evaluate the value of the collateral utilizing the same framework described above for a performing loan to determine the value of the debt instrument. See Note 4 to the accompanying consolidated financial statements for additional information on the determination of fair value.

We report our investments at fair value with changes in value reported through our consolidated statements of operations under the caption “unrealized gain (loss).” In determining fair value, we are required to assume that portfolio investments are to be sold in the principal market to market participants, or in the absence of a principal market, the most advantageous market, which may be a hypothetical market. Market participants are defined as buyers and sellers in the principal or most advantageous market that are independent, knowledgeable, and willing and able to transact. The market in which we can exit portfolio investments with the greatest volume and level activity is considered our principal market.

Determination of fair value involves subjective judgments and estimates. Accordingly, the notes to our consolidated financial statements express the uncertainty with respect to the possible effect of such valuations, and any change in such valuations, on our consolidated financial statements.

## COMPETITION

We compete with a number of specialty and commercial finance companies to make the types of investments that we make in middle-market companies, including business development companies, traditional commercial banks, private investment funds, regional banking institutions, small business investment companies, investment banks and insurance companies. Additionally, with increased competition for investment opportunities, alternative investment vehicles

such as hedge funds may invest in areas they have not traditionally invested in or from which they had withdrawn during the recent economic downturn, including investing in middle-market companies. As a result, competition for investments in lower middle-market companies has intensified, and we expect that trend to continue. Many of our existing and potential competitors are substantially larger and have considerably greater financial, technical and marketing resources than we do. For example, some competitors may have a lower cost of funds and access to funding sources that are not available to us. In addition, some of our competitors may have higher risk tolerances or different risk assessments, which could allow them to consider a wider variety of investments and establish more relationships than us.

We use the expertise of the investment professionals of MC Advisors to assess investment risks and determine appropriate pricing and terms for investments in our loan portfolio. In addition, we expect that the relationships of the senior professionals of MC Advisors will enable us to learn about, and compete effectively for, investment opportunities with attractive middle-market companies, independently or in conjunction with the private equity clients of MC Advisors. For additional information concerning the competitive risks we face, see “Risk Factors — Risks Relating to Our Business and Structure — We operate in a highly competitive market for investment opportunities, which could reduce returns and result in losses.”

## **INFORMATION TECHNOLOGY**

We utilize a number of industry standard practices and software packages to secure, protect, manage and back up all corporate data. We outsource portions of our information technology function to efficiently monitor and maintain our systems. Also, we conduct a daily backup of our systems to ensure the security and stability of the network.

## **ELECTION TO BE TAXED AS A RIC**

As a BDC, we have elected to be treated as a RIC under Subchapter M of the Code. As a RIC, we generally do not have to pay corporate-level federal income taxes on any ordinary income or capital gains that we timely distribute to our stockholders as dividends. To continue to qualify as a RIC, we must, among other things, meet certain source-of income and asset diversification requirements (as described below). In addition, we must distribute to our stockholders, for each taxable year, at least 90% of our “investment company taxable income,” which is generally our net ordinary income plus the excess of realized net short-term capital gains over realized net long-term capital losses (the “Annual Distribution Requirement”). Generally we would expect these distributions to be taxable to our stockholders as ordinary income and not to be eligible for the reduced maximum tax rates associated with qualified dividends.

## **TAXATION AS A RIC**

If we continue to:

• qualify as a RIC; and

• satisfy the Annual Distribution Requirement;

then we will not be subject to U.S. federal income tax on the portion of our investment company taxable income and net capital gains, defined as net long-term capital gains in excess of net short-term capital losses we distribute to our stockholders.

We will be subject to U.S. federal income tax at the regular corporate rates on any net income or net capital gain not distributed (or deemed distributed) to our stockholders.

We will be subject to a 4% nondeductible federal excise tax on our undistributed income unless we distribute in a timely manner an amount at least equal to the sum of (a) 98% of our ordinary income for each calendar year, (b) 98.2% of our capital gain net income (both long-term and short-term) for the one-year period ending October 31 in that calendar year and (c) any income realized, but not distributed, in the preceding years (the “Excise Tax Avoidance Requirement”). For this purpose, however, any ordinary income or capital gain net income retained by us that is subject to corporate income tax for the tax year ending in that calendar year will be considered to have been distributed by year end. For the years ended December 31, 2018, 2017 and 2016, we recorded \$11 thousand, \$0.1 million and \$0.7 million on our consolidated statements of operations for U.S. federal excise taxes.

In order to qualify as a RIC for federal income tax purposes, we must, among other things:

- meet the Annual Distribution Requirement;

- qualify to be treated as a business development company under the 1940 Act at all times during each taxable year;

- derive in each taxable year at least 90% of our gross income from dividends, interest, payments with respect to certain securities loans, gains from the sale of stock or other securities, or other income derived with respect to our business of investing in such stock or securities, and net income derived from interests in “qualified publicly traded partnerships” (partnerships that are traded on an established securities market or tradable on a secondary market, other than partnerships that derive 90% of their income from interest, dividends and other permitted RIC income) (the “90% Income Test”); and

- diversify our holdings so that at the end of each quarter of the taxable year:

- at least 50% of the value of our assets consists of cash, cash equivalents, U.S. government securities, securities of other RICs, and other securities if such other securities of any one issuer do not represent more than 5% of the value of our assets or more than 10% of the outstanding voting securities of the issuer (which for these purposes includes the equity securities of a “qualified publicly traded partnership”); and



no more than 25% of the value of our assets is invested in the securities, other than U.S. government securities or securities of other RICs, of one issuer or of two or more issuers that are controlled, as determined under applicable tax rules, by us and that are engaged in the same or similar or related trades or businesses or in the securities of one or more qualified publicly traded partnerships (the “Diversification Tests”).

To the extent that we invest in entities treated as partnerships for federal income tax purposes (other than a “qualified publicly traded partnership”), we generally must include the items of gross income derived by the partnerships for purposes of the 90% Income Test, and the income that is derived from a partnership (other than a “qualified publicly traded partnership”) will be treated as qualifying income for purposes of the 90% Income Test only to the extent that such income is attributable to items of income of the partnership which would be qualifying income if realized by us directly. In addition, we generally must take into account our proportionate share of the assets held by partnerships (other than a “qualified publicly traded partnership”) in which we are a partner for purposes of the Diversification Tests.

In order to prevent our receipt of income that would not satisfy the 90% Income Test, we may establish one or more special purpose corporations to hold assets from which we do not anticipate earning dividend, interest or other qualifying income under the 90% Income Test. Any investments held through a special purpose corporation would generally be subject to federal income taxes and other taxes, and therefore would be expected to achieve a reduced after-tax yield.

We may be required to recognize taxable income in circumstances in which we do not receive a corresponding payment in cash. For example, if we hold debt obligations that are treated under applicable tax rules as having original issue discount (such as debt instruments with payment-in-kind interest or, in certain cases, increasing interest rates or issued with warrants), we must include in income each year a portion of the original issue discount that accrues over the life of the obligation, regardless of whether cash representing such income is received by us in the same taxable year. We may also have to include in our income other amounts that we have not yet received in cash, such as deferred loan origination fees that are paid after origination of the loan or are paid in non-cash compensation such as warrants or stock. We anticipate that a portion of our income may constitute original issue discount or other income required to be included in taxable income prior to receipt of cash.

Because any original issue discount or other amounts accrued will be included in our investment company taxable income for the year of the accrual, we may be required to make a distribution to our stockholders in order to satisfy the Annual Distribution Requirement, even though we will not have received any corresponding cash amount. As a result, we may have difficulty meeting the Annual Distribution Requirement. We may have to sell some of our investments at times and/or at prices we do not consider advantageous, raise additional debt or equity capital or forgo new investment opportunities for this purpose. If we are not able to obtain cash from other sources, we may fail to qualify for RIC tax treatment and thus become subject to corporate-level federal income tax.

Gain or loss realized from warrants acquired by us as well as any loss attributable to the lapse of such warrants generally will be treated as capital gain or loss. Such gain or loss generally will be long-term or short-term, depending on how long we held a particular warrant.

Our investments in non-U.S. securities may be subject to non-U.S. income, withholding and other taxes. In that case, our yield on those securities would be decreased. Stockholders will generally not be entitled to claim a credit or deduction with respect to non-U.S. taxes paid by us.

If we purchase shares in a “passive foreign investment company” (a “PFIC”), we may be subject to federal income tax on a portion of any “excess distribution” or gain from the disposition of such shares even if such income is distributed as a taxable dividend by us to our stockholders. Additional charges in the nature of interest may be imposed on us in respect of deferred taxes arising from such distributions or gains. If we invest in a PFIC and elect to treat the PFIC as a “qualified electing fund” (a “QEF”), under the Code, in lieu of the foregoing requirements, we will be required to include in income each year a portion of the ordinary earnings and net capital gain of the QEF, even if such income is not distributed to us. Alternatively, we can elect to mark-to-market at the end of each taxable year our shares in a PFIC; in that case, we will recognize as ordinary income any increase in the value of such shares and as ordinary loss any decrease in such value to the extent it does not exceed prior increases included in income. Under either election, we may be required to recognize in a year income in excess of our distributions from PFICs and our proceeds from dispositions of PFIC stock during that year, and such income will be taken into account for purposes of the Annual Distribution Requirement and the 4% federal excise tax.

Under Section 988 of the Code, gain or loss attributable to fluctuations in exchange rates between the time we accrue income, expenses, or other liabilities denominated in a foreign currency and the time we actually collect such income or pay such expenses or liabilities is generally treated as or