AKIN GUMP STRAUSS HAUER & FELD LLP

May 28, 2004

PRIVATE EQUITY GOES PUBLIC

PRIVATE EQUITY GROUPS AND BUSINESS DEVELOPMENT COMPANIES (BDCs)

Recently, several leading U.S. private equity sponsors have raised, or announced plans to raise, funds for investment by BDCs. What are BDCs? How do they operate? What is fueling the deployment of these vehicles by private equity groups? Set forth below are answers to these and other frequently asked questions about BDCs.

SOME FREQUENTLY ASKED QUESTIONS

- What are BDCs?
- Which private equity groups have moved to launch BDCs recently?
- What is driving private equity groups to establish BDCs?
- Will the BDC trend continue?
- How are BDC managers compensated?
- How are BDCs regulated?
- How are BDCs treated for tax purposes?

WHAT ARE BUSINESS DEVELOPMENT COMPANIES?

BDCs are specially regulated retail investment companies that typically make private equity-style investments in small and middle-market companies. The new batch of BDCs sponsored by private equity groups is generally focused on mezzanine and debt investments. BDCs are subject to some standard and other modified provisions of the Investment Company Act of 1940 (the 1940 Act). Unlike other registered funds, BDC managers may charge performance fees. BDCs have greater flexibility than do typical registered funds to use leverage and to engage in certain affiliate transactions with portfolio companies. Where open-end mutual funds are structured such that investors can only sell and buy shares directly to and from the

This document is distributed for informational use only; it does not constitute legal advice and should not be used as such.

© 2004 Akin Gump Strauss Hauer & Feld LLP

fund itself, BDCs are closed-end funds whose shares trade publicly on the open market. As a result, BDCs are subject to the Sarbanes-Oxley Act of 2002 and other public company rules and regulations.

WHICH PRIVATE EQUITY GROUPS HAVE MOVED TO LAUNCH BDCs RECENTLY?

A number of private equity firms — including Apollo, Blackstone and KKR — have organized BDCs and commenced the SEC registration process during the past six months. Apollo Investment Corporation, the only BDC listed below that has thus far completed the SEC registration process and gone public, raised approximately $900 million in its initial public offering on April 5, 2004.

Company	SEC Filing Date
Brantley Mezzanine Capital Corporation	December 19, 2003
Apollo Investment Corporation	February 6, 2004 (began trading on Nasdaq April 5, 2004)
KKR BDC Inc.	April 12, 2004
Blackridge Investments Corp.	April 14, 2004
Evercore Investment Corporation	April 14, 2004
Porticoes Capital Corporation	April 14, 2004
Blackrock Kelso Capital	April 16, 2004
Marathon Capital Finance Corporation	April 16, 2004
Prospect Street Energy Corporation	April 16, 2004
Triarc Deerfield Investment Corporation	April 19, 2004
Orchard First Source Inc.	April 20, 2004
Ares Capital Corporation	April 21, 2004
THL Investment Capital Corporation	May 5, 2004
Gores Investment Corporation	May 6, 2004
Gleacher Investment Corporation	May 11, 2004

This document is distributed for informational use only; it does not constitute legal advice and should not be used as such.
© 2004 Akin Gump Strauss Hauer & Feld LLP

WHAT IS DRIVING PRIVATE EQUITY GROUPS TO ESTABLISH BDCs?

BDCs appear to be attracting attention for a number of reasons.

- ***Permanent Capital***. BDCs allow investors the same degree of liquidity as other publicly traded investments while providing their managers with "permanent capital" that is not subject to shareholder redemptions or the requirement that capital (as well as any returns on such capital) be distributed to investors as investments are realized or otherwise generate income. Unlike the just-in-time periodic capital call funding feature of a private equity fund, a BDC is fully funded as of the date of its public offering because BDC investors pay for their shares in full at the time of investment.

- ***New Investors***. BDCs provide access to the public markets; shareholders are not required to meet income, net worth or sophistication criteria. Retail investors may welcome this opportunity to gain access to the private equity market through funds managed by major private equity players. It appears that institutional investors are less inclined to invest in BDCs primarily because fees are generally higher than those of typical private equity funds.

- ***Higher Fees***. Another plus of the BDC structure is that managers may immediately begin earning management fees on the amount of capital raised from the BDC's initial public offering. BDC managers may double their annual management fees by borrowing funds in an amount equal to the BDC's aggregate net asset value (the maximum amount of leverage that BDCs are permitted to incur pursuant to the 1940 Act) and calculating the management fee based on gross assets, including any borrowings. In addition, unlike typical closed-end funds, subject to certain limitations, BDC managers may charge performance-based fees.

- ***Mezzanine Financing Opportunities***. Most of the new BDCs target middle-market company mezzanine or debt investments. In expecting that this type of investment will both generate current income and offer some opportunity for gains, investors may find that the new BDCs serve as a relatively safe way to tap some upside, which is especially welcome at a time when interest rates are still low and short-term instruments offer little return. At the same time, managers appear to see middle-market businesses as underserved as far as financing is concerned. The current low interest rate environment seems to have made it more difficult for middle-market companies to secure adequate debt financing from banks, which tend to view such companies as higher risk than larger institutional borrowers.

WILL THE BDC TREND CONTINUE?

It remains to be seen whether BDCs will continue to captivate the attention of private equity groups. Of course, the performance of BDCs now being sold and whether BDC shares wind up trading at a discount to net asset value will likely serve as the best indicators of staying power. Skeptics and other observers alike will note that closed-end publicly traded funds often trade at a discount to net asset value. Moreover, even if their market performance is acceptable, as interests rates rise the new BDCs may become less attractive relative to other candidates vying for investor dollars.

In any case, as they look to the pros and cons of incorporating BDCs into their stables of offerings, private equity groups must continue to evaluate a number of complicating factors. Will the group's existing vehicles permit investment opportunities to be directed to a new BDC? Can the new BDC co-invest in a transaction alongside existing funds? Thus far, although it appears that many major players have the flexibility to launch BDCs, few, if any, of the new vehicles will be investing alongside the private funds in the same companies. In addition, accessing the public markets means more

This document is distributed for informational use only; it does not constitute legal advice and should not be used as such.
© 2004 Akin Gump Strauss Hauer & Feld LLP

regulation in a variety of areas, including, among others, disclosure, fees, governance and valuation. Accordingly, while the advantages the new BDCs offer are clear, there are countervailing factors that cannot be easily dismissed.

HOW ARE BDC MANAGERS COMPENSATED?

BDCs generally provide for the following fees to be paid to their managers:

- ***Management Fee***. A management fee equal to an annual rate of 1.75 percent to 2.5 percent of the gross assets of the portfolio (including any borrowings), paid quarterly in arrears.
- ***Performance Fee (Based on Net Investment Income)***. A performance fee equal to 20 percent of the annual net investment income of the portfolio paid out as follows:
  - 0 percent of all net investment income earned at or below a hurdle rate of 7 percent
  - 100 percent of all net investment income earned above the 7 percent hurdle rate but below a rate of 8.75 percent (commonly referred to as a "catch-up" mechanism because it serves to restore the intended 80/20 split), and
  - 20 percent of all net investment income earned above the 8.75 percent rate.
- ***Performance Fee (Based on Capital Gains)***. A performance fee of 20 percent of the annual realized capital gains of the fund.

  While the Investment Advisers Act of 1940 generally prohibits managers from charging performance fees to retail investors, this prohibition does not apply to BDC managers as long as (1) the performance fee does not exceed 20 percent of the realized capital gains over a specified period, (2) the fee is computed net of all realized capital losses and unrealized capital depreciation and (3) the BDC does not have certain options, warrants or rights outstanding and does not have certain types of profit-sharing plans.
- ***Sales Commissions***. As is the case with traditional closed-end funds, brokers that sell BDC shares generally receive significant compensation from front-end sales loads charged to investors.

HOW ARE BDCs REGULATED?

The Small Business Investment Incentive Act of 1980 was enacted to promote public investment in private companies and to enable BDCs to compete with private venture capital enterprises. It modified certain provisions of the 1940 Act, providing BDCs with more flexibility than typical closed-end funds to issue derivative securities, to use leverage and to engage in affiliated transactions with portfolio companies. BDC managers were also permitted to charge performance-based fees.

- ***Eligible Investments***. The BDC structure is intended to promote investment in "eligible portfolio companies." Eligible portfolio companies are generally private U.S. companies that are not investment companies and that do not have outstanding margin securities or a class of securities listed on a national exchange. In general, the 1940 Act requires that BDCs have at least 70 percent of their total assets in eligible assets that include:

  (1) eligible portfolio companies (generally smaller private companies), and

  (2) cash, government securities or high-quality debt securities maturing one year or less from the time of investment.

This document is distributed for informational use only; it does not constitute legal advice and should not be used as such.
© 2004 Akin Gump Strauss Hauer & Feld LLP

- ***Leverage***. With respect to leverage, any debt or senior security issued by a BDC must have asset coverage of 200 percent (i.e., debt and senior securities cannot exceed half of the BDC's total assets), and no dividends can be declared on common stock unless the BDC's debt and senior securities have asset coverage of 200 percent. This asset coverage requirement is less restrictive than the 300 percent asset coverage requirement imposed on traditional closed-end funds and mutual funds.

- ***Affiliate Transactions***. BDCs have greater flexibility than typical closed-end funds to engage in certain affiliated transactions. Unlike closed-end funds, a BDC may generally engage in a transaction between itself and a person who is directly or indirectly controlled by the BDC and certain affiliates of such person. Certain transactions involving a BDC and its affiliates (including any director, officer, employee or member of an advisory board of a BDC) require prior approval by a majority of the BDC's disinterested directors on the basis that the transaction's terms are reasonable and fair to the BDC's shareholders and the transaction is consistent with the interests of the BDC's shareholders and policies. Depending on the relationship between the affiliate and the BDC, transactions may require SEC approval.

- ***Management***. The 1940 Act requires that a majority of the directors or general partners of a BDC must be persons who are not interested persons of the BDC. The officers of a BDC may manage the BDC, or an external manager may be appointed pursuant to an investment advisory contract. The contract must be initially approved by the BDC's shareholders and subsequently approved by the BDC's board of directors, including a majority of the board's independent directors, on an annual basis. External investment managers of BDCs are required to be registered with the SEC as investment advisers and are subject to the provisions of the Investment Advisers Act of 1940.

- ***Derivatives***. Unlike traditional investment companies, which are subject to certain board and shareholder approval requirements and certain other limitations, BDCs are able to issue derivative securities, including options, warrants and rights that convert to voting securities.

- ***Organization***. BDCs are required to be organized under the laws of, and have their principal place of business in, the United States. Like mutual funds, BDCs are generally formed in Maryland due to state laws intended to discourage takeovers and proxy contests.

- ***Filings***. BDCs are required to (1) file a notice with the SEC pursuant to which the BDC elects to be treated as a BDC, (2) register a class of equity securities under Section 12 of the Securities Exchange Act of 1934 and (3) file reports — including 10-Qs, 10Ks and 8-Ks — like those filed by publicly traded operating companies.

HOW ARE BDCs TREATED FOR TAX PURPOSES?

A BDC may elect to be taxed as a corporation or as a regulated investment company (RIC) under Subchapter M of the Internal Revenue Code. As a RIC, a BDC avoids taxation on the portion of income and capital gains distributed to shareholders. To qualify for treatment as a RIC, in addition to qualifying as a BDC under the 1940 Act at all times during each taxable year, a BDC also must comply with certain requirements with respect to the source of its investment company income and its portfolio diversification. To maintain its RIC status, the BDC must distribute to its shareholders for each taxable year at least 90 percent of its "investment company taxable income," which generally consists of the BDC's ordinary income plus the excess of realized net short-term capital gains over realized net long-term capital losses.

This document is distributed for informational use only; it does not constitute legal advice and should not be used as such.
© 2004 Akin Gump Strauss Hauer & Feld LLP

A 4 percent excise tax applies to certain undistributed income of the BDC unless at least 98 percent of certain income and net gains of the BDC is distributed for the calendar year.

Generally, distributions by a BDC are taxable as either ordinary income or capital gains (including "qualified dividend" income), generally in the same manner as distributions from mutual funds and closed-end funds.

A BDC shareholder will recognize taxable gain or loss when the shareholder sells its shares. If a shareholder holds its shares for more than one year, gains or losses arising from the sale generally will be treated as long-term capital gains or losses. Gains or losses from the sale of shares held for one year or less generally are classified as short-term capital gains or losses.

Many BDCs have dividend reinvestment plans for shareholders. Pursuant to these plans, cash dividends paid to investors are automatically reinvested in shares of the BDC. Shareholders that wish to receive distributions in cash may opt out of the dividend reinvestment plan. Shareholders that participate in the plan, however, are subject to the same federal, state and local tax consequences with respect to reinvested distributions as shareholders who elect to receive distributions in cash.

CONTACT INFORMATION

If you have any questions or wish to learn more about this topic, please contact the partner who represents you, or:

David M. Billings................44.20.7012.9620.................dbillings@akingump.com......................London
Prakash H. Mehta................202.887.4248......................pmehta@akingump.com........................Washington
Eliot D. Raffkind................214.969.4667......................eraffkind@akingump.com......................Dallas
Ann E. Tadajweski.............212.872.1087......................atadajweski@akingump.com..................New York
Stephen M. Vine.................212.872.1030......................svine@akingump.com...........................New York

Austin Brussels Dallas Houston London Los Angeles Moscow New York
Philadelphia Riverside Riyadh (Affiliate) San Antonio San Francisco Washington, D.C.

This document is distributed for informational use only; it does not constitute legal advice and should not be used as such.
© 2004 Akin Gump Strauss Hauer & Feld LLP