

GLADSTONE INVESTMENT CORPORATION\DE

Form 10-K

May 15, 2017

Table of Contents

**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 March 31, 2017**

**OR**

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission file number 814-00704**

**GLADSTONE INVESTMENT CORPORATION**

**(Exact name of registrant as specified in its charter)**

**Delaware**  
**(State or other jurisdiction of**  
**incorporation or organization)**

**1521 Westbranch Drive, Suite 100**  
**McLean, Virginia**  
**(Address of principal executive offices)**

**83-0423116**  
**(I.R.S. Employer**  
**Identification No.)**

**22102**  
**(Zip Code)**

**(703) 287-5800**  
**(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, \$0.001 par value per share</b>	<b>NASDAQ Global Select Market</b>
<b>6.75% Series B Cumulative Term Preferred Stock, \$0.001 par value per share</b>	<b>NASDAQ Global Select Market</b>
<b>6.50% Series C Cumulative Term Preferred Stock, \$0.001 par value per share</b>	<b>NASDAQ Global Select Market</b>
<b>6.25% Series D Cumulative Term Preferred Stock, \$0.001 par value per share</b>	<b>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 and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES NO

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of 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.

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

Non-accelerated filer (Do not check if a smaller reporting company)

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

The aggregate market value of the voting stock held by non-affiliates of the Registrant on September 30, 2016, based on the closing price on that date of \$8.89 on the NASDAQ Global Select Market, was \$260,762,147. For the purposes of calculating this amount only, all directors and executive officers of the Registrant have been treated as affiliates. There were 32,370,958 shares of the Registrant's Common Stock, \$0.001 par value, outstanding as of May 12, 2017.

**Documents Incorporated by Reference.** Portions of the Registrant's definitive proxy statement relating to the Registrant's 2017 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission pursuant to Regulation 14A are incorporated by reference into Part III of this Annual Report on Form 10-K as indicated herein. Such proxy statement will be filed with the Securities and Exchange Commission no later than 120 days following the end of the Registrant's fiscal year ended March 31, 2017.

**Table of Contents**

**GLADSTONE INVESTMENT CORPORATION**

**FORM 10-K FOR THE FISCAL YEAR ENDED**

**MARCH 31, 2017**

**TABLE OF CONTENTS**

PART I	ITEM 1	<u>Business</u>	2
	ITEM 1A	<u>Risk Factors</u>	18
	ITEM 1B	<u>Unresolved Staff Comments</u>	35
	ITEM 2	<u>Properties</u>	35
	ITEM 3	<u>Legal Proceedings</u>	35
	ITEM 4	<u>Mine Safety Disclosures</u>	35
PART II	ITEM 5	<u>Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	36
	ITEM 6	<u>Selected Financial Data</u>	38
	ITEM 7	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	39
	ITEM 7A	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	62
	ITEM 8	<u>Financial Statements and Supplementary Data</u>	63
	ITEM 9	<u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	108
	ITEM 9A	<u>Controls and Procedures</u>	108
	ITEM 9B	<u>Other Information</u>	108
PART III	ITEM 10	<u>Directors, Executive Officers and Corporate Governance</u>	109
	ITEM 11	<u>Executive Compensation</u>	109
	ITEM 12	<u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	109
	ITEM 13	<u>Certain Relationships and Related Transactions, and Director Independence</u>	109
	ITEM 14	<u>Principal Accountant Fees and Services</u>	109
PART IV	ITEM 15	<u>Exhibits and Financial Statement Schedule</u>	110
	ITEM 16	<u>Form 10-K Summary</u>	111
	<u>SIGNATURES</u>		112

---

Table of Contents

**FORWARD-LOOKING STATEMENTS**

All statements contained herein, other than historical facts, may constitute forward-looking statements. These statements may relate to, among other things, our future operating results, our business prospects and the prospects of our portfolio companies, actual and potential conflicts of interest with Gladstone Management Corporation and its affiliates, the use of borrowed money to finance our investments, the adequacy of our financing sources and working capital, and our ability to co-invest, among other factors. In some cases, you can identify forward-looking statements by terminology such as estimate, may, might, believe, will, provided, anticipate, future, could, growth, plan, project, intend, expect, should, would, if, seek, or the negative or variations of such terms or comparable terminology. These forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance, or achievements to be materially different from any future results, levels of activity, performance, or achievements expressed or implied by such forward-looking statements. Such factors include, but are not limited to: (1) the recurrence of adverse events in the economy and the capital markets; (2) risks associated with negotiation and consummation of pending and future transactions; (3) the loss of one or more of our executive officers, in particular David Gladstone, Terry Lee Brubaker, or David Dullum; (4) changes in our investment objectives and strategy; (5) availability, terms (including the possibility of interest rate volatility) and deployment of capital; (6) changes in our industry, interest rates, exchange rates, regulation, or the general economy; (7) the degree and nature of our competition; (8) our ability to maintain our qualification as a regulated investment company and as a business development company; and (9) those factors described in Item 1A. *Risk Factors* of this Annual Report on Form 10-K. We caution readers not to place undue reliance on any such forward-looking statements. Actual results could differ materially from those anticipated in our forward-looking statements and future results could differ materially from historical performance. We have based forward-looking statements on information available to us on the date of this Annual Report on Form 10-K. Except as required by the federal securities laws, we undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, after the date of this Annual Report on Form 10-K. Although we undertake no obligation to revise or update any forward-looking statements, 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 have filed, or in the future may file, with the U.S. Securities and Exchange Commission, including subsequent annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K.

*In this Annual Report on Form 10-K (the Annual Report), the Company, we, us, and our refer to Gladstone Investment Corporation and its wholly-owned subsidiaries unless the context otherwise indicates. Dollar amounts, except per share amounts, are in thousands unless otherwise indicated.*

**PART I**

The information contained in this section should be read in conjunction with our accompanying *Consolidated Financial Statements* and the notes thereto appearing elsewhere in this Annual Report.

**ITEM 1. BUSINESS**

**Overview**

*Organization*

We were incorporated under the General Corporation Law of the State of Delaware on February 18, 2005. On June 22, 2005, we completed our initial public offering and commenced operations. We operate as an externally managed, closed-end, non-diversified management investment company and have elected to be treated as a business development company ( BDC ) under the Investment Company Act of 1940, as amended (the 1940 Act ). For federal income tax purposes, we have elected to be treated as a regulated investment company ( RIC ) under Subchapter M of the Internal Revenue Code of 1986, as amended (the Code ). To continue to qualify as a RIC for federal income tax purposes and obtain favorable RIC tax treatment, we must meet certain requirements, including certain minimum distribution requirements. Since our initial public offering in 2005 and through March 31, 2017, we have made 141 consecutive monthly distributions to common stockholders.

Our shares of common stock, 6.75% Series B Cumulative Term Preferred Stock ( Series B Term Preferred Stock ), 6.50% Series C Cumulative Term Preferred Stock ( Series C Term Preferred Stock ) and 6.25% Series D Cumulative Term Preferred Stock ( Series D Term Preferred Stock ) are traded on the NASDAQ Global Select Market ( NASDAQ ) under the trading symbols GAIN, GAINO, GAINN, and GAINM, respectively.

---

**Table of Contents**

***Investment Adviser and Administrator***

We are externally managed by Gladstone Management Corporation (the Adviser), an affiliate of ours, under an investment advisory and management agreement (the Advisory Agreement) and another of our affiliates, Gladstone Administration, LLC, (the Administrator) provides administrative services to us pursuant to a contractual agreement (the Administration Agreement). Each of the Adviser and Administrator are privately-held companies that are indirectly owned and controlled by David Gladstone, our chairman and chief executive officer. Mr. Gladstone and Terry Brubaker, our vice chairman and chief operating officer, also serve on the board of directors of the Adviser, the board of managers of the Administrator, and serve as executive officers of the Adviser and the Administrator. The Administrator employs, among others, our chief financial officer and treasurer, chief valuation officer, chief compliance officer, general counsel and secretary (who also serves as the president of the Administrator) and their respective staffs. The Adviser and Administrator have extensive experience in our lines of business and also provide investment advisory and administrative services, respectively, to our affiliates, including, but not limited to: Gladstone Commercial Corporation (Gladstone Commercial), a publicly-traded real estate investment trust; Gladstone Capital Corporation (Gladstone Capital), a publicly-traded BDC and RIC; and Gladstone Land Corporation, a publicly-traded real estate investment trust (Gladstone Land, together with Gladstone Commercial, and Gladstone Capital, collectively the Affiliated Public Funds). In the future, the Adviser and Administrator may provide investment advisory and administrative services, respectively, to other funds and companies, both public and private.

The Adviser is organized as a corporation under the laws of the State of Delaware on July 2, 2002, and is a registered investment adviser under the Investment Advisers Act of 1940, as amended. The Administrator was organized as a limited liability company under the laws of the State of Delaware on March 18, 2005. The Adviser and Administrator are headquartered in McLean, Virginia, a suburb of Washington, D.C. The Adviser also has offices in several other states.

***Investment Objectives and Strategy***

We were established for the purpose of investing in debt and equity securities of established private businesses operating in the United States (U.S.). Our investment objectives are to: (i) achieve and grow current income by investing in debt securities of established businesses that we believe will provide stable earnings and cash flow to pay expenses, make principal and interest payments on our outstanding indebtedness and make distributions to stockholders that grow over time; and (ii) provide our stockholders with long-term capital appreciation in the value of our assets by investing in equity securities, generally in combination with the aforementioned debt securities, of established businesses that we believe can grow over time to permit us to sell our equity investments for capital gains. To achieve our objectives, our investment strategy is to invest in several categories of debt and equity securities, with individual investments generally totaling up to \$30 million, although investment size may vary, depending upon our total assets or available capital at the time of investment. We intend that our investment portfolio over time will consist of approximately 75% in debt securities and 25% in equity securities, at cost. As of March 31, 2017, our investment portfolio was made up of 72.0% in debt securities and 28.0% in equity securities, at cost.

We focus on investing in lower middle market private businesses (which we generally define as private companies with annual earnings before interest, taxes, depreciation and amortization (EBITDA) of \$3 million to \$20 million) (Lower Middle Market) in the U.S. that meet certain criteria, including, but not limited to, the following: the sustainability of the business free cash flow and its ability to grow it over time, adequate assets for loan collateral, experienced management teams with a significant ownership interest in the portfolio company, reasonable capitalization of the portfolio company, including an ample equity contribution or cushion based on prevailing enterprise valuation multiples, and the potential to realize appreciation and gain liquidity in our equity position, if any. We anticipate that liquidity in our equity position will be achieved through a merger or acquisition of the portfolio

company, a public offering of the portfolio company's stock or, to a lesser extent, by exercising our right to require the portfolio company to repurchase our warrants, as applicable, though there can be no assurance that we will always have these rights. We invest in portfolio companies that need funds for growth capital or to finance acquisitions or recapitalize or, to a lesser extent, refinance their existing debt facilities. We seek to avoid investing in high-risk, early-stage enterprises.

We invest by ourselves or jointly with other funds and/or management of the portfolio company, depending on the opportunity. In July 2012, the U.S. Securities and Exchange Commission (SEC) granted us an exemptive order (the Co-Investment Order) that expanded our ability to co-invest with certain of our affiliates, including Gladstone Capital, under certain circumstances and any future business development company or closed-end management investment company that is advised (or sub-advised if it controls the fund) by our external investment adviser, or any combination of the foregoing, subject to the conditions in the SEC's order. Since 2012, we have opportunistically made several co-investments with our affiliate Gladstone Capital pursuant to the Co-Investment Order. We believe the Co-Investment Order has enhanced and will continue to enhance our ability to further our investment objectives and strategies. If we are participating in an investment with one or more co-investors, whether or not an affiliate of ours, our investment is likely to be smaller than if we were investing alone.



## Table of Contents

In general, our investments in debt securities have a term of five years, accrue interest at variable rates (based on the one-month London Interbank Offered Rate ( LIBOR )) and, to a lesser extent, at fixed rates. As of March 31, 2017, our loan portfolio consisted of 92.9% variable rate loans with floors and 7.1% fixed rate loans based on the total principal balance of all outstanding debt investments. We seek debt instruments that pay interest monthly or, at a minimum, quarterly, and which may include a yield enhancement such as a success fee or, to a lesser extent, deferred interest provision and are primarily interest only, with all principal and any accrued but unpaid interest due at maturity. Generally, success fees accrue at a set rate and are contractually due upon a change of control of the business. Some debt securities may have deferred interest whereby some portion of the interest payment is added to the principal balance so that the interest is paid, together with the principal, at maturity. This form of deferred interest is often called paid-in-kind ( PIK ) interest. As of March 31, 2017, we did not have any securities with a PIK feature.

Typically, our investments in equity securities take the form of common stock, preferred stock, limited liability company interests, or warrants or options to purchase any of the foregoing. Often, these equity investments occur in connection with our original investment, buyouts and recapitalizations of a business, or refinancing existing debt. Since our initial public offering in 2005 and through March 31, 2017, we have made investments in 45 companies, excluding investments in syndicated loans.

We expect that our investment portfolio will continue to primarily include the following three categories of investments in private companies in the U.S.:

*First Lien Secured Debt Securities:* We seek to invest a portion of our assets in first lien secured debt securities also known as senior loans, senior term loans, lines of credit and senior notes. Using its assets as collateral, the borrower typically uses first lien secured debt to cover a substantial portion of the funding needs of the business. These debt securities usually take the form of first priority liens on all, or substantially all, of the assets of the business.

*Second Lien Secured Debt Securities:* We seek to invest a portion of our assets in second lien secured debt securities, which may also be referred to as subordinated loans, subordinated notes and mezzanine loans. These second lien secured debt securities rank junior to the borrower's first lien secured debt securities and may be secured by second priority liens on all or a portion of the assets of the business. Additionally, we may receive other yield enhancements, such as warrants to buy common and preferred stock or limited liability interests, in connection with these second lien secured debt securities.

*Preferred and Common Equity/Equivalents:* We seek to invest a portion of our assets in equity securities, which consist of preferred and common equity, limited liability company interests, warrants or options to acquire such securities, and are generally in combination with our debt investment in a business. Additionally, we may receive equity investments derived from restructurings on some of our existing debt investments. In many cases, we will own a significant portion of the equity of the businesses in which we invest.

Pursuant to the 1940 Act, we must maintain at least 70% of our total assets in qualifying assets, which generally include each of the investment types listed above. Therefore, the 1940 Act permits us to invest up to 30% of our assets in other non-qualifying assets. See *Regulation as a BDC Qualifying Assets* for a discussion of the types of qualifying assets in which we are permitted to invest pursuant to Section 55(a) of the 1940 Act.

Because the majority of the loans in our portfolio consist of term debt in private companies that typically cannot or will not expend the resources to have their debt securities rated by a credit rating agency, we expect that most, if not

all, of the debt securities we acquire will be unrated. Investors should assume that these loans would be rated below what is today considered investment grade quality. Investments rated below investment grade are often referred to as high yield securities or junk bonds and may be considered higher risk as compared to investment-grade debt instruments. With the exception of our policy to conduct our business as a BDC, these investment policies are not fundamental and may be changed without stockholder approval.

### ***Investment Policies***

We seek to achieve a high level of current income and capital gains through investments in secured debt securities and preferred and common stock that we generally acquire in connection with buyouts and other recapitalizations. The following investment policies, along with the investment objectives, may not be changed without the approval of our board of directors (our Board of Directors), a majority of whom are not interested persons as defined in Section 2(a)(19) of the 1940 Act:

We will at all times conduct our business so as to retain our status as a BDC. In order to retain that status, we must be operated for the purpose of investing in certain categories of qualifying assets. In addition, we may not acquire any assets (other than non-investment assets necessary and appropriate to our operations as a BDC or qualifying assets) if, after giving effect to such acquisition, the value of our qualifying assets is less than 70% of the value of our total assets. We anticipate that the securities we seek to acquire will generally be qualifying assets.

**Table of Contents**

We will at all times endeavor to conduct our business so as to retain our status as a RIC under the Code. To do so, we must meet income source, asset diversification and annual distribution requirements. We may issue senior securities, such as debt or preferred stock, to the extent permitted by the 1940 Act for the purpose of making investments, to fund share repurchases, or for temporary emergency or other purposes.

*Investment Concentrations*

As of March 31, 2017, our investment portfolio consisted of investments in 35 portfolio companies located in 17 states across 18 different industries with an aggregate fair value of \$501.6 million. Our investments in J.R. Hobbs Co. Atlanta, LLC ( JR Hobbs ), Counsel Press, Inc. ( Counsel Press ), Cambridge Sound Management, Inc. ( Cambridge ), Nth Degree, Inc. ( Nth Degree ), and Drew Foam Companies, Inc. ( Drew Foam ) represented our five largest portfolio investments at fair value and collectively comprised \$137.5 million, or 27.4%, of our total investment portfolio at fair value. The following table summarizes our investments by security type as of March 31, 2017 and 2016:

	March 31, 2017				March 31, 2016			
	Cost		Fair Value		Cost		Fair Value	
Secured first lien debt	\$ 284,823	54.3%	\$ 268,150	53.5%	\$ 296,247	57.2%	\$ 280,037	57.4%
Secured second lien debt	93,078	17.7	95,040	18.9	72,978	14.1	64,484	13.2
Total debt	377,901	72.0	363,190	72.4	369,225	71.3	344,521	70.6
Preferred equity	140,791	26.8	113,515	22.6	141,702	27.3	113,550	23.3
Common equity/equivalents	6,477	1.2	24,874	5.0	7,198	1.4	29,585	6.1
Total equity/equivalents	147,268	28.0	138,389	27.6	148,900	28.7	143,135	29.4
<b>Total investments</b>	<b>\$ 525,169</b>	<b>100.0%</b>	<b>\$ 501,579</b>	<b>100.0%</b>	<b>\$ 518,125</b>	<b>100.0%</b>	<b>\$ 487,656</b>	<b>100.0%</b>

Our investments at fair value consisted of the following industry classifications as of March 31, 2017 and 2016:

	March 31, 2017		March 31, 2016	
	Fair Value	Percentage of Total Investments	Fair Value	Percentage of Total Investments
Home and Office Furnishings, Housewares, and Durable Consumer Products	\$ 93,062	18.6%	\$ 86,811	17.8%
Diversified/Conglomerate Service	85,248	17.0	49,901	10.2
Chemicals, Plastics, and Rubber	65,156	13.0	90,602	18.6
Diversified/Conglomerate Manufacturing	40,303	8.0	64,986	13.3
Leisure, Amusement, Motion Pictures, Entertainment	32,453	6.5	43,330	8.9
Automobile	20,792	4.1	24,402	5.0
Textiles and Leather	20,369	4.1	11,995	2.5
Farming and Agriculture	19,096	3.8	21,005	4.3
	19,011	3.8	315	0.1

Personal and Non-Durable Consumer Products (Manufacturing Only)				
Containers, Packaging, and Glass	<b>18,266</b>	<b>3.6</b>	20,108	4.1
Machinery (Non-agriculture, Non-construction, Non-electronic)	<b>17,283</b>	<b>3.4</b>	20,011	4.1
Aerospace and Defense	<b>16,042</b>	<b>3.2</b>	10,000	2.1
Cargo Transport	<b>15,891</b>	<b>3.2</b>	14,484	3.0
Beverage, Food, and Tobacco	<b>14,802</b>	<b>3.0</b>	9,050	1.8
Telecommunications	<b>14,000</b>	<b>2.8</b>	14,000	2.9
Other < 2.0%	<b>9,805</b>	<b>1.9</b>	6,656	1.3
<b>Total investments</b>	<b>\$ 501,579</b>	<b>100.0%</b>	\$ 487,656	100.0%

**Table of Contents**

Our investments at fair value were included in the following U.S. geographic regions as of March 31, 2017 and 2016:

	March 31, 2017		March 31, 2016	
	Fair Value	Percentage of Total Investments	Fair Value	Percentage of Total Investments
South	\$ 175,136	34.9%	\$ 129,934	26.6%
Northeast	159,614	31.8	183,265	37.6
West	123,475	24.6	124,713	25.6
Midwest	43,354	8.7	49,744	10.2
<b>Total investments</b>	<b>\$ 501,579</b>	<b>100.0%</b>	<b>\$ 487,656</b>	<b>100.0%</b>

The geographic region indicates the location of the headquarters for our portfolio companies. A portfolio company may have additional business locations in other geographic regions.

**Investment Process*****Overview of Investment and Approval Process***

To originate investments, the Adviser's investment professionals use an extensive referral network comprised primarily of private equity sponsors, venture capitalists, leveraged buyout funds, investment bankers, attorneys, accountants, commercial bankers and business brokers. The Adviser's investment professionals review information received from these and other sources in search of potential financing opportunities. If a potential opportunity matches our investment objectives, the investment professionals will seek an initial screening of the opportunity with our president, David Dullum, to authorize the submission of an indication of interest ( IOI ) to the prospective portfolio company. If the prospective portfolio company passes this initial screening and the IOI is accepted by the prospective company, the investment professionals will seek approval to issue a letter of intent ( LOI ) from the Adviser's investment committee, which is composed of Messrs. Gladstone, Brubaker, and Dullum, to the prospective company. If this LOI is issued, then the Adviser and Gladstone Securities, LLC ( Gladstone Securities ) (collectively, the Due Diligence Team ) will conduct a due diligence investigation and create a detailed profile summarizing the prospective portfolio company's historical financial statements, industry, competitive position and management team and analyzing its conformity to our general investment criteria. The investment professionals then present this profile to the Adviser's investment committee, which must approve each investment. Further, each investment is available for review by the members of our Board of Directors, a majority of whom are not interested persons as defined in Section 2(a)(19) of the 1940 Act, and our Board of Directors reviews and approves any investments we may make pursuant to the Co-Investment Order.

***Prospective Portfolio Company Characteristics***

We have identified certain characteristics that we believe are important in identifying and investing in prospective portfolio companies. The criteria listed below provide general guidelines for our investment decisions, although not all of these criteria may be met by each portfolio company.

*Experienced Management:* We typically require that the businesses in which we invest have experienced management teams or a hiring plan in place to install an experienced management team. We also require the businesses to have in place proper incentives to induce management to succeed and act in concert with our interests as investors, including having significant equity or other interests in the financial performance of their companies.

*Value-and-Income Orientation and Positive Cash Flow:* Our investment philosophy places a premium on fundamental analysis from an investor's perspective and has a distinct value and income orientation. In seeking value, we focus on established companies in which we can invest at relatively low multiples of EBITDA, and that have positive operating cash flow at the time of investment. In seeking income, we typically invest in companies that generate relatively stable to growing sales, cash flows, and EBITDA to fixed charges coverage, which provides some assurance that the borrowers will be able to service their debt. We do not expect to invest in start-up companies or companies with what we believe to be speculative business plans.

*Strong Competitive Position in an Industry:* We seek to invest in businesses that have developed strong market positions and significant relative market share within their respective markets and that we believe are well-positioned to capitalize on growth opportunities. We seek businesses that demonstrate significant competitive advantages versus their competitors, which we believe will help to protect their market positions and profitability.

*Liquidation Value of Assets:* The projected liquidation value of the assets, if any, is an important factor in our investment analysis in collateralizing our debt securities.

## **Table of Contents**

### ***Extensive Due Diligence***

The Due Diligence Team conducts what we believe are extensive due diligence investigations of our prospective portfolio companies and investment opportunities. The due diligence investigation may begin with a review of publicly available information followed by in-depth business analysis, including, but not limited to, some or all of the following:

A review of the prospective portfolio company's historical and projected financial information, including a quality of earnings analysis;

Visits to the prospective portfolio company's business site(s) and evaluation of potential environmental issues;

Interviews with the prospective portfolio company's management, employees, customers and vendors;

Review of loan documents and material contracts;

Background checks and a management capabilities assessment on the prospective portfolio company's management team; and

Research, including market analyses, on the prospective portfolio company's products, services or particular industry and its competitive position therein.

Additional due diligence of a potential investment may be conducted on our behalf by attorneys and independent accountants, as well as other outside advisers, prior to the closing of the investment, as appropriate.

### ***Investment Structure***

Once the Adviser has determined that an investment meets our standards and investment criteria, the Adviser works with the management of that company and other capital providers to structure the transaction in a way that we believe will provide us with the greatest opportunity to maximize our return on the investment, while providing appropriate incentives to management of the company. As discussed above, the capital classes through which we typically structure a deal include first lien secured debt, second lien secured debt, and preferred and common equity or equivalents. Through its risk management process, the Adviser seeks to limit the downside risk of our investments by:

Making investments with an expected total return (including interest, yield enhancements and potential equity appreciation) that it believes compensates us for the credit risk of the investment;

Seeking collateral or superior positions in the portfolio company's capital structure where possible;

Incorporating put and call protection rights into the investment structure where possible;

Negotiating covenants in connection with our investments that afford our portfolio companies as much flexibility as possible in managing their businesses, while also preserving our capital; and

Holding board seats or securing board observation rights at the portfolio company.

We expect to hold most of our debt investments until maturity or repayment. From time to time, we may sell our investments (including our equity investments) earlier if a liquidity event takes place, such as a recapitalization of a portfolio company, an initial public offering, or a sale to a third party, including strategic buyers, private equity funds, or existing investors in the portfolio company, and which may be privately negotiated transactions.

### ***Competitive Advantages***

A large number of entities compete with us and make the types of investments that we seek to make in Lower Middle Market companies. Such competitors include private equity funds, leveraged buyout funds, other BDCs, venture capital funds, investment banks and other equity and non-equity based investment funds, and other financing sources, including traditional financial services



## Table of Contents

companies such as commercial banks. Many of our competitors are substantially larger than we are and have considerably greater funding sources or are able to access capital more cost effectively. In addition, certain 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 a larger portfolio of investments. Furthermore, many of these competitors are not subject to the regulatory restrictions that the 1940 Act imposes on us as a BDC. However, we believe that we have the following competitive advantages over many other providers of financing to Lower Middle Market companies.

### *Management Expertise*

Our Adviser has an investment committee for each of the Company and the Affiliated Public Funds. Mr. Gladstone and Mr. Brubaker serve as members of the Adviser's investment committees for each of the Company and each of the Affiliated Public Funds. Mr. Gladstone and Mr. Dullum have extensive experience in investing in Lower Middle Market companies and with operating in the BDC marketplace in general. Mr. Brubaker has substantial experience in acquisitions and operations of companies. These three individuals comprising our executive management dedicate a significant portion of their time to managing our investment portfolio. They have extensive experience providing capital to Lower Middle Market companies and have worked together at the Gladstone family of companies for more than ten years. In addition, we have access to the resources and expertise of the Adviser's investment professionals and support staff who possess a broad range of transactional, financial, managerial, and investment skills.

### *Increased Access to Investment Opportunities Developed Through Extensive Research Capability and Network of Contacts*

The Adviser seeks to identify potential investments through active origination and due diligence and through its dialogue with numerous management teams, members of the financial community and potential corporate partners with whom the Adviser's investment professionals have long-term relationships. We believe that the Adviser's investment professionals have developed a broad network of contacts within the investment, commercial banking, private equity and investment management communities, and that their reputation, experience, and focus on investing in Lower Middle Market companies enables us to source and identify well-positioned prospective portfolio companies, which provide attractive investment opportunities. Additionally, the Adviser expects to generate information from its professionals' network of accountants, consultants, lawyers and management teams of portfolio companies and other companies to support the Adviser's investment activities.

### *Disciplined, Value and Income-Oriented Investment Philosophy with a Focus on Preservation of Capital*

In making its investment decisions, the Adviser focuses on the risk and reward profile of each prospective portfolio company, seeking to minimize the risk of capital loss without foregoing the potential for capital appreciation. We expect the Adviser to use the same value and income-oriented investment philosophy that its professionals use in the management of the other Gladstone Companies and to commit resources to manage downside exposure. The Adviser's approach seeks to reduce our risk in investments by using some or all of the following approaches:

Focusing on companies with attractive and sustainable market positions and cash flow;

Investing in businesses with experienced and established management teams;

Engaging in extensive due diligence from the perspective of a long-term investor;

Investing at low price-to-cash flow multiples; and

Adopting flexible transaction structures by drawing on the experience of the investment professionals of the Adviser and its affiliates.

*Longer Investment Horizon*

Unlike private equity and venture capital funds that are typically organized as finite-life partnerships, we are not subject to standard periodic capital return requirements. The partnership agreements of most private equity and venture capital funds typically provide that these funds may only invest invest