

This article by Jim Roumell is excerpted from a letter of [Roumell Asset Management](#).

Medley Capital (MCC), a BDC (Business Development Company), reported a disappointing, but not surprising, quarter as management has been telegraphing that there would be another couple quarters before they are out of the woods. Highlights of the quarter were as follows:

- NAV is now \$7.71, down 8.8% from \$8.45 at Sept 30
- Net Investment Income for Q4 was \$0.13, down from \$0.16 in Q3
- Dividend was maintained at \$0.16 per share
- NAV decline was driven by \$39.1 million of unrealized portfolio losses (due primarily to 3 borrowers in the legacy portfolio)
- \$83 million of new loans during Q4 (primarily senior secured to sponsor backed borrowers)
- Equity holdings climbed from 16% to 20% driven by debt for equity exchanges

MCC's stock sold-off to under \$4.50/share allowing us to average down and purchase additional shares at a roughly 50% discount to NAV. In other words, despite negative headwinds, we found MCC's share price highly attractive in the context of this BDC's underlying intrinsic value.

As noted above, the primary issue for the quarter was the \$39 million in unrealized losses (URL) stemming from pre-2015 vintage loans. The URL was \$0.72 per share. This is significant. However, the disclosures are net positive, in our view, in that the "bad stuff" is clearly very contained to roughly 8% of the portfolio and has all to do with legacy loans representing an increasingly smaller percentage of total assets. The annual loss rate on FY 2015 and after originated loans (over 40% of the portfolio) is 0%. Class 1, 2 and 3 assets (credits performing better than expected, as expected and below expectations but no loss is expected), now make up 90% of the portfolio. Class 1, 2 and 3 assets are 1%, 77% and 12%, respectively.

Equity positions rose from 16% to 20% driven by debt for equity exchanges. It's important to note that MCC is the controlling shareholder in its equity positions and can thus drive liquidity events. Further, though it appears that MCC has 20% in equity, it's really only 12% in terms of debt for equity swaps on small company conversions. MCC invested in a JV with Great American Life (GALIC) wherein MCC contributed \$87.5 million and GALIC \$12.5 million, but because MCC is in a first loss position it must categorize this investment as equity. The loans in this JV are 1st lien, secured loans. Adjusting for this fact, the MCC portfolio goes to 75% 1st lien, 13% 2nd lien and 12% equity versus what is often shown as 67% 1st lien, 13% 2nd lien and 20% equity.

Regarding credit deterioration, CEO Brook Taub stated that he believes that "the majority of issues are behind us". We continue to believe that Brook and the Board understand the value of maintaining the dividend while the shares trade at such a deep discount to NAV. We understand MCC's reluctance to buy back shares in order to maximize liquidity, and not

risk being a forced seller. We believe the maintenance of the dividend is effectively MCC's way of being shareholder-friendly during this turnaround period.

A simple walk-through of how much cushion MCC has before triggering '40 Act asset coverage ratio limits clearly indicates that it has a good amount of room, i.e., \$112 million or 13% of loans (BDC's are not permitted to incur indebtedness unless immediately after such borrowing they have an asset coverage for total borrowings of at least 200%; i.e., the amount of debt may not exceed 50% of the value of assets). The problem legacy loans (marked at 37 now), represent about 8% of the portfolio. What that means is that MCC could absorb a 100% write-off of those problem loans representing 8% of the total portfolio in a draconian scenario, which would take the NAV to \$6.48/share, still not triggering a '40 Act liquidity event.

It should also be pointed out that MCC's interests are aligned with common shareholders. The JV that Medley Management, Inc. (MDLY) set-up to buy MCC shares (Fortress Capital invested \$40 million and MDLY invested \$12 million) now has Fortress under water despite the first 20% of losses going to MDLY because of MCC's share price decline. MDLY manages the operations of MCC through a formal management agreement. We don't expect MDLY to do anything that would harm a major institutional client or anything that would undermine MDLY's own significant investment in MCC's shares. MDLY is 80% owned by original partners. CEO Brook Taub is the largest single owner. We continue to believe that the company fully appreciates the value in maintaining its dividend as a way to return NAV to shareholders despite currently under earning it. With \$50 million in cash on hand at the end of the quarter MCC has the means to maintain it.