Kroll BondRatings™
Our name is on the line

Issuer Rating: BBB+
Senior Unsecured Debt Rating: BBB+
Outlook: Stable

Financial Institutions

BDC Rating Report

Prospect Capital Corporation

Analytical Contacts:

Marjan Riggi, Senior Director
mriggi@krollbondratings.com
646-731-2354

Isabelle Nana, Senior Financial Analyst
inana@krollbondratings.com
240-394-4153

Greg Root, Managing Director
groot@krollbondratings.com
646-731-2381

July 12, 2013

Table of Contents

Executive Summary

Kroll Bond Rating Agency (KBRA) has assigned an issuer rating of BBB+ with a stable outlook to Prospect Capital Corporation (Prospect or the Company), a Business Development Company (BDC) based in New York, NY. Prospect completed its Initial Public Offering (IPO) in June 2004. The Company's stock trades on the NASDAQ Stock Market under the ticker symbol "PSEC."

The BBB+ rating of Prospect reflects the Company's significant position in senior secured debt investments, strong leverage metrics that are well below the BDC regulatory limits, excellent asset quality performance to date, and the quality of its credit originations and monitoring. The rating is also supported by Prospect's proven management expertise in middle market lending. These strengths are balanced by the potential risks related to the Company's rapid growth trajectory during the past 18 months as well as the potentially more volatile performance embedded in equity exposures within its "buyout" portfolio and CLO investments .

The rating is based on KBRA's Finance Company Rating Methodology, published on April 1, 2013.

Rating Drivers

The rating assigned to Prospect Capital Corporation reflects the balance between the credit positives and challenges below:

Credit Positives

-Strong leverage metrics
-Very low non-accruals to date
-Good cash and liquidity position
-Strong track record in both debt and equity issuance
-Low asset encumbrance
-Solid expertise in middle market lending
-Strong and stable management team

Credit Challenges

-Exposure to higher valuation volatility due to equity and subordinated investments
-Potential risks related to concentration of investments in newer vintages
-Relatively illiquid investments
-Potential Net Asset Value (NAV) decline due to the quarterly fair value calculation of investments
-Limitation on retaining earnings as capital due to RIC status requirements for distribution
-Key man risk

Kroll BondRatings™

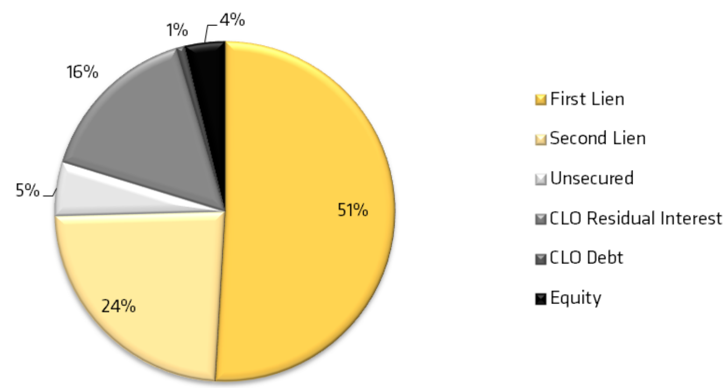
Key Business Factors Rating Determinants

Market Share, Branding and Viability

Prospect is a business development company (BDC) that specializes in providing capital to middle-market companies and private equity financial sponsors for re-financings, leveraged buyouts, acquisitions, recapitalizations, later-stage growth investments and capital expansion. The Company is an externally managed closed-end investment company managed by Prospect Capital Management (PCM), a Delaware-based limited liability corporation that is registered as an investment adviser with the U.S. Security and Exchange Commission (SEC) under the Investment Advisers Act since March 31, 2004.

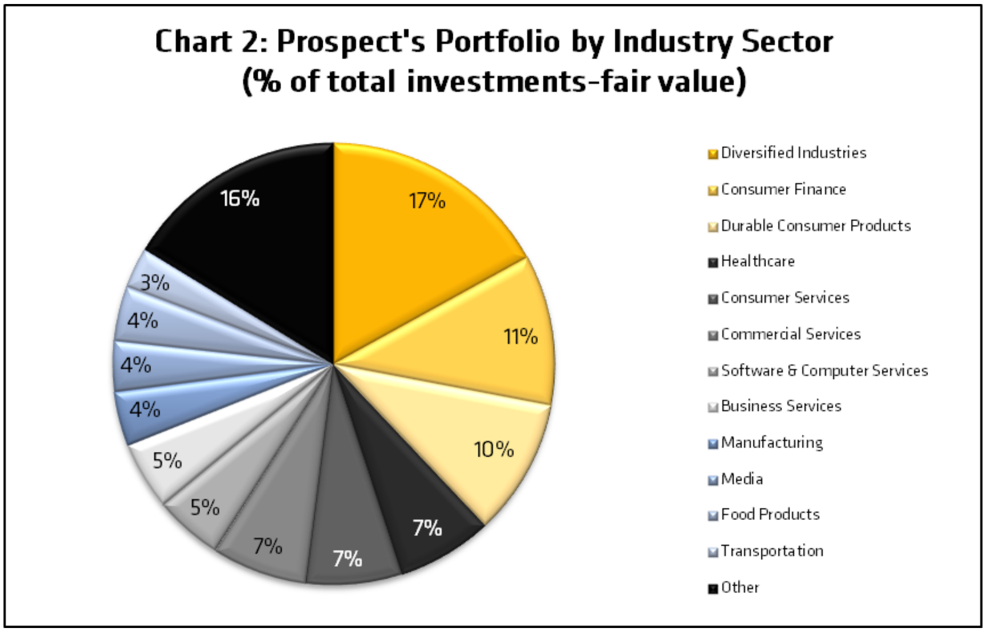
Prospect is focused primarily on secured first and second lien debt financing, which made up nearly 75% of its total investments as of March 31, 2013. The remaining 25% of Prospect's investments include unsecured loans, CLO residuals and other equity like investments. The Company concentrates on investing in companies with EBITDAs between $5 million and $150 million and sales values between $25 million and $500 million. Generally sized between $10 million and $100 million per transaction, these investments are primarily in senior and subordinated debt and, to a smaller extent, in the equity of companies in need of capital for acquisitions, divestitures, growth, development and recapitalization. At the time of the investment, the companies are primarily privately held.

Chart 1:
Prospect Capital: Composition of Investments at Fair Value as of March 31, 2013



As illustrated in Chart 2 on the following page, and compared to most of its BDC peers, Prospect has a well-diversified portfolio and invests across all industries, with a particular expertise in the energy and industrials. Most recently, Prospect has been active in pursuing real estate investments, particularly in the multi-family residential real estate asset class and rent-producing properties that generate attractive current yields as well as long-term capital appreciation potential.

As of March 31, 2013, nearly 80% of Prospect's investments were well spread across all regions in the United States, with 26% located in the Southeast, 16% in the Midwest, 17% in the Northwest, 14% in Western US, and 7% in the Southwest. Approximately 16.5% of Prospect's investment portfolio is located in the Cayman Islands (CLO portfolio which primarily invests in U.S. companies), 2.7% in Canada and the remaining 0.4% in Ireland. In terms of size concentrations, the largest exposure (First Tower) represents 8.4% of total assets, and the top 10 investments make up around 30% of the total investment portfolio. In KBRA's view Prospect's portfolio is highly diversified by sector and geography, and its exposure concentrations by size of investments are fair when compared to peers.



By market capitalization and total assets, Prospect is now the third largest BDC behind American Capital, Ltd, and Ares Capital Corporation. This has been accomplished by the rather fast pace of growth in the last 18 months, with total assets having increased almost three fold to $4.05 billion, from $1.5 billion at the fiscal year ended June 30, 2011. The Company has good brand recognition in the industry and its portfolio is highly diversified both by sector and geography. Prospect has an extensive network of industry and sponsor contacts for the sourcing of its investments, which helps the Company to be more selective while having a healthy pipeline of deals to consider. Like many other BDCs, Prospect has a relatively moderate market share of middle market loans, as it competes with much larger banks on many deals. KBRA believes, however, that given stricter regulatory rules and potentially tougher capital charges for leveraged lending by banks, the franchise value of most BDCs is likely to strengthen in the near future.

KBRA notes that the fast growth trajectory of Prospect's portfolio is of some concern; however, it has helped expand the Company's reach within its markets, has diversified its exposures, and should help boost its earnings stream with a component of selective higher return investments. Additionally, Prospect has noted that its origination and underwriting criteria have remained consistent throughout the most recent growth spurt, and indeed enhanced by a significant investment in additional staff to support the larger portfolio in advance of such growth. In KBRA's view, Prospect's overall market positioning within the broader network of competitors, which includes banks, is currently adequate and in our view strengthening, which should support its competitive advantage and earnings growth going forward. KBRA also notes that Prospect does not plan to maintain the rate of growth seen in the past two years.

Business Risk Management

The management team at Prospect is highly experienced in middle market lending and focuses on providing capital to companies with strong cash flows. The Company expends significant effort on reducing risk by focusing primarily on senior secured debt (75% of portfolio fair value), which is more stable in stress scenarios than subordinated securities and equities due to its higher ranking in the capital structure. KBRA notes, however, that Prospect still has considerable exposure to subordinate debt, CLO investments and equity investments (25% of portfolio fair value), which carry both higher credit risk and higher valuation volatility.

As a Registered Investment Company (RIC), Prospect must distribute at least 90% of its taxable income to shareholders and is required to apply fair value accounting to its investment portfolio on a quarterly basis. This could bring high volatility to the Company's Net Asset Value (NAV), especially since 25% of Prospect's portfolio includes equity-like exposures, which tend to have higher fair value volatility in stress scenarios. But as a BDC, Prospect must also keep its leverage ratio (debt/equity) equal to or less than 1, which provides a level of protection for creditors against the inherent volatile credit performance of the underlying investments. Importantly, Prospect has historically maintained its leverage levels well below BDC regulatory limits (currently at approx. 0.55x) and lower than most peers, which provides further cushion against the more volatile segments of its portfolio. Given the current composition of Prospect's portfolio, KBRA views the maintenance of this low leverage as a key driver behind the BBB+ rating of the Company.

In KBRA's view, Prospect has rigorous credit origination and monitoring processes, which allow the Company to minimize its credit risk exposures. Prospect's deal origination process involves screening and preliminary due diligence performed by the Deal Team. The screening includes management review, business and market review, cash flow analysis and valuation, and an analysis of historical performance of the investment opportunity. After the origination and screening stage, further detailed review and due diligence are performed before the investment opportunity goes through the underwriting process and a formal due diligence, which includes on-site visits, interviews with management, key employees, select customers, and vendors, and background checks. Third-party law firms prepare documentation for all loans which are then reviewed by Prospect's 12-person in-house legal team. Prospect's senior management must approve all initial investments, follow-on investment, and significant changes to exposures and exit strategies.

Prospect has a high rejection rate; typically, less than 2% of the received investment opportunities are approved per year. Once approved and funded, all investments must undergo periodic (typically monthly) financial reporting and monitoring. Where Prospect is the lead lender or controlling investor, the Company maintains constant contact with the management and owners of the portfolio companies and maintains Board observation rights on certain transactions. Any sign of credit deterioration in an investment triggers the involvement of the Chief Credit Officer and two portfolio managers who closely deal with workouts and potentially take over the management of the transaction. Importantly, and a strength in KBRA's view, the Company uses a third party valuation firm for both its new originations and for its quarterly fair value process, which further supports the transparency and confidence in the portfolio value at each quarterly earnings period.

Key business risk exposures for Prospect include the Company's fast pace of growth in the past eighteen months as well as the potential fair value volatility and credit risks related to its equity-like investments. However, in KBRA's view, the Company's 120 investment counterparties are better diversified than in the past, credit underwriting remains strong and boosted by the increase in staff, and these provide an extra cushion for potential risks related to new vintages. KBRA notes further that due to Prospect's stringent credit monitoring processes, the Company has had low non-accruals in its portfolio of investments since inception and no non-accruals related to loans originated in the past five years (roughly $5 billion of investments); this track record in managing credit issues is a key supporting factor for its rating.

Economic and Operational Risk

In common with other BDCs, and due to regulatory limitations on leverage and income distribution, Prospect is very reliant on the equity and debt markets to finance its operations. In addition, given quarterly marking of portfolio investments, the Company's capital levels could be subject to severe pressure during market downturns that limit access to capital markets and/or may lead to breaches of regulatory triggers. As such, like other BDCs, Prospect has significant exposure to liquidity risk. Much of this risk is alleviated by the SEC restrictions on leverage levels, which prevent BDCs from becoming over-leveraged.

Prospect invests in companies with strong cash flows and acceptable underlying leverage. However, the Company's portfolio investments are subject to fair value volatility, mainly due to its exposures to equity investments. One of the main operational risks for Prospect includes the Company's dependency upon key management personnel, such as John Barry, Chairman and CEO (23 years with Prospect), and Grier Eliasek, President and Chief Operating Officer (13 years with Prospect). The Company's ability to function and remain competitive could be significantly impaired if it loses any key member of its senior management team. However, KBRA believes that this risk is somewhat mitigated by the management stake in the Company which is approximately 3%.

As a BDC, Prospect is regulated by the SEC and is subject to several provisions of the Investment Company Act of 1940, including a limitation on the level of debt, a code of ethics, a comprehensive compliance program, filing of quarterly reports and annual reports, as well as proxy statements, with the SEC.

Key Financial Factors Rating Determinants

Profitability

Prospect has recorded relatively strong earnings over the past few years and net investment income (NII) has exceeded dividends by over $66 million since the Company's inception. Cumulative net investment income for the three quarters ending March 2013 stood at $233 million, compared to $122 million in the similar period last year. NII is essentially net operating income for a BDC, without the impact of realized and unrealized income/loss, and is a good indicator of a BDC's recurring and distributable net income. On an annual basis, NII has kept pace with the growth of its investment portfolio over the past five years. Notably, Prospect successfully weathered the financial crisis of 2009 and 2010, and its NII fully covered the impact of the relatively high net realized losses during the crisis. For the nine months ending March 31, 2013, Prospect experienced some fair value volatility and a small realized loss of $12.3 million related to a few investment dispositions at a loss. During the same period, the Company also recorded an unrealized depreciation of $82.3 million related primarily to a reduction in fair value of Ajax and First Tower investments. In KBRA's view, unrealized losses for the period are of some concern as they may lead to higher realized losses in future periods. However, Prospect has had a history of strong NII as well as exit realizations, and given the composition of its current portfolio, KBRA expects NII and exit proceeds to remain solid for the near future.

As mentioned above, Prospect significantly increased its investment portfolio over the past eighteen months, with total investments (at fair value) increasing by nearly 150% from $1.5 billion in June 2011 to $3.7 billion as of March 31, 2013. Over the same period, Prospect's total debt also increased by over 240%, leading to higher interest expenses. As a result, the Company's interest coverage, as measured by NII (including PIK accruals) plus interest expense / interest expense, deteriorated somewhat, though it still remained adequate at 5.6x for the 9-months ending March 31, 2013, compared to 6.2x for year-end 2012, and 6.4x at year-end 2011. KBRA notes further that Prospect has had a successful track record in realization of investments (namely 65 realizations since inception at an average IRR of 34%), which should further cushion its interest coverage metrics in case of a liquidity need. Proceeds from disposition of investments for the nine months ending March 31, 2013 were approximately $610 million.

Prospect is an externally managed BDC with a standard cost structure of 2% of assets and 20% of net profits paid to its external managers. The Company's overall expense ratio (non-interest expenses as a percentage of total managed assets) has remained relatively stable over the past few years and stood at 5.82% for 3 quarters ending March 2013. In addition, the Company reported a dividend yield of 12.75% as of March 31, 2013, significantly higher than the industry median of 8.99%, which is a positive for equity issuance going forward.

Prospect Capital Corporation					
Key Statistics ($ in thousands, except per share data)	Mar-13 (YTD)	2012	2011	2010	2009
Balance sheet					
Investments, at value	$3,707,722	$2,094,221	$1,463,010	$748,483	$547,168
Cash and cash equivalents	278,058	121,194	61,395	69,952	108,677
Total assets	4,047,017	2,255,524	1,549,317	832,695	667,025
Portfolio Composition					
Revolving Line of Credit	9,930	868	7,278	5,017	-
Senior Secured Debt	1,878,542	1,080,053	789,981	287,470	220,993
Subordinated Secured Debt	876,859	488,113	448,675	313,511	194,547
Subordinated Unsecured Debt	189,653	73,195	55,336	30,895	16,331
CLO Debt	29,844	27,717	-	-	-
CLO Residual Interest	582,939	218,009	-	-	-
Equity	139,955	206,266	161,740	111,590	115,297
Earnings and Expenses					
Total investment income	409,866	320,910	169,476	114,559	100,481
Total operating expenses	177,038	134,226	75,255	47,369	41,318
Net investment income	232,828	186,684	94,221	67,190	59,163
Net realized gain (loss) on investments	-12,362	36,588	16,465	-51,545	-39,078
Net change in unrealized (depreciation) appreciation on investments	-82,299	-32,368	7,552	3,980	15,019
Net realized gain (loss) and unrealized (dep.) appr. on investments	-94,661	4,220	24,017	-47,565	-24,059
Net increase in net assets from operations	138,167	190,904	118,238	19,625	35,104
Cash dividends declared per common share	$0.95	$1.24	$1.24	$1.70	$1.15

Source: Prospect Capital's Annual and Interim Reports

Liquidity

Overall, Prospect's liquidity position remained strong over the nine-month period ending March 31, 2013, as the Company recorded $577.2 million in available liquidity, $24.7 million of which was cash and $552.5 million in available bank credit lines. These are boosted by an additional $253.3 million of investments in money market funds. Prospect has a diversified wholesale funding profile and has raised funds frequently with favorable pricing in both securitized and various forms of unsecured debt markets. Since 2010, the Company has successfully increased its credit facility from $285 million to $552.5 million, though no amount was drawn on its credit facility as of March 2013. The Company began issuing senior convertible notes in 2010, which has increased from $150 million to $847 million as of March 31, 2013, and has generally helped its overall cost of funding. Senior unsecured notes, which were initiated in 2012, also increased significantly from $100 million to $348 million as of March 31, 2013. Additionally, Prospect is the first BDC to initiate a medium-term note program, issuing $199 million in senior unsecured notes with 7-year to 30-year maturities and coupons ranging from 4.0% to 7.0%, which further helps its financing needs while allowing it to access the retail market in smaller denominations and at more opportunistic intervals.

Importantly, Prospect has a policy of matched-book funding with a bias toward longer term financing. Currently no debt maturities are scheduled until $150 million of convertibles mature at the end of 2015, and these are matched with $200 million of assets that mature in or prior to 2015. Moreover, of the Company's $4.05 billion of total assets as of March 31, 2013, $3.3 billion were reported as unencumbered assets, which provide a certain level of support for liquidity in case of need.

Prospect Capital Corporation: Diversified Funding Sources

Issuance (as of March 31, 2013)	Coupon	Amount	Outstanding	Maturity
Senior Unsecured Convertible Notes				
• December 2010 Convert	6.25%	$150,000,000	$150,000,000	12/15/2015
• February 2011 Convert	5.50%	$172,500,000	$167,500,000	8/15/2016
• April 2012 Convert	5.38%	$130,000,000	$130,000,000	10/15/2017
• August 2012 Convert	5.75%	$200,000,000	$200,000,000	3/5/2018
• December 2012 Convert	5.88%	$200,000,000	$200,000,000	1/15/2019
Senior Unsecured Retail Notes				
• Baby Bond – April 2012	6.95%	$100,000,000	$100,000,000	11/15/2022
• Prospect Capital InterNotes®	4.00% - 7.00% (1)	$199,400,000	$199,400,000	June 2019 – Mar 2043
Senior Unsecured Institutional Term Debt – March 2013				
	5.875%	$250,000,000	$250,000,000	3/15/2023
Senior Secured Credit Facility – 17 Lenders				
	1ML + 2.75%	$552,500,000	$0	3/27/2017

(1) Includes $1,225,000 of floating rate notes.

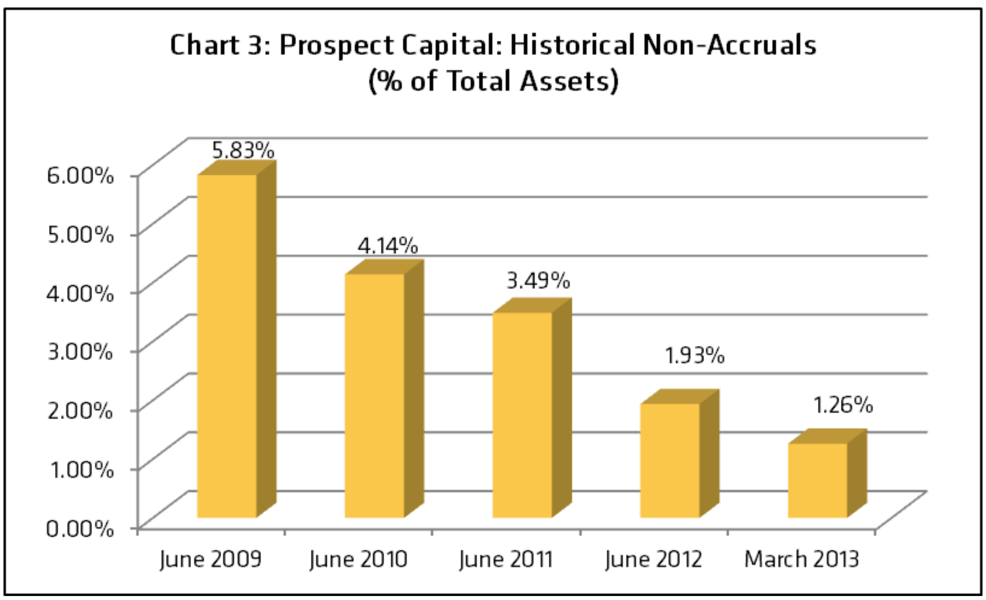
Capital Adequacy

As of the last reporting period at March 31, 2013, the Company reported a leverage ratio of 0.55x and a net leverage ratio of 0.44x, compared to the regulatory leverage limit of 1 to 1. Historically, Prospect's leverage has been below 0.5x and one of the lowest among its peers. This grants Prospect an additional borrowing capacity of approximately $1.16 billion were the Company to go to the optimum BDC allowed leverage of 1 to 1. Over the past nine months, Prospect's Debt-to-EBIT ratio has increased considerably, reflecting the increased level of debt incurred by the Company. The Debt-to-EBIT ratio increased from 2.9 times in June 2012 to 5.5 times as of March 31, 2013, though KBRA expects this multiple to improve as earnings from newer originations will accrete to EBIT over time. Overall, and in view of the composition of its investment portfolio, as well as the Company's leverage limits that are well below regulatory limits, KBRA views Prospect's current leverage metrics as well positioned and reflective of its balance sheet risks and a key driver for its BBB+ rating.

Asset Quality

As of March 31, 2013, Prospect had investments in 120 long-term portfolio investments, which had an amortized cost of $3.8 billion and a fair value of $3.7 billion, up from 85 long-term portfolio investments, with $2.1 billion at cost and $2.09 billion fair value as of June 2012.

Prospect had nine loan investments in non-accrual status[1], totaling $163 million at cost and $51 million at fair value, representing 1.26% of total assets. The loan principal and the fair value of these loans amounted to $171.15 million and $43.64 million, respectively as of June 30, 2012. Mainly as a result of the growth in the portfolio, non-accruals as a percentage of total assets have decreased considerably since 2009 as illustrated below. KBRA notes that the overall volume of non-accruals has remained fairly stable over the past 4 years, with some improvement seen in the nine months ending March 31, 2013 (at $163 million), versus fiscal year-end June 2012 (at $171 million). KBRA adds further that Prospect announced in June 2013 that it had sold its non-accrual oil and gas assets located in Martin County, Texas (previously held by H&M Oil and Gas, LLC, or H&M), and had received cash distributions and other payments for a combined gross of $66 million. The Company estimates that, due to recent cash flows received from this sale in the current quarter, the fair market value of Prospect's loan assets on non-accrual as a percentage of total assets would have stood at approximately 0.2% on such date, down from the previously reported 1.3% reported as of March 31, 2013 below.



As stated above, none of the loans originated in the past five years have been placed on non-accrual status, though KBRA notes that a considerable portion of Prospect’s portfolio consists of newer vintages of 2012 and

[1] Loans with principal or interest payments that are past due 90 days or more or when there is reasonable doubt that principal or interest will be collected.

2013 with potential risk in case of a market downturn. Nonetheless, given the positive trend in asset quality performance of loans originated in the past five years and the improvement related to the work-out of some older non-accruals, KBRA views Prospect's asset quality performance as strong.

Outlook

The outlook for the rating of Prospect Capital Corporation is stable. The stable outlook is supported by the Company's strong leverage metrics, which have a comfortable cushion below regulatory maximums and should provide good coverage in case of higher net realized losses in a forward economic stress scenario.

Drivers of Rating Change

Rating Upgrade

The rating of Prospect has a stable outlook and therefore in the near future a rating upgrade is not expected.

Rating Downgrade

-A significant downturn in the economy with impact on the performance of Prospect beyond KBRA's stress scenarios.
-An increase in riskier investments such equity exposures with potential pressure on asset quality in stress scenarios.
-An increase in leverage with likely negative impact on net asset value and performance in stressed scenarios.
-A significant increase in asset encumbrance as well as other stresses in liquidity profile.
-A significant change in the current management structure coupled with a negative change in strategy and/or credit monitoring as well as originations may also indicate a reason for a rating downgrade.