

KCAP Financial, Inc.  
Form 10-K  
March 09, 2017

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

**FORM 10-K**

☒ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934  
**For the fiscal year ended December 31, 2016**

☐ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934  
**For the transition period from                      to**  
**Commission File No. 814-00735**

**KCAP Financial, Inc.**

(Exact name of Registrant as specified in its charter)

Delaware  
(State or other jurisdiction of  
incorporation or organization)

20-5951150  
(I.R.S. Employer  
Identification Number)

**295 Madison Avenue, 6<sup>th</sup> Floor**  
**New York, New York 10017**  
**(Address of principal executive offices)**  
**(212) 455-8300**

(Registrant's telephone number, including area code)

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

|   |  |
|---|--|
| Title of each class   | Name of exchange on which registered   |
| <b>Common Stock, par value \$0.01 per share</b>                         | <b>The NASDAQ Global Select Market</b> |
| <b>7.375% Notes Due 2019</b>  | <b>New York Stock Exchange</b>         |
| <b>Securities registered pursuant to Section 12(g) of the Act: None</b> |  |

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 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 (§232.405 of this chapter) 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 (§229.405 of this chapter) 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. ☐

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Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ☐      Accelerated filer ☒      Non-accelerated filer ☐      Smaller Reporting Company ☐  
(Do not check if a smaller reporting company)

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 and non-voting common stock held by non-affiliates of the registrant as of June 30, 2016 was approximately \$145,576,639 based upon a closing price of \$3.92 reported for such date by The NASDAQ Global Select Market. Common shares held by each executive officer and director and by each person who owns 5% or more of the outstanding common shares have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

The number of outstanding shares of common stock of the registrant as of March 6, 2017 was 37,217,968.

## DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive proxy statement for the 2017 annual meeting of stockholders to be filed with the Securities and Exchange Commission within 120 days following the end of the registrant's fiscal year-end are incorporated by reference into Part III of this report.

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## **NOTE ABOUT REFERENCES TO KCAP FINANCIAL, INC.**

In this Annual Report on Form 10-K (this Annual Report ), the Company , KCAP , we , us and our refer to KCAP Financial, Inc. and its wholly owned subsidiaries, KCAP Senior Funding I, LLC and KCAP Senior Funding I Holdings, LLC, unless the context otherwise requires.

## **NOTE ABOUT TRADEMARKS**

KCAP Financial, Inc., our logo and other trademarks of KCAP Financial, Inc. are the property of KCAP Financial, Inc. All other trademarks or trade names referred to in this Annual Report are the property of their respective owners.

## **NOTE ABOUT FORWARD-LOOKING STATEMENTS**

This Annual Report includes forward-looking statements. The matters discussed in this Annual Report, as well as in future oral and written statements by management of KCAP Financial, Inc., that are forward-looking statements are based on current management expectations that involve substantial risks and uncertainties which could cause actual results to differ materially from the results expressed in, or implied by, these forward-looking statements.

Forward-looking statements relate to future events or our future financial performance. We generally identify forward-looking statements by terminology such as may, will, should, expects, plans, anticipates, could, target, projects, contemplates, believes, estimates, predicts, potential or continue or the negative of the other similar words, although not all forward-looking statements include these words. Important assumptions include our ability to originate new investments, achieve certain margins and levels of profitability, the availability of additional capital, and the ability to maintain certain debt to asset ratios. 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 or objectives will be achieved. The forward-looking statements contained in this Annual Report include statements as to:

- our future operating results;
- our business prospects and the prospects of our existing and prospective portfolio companies;
- the return or impact of current and future investments;
- our contractual arrangements and other relationships with third parties;
- the dependence of our future success on the general economy and its impact on the industries in which we invest;
- the financial condition and ability of our existing and prospective portfolio companies to achieve their objectives;
- our expected financings and investments;
- our regulatory structure and tax treatment;
- our ability to operate as a business development company and a regulated investment company, including the impact of changes in laws or regulations governing our operations or the operations of our wholly-owned portfolio companies, including Katonah Debt Advisors, L.L.C. and Trimaran Advisors, L.L.C. (the Asset Manager Affiliates );
- the adequacy of our cash resources and working capital;
- the timing of cash flows, if any, from the operations of our portfolio companies, including the Asset Manager Affiliates;
- the impact of a protracted decline in the liquidity of credit markets on our business;
- the impact of fluctuations in interest rates on our business;
- the valuation of our investments in portfolio companies, particularly those having no liquid trading market;
- our ability to recover unrealized losses;



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market conditions and our ability to access additional capital; and  
the timing, form and amount of any dividend distributions.

For a discussion of factors that could cause our actual results to differ from forward-looking statements contained in this Annual Report, please see the discussion under Risk Factors in Item 1A. You should not place undue reliance on these forward-looking statements. The forward-looking statements made in this Annual Report relate only to events as of the date on which the statements are made. We undertake no obligation to update any forward-looking statement to reflect events or circumstances occurring after the date of this Annual Report unless required by law.

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**PART I**

Item 1.

*Business*

**GENERAL**

We are an internally managed, non-diversified closed-end investment company that is regulated as a Business Development Company, or BDC, under the Investment Company Act of 1940 (the 1940 Act). We have three principal areas of investments:

First, the Company originates, structures, and invests in senior secured term loans and mezzanine debt primarily in privately-held middle market companies (the Debt Securities Portfolio). In addition, from time to time the Company may invest in the equity securities of privately held middle market companies.

Second, the Company has invested in asset management companies (Katonah Debt Advisors, L.L.C. and Trimaran Advisors L.L.C., collectively the Asset Manager Affiliates) that manage collateralized loan obligation funds (CLO Funds).

Third, the Company invests in debt and subordinated securities issued by CLOs (CLO Fund Securities). These CLO Fund Securities are primarily managed by our Asset Manager Affiliates, but from time-to-time the Company makes investments in CLO Fund Securities managed by other asset managers. The CLO Funds typically invest in broadly syndicated loans, high-yield bonds and other credit instruments.

The Company may also invest in other investments such as loans to publicly-traded companies, high-yield bonds and distressed debt securities. The Company may also receive warrants or options to purchase common stock in connection with its debt investments.

In our Debt Securities Portfolio, our investment objective is to generate current income and, to a lesser extent, capital appreciation from the investments in senior secured term loans, mezzanine debt and selected equity investments in privately-held middle market companies. We define the middle market as comprising companies with earnings before interest, taxes, depreciation and amortization (EBITDA) of \$10 million to \$50 million and/or total debt of \$25 million to \$150 million. We primarily invest in first and second lien term loans which, because of their priority in a company's capital structure, we expect will have lower default rates and higher rates of recovery of principal if there is a default and which we expect will create a stable stream of interest income. The investments in our Debt Securities Portfolio are all or predominantly below investment grade, and have speculative characteristics with respect to the issuer's capacity to pay interest and repay principal. While our primary investment focus is on making loans to, and selected equity investments in, privately-held middle market companies, we may also invest in other investments such as loans to smaller private companies or publicly-traded companies, high-yield bonds and distressed debt securities. We may also receive warrants or options to purchase common stock in connection with our debt investments.

From our Asset Manager Affiliates investment, we expect to receive recurring cash distributions and generate capital appreciation through the addition of new CLO Funds managed by our Asset Manager Affiliates. We may also seek to monetize our investment in the Asset Manager Affiliates if and when business conditions warrant. The Asset Manager Affiliates manage CLO Funds that invest in broadly syndicated loans, high-yield bonds and other credit instruments.

The Asset Manager Affiliates are registered under the Investment Advisers Act of 1940 (the Advisers Act), and are each managed independently from KCAP by a separate management team (however, certain of the Company's executive officers also act in similar capacities for one or both of the Asset Manager Affiliates).

In addition, our investments in CLO Fund Securities, which are primarily made up of minority investments in the subordinated securities or preferred stock of CLO Funds raised and managed by our Asset Manager Affiliates, are anticipated to provide the Company with recurring cash distributions and complement our investment in the Asset Manager Affiliates.

Because we are internally managed by our executive officers under the supervision of our Board of Directors and do not depend on a third party investment advisor, we do not pay investment advisory fees, but instead incur the operating costs associated with employing investment and portfolio management professionals.

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As a BDC, we are required to comply with regulatory requirements, including limitations on our use of debt. We are permitted to, and expect to continue to, finance our investments through borrowings. However, as a BDC, we are only generally allowed to borrow amounts such that our asset coverage, as defined in the 1940 Act, equals at least 200% after such borrowing. The 1940 Act also generally prohibits us from declaring any cash dividend or distribution on any class of our capital stock if our asset coverage is below 200% at the time of the declaration of the dividend or distribution.

Subject to market conditions, we intend to grow our portfolio of assets by raising additional capital, including through the prudent use of leverage available to us. Because we also recognize the need to have funds available for operating our business and to make investments, we seek to have adequate liquidity at all times to cover normal cyclical swings in funding availability and to allow us to meet abnormal and unexpected funding requirements. As a result, we may hold varying amounts of cash and other short-term investments from time-to-time for liquidity purposes.

We have elected to be treated for U.S. federal income tax purposes as a Regulated Investment Company ( RIC ) under the Internal Revenue Code (the Code ) and intend to operate in a manner to maintain our RIC tax treatment. Accordingly, we generally will not pay corporate-level U.S. federal income taxes on any net ordinary tax-basis taxable income or capital gains that we timely distribute to our shareholders as dividends. To maintain our RIC tax treatment, we must meet the specified source-of-income and asset diversification requirements and distribute to our stockholders annually at least 90% of our net ordinary tax-basis taxable income and realized net short-term capital gains in excess of realized net long-term capital losses, if any, for each year.

We were formed in August 2006, as Kohlberg Capital Corporation. In December 2006, we completed our initial public offering ( IPO ), which raised net proceeds of approximately \$200 million after the exercise of the underwriters over-allotment option. In connection with our IPO, we issued an additional 3,484,333 shares of our common stock in exchange for the ownership interests of Katonah Debt Advisors, L.L.C. and certain CLO Fund Securities.

In April 2008, the Company completed a rights offering that resulted in the issuance of 3.1 million shares of our common stock, and net proceeds of \$27 million.

On February 29, 2012, the Company purchased Trimaran Advisors, L.L.C. ( Trimaran Advisors ), an asset manager similar to Katonah Debt Advisors, L.L.C. ( Katonah Debt Advisors ), for total consideration of \$13.0 million in cash and 3,600,000 shares of the Company's common stock. Contemporaneous with the acquisition of Trimaran Advisors, the Company acquired from Trimaran Advisors equity interests in certain CLO Funds managed by Trimaran Advisors for an aggregate purchase price of \$12.0 million in cash. As of December 31, 2016, the Asset Manager Affiliates had approximately \$3.0 billion of par value assets under management.

On July 11, 2012, we changed our name from Kohlberg Capital Corporation to KCAP Financial, Inc.

On February 14, 2013, the Company completed a public offering of 5,232,500 shares of common stock, which included the underwriters' full exercise of their option to purchase up to 682,500 shares of common stock, at a price of \$9.75 per share, raising approximately \$51.0 million in gross proceeds. In conjunction with this offering, the Company also sold 200,000 shares of common stock to a member of its Board of Directors, at a price of \$9.31125 per share, raising approximately \$1.9 million in gross proceeds.

On October 6, 2014, the Company priced a follow-on public offering of 3.0 million shares of its common stock at a price of \$8.02 per share. The offering raised net proceeds of approximately \$23.8 million, net of underwriting discounts and offering expenses.

Including employees of our Asset Manager Affiliates, we employ an experienced team of 15 investment professionals and 25 total staff members. Dayl W. Pearson, our President and Chief Executive Officer, and one of our directors, has been in the financial services industry for nearly 40 years. During the past 26 years, Mr. Pearson has focused almost exclusively on the middle market and has originated, structured and underwritten over \$7 billion of debt and equity securities. R. Jon Corless, our Chief Investment Officer with primary responsibility for the Debt Securities Portfolio, has managed investment portfolios in excess of

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\$4 billion at several institutions and has been responsible for managing portfolios of leveraged loans, high-yield bonds, mezzanine securities and middle market loans. Dominick J. Mazzitelli is the President and portfolio manager of the Asset Manager Affiliates. He has over 20 years of experience within the credit markets, with most of his career focused on the leveraged finance markets. Edward U. Gilpin, our Chief Financial Officer, Secretary and Treasurer, has been in financial services for over 30 years, with significant experience in overseeing the financial operations and reporting for asset management businesses, including the fair value accounting of CLO securities owned by them.

Under the investment company rules and regulations pursuant to Article 6 of Regulation S-X and the Financial Standards Board Accounting Standards Codification 946, *Financial Services – Investment Companies* (ASC 946), we are precluded from consolidating portfolio company investments, including those in which we have a controlling interest, unless the portfolio company is another investment company. An exception to this general principle in ASC 946 occurs if we own a controlled operating company that provides all or substantially all of its services directly to us, or to an investment company of ours. Other than KCAP Funding, Kohlberg Capital Funding I LLC, KCAP Senior Funding I Holdings LLC and KCAP Senior Funding I LLC, none of the investments made by us qualify for this exception. Therefore, our portfolio investments, including our investments in the Asset Manager Affiliates, are carried on the balance sheet at fair value with any adjustments to fair value recognized as Net Change in Unrealized Appreciation (Depreciation) in our statement of operations until the investment is exited, at which point any gain or loss on exit is reclassified and recognized as a Net Realized Gain (Loss) from Investments.

Our common stock is traded on The NASDAQ Global Select Market under the symbol KCAP. The net asset value per share of our common stock at December 31, 2016 was \$5.24. On December 31, 2016, the last reported sale price of a share of our common stock on The NASDAQ Global Select Market was \$3.98. In addition, our 7.375% notes due 2019 ( 7.375% Notes Due 2019 ) are traded on the New York Stock Exchange under the symbol KAP. The last reported price of our 7.375% Notes Due 2019, which have a par value of \$25.00, was \$25.51.

## **Our Corporate Information**

Our principal executive offices are located at 295 Madison Avenue, 6<sup>th</sup> Floor, New York, New York 10017, and our telephone number is (212) 455-8300. We maintain a website on the Internet at <http://www.kcapfinancial.com>. The information contained in our website is not incorporated by reference into this Annual Report. We make available on or through our website certain reports and amendments to those reports that we file with or furnish to the SEC in accordance with the Securities Exchange Act of 1934 (the Exchange Act ). These include our annual reports on Form 10-K, our quarterly reports on Form 10-Q and our current reports on Form 8-K. We make this information available on our website free of charge as soon as reasonably practicable after we electronically file the information with, or furnish it to, the SEC.

## **Investment Portfolio**

Our investment portfolio generates investment income, which is generally used to pay principal and interest on our borrowings, operating expenses, and to fund our distributions to our stockholders. Our investment portfolio consists of three primary components: the Debt Securities Portfolio, the CLO Fund Securities and our investment in our wholly owned Asset Manager Affiliates.

*Debt Securities Portfolio.* We target privately-held middle market companies that have strong historical cash flows, experienced management teams and identifiable and defensible market positions in industries with positive dynamics. We generally target companies that generate positive cash flows because we look to cash flows as the primary source for servicing debt.

We employ a disciplined approach in the selection and monitoring of our investments. Generally, we target investments that will generate a current return through interest income to provide for stability in our shareholder distributions and place less reliance on realized capital gains from our investments. Our investment philosophy is focused on preserving capital with an appropriate return profile relative to risk. Our investment due diligence and selection generally focuses on an underlying issuer's net cash flow after capital expenditures to service its debt rather than on multiples of net income, valuations or other broad benchmarks

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which frequently miss the nuances of an issuer's business and prospective financial performance. We also generally avoid concentrations in any one industry or issuer. We manage risk by following our internal credit policies and procedures.

When we extend senior and junior secured term loans, we will generally take a security interest in the available assets of the portfolio company, including the equity interests of its subsidiaries, which we expect to help mitigate the risk that we will not be repaid. Nonetheless, there is a possibility that our lien could be subordinated to claims of other creditors. Structurally, mezzanine debt ranks subordinate in priority of payment to senior term loans and is often unsecured. Relative to equity, mezzanine debt ranks senior to common and preferred equity in a borrower's capital structure. Typically, mezzanine debt has elements of both debt and equity instruments, offering the fixed returns in the form of interest payments associated with a loan, while providing an opportunity to participate in the capital appreciation of a borrower, if any, through an equity interest that is typically in the form of equity purchased at the time the mezzanine loan is originated or warrants to purchase equity at a future date at a fixed cost. Mezzanine debt generally earns a higher return than senior secured debt due to its higher risk profile and usually less restrictive covenants. The warrants associated with mezzanine debt are typically detachable, which allows lenders to receive repayment of their principal on an agreed amortization schedule while retaining an equity interest in the borrower. Mezzanine debt also may include a put feature, which permits the holder to sell its equity interest back to the borrower at a price determined through an agreed formula.

Below are summary attributes for our Debt Securities Portfolio as of and for the year ended December 31, 2016:

represented approximately 65% of total investment portfolio;  
contained credit instruments issued by corporate borrowers;  
primarily comprised of senior secured and junior secured loans (84% and 15% of Debt Securities Portfolio, respectively);

spread across 27 different industries and 82 different entities;  
average par balance per investment of approximately \$3.1 million;  
all issuers were current on their debt service obligations; and  
weighted average interest rate of 7.0% on income producing debt investments.  
Our investments generally average between \$1 million to \$20 million, although particular investments may be larger or smaller. The size of individual investments will vary according to their priority in a company's capital structure, with larger investments in more secure positions in an effort to maximize capital preservation. The size of our investments and maturity dates may vary as follows:

senior secured term loans from \$2 to \$20 million maturing in five to seven years;  
second lien term loans from \$5 to \$15 million maturing in six to eight years;  
senior unsecured loans from \$5 to \$23 million maturing in six to eight years;  
mezzanine loans from \$5 to \$15 million maturing in seven to ten years; and  
equity investments from \$1 to \$5 million.

*Asset Manager Affiliates.* We expect to receive recurring cash distributions and seek to generate capital appreciation from our investment in our Asset Manager Affiliates. We may also seek to monetize our investment the Asset Manager Affiliates if and when business conditions warrant. As a manager of CLO Funds, our Asset Manager Affiliates receive contractual and recurring management fees from the CLO Funds for their management and advisory services. In addition, our Asset Manager Affiliates may also earn income related to net interest on assets accumulated for future CLO issuances on which they have provided a first loss guaranty in connection with loan warehouse arrangements for their future CLO Funds.





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The periodic management fees that our Asset Manager Affiliates receive are generally based on a fixed percentage of the par value of assets under management and are recurring in nature for the term of the CLO Fund, so long as the Asset Manager Affiliate manages the fund. As a result, the management fees earned by our Asset Manager Affiliates are not subject to market value fluctuations in the underlying collateral. The management fees that our Asset Manager Affiliates receive generally have three contractual components: a senior management fee, a subordinated management fee and the possibility of an incentive management fee if certain conditions are met. Currently, all CLO Funds managed by the Asset Manager Affiliates are paying both their senior and subordinated management fees on a current basis. During 2016, two CLO Funds have achieved the minimum investment return threshold and our Asset Manager Affiliates received incentive fees from those CLO Funds.

Subject to the conditions of the capital markets, we expect to continue to make investments in CLO Funds managed by our Asset Manager Affiliates, which we believe will provide us with a current cash investment return. We believe that these investments will provide our Asset Manager Affiliates with greater opportunities to access new sources of capital, which will ultimately increase our Asset Manager Affiliates' assets under management and resulting management fee income. See Item 1A. Risk Factors for a discussion of the risks relating to our ability to access the capital markets and the impact of certain risk retention rules which require that we or our Asset Manager Affiliates make and maintain certain minimum investments in CLO Funds managed by the Asset Manager Affiliates.

The after-tax net free cash flow that our Asset Manager Affiliates generate through the fees they receive for managing CLO Funds and after paying their expenses pursuant to an overhead allocation agreement with the Company associated with their operations, including compensation of their employees, may be distributed to us. Distributions from our Asset Manager Affiliates' tax basis earnings and profits are recorded as Dividends From Asset Manager Affiliates in our financial statements when declared. From time to time our Asset Manager Affiliates may distribute cash in excess of tax basis earnings and profits. This excess is deemed a return of capital ( ROC ) and is recorded in unrealized gains (losses) on the statement of operations.

Below are summary attributes for our Asset Manager Affiliates, as of and for the year ended December 31, 2016:

- represented approximately 11% of total investment portfolio;
- had approximately \$3.0 billion par value of assets under management;
- receive contractual and recurring asset management fees based on par value of managed investments;
- may receive an incentive management fee from a CLO Fund, provided that the CLO Fund achieves a minimum designated return on investment. In 2016, two such funds paid incentive fees to our Asset Manager Affiliates;
- distributions paid by our Asset Manager Affiliates are an additional source of cash to pay our distributions to our stockholders and service our debt obligations; and
- for the year ended December 31, 2016, we received cash distributions of approximately \$2.7 million, of which \$1.4 million was recognized as investment income from our Asset Manager Affiliates and the remaining amount as a return of capital.

*CLO Fund Securities.* Subject to the conditions of the capital markets, we expect to continue to make investments in the CLO Funds managed by our Asset Manager Affiliates, which we believe will provide us with a current cash investment return. We believe that these investments will provide our Asset Manager Affiliates with greater opportunities to access new sources of capital which will ultimately increase our Asset Manager Affiliates' assets under management and resulting management fee income.

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Below are summary attributes for our CLO Fund Securities, as of and for the year-ended December 31, 2016, unless otherwise specified:

CLO Fund Securities represented approximately 15% of total investment portfolio at December 31, 2016; 98% of CLO Fund Securities Portfolio represented investments in subordinated securities or equity securities issued by CLO Funds and 2% of CLO Fund Securities Portfolio was a rated note;

all CLO Funds invested primarily in credit instruments issued by corporate borrowers; GAAP-basis investment income of \$13.3 million; cash distributions received of approximately \$15.4 million (approximately \$14.1 million taxable distributable income, \$1.3 million tax return of capital to KCAP).

## **Structure and Process**

### **Structure**

We are an internally managed BDC with 25 full-time employees (inclusive of employees of our Asset Manager Affiliates). The following are our key functional teams that execute our business strategy:

Our BDC investment team consists of 7 professionals who originate, structure, and invest in senior secured term loans, mezzanine debt and selected equity securities primarily in privately-held middle market companies as well as CLO Funds.

Our Asset Manager Affiliates team consists of 8 professionals who structure, purchase and manage portfolios of primarily broadly syndicated corporate senior debt for CLOs.

The remainder of the employees include senior management, operations, financial accounting, compliance and human resource personnel.

### **Process**

KCAP will review potential investment opportunities and conduct due diligence that will typically include a review of historical and prospective financial information, participation in a presentation held by the prospective portfolio company's management and/or the transaction sponsor, a review of the prospective portfolio company's product or service, an analysis and understanding of the drivers of the particular industry in which the prospective portfolio company operates, and an assessment of the debt service capabilities of the prospective portfolio company under a variety of assumed forecast scenarios.

Due to our ability to source transactions through multiple channels, we expect to continue to maintain a pipeline of opportunities to allow comparative risk return analysis and selectivity. By focusing on the drivers of revenue and cash flow, we develop our own underwriting cases, and multiple stress and event specific case scenarios for each company analyzed.

We focus on lending and investing opportunities in:

companies with EBITDA of \$10 to \$50 million;  
companies with financing needs of \$25 to \$150 million;  
companies purchased by well-regarded private equity sponsors;  
non-sponsored companies with successful management and systems;  
high-yield bonds and broadly syndicated loans to larger companies on a selective basis; and  
equity co-investment in companies where we see substantial opportunity for capital appreciation.

We expect to continue to source investment opportunities from:

private equity sponsors;  
regional investment banks for non-sponsored companies;

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other middle market lenders with whom we can participate in loans; and  
our Asset Manager Affiliates, with regard to high-yield bonds and syndicated loans.

In our experience, good credit judgment is based on a thorough understanding of both the qualitative and quantitative factors that determine a company's performance. Our analysis begins with an understanding of the fundamentals of the industry in which a company operates, including the current economic environment and the outlook for the industry.

We also focus on the company's relative position within the industry and its historical ability to weather economic cycles. Other key qualitative factors include the experience and depth of the management team and the financial sponsor, if any.

Only after we have a comprehensive understanding of the qualitative factors do we focus on quantitative metrics. We believe that with the context provided by the qualitative analysis, we can gain a better understanding of a company's financial performance. We analyze a potential portfolio company's sales growth and margins in the context of its competition as well as its ability to manage its working capital requirements and its ability to generate consistent cash flow. Based upon this historical analysis, we develop a set of projections which represents a reasonable underwriting case of most likely outcomes for the company over the period of our investment. We also look at potential downside cases to determine a company's ability to service its debt in a stressed credit environment.

Elements of the *qualitative analysis* we use in evaluating investment opportunities include the following:

industry fundamentals;  
competitive position and market share;  
past ability to work through historical down-cycles;  
quality of financial and technology infrastructure;  
sourcing risks and opportunities;  
labor and union strategy;  
technology risk;  
diversity of customer base and product lines;  
quality of financial sponsor (if applicable); and  
acquisition and integration history.

Elements of the *quantitative analysis* we use in evaluating investment opportunities include the following:

income statement analysis of growth and margin trends;  
cash flow analysis of capital expenditures and free cash flow;  
financial ratio and market share standing among comparable companies;  
financial projections: underwriting versus stress case;  
event specific credit modeling;  
credit profile trend;  
future capital expenditure needs and asset sale plans;  
downside protection to limit losses in an event of default;  
risk adjusted returns and relative value analysis; and  
enterprise and asset valuations.

The origination, structuring and credit approval processes are fully integrated. Our credit team is directly involved in all due diligence and analysis prior to the formal credit approval process by the Investment Committee.

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### **Investment Committee**

The Investment Committee consists of the Chairman of the Board of Directors, the Chief Executive Officer, the Chief Investment Officer, and an additional member of the Board of Directors. The Investment Committee serves to provide investment consistency and adherence to our core investment philosophy and policies.

Upon completion of the due diligence investigation, the underwriting team of investment professionals/analysts will prepare a credit underwriting memorandum that will summarize the contemplated transaction, present the investment highlights, analyze the risk in the transaction and mitigating factors to those risks, analyze the prospective portfolio's historical financial statements, financial projections, industry and management team, and will then present this memorandum with its recommendations to the Investment Committee for review and approval.

The approval of a majority of the Investment Committee is required for all investments of less than \$15 million, and the unanimous approval of the Investment Committee is required for investments of \$15 million or greater.

### **Monitoring**

Our management team has significant experience monitoring credit portfolios. Along with origination and credit analysis, portfolio management is one of the key elements of our business. Most of our investments will not be liquid and, therefore, we must prepare to act quickly if potential issues arise so that we can work closely with management and the private equity sponsor, if applicable, of the portfolio company to take any necessary remedial action. In addition, most of our senior management team, including the credit team at the Asset Manager Affiliates, has substantial workout and restructuring experience.

In order to assist us in detecting issues with our Debt Securities Portfolio companies as early as possible, we perform a financial analysis at least quarterly on each portfolio company. This analysis typically includes:

A summary of the portfolio company's current total credit exposure as well as the KCAP portion of this exposure.  
A summary and update of the portfolio company's financial condition and performance, including but not limited to, performance versus plan, deterioration/improvement in market position, or industry fundamentals, management changes or additions, and ongoing business strategy.

Reaffirmation of, or proposal to change, the risk rating of the underlying investment.

A summary of the portfolio company's financial covenant results vis a vis financial covenant levels established in the credit agreement.

Watch list credits are followed closely and discussed periodically with the Chief Investment Officer, as appropriate.

### **DETERMINATION OF NET ASSET VALUE**

We determine the net asset value per share of our common stock quarterly. The net asset value per share is equal to the value of our total assets minus liabilities and any preferred stock outstanding divided by the total number of shares of common stock outstanding.

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Our net asset value per share was \$5.24 and \$5.82 as of December 31, 2016 and December 31, 2015, respectively.

Since we report our assets at fair value for each reporting period, net asset value also represents the amount of stockholders' equity per share for the reporting period. Our net asset value is comprised mostly of investment assets less debt and other liabilities:

|   | December 31, 2016         |                          | December 31, 2015         |                          |
|---|---------------------------|--------------------------|---------------------------|--------------------------|
|   | Fair Value <sup>(1)</sup> | per Share <sup>(1)</sup> | Fair Value <sup>(1)</sup> | per Share <sup>(1)</sup> |
| Investments at fair value:  |                           |                          |                           |                          |
| Investments in money market accounts <sup>(2)</sup>                             | \$28,699,269              | \$ 0.77                  | \$2,129,381               | \$ 0.06                  |
| Investments in debt securities  | 238,343,330               | 6.41                     | 284,639,244               | 7.67                     |
| Investments in CLO Fund Securities  | 54,174,350                | 1.46                     | 55,872,382                | 1.51                     |
| Investments in equity securities  | 5,056,355                 | 0.14                     | 9,548,488                 | 0.26                     |
| Investments in Asset Manager Affiliates   | 40,198,000                | 1.08                     | 57,381,000                | 1.55                     |
| Cash  | 1,307,257                 | 0.03                     |                           |                          |
| Restricted Cash <sup>(3)</sup>  | 8,528,298                 | 0.23                     | 7,138,272                 | 0.19                     |
| All other assets  | 5,065,124                 | 0.14                     | 4,495,930                 | 0.11                     |
| Total Assets  | \$381,371,983             | \$ 10.26                 | \$421,204,697             | \$ 11.35                 |
| Notes payable – KCAP Senior Funding I, LLC (net of discount and offering costs) | \$142,604,419             | \$ 3.84                  | \$141,316,396             | \$ 3.81                  |
| 7.375% Notes Due 2019 (net of offering costs)                                   | 32,980,151                | 0.89                     | 40,509,656                | 1.09                     |
| Convertible Notes (net of offering costs)                                       |                           |                          | 19,277,709                | 0.52                     |
| Payable for open trades   | 7,884,943                 | 0.21                     |                           |                          |
| Other liabilities   | 2,977,545                 | 0.08                     | 4,000,466                 | 0.11                     |
| Total Liabilities   | 186,447,058               | 5.02                     | 205,104,227               | 5.53                     |
| NET ASSET VALUE   | \$194,924,925             | \$ 5.24                  | \$216,100,470             | \$ 5.82                  |

Our balance sheet at fair value and resultant net asset value are calculated on a basis consistent with accounting principles generally accepted in the United States of America ( GAAP ). Our per share presentation of such amounts

(1)(other than net asset value per share) is an internally derived non-GAAP performance measure calculated by dividing the applicable balance sheet amount by outstanding shares. We believe that the per share amounts for such balance sheet items are helpful in analyzing our balance sheet both quantitatively and qualitatively.

(2) Includes restricted cash held under employee benefit plans.

(3) Consists of cash held for quarterly interest and principal payments to the holders of notes issued by KCAP Senior Funding I, LLC, our wholly owned subsidiary.

## Valuation

As a BDC, we invest primarily in illiquid securities, including loans to and warrants of private companies and interests in other illiquid securities, such as interests in CLO Fund Securities. These portfolio investments may be subject to restrictions on resale and will generally have no established trading market. As a result, our Board of Directors determines in good faith the fair value of our portfolio investments pursuant to a valuation policy developed in accordance with the Financial Accounting Standards Board Accounting Standards Codification 820, Fair Value Measurements and Disclosures ( ASC 820: Fair Value ), and a valuation process approved by our Board of Directors and in accordance with the 1940 Act. Our valuation policy is intended to provide a consistent basis for determining the fair value of the portfolio. Our Board of Directors is ultimately and solely responsible for making a good faith determination of the fair value of portfolio investments on a quarterly basis. The Company uses an independent

valuation firm to provide third party valuation consulting services to the Company and the Board of Directors. For additional information concerning valuation, see Item 7: Management's Discussion and Analysis of Financial Condition and Results of Operations – Valuation of Portfolio Investments ; and Notes 2 and 4 to the financial statements.

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### **Competition**

Our primary competitors also provide financing to prospective portfolio companies. These include commercial banks, specialty finance companies, hedge funds, structured investment funds, other BDCs and investment banks. Our competitors may have a lower cost of funds, and many have access to funding sources that are not available to us. Many of these entities have greater managerial resources than we have, and the 1940 Act imposes certain regulatory restrictions on us as a BDC to which many of our competitors are not subject. For additional information concerning the competitive risks we face, see Item 1A. Risk Factors – Risks Related to Our Business and Structure. We operate in a highly competitive market for investment opportunities.

We believe that we provide a unique combination of an experienced middle market loan origination and a CLO management platform at the Asset Manager Affiliates that includes experienced lenders with broad industry expertise. We believe that this combination of resources provides us with a thorough credit process and multiple sources of investment opportunities that make us attractive within our market.

### **Employees**

As of December 31, 2016, we and our Asset Manager Affiliates had 25 employees, including an experienced team of 15 investment professionals.

### **REGULATION**

The following discussion is a general summary of some of the material prohibitions and restrictions governing BDCs generally. It does not purport to be a complete description of all the laws and regulations affecting BDCs.

A BDC is a unique kind of investment company that primarily focuses on investing in or lending to private or relatively small publicly traded companies and making managerial assistance available to them. The 1940 Act contains prohibitions and restrictions relating to transactions between BDCs and their directors and officers and certain other related persons and requires that a majority of the directors be persons other than interested persons, as that term is defined in the 1940 Act. We have implemented certain procedures to ensure that we do not engage in any prohibited transactions with any persons affiliated with us.

In addition, the 1940 Act provides that we may not change the nature of our business so as to cease to be, or to withdraw our election as, a BDC unless approved by a majority of our outstanding voting securities. A majority of the outstanding voting securities of a company is defined under the 1940 Act as the lesser of (i) 67% or more of such company's shares present at a meeting or represented by proxy if more than 50% of the outstanding shares of such company are present or represented by proxy or (ii) more than 50% of the outstanding shares of such company.

### **Qualifying Assets**

Under the 1940 Act, a BDC may not acquire any asset other than assets of the type listed in Section 55(a) of the 1940 Act, or Qualifying Assets, unless, at the time the acquisition is made, Qualifying Assets represent at least 70% of the company's total assets. The principal categories of Qualifying Assets relevant to our business are the following:

Securities of an eligible portfolio company purchased in transactions not involving any public offering. An eligible portfolio company is defined in the 1940 Act as any issuer which:



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- (a) is organized under the laws of, and has its principal place of business in, the United States;
- (b) is not an investment company (other than a small business investment company wholly-owned by the BDC) or a company that would be an investment company but for certain exclusions under the 1940 Act; and
- (c) satisfies any of the following:
  - does not have any class of securities listed on a national securities exchange (or, if it has a class of securities listed
  - (i) on a national securities exchange, has an aggregate market value of outstanding voting and non-voting common equity of less than \$250 million);

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- (ii) is controlled by a BDC or a group of companies including a BDC and the BDC has an affiliated person who is a director of the eligible portfolio company;
- (iii) is a small and solvent company having total assets of not more than \$4 million and capital and surplus of not less than \$2 million; or
- (iv) does not have outstanding any class of securities with respect to which a broker or dealer may extend margin credit.

Securities of any eligible portfolio company that we control;

Securities purchased in a private transaction from a U.S. issuer that is not an investment company and is in bankruptcy and subject to reorganization;

Securities received in exchange for or distributed on or with respect to securities described above, or pursuant to the conversion of warrants or rights relating to such securities; and

Cash, cash equivalents, U.S. government securities or high-quality debt securities maturing in one year or less from the time of investment.

## **Significant Managerial Assistance**

A BDC must be organized and have its principal place of business in the United States and must be operated for the purpose of making investments in the types of securities described above. In addition, BDCs must generally offer to make available to such issuer of the securities (other than small and solvent companies described above) significant managerial assistance; except that, where we purchase such securities in conjunction with one or more other persons acting together, one of the other persons is the group may make available such managerial assistance. Making available significant managerial assistance means, among other things, any arrangement whereby the BDC, through its directors, officers or employees, offers to provide, and, if accepted, does so provide, guidance and counsel concerning the management, operations or business objectives and policies of a portfolio company through monitoring of portfolio company operations, selective participation in board and management meetings, consulting with and advising a portfolio company's officers or other organizational or financial guidance.

## **Temporary Investments**

Pending investment in other types of Qualifying Assets, as described above, our investments may consist of cash, cash equivalents, U.S. government securities or high quality debt securities maturing in one year or less from the time of investment, which we refer to, collectively, as temporary investments, so that at least 70% of our assets are Qualifying Assets. Typically, we invest in U.S. treasury bills or in repurchase agreements, provided that such agreements are fully collateralized by cash or securities issued by the U.S. government or its agencies. A repurchase agreement involves the purchase by an investor, such as us, of a specified security and the simultaneous agreement by the seller to repurchase it at an agreed upon future date and at a price which is greater than the purchase price by an amount that reflects an agreed-upon interest rate. There is no percentage restriction on the proportion of our assets that may be invested in such repurchase agreements. However, if more than 25% of our total assets constitute repurchase agreements that are treated, under applicable tax rules, as being issued by a single counterparty, we would not meet the diversification tests imposed on us by the Code to qualify for tax treatment as a RIC for U.S. federal income tax purposes. Thus, we do not intend to enter into repurchase agreements treated as issued, under applicable tax rules, by a single counterparty in excess of this limit. We monitor the creditworthiness of the counterparties with which we enter into repurchase agreement transactions.

## **Indebtedness; Coverage Ratio**

We are permitted, under specified conditions, to issue multiple classes of indebtedness and one class of stock senior to our common stock if our asset coverage, as defined in the 1940 Act, is at least equal to 200% immediately after each such issuance. In addition, with respect to certain types of senior securities, we must make provisions to prohibit any dividend distribution to our stockholders or the repurchase of certain of our securities, unless we meet the applicable asset coverage ratios at the time of the dividend distribution or repurchase. We may also borrow amounts up to 5% of the value of our total assets for temporary purposes.

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For a discussion of the risks associated with the resulting leverage, see Item 1A. Risk Factors Risks Related to Our Business and Structure We borrow money, which magnifies the potential for gain or loss on amounts invested and may increase the risk of investing in us. As of December 31, 2016, our asset coverage ratio was 205%, above the minimum required asset coverage level of 200%.

## **Common Stock**

We are not generally able to issue and sell our common stock at a price below net asset value per share. We may, however, sell our common stock, at a price below the current net asset value of the common stock if our Board of Directors determines that such sale is in our best interests and that of our stockholders, and our stockholders approve such sale. In any such case, the price at which our common stock is to be issued and sold may not be less than a price which, in the determination of our Board of Directors, closely approximates the market value of such common stock (less any distributing commission or discount). We may also make rights offerings to our stockholders at prices per share less than the net asset value per share, subject to applicable requirements of the 1940 Act. See Item 1A. Risk Factors Risks Relating to Our Business and Structure Regulations governing our operation as a BDC affect our ability to, and the way in which we, raise additional capital.

## **Code of Ethics**

We adopted and maintain a code of ethics pursuant to Rule 17j-1 under the 1940 Act that establishes procedures for personal investments and restricts certain personal securities transactions. Personnel subject to the code may invest in securities for their personal investment accounts, including securities that may be purchased or held by us, so long as such investments are made in accordance with the code's requirements. A copy of the code of ethics is available on the Corporate Governance section of the Company's website at <http://www.kcapfinancial.com>. Our code of ethics may also be reviewed and copied at the Public Reference Room of the SEC at 100 F Street, N.E., Washington, D.C. 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330.

Copies of the code of ethics may be obtained, after paying a duplicating fee, by electronic request at the following e-mail address: [publicinfo@sec.gov](mailto:publicinfo@sec.gov), or by writing the SEC's Public Reference Section, Washington, D.C. 20549-0102.

In addition, our code of ethics is available on the SEC's website at <http://www.sec.gov>.

## **Privacy Principles**

We are committed to maintaining the privacy of our stockholders and safeguarding their non-public personal information. The following information is provided to help you understand what personal information we collect, how we protect that information and why, in certain cases, we may share information with select other parties.

Generally, we do not receive any non-public personal information relating to our stockholders, although some non-public personal information of our stockholders may become available to us. We do not disclose any non-public personal information about our stockholders or former stockholders to anyone, except as is necessary to service stockholder accounts, such as to a transfer agent, or as otherwise permitted by law.

We restrict access to non-public personal information about our stockholders to our employees with a legitimate business need for the information. We maintain safeguards designed to protect the non-public personal information of our stockholders.

## **Proxy Voting Policy and Procedures**

Although the securities we hold are not typically voting securities, some of our investments could entitle us to voting rights. If this were to occur we would vote our portfolio securities in the best interest of our stockholders and we would review on a case-by-case basis each proposal submitted to a stockholder vote to determine its impact on the portfolio securities held by us. Although we would generally vote against proposals that we believe may have a negative impact on our portfolio securities, we may vote for such a proposal if we were to believe there exists a compelling long-term reason to do so.

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Our voting decisions would be made by our Investment Committee. To ensure that our vote would not be the product of a conflict of interest, we would require that (1) anyone involved in the decision making process disclose to our Chief Compliance Officer any potential conflict that he or she is aware of and any contact that he or she has had with any interested party regarding a vote; and (2) employees involved in the decision making process or vote administration are prohibited from revealing how we intend to vote on a proposal to reduce any attempted influence from interested parties.

## **Other**

We are periodically examined by the SEC for compliance with the 1940 Act.

We are required to provide and maintain a bond issued by a reputable fidelity insurance company to protect us against larceny and embezzlement. Furthermore, as a BDC, we are prohibited from indemnifying any director or officer against any liability to our stockholders arising from willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of such person's office.

We are required to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws and to review these policies and procedures annually for their adequacy and the effectiveness of their implementation. We have a designated Chief Compliance Officer who is responsible for administering these policies and procedures.

## **TAXATION AS A REGULATED INVESTMENT COMPANY**

We have elected to be treated for U.S. federal income tax purposes as a Regulated Investment Company ( "RIC" ) under subchapter M of the Internal Revenue Code of 1986, as amended (the "Code" ), and intend to operate in a manner to maintain our RIC tax treatment. As a RIC, we generally will not have to pay corporate-level U.S. federal income taxes on any ordinary income or capital gains that we timely distribute to our stockholders as dividends. 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 taxable income plus the excess of our realized net short-term capital gains over our realized net long-term capital losses (the "Annual Distribution Requirement" ).

### **Taxation as a RIC**

For any taxable year in which we qualify as a RIC and satisfy the Annual Distribution Requirement, we generally will not be subject to U.S. federal income tax on the portion of our investment company taxable income and net capital gain, defined as net long-term capital gains in excess of net short-term capital losses, we distribute to stockholders. We will be subject to U.S. federal income tax at the regular corporate rates on any net ordinary income or net capital gain not distributed (or deemed distributed) to our stockholders.

We will be subject to a 4% nondeductible U.S. 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 net ordinary income for each calendar year, (b) 98.2% of our capital gain net income for the one-year period ending October 31 in that calendar year and (c) any income or gains realized, but not distributed, in the preceding year and on which we paid no U.S. federal income tax (the "Excise Tax Avoidance Requirement" ). For this purpose, however, any net ordinary income or capital gain net income retained by us that is subject to corporate-level U.S. federal income tax for the tax year ending in that calendar

year will be considered to have been distributed by year end (or earlier if estimated taxes are paid). Although we generally endeavor to make sufficient distributions each taxable year to satisfy the Excise Tax Avoidance Requirement, we may incur a U.S. federal excise tax.

To qualify as a RIC for U.S. federal income tax purposes, we must, among other things:

qualify to be regulated 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

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from interests in qualified publicly traded partnerships (which generally are 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; 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 ).

If we do not satisfy the requirements of the Diversification Tests as of the end of any quarter, we will not lose our status as RIC provided that (i) we satisfied the requirements in a prior quarter and (ii) our failure to satisfy the requirements in the current quarter is not due in whole or in part to an acquisition of any security or other property.

We may invest in partnerships, including qualified publicly traded partnerships, which may result in our being subject to state, local or foreign income, franchise or withholding liabilities.

We may be required to recognize taxable income in circumstances in which we do not receive 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 ( PIK ) interest or, in certain cases, with 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. Because any original issue discount accrued will be included in our investment company taxable income for the year of 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. If we are not able to obtain sufficient cash from other sources to satisfy the Annual Distribution Requirement, we may fail to qualify as a RIC and become subject to corporate-level U.S. federal income taxes on all of our taxable income without the benefit of the dividends-paid deduction.

Although we do not presently expect to do so, we are authorized to borrow funds and to sell assets in order (i) to satisfy the Annual Distribution Requirement and to otherwise eliminate our liability for U.S. federal income and excise taxes and (ii) to satisfy the Diversification Tests. However, under the 1940 Act, we are not permitted to borrow additional funds or to make distributions to our stockholders while our debt obligations and other senior securities are outstanding unless a certain asset coverage test is met. See Regulation Indebtedness; Coverage Ratio. Moreover, our ability to dispose of assets to meet the Annual Distribution Requirement, the Excise Tax Avoidance Requirement or the Diversification Tests may be limited by (a) the illiquid nature of our portfolio and/or (b) other requirements relating to our qualification as a RIC. If we dispose of assets in order to meet the Annual Distribution Requirement, the Excise Tax Avoidance Requirement, or the Diversification Tests, we may make such dispositions at times that, from an investment standpoint, are not advantageous.

Certain of our investment practices may be subject to special and complex U.S. federal income tax provisions that may, among other things, (a) treat dividends that would otherwise constitute qualified dividend income as non-qualified dividend income, (b) treat dividends that would otherwise be eligible for the corporate dividends received deduction as ineligible for such treatment, (c) disallow, suspend or otherwise limit the allowance of certain losses or deductions, (d) convert lower-taxed long-term capital gain into higher-taxed short-term capital gain or ordinary income, (e) convert an ordinary loss or a deduction into a capital loss (the deductibility of which is more limited), (f) cause us to recognize income or gain without a corresponding receipt of cash, (g) adversely affect the time





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is deemed to occur, (h) adversely alter the characterization of certain complex financial transactions and (i) produce income that will not be qualifying income for purposes of the 90% Income Test. We intend to monitor our transactions and may make certain tax elections to mitigate the effect of these provisions and prevent our disqualification as a RIC.

Gain or loss realized by us 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 capital gain or loss generally will be long-term or short-term, depending on how long we held a particular warrant.

Some of the income and fees that we may recognize will not satisfy the 90% Income Test. In order to ensure that such income and fees do not disqualify us as a RIC for a failure to satisfy the 90% Income Test, we may hold assets that generate such income and provide services that generate such fees indirectly through one or more entities treated as corporations for U.S. federal income tax purposes. Such corporations will be required to pay corporate-level U.S. federal income taxes on their earnings, which ultimately will reduce our return on such income and fees.

### **Failure to Qualify as a Regulated Investment Company**

If we were unable to qualify for treatment as a RIC, we would be subject to tax on all of our taxable income at regular corporate rates, regardless of whether we make any distributions to our stockholders. Distributions would not be required, and any distributions made would be taxable to our stockholders as ordinary dividend income that, subject to certain limitations, may be eligible for the 20.0% maximum rate to the extent of our current and accumulated earnings and profits. Subject to certain limitations under the Code, corporate distributees would be eligible for the dividends-received deduction. Distributions in excess of our current and accumulated earnings and profits would be treated first as a return of capital to the extent of the stockholder's tax basis, and any remaining distributions would be treated as a capital gain. If we fail to qualify as a RIC for a period greater than two taxable years, to qualify as a RIC in a subsequent year we may be subject to regular corporate tax on any net built-in gains with respect to certain of our assets (i.e., the excess of the aggregate gains, including items of income, over aggregate losses that would have been realized with respect to such assets if we had been liquidated) that we elect to recognize on requalification or when recognized over the next five years.

### **DIVIDEND REINVESTMENT PLAN**

We have adopted a dividend reinvestment plan that provides for reinvestment of our distributions on behalf of our stockholders, unless a stockholder elects to receive cash as provided below. As a result, if our Board of Directors authorizes, and we declare, a cash distribution, then our stockholders who have not opted out of our dividend reinvestment plan will have their cash distributions automatically reinvested in additional shares of our common stock, rather than receiving the cash.

No action is required on the part of a registered stockholder to have such shareholder's cash distribution reinvested in shares of our common stock. A registered stockholder may elect to receive an entire distribution in cash by notifying American Stock Transfer & Trust Company, the plan administrator and our transfer agent and registrar, in writing so that such notice is received by the plan administrator no later than the record date for distributions to stockholders. The plan administrator will set up an account for shares acquired through the plan for each stockholder who has not elected to receive distributions in cash and hold such shares in non-certificated form. Upon request by a stockholder participating in the plan, received in writing not less than ten days prior to the record date, the plan administrator will, instead of crediting shares to the participant's account, issue a certificate registered in the participant's name for the number of whole shares of our common stock and a check for any fractional share.

Those stockholders whose shares are held by a broker or other financial intermediary may receive distributions in cash by notifying their broker or other financial intermediary of their election.

We intend to use primarily newly issued shares to implement the plan, whether our shares are trading at a premium or at a discount to net asset value. However, we reserve the right to purchase shares in the open market in connection with our implementation of the plan. The number of shares to be issued to a stockholder is determined by dividing the total dollar amount of the dividend payable to such stockholder by the market price per share of our common stock at the close of regular trading on The NASDAQ Global Select Market

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on the dividend payment date. Market price per share on that date will be the closing price for such shares on The NASDAQ Global Select Market or, if no sale is reported for such day, at the average of their reported bid and asked prices. Shares purchased in open market transactions by the plan administrator of the dividend reinvestment plan will be allocated to a stockholder based upon the average purchase price, excluding any brokerage charges or other charges, of all shares of common stock purchased with respect to the distribution.

There are no brokerage charges or other charges to stockholders who participate in the plan. The plan administrator's fees under the plan are paid by us. If a participant elects by written notice to the plan administrator to have the plan administrator sell part or all of the shares held by the plan administrator in the participant's account and remit the proceeds to the participant, the plan administrator is authorized to deduct a \$15.00 transaction fee plus a \$0.10 per share brokerage commission from the proceeds.

If your distributions are reinvested, you will be required to pay tax on the distributions in the same manner as if the distributions were received in cash. The taxation of distributions will not be affected by the form in which you receive them.

Participants may terminate their accounts under the plan by notifying the plan administrator via its website at [www.amstock.com](http://www.amstock.com), by filling out the transaction request form located at bottom of their statement and sending it to the plan administrator at the address set forth below or by calling the plan administrator at 1-866-668-8564.

The plan may be terminated by us upon notice in writing mailed to each participant at least 30 days prior to any record date for the payment of any dividend by us. All correspondence concerning the plan should be directed to, and additional information about the plan may be obtained from, the plan administrator by mail at American Stock Transfer & Trust Company, Attn. Dividend Reinvestment Department, P.O. Box 922, Wall Street Station, New York, NY 10269-0560 or by telephone at 1-866-668-8564.

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Item 1A.

**Risk Factors**

*Investing in our securities involves a high degree of risk. In addition to the other information contained in this annual report on Form 10-K, the following information should be carefully considered before making an investment in our securities. The risks set out below are not the only risks we face. Additional risks and uncertainties not presently known to us or not presently deemed material by us might also impair our operations and performance. If any of the following events occur, our business, financial condition and results of operations could be materially and adversely affected. In such case, our net asset value and the trading price of our securities could decline, and you may lose part or all of your investment.*

## **Risks Related to Economic Conditions**

**Economic recessions or downturns may have a material adverse effect on our business, financial condition and results of operations, and could impair the ability of our portfolio companies to repay loans.**

Economic recessions or downturns may result in a prolonged period of market illiquidity which could have a material adverse effect on our business, financial condition and results of operations. Unfavorable economic conditions also could increase our funding costs, limit our access to the capital markets or result in a decision by lenders not to extend credit to us. These events could limit our investment originations, limit our ability to grow and negatively impact our operating results.

In the event of economic recessions and downturns, the financial results of middle-market companies, like those in which we invest, will likely experience deterioration, which could ultimately lead to difficulty in meeting debt service requirements and an increase in defaults. Additionally, the end markets for certain of our portfolio companies' products and services would likely experience negative financial trends. The performances of certain of our portfolio companies have been, and may continue to be, negatively impacted by these economic or other conditions, which may ultimately result in our receipt of a reduced level of interest income from our portfolio companies and/or losses or charge offs related to our investments, and, in turn, may adversely affect distributable income. Further, adverse economic conditions may decrease the value of collateral securing some of our loans and the value of our equity investments. As a result, we may need to modify the payment terms of our investments, including changes in payment-in-kind interest provisions and/or cash interest rates. These factors may result in our receipt of a reduced level of interest income from our portfolio companies and/or losses or charge offs related to our investments, and, in turn, may adversely affect distributable income and have a material adverse effect on our results of operations.

**The capital markets may experience periods of disruption and instability. Such market conditions may materially and adversely affect debt and equity capital markets, which may have a negative impact on our business and operations.**

From time to time, capital markets may experience periods of disruption and instability. For example, between 2008 and 2009, the global capital markets were unstable as evidenced by periodic disruptions in liquidity in the debt capital markets, significant write-offs in the financial services sector, the re-pricing of credit risk in the broadly syndicated credit market and the failure of major financial institutions. Despite actions of the U.S. federal government and foreign governments, these events contributed to worsening general economic conditions that materially and adversely impacted the broader financial and credit markets and reduced the availability of debt and equity capital for the market

as a whole and financial services firms in particular. While market conditions have largely recovered from the events of 2008 and 2009, there have been continuing periods of volatility, some lasting longer than others. For example, beginning in the second half of 2015 and continuing into 2016, economic uncertainty and market volatility in China and geopolitical unrest in the Middle East, combined with continued volatility of oil prices, among other factors, have caused disruption in the capital markets, including the markets in which we participate. In addition, the referendum by British voters to exit the European Union ( Brexit ) in June 2016 has led to further disruption and instability in the global markets. The potential impact of the results of the 2016 U.S. Presidential and congressional election and resulting uncertainties regarding possible policies that could be implemented has also led to further disruption and instability in the global markets. There can be no assurance these market conditions will not continue or worsen in the future.

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Equity capital may be difficult to raise during periods of adverse or volatile market conditions because, subject to some limited exceptions, as a BDC, we are generally not able to issue additional shares of our common stock at a price less than net asset value without first obtaining approval for such issuance from our stockholders and our independent directors.

Volatility and dislocation in the capital markets can also create a challenging environment in which to raise or access debt capital. The reappearance of market conditions similar to those experienced from 2008 through 2009 for any substantial length of time could make it difficult to extend the maturity of or refinance our existing indebtedness or obtain new indebtedness with similar terms and any failure to do so could have a material adverse effect on our business. The debt capital that will be available to us in the future, if at all, may be at a higher cost and on less favorable terms and conditions than what we currently experience. If we are unable to raise or refinance debt, then our equity investors may not benefit from the potential for increased returns on equity resulting from leverage and we may be limited in our ability to make new commitments or to fund existing commitments to our portfolio companies.

Significant changes or volatility in the capital markets may also have a negative effect on the valuations of our investments. While most of our investments are not publicly traded, applicable accounting standards require us to assume as part of our valuation process that our investments are sold in a principal market to market participants (even if we plan on holding an investment through its maturity). Significant changes in the capital markets may also affect the pace of our investment activity and the potential for liquidity events involving our investments. Thus, the illiquidity of our investments may make it difficult for us to sell such investments to access capital if required, and as a result, we could realize significantly less than the value at which we have recorded our investments if we were required to sell them for liquidity purposes. An inability to raise or access capital could have a material adverse effect on our business, financial condition or results of operations.

### **Uncertainty about the financial stability of the United States, China and several countries in the European Union could have a significant adverse effect on our business, financial condition and results of operations.**

Due to federal budget deficit concerns, S&P downgraded the federal government's credit rating from AAA to AA+ for the first time in history on August 5, 2011. Further, Moody's and Fitch had warned that they may downgrade the federal government's credit rating. Further downgrades or warnings by S&P or other rating agencies, and the United States government's credit and deficit concerns in general, could cause interest rates and borrowing costs to rise, which may negatively impact both the perception of credit risk associated with our debt portfolio and our ability to access the debt markets on favorable terms. In addition, a decreased U.S. government credit rating could create broader financial turmoil and uncertainty, which may weigh heavily on our financial performance and the value of our common stock.

In 2010, a financial crisis emerged in Europe, triggered by high budget deficits and rising direct and contingent sovereign debt in Greece, Ireland, Italy, Portugal and Spain, which created concerns about the ability of these nations to continue to service their sovereign debt obligations. While the financial stability of many of such countries has improved significantly, risks resulting from any future debt crisis in Europe or any similar crisis could have a detrimental impact on the global economic recovery, sovereign and non-sovereign debt in these countries and the financial condition of European financial institutions. In July and August 2015, Greece reached agreements with its international creditors for bailouts that provide aid in exchange for austerity terms that had previously been rejected by Greek voters. Market and economic disruptions have affected, and may in the future affect, consumer confidence levels and spending, personal bankruptcy rates, levels of incurrence and default on consumer debt and home prices, among other factors. We cannot assure you that market disruptions in Europe, including the increased cost of funding for certain governments and financial institutions, will not impact the global economy, and we cannot assure you that

assistance packages will be available, or if available, be sufficient to stabilize countries and markets in Europe or elsewhere affected by a financial crisis. To the extent uncertainty regarding any economic recovery in Europe negatively impacts consumer confidence and consumer credit factors, our business, financial condition and results of operations could be significantly and adversely affected.



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In the second quarter of 2015, stock prices in China experienced a significant drop, resulting primarily from continued sell-off of shares trading in Chinese markets. In addition, in August 2015, Chinese authorities sharply devalued China's currency. Since then, the Chinese capital markets have continued to experience periods of instability. In June 2016, British voters passed a referendum to exit the European Union leading to heightened volatility in global markets and foreign currencies. These market and economic disruptions have affected, and may in the future affect, the U.S. capital markets, which could adversely affect our business, financial condition or results of operations.

In October 2014, the Federal Reserve announced that it was concluding its bond-buying program, or quantitative easing, which was designed to stimulate the economy and expand the Federal Reserve's holdings of long-term securities, suggesting that key economic indicators, such as the unemployment rate, had showed signs of improvement since the inception of the program. It is unclear what effect, if any, the conclusion of the Federal Reserve's bond-buying program will have on the value of our investments. Additionally, the Federal Reserve raised the Federal Funds Rate in December 2015 and again in December 2016, and has announced its intention to continue to raise the federal funds rate over time. These developments, along with the United States government's credit and deficit concerns, the European sovereign debt crisis and the economic slowdown in China, could cause interest rates and borrowing costs to rise, which may negatively impact our ability to access the debt markets on favorable terms.

## **Risks Related to Our Business and Structure**

### **Ineffective internal controls could impact our business and operating results.**

Our internal control over financial reporting may not prevent or detect misstatements because of its inherent limitations, including the possibility of human error, the circumvention or overriding of controls, or fraud. Even effective internal controls can provide only reasonable assurance with respect to the preparation and fair presentation of financial statements. If we fail to maintain the adequacy of our internal controls, including any failure to implement required new or improved controls, or if we experience difficulties in their implementation, our business and operating results could be harmed and we could fail to meet our financial reporting obligations.

### **We are dependent upon our senior management for our future success, and if we are unable to hire and retain qualified personnel or if we lose any member of our senior management team, our ability to achieve our investment objectives could be significantly harmed.**

We depend on the members of our senior management as well as other key personnel for the identification, final selection, structuring, closing and monitoring of our investments. These employees have critical industry experience and relationships that we rely on to implement our business plan. Our future success depends on the continued service of our senior management team. The departure of any of the members of our senior management or a significant number of our senior personnel could have a material adverse effect on our ability to achieve our investment objective. As a result, we may not be able to operate our business as we expect, and our ability to compete could be harmed, which could cause our operating results to suffer.

Additionally, the management agreements governing some of the CLO funds managed by our Asset Manager Affiliates have key person provisions that provide certain CLO investors with rights upon the departure of a key person, as defined in each agreement. As a result, the departure of a key person could trigger a material change in the Asset Manager Affiliate's role in managing the CLO Funds, and therefore KCAP's financial benefits from its investments in the Asset Manager Affiliates.

## **We operate in a highly competitive market for investment opportunities.**

A large number of entities compete with us to make the types of investments that we make. We compete with other BDCs, as well as a number of investment funds, investment banks and other sources of financing, including traditional financial services companies, such as commercial banks and finance companies. Many of our competitors are substantially larger and have considerably greater financial, marketing and other resources than we do. For example, some competitors may have a lower cost of funds and access to funding sources

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that are not available to us. This may enable some of our competitors to make commercial loans with interest rates that are lower than the rates we typically offer. We may lose prospective portfolio investments if we do not match our competitors' pricing, terms and structure. If we do match our competitors' pricing, terms or structure, we may experience decreased net interest income. 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, establish more relationships and build their market shares. Furthermore, many of our potential competitors are not subject to the regulatory restrictions that the 1940 Act imposes on us as a BDC. As a result of this competition, there can be no assurance that we will be able to identify and take advantage of attractive investment opportunities or that we will be able to fully invest our available capital. If we are not able to compete effectively, our business and financial condition and results of operations will be adversely affected.

**If we are unable to source investments effectively, we may be unable to achieve our investment objectives and provide returns to stockholders.**

Our ability to achieve our investment objective depends on our senior management team's ability to identify, evaluate and invest in suitable companies that meet our investment criteria. Accomplishing this result on a cost-effective basis is largely a function of our marketing capabilities, our management of the investment process, our ability to provide efficient services and our access to financing sources on acceptable terms. In addition to monitoring the performance of our existing investments, members of our management team may also be called upon to focus their attention on other aspects of our business, including strategic opportunities available to us and/or the Asset Manager Affiliates from time to time. These demands on their time may distract them or slow the rate of investment. To grow, we need to continue to hire, train, supervise and manage new employees and to implement computer and other systems capable of effectively accommodating our growth. However, we cannot provide assurance that any such employees will contribute to the success of our business or that we will implement such systems effectively. Failure to source investments effectively could have a material adverse effect on our business, financial condition and results of operations.

**Our business model depends to a significant extent upon strong referral relationships, and our inability to maintain or develop these relationships, as well as the failure of these relationships to generate investment opportunities, could adversely affect our business.**

We expect that members of our senior management team will maintain their relationships with intermediaries, financial institutions, investment bankers, commercial bankers, financial advisors, attorneys, accountants, consultants and other individuals within their networks, and we will rely to a significant extent upon these relationships to provide us with potential investment opportunities. If our senior management team fails to maintain its existing relationships or develop new relationships with sources of investment opportunities, we will not be able to grow our investment portfolio. In addition, individuals with whom members of our senior management team have relationships are not obligated to provide us with investment opportunities, and, therefore, there is no assurance that such relationships will generate investment opportunities for us.

**We may have difficulty paying distributions required to maintain our RIC status if we recognize income before or without receiving cash equal to such income.**

If we are unable to source investments effectively, we may be unable to achieve our investment objectives and provide

In accordance with the Code, we include in income certain amounts that we have not yet received in cash, such as contracted non-cash PIK interest, which represents contractual interest added to the loan balance and due at the end of the loan term. The increases in loan balances as a result of contracted non-cash PIK arrangements are included in income for the period in which such non-cash PIK interest was received, which is often in advance of receiving cash payment, and are separately identified on our statements of cash flows. We also may be required to include in income certain other amounts that we will not receive in cash. Any warrants that we receive in connection with our debt investments generally are valued as part of the negotiation process with the particular portfolio company. As a result, a portion of the aggregate purchase price for the debt investments and warrants is allocated to the warrants that we receive. This generally results in the associated debt investment having original issue discount for tax purposes, which we must recognize as ordinary income as it accrues. This increases the amounts we are required to distribute to maintain our

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qualification for tax treatment as a RIC. Because such original issue discount income might exceed the amount of cash received in a given year with respect to such investment, we might need to obtain cash from other sources to satisfy such distribution requirements. Other features of the debt instruments that we hold may also cause such instruments to generate original issue discount.

Since, in certain cases, we may recognize income before or without receiving cash representing such income, we may have difficulty meeting the annual distribution requirement necessary to maintain RIC tax treatment under the Code.

Accordingly, we may have to sell some of our investments at times and/or at prices we would 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 U.S. federal income tax. For additional discussion regarding the tax implications of a RIC, see Business Regulation Taxation as a Regulated Investment Company.

**Our Asset Manager Affiliates may incur losses as a result of first loss agreements that they may enter into from time-to-time in connection with warehousing credit arrangements which may be put in place prior to raising a CLO Fund and pursuant to which they would typically agree to reimburse credit providers for a portion of losses (if any) on warehouse investments.**

Our Asset Manager Affiliates enter into first loss agreements in connection with warehouse credit lines established to fund the initial accumulation of loan investments for future CLO Funds that our Asset Manager Affiliates will manage. Under such agreements, our Asset Manager Affiliates generally make a junior investment in a warehouse facility, which serves as a loss buffer for the senior capital provider. Such junior investment may be subject to losses (either in whole or in part) that stem from factors including (i) losses as a result of individual loan or other investments being ineligible for purchase by the CLO Fund (typically due to a payment default on such loan or other investments) when such fund formation is completed or (ii) if the CLO Fund has not been completed before the expiration of the warehouse credit line, the loss (if any, and net of any accumulated interest income) on the resale of such loans funded by the warehouse credit line, or (iii) realized losses from trading activity within the warehouse facility. As a result, our Asset Manager Affiliates may incur losses if loans and debt obligations, if applicable, that had been purchased in the warehouse facility become ineligible for inclusion in the CLO Fund or if a planned CLO Fund does not close.

**Any unrealized losses we experience on our loan portfolio may be an indication of future realized losses, which could reduce our income available to make distributions.**

As a BDC, we are required to carry our investments at market value or, if no market value is ascertainable, at the fair value as determined in good faith by our Board of Directors pursuant to a valuation methodology approved by our Board of Directors. Decreases in the market values or fair values of our investments will be recorded as unrealized losses. An unrealized loss in our loan portfolio could be an indication of a portfolio company's inability to meet its repayment obligations with respect to the affected loans. This could result in realized losses in the future and ultimately in reductions of our income available to pay dividends or interest and principal on our securities and could cause you to lose all or part of your investment.

## **We may experience fluctuations in our quarterly and annual operating results and credit spreads.**

We could experience fluctuations in our quarterly and annual operating results due to a number of factors, some of which are beyond our control, including our ability to make investments in companies that meet our investment criteria, the interest rate payable on the debt securities we acquire (which could stem from the general level of interest rates, credit spreads, or both), the default rate on such securities, prepayment upon the triggering of covenants in our middle market loans as well as our CLO Funds, our level of expenses, variations in and timing of the recognition of realized and unrealized gains or losses, the degree to which we encounter competition in our markets and general economic conditions. As a result of these factors, results for any period should not be relied upon as being indicative of performance in future periods.

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**We are exposed to risks associated with changes in interest rates and spreads.**

Changes in interest rates may have a substantial negative impact on our investments, the value of our securities and our rate of return on invested capital. A reduction in the interest spreads on new investments could also have an adverse impact on our net interest income. An increase in interest rates could decrease the value of any investments we hold which earn fixed interest rates, including mezzanine securities and high-yield bonds, and also could increase our interest expense, thereby decreasing our net income. An increase in interest rates due to an increase in credit spreads, regardless of general interest rate fluctuations, could also negatively impact the value of any investments we hold in our portfolio.

In addition, an increase in interest rates available to investors could make an investment in our securities less attractive than alternative investments, a situation which could reduce the value of our securities. Conversely, a decrease in interest rates may have an adverse impact on our returns by requiring us to seek lower yields on our debt investments and by increasing the risk that our portfolio companies will prepay our debt investments, resulting in the need to redeploy capital at potentially lower rates. A decrease in market interest rates may also adversely impact our returns on idle funds, which would reduce our net investment income.

**We borrow money, which magnifies the potential for gain or loss on amounts invested and may increase the risk of investing in us.**

Borrowings, also known as leverage, magnify the potential for gain or loss on amounts invested and, therefore, increase the risks associated with investing in us. We have issued senior securities, and in the future may borrow from, or issue additional senior securities (such as preferred or convertible securities or debt securities) to, banks and other lenders and investors. Subject to prevailing market conditions, we intend to grow our portfolio of assets by raising additional capital, including through the prudent use of leverage available to us. Lenders and holders of such senior securities would have fixed dollar claims on our assets that are superior to the claims of our common stockholders. Leverage is generally considered a speculative investment technique. Any increase in our income in excess of interest payable on our outstanding indebtedness would cause our net income to increase more than it would have had we not incurred leverage, while any decrease in our income would cause net income to decline more sharply than it would have had we not incurred leverage. Such a decline could negatively affect our ability to make distributions to our stockholders and service our debt obligations. In addition, our common stockholders will bear the burden of any increase in our expenses as a result of leverage. There can be no assurance that our leveraging strategy will be successful.

Our outstanding indebtedness imposes, and additional debt we may incur in the future will likely impose, financial and operating covenants that restrict our business activities, including limitations that could hinder our ability to finance additional loans and investments or to make the distributions required to maintain our status as a RIC. A failure to add new debt facilities or issue additional debt securities or other evidences of indebtedness in lieu of or in addition to existing indebtedness could have a material adverse effect on our business, financial condition or results of operations.

**Our indebtedness could adversely affect our financial health and our ability to respond to changes in our business.**

With certain limited exceptions, we are only allowed to borrow amounts or issue senior securities such that our asset coverage, as defined in the 1940 Act, is at least 200% immediately after such borrowing or issuance. As of December 31, 2016, our asset coverage ratio was 205%. The amount of leverage that we employ in the future will depend on our management's and our Board of Directors' assessment of market and other factors at the time of any proposed borrowing. There is no assurance that a leveraging strategy will be successful. As a result of the level of our leverage:

our exposure to risk of loss is greater if we incur debt or issue senior securities to finance investments because a decrease in the value of our investments has a greater negative impact on our equity returns and, therefore, the value of our business if we did not use leverage;

the decrease in our asset coverage ratio resulting from increased leverage and the covenants contained in documents governing our indebtedness (which may impose asset coverage or

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investment portfolio composition requirements that are more stringent than those imposed by the 1940 Act) limit our flexibility in planning for, or reacting to, changes in our business and industry, as a result of which we could be required to liquidate investments at an inopportune time;

we are required to dedicate a portion of our cash flow to interest payments, limiting the availability of cash for dividends and other purposes; and

our ability to obtain additional financing in the future may be impaired.

We cannot be sure that our leverage will not have a material adverse effect on us. In addition, we cannot be sure that additional financing will be available when required or, if available, will be on terms satisfactory to us. Further, even if we are able to obtain additional financing, we may be required to use some or all of the proceeds thereof to repay our outstanding indebtedness.

### **Because we intend to continue to distribute substantially all of our income and net realized capital gains to our stockholders, we will need additional capital to finance our growth.**

In order to continue to qualify as a RIC, to avoid payment of excise taxes and to minimize or avoid payment of U.S. federal income taxes, we intend to continue to distribute to our stockholders substantially all of our net ordinary income and realized net capital gains except for certain net long-term capital gains (which we may retain, pay applicable U.S. federal income taxes with respect thereto, and elect to treat as deemed distributions to our stockholders). As a BDC, in order to incur new debt, we are generally required to meet a coverage ratio of total assets to total senior securities, which includes all of our borrowings and any preferred stock we may issue in the future, of at least 200%, as measured immediately after issuance of such security. This requirement limits the amount that we may borrow. Because we will continue to need capital to grow our loan and investment portfolio, this limitation may prevent us from incurring debt and require us to issue additional equity at a time when it may be disadvantageous to do so. We cannot assure you that debt and equity financing will be available to us on favorable terms, or at all, and debt financings may be restricted by the terms of such borrowings. Also, as a business development company, we generally are not permitted to issue equity securities priced below net asset value without stockholder approval. If additional funds are not available to us, we could be forced to curtail or cease new lending and investment activities.

### **We may from time to time expand our business through acquisitions, which could disrupt our business and harm our financial condition.**

We may pursue potential acquisitions of, and investments in, businesses complementary to our business and from time to time engage in discussions regarding such possible acquisitions. For example, in February 2012, we completed the acquisition of Trimaran Advisors. Such acquisition and any other acquisitions we may undertake involve a number of risks, including:

failure of the acquired businesses to achieve the results we expect;  
substantial cash expenditures;

diversion of capital and management attention from operational matters;

our inability to retain key personnel of the acquired businesses;

incurrence of debt and contingent liabilities and risks associated with unanticipated events or liabilities; and the potential disruption and strain on our existing business and resources that could result from our planned growth and continuing integration of our acquisitions.

If we fail to properly evaluate acquisitions or investments, we may not achieve the anticipated benefits of such acquisitions, we may incur costs in excess of what we anticipate, and management resources and attention may be

Because we intend to continue to distribute substantially all of our income and net realized capital gains to our stock

diverted from other necessary or valuable activities. Any acquisition, including the Trimaran Advisors acquisition, may not result in short-term or long-term benefits to us. If we are unable to integrate or successfully manage any business that we acquire, we may not realize anticipated cost savings, improved efficiencies or revenue growth, which may result in reduced profitability or operating losses.

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**Our Board of Directors may change our investment objective, operating policies and strategies without prior notice or stockholder approval.**

Our Board of Directors has the authority to modify or waive certain of our operating policies and strategies without prior notice and without stockholder approval. However, absent stockholder approval, we may not change the nature of our business so as to cease to be, or withdraw our election as, a BDC. We cannot predict the effect any changes to our current operating policies and strategies would have on our business and operating results. Nevertheless, the effects may adversely affect our business and they could negatively impact our ability to pay you dividends and could cause you to lose all or part of your investment in our securities.

**Pending legislation may allow us to incur additional leverage.**

As a BDC under the 1940 Act, we are generally not permitted to incur indebtedness unless immediately after such borrowing we 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 our assets). Legislation introduced in the U.S. House of Representatives, if eventually passed, would modify this section of the 1940 Act and increase the amount of debt that business development companies may incur by modifying the percentage from 200% to 150%, as proposed. As a result, we may be able to incur additional indebtedness in the future and therefore your risk of an investment in our securities may increase.

**Our businesses may be adversely affected by litigation and regulatory proceedings.**

From time to time, we may be subject to legal actions as well as various regulatory, governmental and law enforcement inquiries, investigations and subpoenas. In any such claims or actions, demands for substantial monetary damages may be asserted against us and may result in financial liability or an adverse effect on our reputation among investors. We may be unable to accurately estimate our exposure to litigation risk when we record balance sheet reserves for probable loss contingencies. As a result, any reserves we establish to cover any settlements or judgments may not be sufficient to cover our actual financial exposure, which may have a material impact on our results of operations or financial condition. In regulatory enforcement matters, claims for disgorgement, the imposition of penalties and the imposition of other remedial sanctions are possible.

**Regulations governing our operation as a BDC affect our ability to, and the way in which we, raise additional capital.**

Our business requires a substantial amount of additional capital. We may acquire additional capital from the issuance of senior securities or other indebtedness, the issuance of additional shares of our common stock or from securitization transactions. However, we may not be able to raise additional capital in the future on favorable terms or at all. We may issue debt securities or preferred securities, which we refer to collectively as senior securities, and we may borrow money from banks or other financial institutions, up to the maximum amount permitted by the 1940 Act. The 1940 Act permits us to issue senior securities or incur indebtedness only in amounts such that our asset coverage, as defined in the 1940 Act, equals at least 200% immediately after such issuance or incurrence. With respect to certain types of senior securities, we must make provisions to prohibit any dividend distribution to our stockholders or the repurchase of certain of our securities, unless we meet the applicable asset coverage ratios at the time of the dividend distribution or repurchase. If the value of our assets declines, we may be unable to satisfy the asset coverage test. Furthermore, any amounts that we use to service our indebtedness would not be available for distributions to our common stockholders.

Our Board of Directors may change our investment objective, operating policies and strategies without prior notice or

All of the costs of offering and servicing such debt or preferred stock (if issued by us in the future), including interest or preferential dividend payments thereon, will be borne by our common stockholders. The interests of the holders of any debt or preferred stock we may issue will not necessarily be aligned with the interests of our common stockholders. In particular, the rights of holders of our debt or preferred stock to receive interest, dividends or principal repayment will be senior to those of our common stockholders. Also, in the event we issue preferred stock, the holders of such preferred stock will have the ability to elect two members of our board of directors. In addition, we may grant a lender a security interest in a significant portion or all of our assets, even if the total amount we may borrow from such lender is less than the amount of such lender's security interest in our assets.

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We are not generally able to issue and sell our common stock at a price below net asset value per share. We may, however, sell our common stock at a price below the then-current net asset value of our common stock if our board of directors determines that such sale is in the best interests of KCAP and its stockholders, and our stockholders approve, giving us the authority to do so. Although we currently do not have such authorization, we previously sought and received such authorization from our stockholders in the past and may seek such authorization in the future. In any such case, the price at which our securities are to be issued and sold may not be less than a price which, in the determination of our board of directors, closely approximates the market value of such securities (less any distributing commission or discount). We are also generally prohibited under the 1940 Act from issuing securities convertible into voting securities without obtaining the approval of our existing stockholders. In addition to issuing securities to raise capital as described above; we may securitize a portion of the loans generate cash for funding new investments. If we are unable to successfully securitize our loan portfolio our ability to grow our business and fully execute our business strategy and our earnings (if any) may be adversely affected. Moreover, even successful securitization of our loan portfolio might expose us to losses, as the residual loans in which we do not sell interests tend to be those that are riskier and more apt to generate losses.

### **Changes in the laws or regulations governing our business and the business of our Asset Manager Affiliates, or changes in the interpretations thereof, and any failure by us or our Asset Manager Affiliates to comply with these laws or regulations, could negatively affect the profitability of our operations.**

Changes in the laws or regulations or the interpretations of the laws and regulations that govern BDCs, Registered Investment Advisers (such as our Asset Manager Affiliates), RICs or non-depository commercial lenders could significantly affect our operations and our cost of doing business. We are subject to federal, state and local laws and regulations as well as the rules of the stock exchange on which our securities are listed, and are subject to judicial and administrative decisions that affect our operations, including our loan originations, maximum interest rates, fees and other charges, disclosures to portfolio companies, the terms of secured transactions, collection and foreclosure procedures and other trade practices. The various regulatory bodies, including the SEC and the NASDAQ Global Select Market, that administer these laws and regulations have issued a significant number of new and increasingly complex requirements and regulations over the course of the last several years and continue to develop additional regulations.

In addition, as registered investment advisers, the Asset Manager Affiliates are subject to new and existing regulations, regulatory risks, costs and expenses associated with operating as registered investment advisers that may limit their ability to operate, structure or expand their businesses in the future. If these laws, regulations or decisions change, or if we expand our business into jurisdictions that have adopted more stringent requirements than those in which we currently conduct business, we may have to incur significant expenses in order to comply or we might have to restrict our operations. In addition, if we do not comply with applicable laws, regulations and decisions, we may lose licenses needed for the conduct of our business and be subject to civil fines and criminal penalties, any of which could have a material adverse effect upon our business, results of operations or financial condition.

Moreover, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act ) has increased and may significantly increase the regulation of the financial services industry. The Dodd-Frank Act contains a broad set of provisions designed to govern the practices and oversight of financial institutions and other participants in the financial markets. One such provision, Section 619 of the Dodd-Frank Act, commonly referred to as the Volcker Rule, contains certain prohibitions and restrictions on the ability of a banking entity which includes insured depository institutions, bank holding companies, foreign banking entities regulated by the Federal Reserve Board and their respective affiliates and nonbank financial company supervised by the Federal Reserve to engage in proprietary

Changes in the laws or regulations governing our business and the business of our Asset Manager Affiliates, or cha

trading and have certain interests in, or relationships with certain private funds ( covered funds ). Under the final regulations implementing the Volcker Rule, which were adopted in December 2013, many CLOs will be covered funds if they invest, or are permitted to invest, in assets other than loans, certain cash equivalents and interest rate or currency hedges. As a result, many banking entities, including many U.S. and non-U.S. broker-dealers with affiliated banks, may be unable to invest in, or in some cases to make a market in, the securities of CLOs in which we have invested, which may reduce liquidity in these securities and have a material adverse effect on their valuation. Moreover, the Volcker Rule regulations may affect the market for CLOs such that our Asset Manager Affiliates may be

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unable to establish, or to obtain warehouse funding for, new CLOs that would be covered funds. If our Asset Manager Affiliates establish CLOs that are structured not to be covered funds and thus do not permit investments in customary assets such as corporate bonds, asset-backed securities or synthetic investments, and we invest in such CLOs, the ability of our Asset Manager Affiliates to manage such CLOs will be constrained by those limitations, which could materially adversely affect any investments we make in such CLOs.

In October 2014, the SEC, the FDIC, the Federal Reserve and certain other prudential banking regulators adopted final rules mandating risk retention for securitizations, including CLOs, which became effective on December 24, 2016. Under the final risk-retentions rules, our Asset Manager Affiliates (or a majority-owned affiliate of such entities, including the Company) will be required to hold interests equal to 5% of the fair value of any CLO they sponsor (unless the CLO invests only in certain qualifying loans, which we do not expect to be the case) and would be prohibited from selling or hedging those interests in accordance with the limitations on such sales or hedges set forth in the final rule. Our Asset Manager Affiliates (or a majority-owned affiliate of such entities, including the Company) will need to have the requisite capital to hold such interests as a condition to their ability to sponsor new CLOs, and the restrictions on hedging such interests may create greater risk with respect to those interests.

Our Asset Manager Affiliates (or a majority owned affiliate s) investments in such CLOs, or their inability to invest in such CLOs (and thus inability to sponsor them) could each have a material adverse effect upon our business, results of operations or financial condition.

In April 2010, the SEC proposed revised rules for asset-backed securities offerings ( Regulation AB II ) that, if adopted, would substantially change the disclosure, reporting and offering process for public and private offerings of asset-backed securities, including CLOs. The proposed rules, if adopted, would have required significant additional disclosures and would have altered the safe-harbor standards for the private placement of asset-backed securities to impose informational requirements similar to those that would apply to registered public offerings of such securities. The application of such informational requirements to CLOs, which have not historically been publicly registered, was unclear. On August 27, 2014, the SEC adopted a set of Regulation AB II final rules that was limited to asset-backed securities that were publicly registered. These rules impose changes to the offering process for publicly registered asset-backed securities and require disclosure of loan-level data for a subset of classes addressed in the proposed rules, but do not at this time extend to privately offered CLOs. However, the SEC has indicated that many aspects of the rule proposals, including the expansion of loan-level or grouped data disclosure requirements to additional asset classes and the possible application of the rules to private offerings of securities, remain under active consideration. The timing of the adoption of any additional final rules, their application to privately offered securities in general and to CLOs in particular, the cost of compliance with such rules, and whether compliance would compromise proprietary methods or strategies of our Asset Manager Affiliates, is currently unclear.

Other financial reform regulations, including regulations requiring clearing and margining of swap transactions, which may affect our ability to enter into hedging transactions; changes in the definition and regulation of commodity pool operators and commodity trading advisors, which could subject our Asset Manager Affiliates to additional regulations; leveraged lending guidance that may affect the ways in which banking institutions originate the loans in which we and our affiliates invest; heightened regulatory capital and liquidity requirements for banks that may affect our ability to borrow on reasonable terms; and non-US regulations of financial market participants that may overlap, expand upon or be inconsistent with US regulations may all have material adverse effects on our business.

**If we do not invest a sufficient portion of our assets in Qualifying Assets, we could be precluded from investing according to our current business strategy.**

If we do not invest a sufficient portion of our assets in Qualifying Assets, we could be precluded from investing according to our current business strategy.

As a BDC, we may not acquire any assets other than Qualifying Assets for purposes of the 1940 Act unless, at the time of and after giving effect to such acquisition, at least 70% of our total assets are qualifying assets. See Item 1: Business Regulation.

We believe that most of the senior loans and mezzanine investments that we acquire constitute qualifying assets. However, investments in the securities of CLO Funds generally do not constitute qualifying assets, and we may invest in other assets that are not qualifying assets. If we do not invest a sufficient portion of our assets in qualifying assets, we may be precluded from investing in what we believe



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are attractive investments, which would have a material adverse effect on our business, financial condition and results of operations. These restrictions could also prevent us from making investments in the equity securities of CLO Funds, which could limit our Asset Manager Affiliates' ability to organize new CLO Funds. Similarly, these rules could prevent us from making follow-on investments in existing portfolio companies (which could result in the dilution of our position).

### **Our ability to enter into transactions with our affiliates is restricted.**

We are prohibited under the 1940 Act from participating in certain transactions with certain of our affiliates without the prior approval of the members of our independent directors and, in some cases, the SEC. Any person that owns, directly or indirectly, 5% or more of our outstanding voting securities is our affiliate for purposes of the 1940 Act and we are generally prohibited from buying or selling any securities (other than our securities) from or to such affiliate, absent the prior approval of our independent directors. The 1940 Act also prohibits certain joint transactions with certain of our affiliates, which could include investments in the same portfolio company (whether at the same or different times), without prior approval of our independent directors and, in some cases, the SEC. If a person acquires more than 25% of our voting securities, we will be prohibited from buying or selling any security (other than any security of which we are the issuer) from or to such person or certain of that person's affiliates, or entering into prohibited joint transactions with such person, absent the prior approval of the SEC. Similar restrictions limit our ability to transact business with our officers or directors or their affiliates.

### **A failure on our part to maintain our status as a BDC would significantly reduce our operating flexibility.**

If we fail to maintain our status as a BDC, we might be regulated as a closed-end investment company that is required to register under the Investment Company Act, which would subject us to additional regulatory restrictions and significantly decrease our operating flexibility. In addition, any such failure could cause an event of default under our outstanding indebtedness, which could have a material adverse effect on our business, financial condition or results of operations.

### **We will be subject to corporate-level U.S. federal income taxes if we are unable to qualify as a RIC under Subchapter M of the Code.**

To maintain RIC tax treatment under the Code, we must meet the following annual distribution, income source and asset diversification requirements:

The annual distribution requirement for a RIC will be satisfied if we distribute to our stockholders on an annual basis at least 90% of our net ordinary income and realized net short-term capital gains in excess of realized net long-term capital losses, if any. Because we use debt financing, we are subject to certain asset coverage ratio requirements under the 1940 Act and are (and may in the future become) subject to certain financial covenants under loan, indenture and credit agreements that could, under certain circumstances, restrict us from making distributions necessary to satisfy the distribution requirement. If we are unable to obtain cash from other sources, we could fail to qualify for RIC tax treatment and thus become subject to corporate-level U.S. federal income taxes.

The source income requirement will be satisfied if we obtain at least 90% of our income for each year from dividends, interest, gains from the sale of stock or securities or similar sources.

The asset diversification requirement will be satisfied if we meet certain asset diversification requirements at the end of each quarter of our taxable year. To satisfy this requirement, at least 50% of the value of our assets must consist of

cash, cash equivalents, U.S. Government securities, securities of other RICs, and other acceptable securities; and no more than 25% of the value of our assets can be invested in the securities, other than U.S. government securities or securities of other RICs, of one issuer, of two or more issuers that are controlled, as determined under applicable Code rules, by us and that are engaged in the same or similar or related trades or businesses or of certain qualified publicly traded partnerships. If we do not satisfy the diversification requirements as of the end of any quarter, we will not lose our status as RIC provided that (i) we satisfied the requirements in a prior quarter and (ii) our failure to satisfy the requirements in the current quarter is not due in whole or in part to an acquisition of any security or other property.

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Failure to meet these requirements may result in our having to dispose of certain investments quickly in order to prevent the loss of RIC status. Because most of our investments will be in private companies, and therefore will be illiquid, any such dispositions could be made at disadvantageous prices and could result in substantial losses. Moreover, if we fail to maintain RIC tax treatment for any reason and are subject to corporate-level U.S. federal income taxes, the resulting taxes could substantially reduce our net assets, the amount of income available for distribution and the amount of our distributions. Such a failure would have a material adverse effect on us and on our stockholders.

### **Proposed regulations may impact our ability to qualify as a RIC if we do not receive timely distributions from our CLO investments.**

We may be required to include in our income our proportionate share of the income of certain CLO investments to the extent that such CLOs are passive foreign investment companies ( PFICs ) for which we have made a qualifying electing fund ( QEF ) election or are controlled foreign corporations ( CFCs ). To qualify as a RIC, we must, among other things, derive in each taxable year at least 90% of our gross income from certain sources specified in the Code (the 90% Income Test ). Although the Code generally provides that the income inclusions from a QEF or a CFC will be good income for purposes of this 90% Income Test to the extent that the QEF or the CFC distribute such income to us in the same taxable year to which the income is included in our income, the Code does not specifically provide whether these income inclusions would be good income for this 90% Income Test if we do not receive distributions from the QEF or CFC during such taxable year. The IRS has issued a series of private rulings in which it has concluded that all income inclusions from a QEF or a CFC included in a RIC's gross income would constitute good income for purposes of the 90% Income Test. Such rulings are not binding on the IRS except with respect to the taxpayers to whom such rulings were issued. Accordingly, under current law, we believe that the income inclusions from a CLO that is a QEF or a CFC would be good income for purposes of the 90% Income Test. Recently, the IRS and U.S. Treasury Department issued proposed regulations that provide that the income inclusions from a QEF or a CFC would not be good income for purposes of the 90% Income Test unless we receive a cash distribution from such entity in the same year attributable to the included income. If such income were not considered good income for purposes of the 90% Income Test, we may fail to qualify as a RIC.

## **Risks Associated with Our Information Technology Systems**

We rely on various information technology systems to manage our operations. Information technology systems are subject to numerous risks including unanticipated operating problems, system failures, rapid technological change, failure of the systems that operate as anticipated, reliance on third party computer hardware, software and IT service providers, computer viruses, telecommunication failures, data breaches, denial of service attacks, spamming, phishing attacks, computer hackers and other similar disruptions, any of which could materially adversely impact our consolidated financial condition and results of operations. Additional risks include, but are not limited to, the following:

### **Disruptions in current systems or difficulties in integrating new systems.**

We regularly maintain, upgrade, enhance or replace our information technology systems to support our business strategies and provide business continuity. Replacing legacy systems with successor systems, making changes to existing systems or acquiring new systems with new functionality have inherent risks including disruptions, delays, or

difficulties that may impair the effectiveness of our information technology systems.

**If we are unable to maintain the availability of our electronic data systems and safeguard the security of our data, our ability to conduct business may be compromised, which impair our liquidity, disrupt our business, damage our reputation and cause losses.**

Cybersecurity refers to the combination of technologies, processes, and procedures established to protect information technology systems and data from unauthorized access, attack, or damage. We are subject to cybersecurity risks. Information cyber security risks have significantly increased in recent years and, while we have not experienced any material losses relating to cyber attacks or other information security breaches, we could suffer such losses in the future. Our computer systems, software and networks may be vulnerable to

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unauthorized access, computer viruses or other malicious code and other events that could have a security impact. If one or more of such events occur, this potentially could jeopardize confidential and other information, including nonpublic personal information and sensitive business data, processed and stored in, and transmitted through, our computer systems and networks, or otherwise cause interruptions or malfunctions in our operations or the operations of our customers or counterparties, which could result in significant losses or reputational damage. This could result in significant losses, reputational damage, litigation, regulatory fines or penalties, or otherwise adversely affect our business, financial condition or results of operations. Privacy and information security laws and regulation changes, and compliance with those changes, may result in cost increases due to system changes and the development of new administrative processes. In addition, we may be required to expend significant additional resources to modify our protective measures and to investigate and remediate vulnerabilities or other exposures arising from operational and security risks. We currently do not maintain insurance coverage relating to cybersecurity risks, and we may be required to expend significant additional resources to modify our protective measures or to investigate and remediate vulnerabilities or other exposures, and we may be subject to litigation and financial losses that are not fully insured.

Third parties with which we do business may also be sources of cybersecurity or other technological risks. We outsource certain functions and these relationships allow for the storage and processing of our information, as well as customer, counterparty, employee and borrower information. While we engage in actions to reduce our exposure resulting from outsourcing, ongoing threats may result in unauthorized access, loss, exposure or destruction of data, or other cybersecurity incidents, with increased costs and other consequences, including those described above.

**Our business and operations could be negatively affected if we become subject to any securities litigation or stockholder activism, which could cause us to incur significant expense, hinder execution of investment strategy and impact our stock price.**

In the past, following periods of volatility in the market price of a company's securities, securities class-action litigation has often been brought against that company. Stockholder activism, which could take many forms or arise in a variety of situations, has been increasing in the BDC space recently. While we are currently not subject to any securities litigation or stockholder activism, we may in the future become the target of securities litigation or stockholder activism. Securities litigation and stockholder activism, including potential proxy contests, could result in substantial costs and divert management's and our board of directors' attention and resources from our business. Additionally, such securities litigation and stockholder activism could give rise to perceived uncertainties as to our future, adversely affect our relationships with service providers and make it more difficult to attract and retain qualified personnel. Also, we may be required to incur significant legal fees and other expenses related to any securities litigation and activist stockholder matters. Further, our stock price could be subject to significant fluctuation or otherwise be adversely affected by the events, risks and uncertainties of any securities litigation and stockholder activism.

## **Risks Related to Our Debt Securitization Financing Transactions**

**We are subject to certain risks as a result of our indirect interests in the subordinated notes and membership interests of KCAP Senior Funding I, LLC.**

On June 18, 2013, KCAP Senior Funding I, LLC, a specialty finance subsidiary of the Company, was capitalized through the issuance of \$140 million of notes (the "KCAP Senior Funding I Notes"). In December 2014, KCAP Senior Funding I, LLC, issued an additional \$56 million of notes. The KCAP Senior Funding I Notes are backed by a diversified portfolio of bank loans.

Under the terms of the master loan sale agreement governing the debt securitization financing transaction, (1) we sold and/or contributed to KCAP Senior Funding I Holdings, LLC ("Holdings") all of our ownership interest in our portfolio loans and participations for the purchase price and other consideration set forth in the master loan sale agreement and (2) Holdings, in turn, sold and/or contributed to KCAP Senior Funding I, LLC (the "Issuer") all of its ownership interest in such portfolio loans and participations for the purchase price and the consideration set forth in the master loan sale agreement. Following these transfers, the Issuer, and not Holdings or us, held all of the ownership interest in such portfolio loans and participations. As a result of the debt securitization financing transaction, we hold indirectly through Holdings all of the

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subordinated notes and membership interests of the Issuer. As a result, we consolidate the financial statements of Holdings and the Issuer in our consolidated financial statements. Because Holdings and the Issuer are disregarded as entities separate from its owner for U.S. federal income tax purposes, each of the sale or contribution of portfolio loans by us to Holdings, and the sale of portfolio loans by Holdings to the Issuer, did not constitute a taxable event for U.S. federal income tax purposes. If the U.S. Internal Revenue Service were to take a contrary position, there could be a material adverse effect on our business, financial condition, results of operations or cash flows.

**The subordinated notes and membership interests of the Issuer are subordinated obligations of the Issuer.**

The subordinated notes of the Issuer are the junior class of notes issued by the Issuer, are subordinated in priority of payment to the secured notes issued by the Issuer and are subject to certain payment restrictions set forth in the indenture governing the notes of the Issuer. Therefore, Holdings only receives cash distributions on the subordinated notes if the Issuer has made all cash interest payments on the secured notes it has issued, and we only receive cash distributions in respect of our indirect ownership of the Issuer to the extent that Holdings receives any cash distributions in respect of its direct ownership of the Issuer. The subordinated notes of the Issuer are also unsecured and rank behind all of the secured creditors, known or unknown, of the Issuer, including the holders of the secured notes it has issued. Consequently, to the extent that the value of either the Issuer's portfolio of loan investments has been reduced as a result of conditions in the credit markets, or as a result of defaulted loans or individual fund assets, the value of the subordinated notes of such securitization issuer at their redemption could be reduced. Accordingly, our investment in the Issuer may be subject to complete loss.

The membership interests in the Issuer represent all of the residual economic interest in the Issuer. As such, the holder of the membership interests of the Issuer is the residual claimant on distributions, if any, made by the Issuer after holders of all classes of notes issued by the Issuer have been paid in full on each payment date or upon maturity of such notes under the debt securitization financing transaction documents.

If an event of default has occurred and acceleration occurs in accordance with the terms of the indenture governing the notes of the Issuer, the secured notes of the Issuer then outstanding will be paid in full before any further payment or distribution on the subordinated notes of the Issuer. In addition, if an event of default occurs, holders of a majority of the most senior class of secured notes then outstanding will be entitled to determine the remedies to be exercised under the indenture, subject to the terms of the indenture. For example, upon the occurrence of an event of default with respect to the notes issued by the Issuer, the trustee or holders of a majority of the most senior class of secured notes of the Issuer then outstanding may declare the principal, together with any accrued interest, of all the notes of such class and any junior classes to be immediately due and payable. This would have the effect of accelerating the principal on such notes, triggering a repayment obligation on the part of the Issuer. If at such time the portfolio loans of the Issuer were not performing well, the Issuer may not have sufficient proceeds available to enable the trustee under the indenture to repay the obligations of holders of the subordinated notes of the Securitization Issuer, or to pay a dividend to holders of the membership interests of the Issuer.

Remedies pursued by the holders of the secured notes of the Issuer could be adverse to the interests of the holders of the subordinated notes of the Issuer, and the holders of such secured notes will have no obligation to consider any possible adverse effect on such other interests. Thus, any remedies pursued by the holders of the secured notes of the Issuer may not be in our best interests and we may not receive payments or distributions upon an acceleration of the secured notes. Any failure of the Issuer to make distributions on the subordinated notes we hold, directly or indirectly, whether as a result of an event of default or otherwise, could have a material adverse effect on our business, financial condition, results of operations and cash flows and may result in an inability of us to make distributions sufficient to

allow our qualification as a RIC.

**The Issuer may fail to meet certain coverage tests.**

Under the documents governing the debt securitization financing transaction, there are two coverage tests applicable to the secured notes. The first such test compares the amount of interest received on the portfolio loans held by the Issuer to the amount of interest payable in respect of the secured notes of the Issuer. To meet this test at any time, interest received on the portfolio loans must equal at least 127% to 150% (based



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upon a graduated scale for the most senior class of secured notes then outstanding as provided for in the indenture) of the interest payable in respect of the secured notes of the Issuer. The second such test compares the principal amount of the portfolio loans held by the Issuer to the aggregate outstanding principal amount of the secured notes of the Issuer. To meet this test at any time, the aggregate principal amount of the portfolio loans held by the Issuer must equal at least 124% to 147% (based upon a graduated scale for the most senior class of secured notes then outstanding as provided for in the indenture) of the outstanding principal amount of the secured notes of the Issuer. If either coverage test is not satisfied, interest and principal received by the Issuer are diverted on the following payment date to pay the most senior class or classes of secured notes to the extent necessary to cause all coverage tests to be satisfied on a pro forma basis after giving effect to all payments made in respect of the notes, which, with respect to the payment of any principal amount of the secured notes, we refer to as a mandatory redemption. If any coverage test with respect to the secured notes is not met, proceeds from the portfolio of loan investments that otherwise would have been distributed to the Issuer and the holders of its subordinated notes will instead be used to redeem first the secured notes of the Issuer, to the extent necessary to satisfy the applicable coverage tests.

### **We may not receive cash on our equity interests in the Issuer.**

We receive cash from the Issuer only to the extent that we or Holdings, as applicable, receives payments on the subordinated notes or membership interests of the Issuer. The Issuer may only make payments on such securities to the extent permitted by the payment priority provisions of the indenture governing the notes, which generally provides that principal payments on the subordinated notes may not be made on any payment date unless all amounts owing under the secured notes issued under such indenture are paid in full. In addition, if the Issuer does not meet the coverage tests set forth in the documents governing the debt securitization financing transaction, cash would be diverted from the subordinated notes of the Issuer to first pay the secured notes of the Issuer in amounts sufficient to cause such tests to be satisfied. In the event that we fail to directly or indirectly receive cash from the Issuer, we could be unable to make distributions in amounts sufficient to maintain our status as a RIC, or at all. We also could be forced to sell investments in portfolio companies at less than their fair value in order to continue making such distributions. However, the indenture places significant restrictions on the Issuer's ability to sell investments. As a result, there may be times or circumstances during which the Issuer is unable to sell investments or take other actions that might be in our best interests.

### **A significant portion of the assets reflected on our financial statements are held by the Issuer and are subject to security interests under the senior secured notes issued by the Issuer and if it defaults on its obligations under the senior secured notes we and the Issuer may suffer adverse consequences, including foreclosure on those assets.**

In connection with our debt securitization financing transaction, we transferred all of our interests in certain portfolio loans to the Issuer. In doing so, we transferred any right we previously had to the payments made on such portfolio loans in exchange for 100% of the residual interests in the Issuer. As a result, we face a heightened risk of loss due to the impact of leverage utilized by the Issuer, which would have the effect of magnifying the impact on us of a loss on any portfolio loan held by the Issuer. In addition, while we serve as the collateral manager for the Issuer, which provides us with the authority to enforce payment obligations and loan covenants of the portfolio loans that we transferred to the Issuer, we are required to exercise such authority for the interests of the Issuer, rather than for our own interests alone.

The structure of the debt securitization financing transaction is intended to prevent, in the event of our bankruptcy or the bankruptcy of Holdings, the consolidation for purposes of such bankruptcy proceedings of the Issuer with our operations or those of Holdings. If the true sale of these assets were not respected in the event of our insolvency, a trustee or debtor-in-possession might reclaim the assets of the Issuer for our estate. However, in doing so, we would become directly liable for all of the indebtedness then outstanding under the debt securitization financing transaction, which would equal the full amount of debt of the Issuer reflected on our consolidated balance sheet. In addition, we cannot assure that the recovery in the event we were consolidated with the Issuer for purposes of any bankruptcy proceeding would exceed the amount to which we would otherwise be entitled as a direct or indirect.

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As of December 31, 2016, \$190.4 million of the assets that are reflected on our consolidated financial statements were held by the Issuer and pledged as collateral under the senior secured notes issued by the Issuer. If the Issuer defaults on its obligations under the senior secured notes, the holders of the senior secured notes may have the right to foreclose upon and sell, or otherwise transfer, the Issuer's assets. In such event, we and the Issuer may be forced to sell the Issuer's investments to raise funds to repay the Issuer's outstanding borrowings in order to avoid foreclosure and these forced sales may be at times and at prices we and the Issuer would not consider advantageous, which could result in a decrease in the value of the Company's equity investment in the Issuer. Moreover, such deleveraging of our company could significantly impair our ability to effectively operate our business in the manner in which we have historically operated. As a result, we could be forced to curtail or cease new investment activities and lower or eliminate the dividends that we have historically paid to our stockholders.

In addition, in certain limited circumstances in the event of default, if the holders of the senior secured notes exercise their right to sell the assets pledged by the Issuer, such sales may be completed at distressed sale prices, thereby diminishing or potentially eliminating the amount of cash available to the Issuer and us after repayment of the amounts outstanding under the senior secured notes.

## **Risks Related to Our Investments**

### **Our investments may be risky, and you could lose all or part of your investment.**

We invest primarily in senior secured term loans, mezzanine debt, selected equity investments issued by middle market companies, CLO Funds and our Asset Manager Affiliates. The investments in our Debt Securities Portfolio are all or predominantly below investment grade, may be highly leveraged, and therefore have speculative characteristics with respect to the issuer's capacity to pay interest and repay principal. Defaults by portfolio companies may harm our operating results.

*Secured Loans.* When we extend secured term loans, we generally take a security interest (either as a first lien position or as a second lien position) in the available assets of these portfolio companies, including the equity interests of their subsidiaries, which we expect to assist in mitigating the risk that we will not be repaid. However, there is a risk that the collateral securing our loans may decrease in value over time, may be difficult to sell in a timely manner, may be difficult to appraise and may fluctuate in value based upon the success of the business and market conditions, including as a result of the inability of the portfolio company to raise additional capital, and, in some circumstances, our lien could be subordinated to claims of other creditors. In addition, deterioration in a portfolio company's financial condition and prospects, including its inability to raise additional capital, may be accompanied by deterioration in the value of the collateral for the loan. Consequently, the fact that a loan is secured does not guarantee that we will receive principal and interest payments according to the loan's terms, or at all, or that we will be able to collect on the loan should we be forced to exercise our remedies.

*Mezzanine Debt.* Our mezzanine debt investments generally are subordinated to senior loans and generally are unsecured. This may result in an above average amount of risk and volatility or loss of principal.

These investments may entail additional risks that could adversely affect our investment returns. To the extent interest payments associated with such debt are deferred, such debt is subject to greater fluctuations in value based on changes in interest rates and such debt could subject us to phantom income. Since we generally do not receive any cash prior to maturity of the debt, the investment is of greater risk.

*Equity Investments.* We have made and expect to make selected equity investments in the middle market companies. In addition, when we invest in senior secured loans or mezzanine debt, we may acquire warrants in the equity of the portfolio company. Our goal is ultimately to dispose of such equity interests and realize gains upon our disposition of such interests. However, the equity interests we receive may not appreciate in value and, in fact, may decline in value. Accordingly, we may not be able to realize gains from our equity interests, and any gains that we do realize on the disposition of any equity interests may not be sufficient to offset any other losses we experience.

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*Risks Associated with Middle Market Companies.* Investments in middle market companies also involve a number of significant risks, including:

limited financial resources and inability to meet their obligations, which may be accompanied by a deterioration in the value of any collateral and a reduction in the likelihood of our realizing the value of any guarantees we may have obtained in connection with our investment;

shorter operating histories, narrower product lines and smaller market shares than larger businesses, which tend to render them more vulnerable to competitors' actions and market conditions, as well as general economic downturns; dependence on management talents and efforts of a small group of persons; therefore, the death, disability, resignation or termination of one or more of these persons could have a material adverse impact on our portfolio company and, in turn, on us;

less predictable operating results, being parties to litigation from time to time, engaging in rapidly changing businesses with products subject to a substantial risk of obsolescence and requiring substantial additional capital expenditures to support their operations, finance expansion or maintain their competitive position;

difficulty accessing the capital markets to meet future capital needs; and

generally less publicly available information about their businesses, operations and financial condition.

*CLO Fund Investments.* Investments in CLO Funds also involve a number of significant risks, including:

CLOs typically are comprised of a portfolio of senior secured loans; payments on CLO investments are and will be payable solely from the cash-flows from such senior secured loans;

CLO investments are exposed to leveraged credit risk;

CLO Funds are highly leveraged;

there is the potential for interruption and deferral of cash-flow from CLO investments;

interest rates paid by corporate borrowers are subject to volatility;

the inability of a CLO collateral manager to reinvest the proceeds of the prepayment of senior secured loans may adversely affect us;

our CLO investments are subject to prepayments and calls, increasing re-investment risk;

we have limited control of the administration and amendment of any CLO in which we invest;

senior secured loans of CLOs may be sold and replaced resulting in a loss to us;

our financial results may be affected adversely if one or more of our significant equity or junior debt investments in a CLO vehicle defaults on its payment obligations or fails to perform as we expect; and

non-investment grade debt involves a greater risk of default and higher price volatility than investment grade debt.

*Asset Manager Affiliates.* We may not receive all or a portion of the cash distributions we expect to continue to receive from our Asset Manager Affiliates, including from their receipt of incentive fees.

We expect to receive cash distributions from our Asset Manager Affiliates. However, the existing asset management agreements pursuant to which our Asset Manager Affiliates receive fee income from the CLO Funds for which they serve as managers may be terminated for cause by the holders of a majority of the most senior class of securities issued by such CLO Funds and the holders of a majority of the subordinated securities issued by such CLO Funds.

Cause is defined in the asset management agreements to include a material breach by our Asset Manager Affiliates of the indenture governing the applicable

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CLO Fund, breaches by our Asset Manager Affiliates of certain specified provisions of the indenture (including, in some cases, a key person provision), material breaches of representations or warranties made by our Asset Manager Affiliates, bankruptcy or insolvency of our Asset Manager Affiliates, fraud or criminal activity on the part of our Asset Manager Affiliates or an event of default under the indenture governing the CLO Funds. We expect that future asset management agreements will contain comparable provisions.

Further, a significant portion of the asset management fees payable to our Asset Manager Affiliates under the asset management agreements are subordinated to the prior payments of interest on the senior securities issued by the CLO Funds. If the asset management agreements are terminated, or the CLO Funds do not generate enough income (due to run-off of existing funds and de-leveraging), or otherwise have insufficient residual cash flow due to diversion of cash as a result of the failure by the CLO Funds to satisfy certain restrictive covenants contained in their indenture agreements to pay the subordinated management fees, the Asset Manager Affiliates will not receive the fee income that they expect to continue to receive which would reduce cash distributions available to us, and in turn reduce our ability to make distributions to our stockholders.

**Our portfolio investments for which there is no readily available market, including our investment in our Asset Manager Affiliates and our investments in CLO Funds, are recorded at fair value as determined in good faith by our Board of Directors. As a result, there is uncertainty as to the value of these investments.**

Our investments consist primarily of securities issued by privately-held companies, the fair value of which is not readily determinable. In addition, we are not permitted to maintain a general reserve for anticipated loan losses. Instead, we are required by the 1940 Act to specifically value each investment and record an unrealized gain or loss for any asset that we believe has increased or decreased in value. We value these securities at fair value as determined in good faith by our Board of Directors pursuant to a valuation methodology approved by our Board of Directors. These valuations are initially prepared by our management and reviewed by our Valuation Committee, which uses its best judgment in arriving at the fair value of these securities. However, the Board of Directors retains ultimate authority to determine the appropriate valuation for each investment.

The Company has engaged an independent valuation firm to provide third party valuation consulting services to the Company's Board of Directors. Each quarter, the independent valuation firm performs third party valuations on the Company's material investments in illiquid securities, such that they are reviewed at least once during a trailing 12 month period. These third party valuation estimates are one of the relevant data points in the Board of Director's determination of fair value. The Board of Directors intends to continue to engage an independent valuation firm in the future to provide certain valuation services, including the review of certain portfolio assets, as part of the quarterly and annual year-end valuation process. In addition to such third-party input, the types of factors that may be considered in valuing our investments include the nature and realizable value of any collateral, the portfolio company's ability to make payments and its earnings, the markets in which the portfolio company does business, comparison to publicly-traded companies, discounted cash flow and other relevant factors. Our investment in our Asset Manager Affiliates is carried at fair value, which is determined after taking into consideration a percentage of assets under management and a discounted cash flow model incorporating different levels of discount rates depending on the hierarchy of fees earned (including the likelihood of realization of senior, subordinate and incentive fees) and prospective modeled performance. Such valuation includes an analysis of comparable asset management companies. Because such valuations, and particularly valuations of private investments and private companies, are inherently uncertain and may be based on estimates, our determinations of fair value may differ materially from the values that

would be assessed if a ready market for these securities existed. Our net asset value could be adversely affected if our determinations regarding the fair value of our illiquid investments were materially higher than the values that we ultimately realize upon the disposal of such securities.

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**We are a non-diversified investment company within the meaning of the 1940 Act, and therefore we may invest a significant portion of our assets in a relatively small number of issuers, which subjects us to a risk of significant loss if any of these issuers defaults on its obligations under any of its debt instruments or as a result of a downturn in the particular industry.**

We are classified as a non-diversified investment company within the meaning of the 1940 Act, and therefore we may invest a significant portion of our assets in a relatively small number of issuers in a limited number of industries. As of December 31, 2016, our largest investment, our 100% equity interest in our Asset Manager Affiliates, equaled approximately 11.0% of the fair value of our total investments. Beyond the asset diversification requirements associated with our qualification as a RIC, we do not have fixed guidelines for diversification, and while we are not targeting any specific industries, relatively few industries may become significantly represented among our investments. To the extent that we assume large positions in the securities of a small number of issuers, our net asset value may fluctuate to a greater extent than that of a diversified investment company as a result of changes in the financial condition or the market's assessment of the issuer, changes in fair value over time or a downturn in any particular industry. We may also be more susceptible to any single economic or regulatory occurrence than a diversified investment company.

**Defaults by our portfolio companies could harm our operating results.**

A portfolio company's failure to satisfy financial or operating covenants imposed by us or other debt holders could lead to defaults and, potentially, acceleration of the time when the loans are due and foreclosure on its secured assets. Such events could trigger cross-defaults under other agreements and jeopardize a portfolio company's ability to meet its obligations under the debt that we hold and the value of any equity securities we own. We may incur expenses to the extent necessary to seek recovery upon default or to negotiate new terms with a defaulting portfolio company.

**When we are a debt or minority equity investor in a portfolio company, which generally is the case, we may not be in a position to control the entity, and its management may make decisions that could decrease the value of our investment.**

Most of our investments are either debt or minority equity investments in our portfolio companies. Therefore, we are subject to the risk that a portfolio company may make business decisions with which we disagree, and the stockholders and management of such company may take risks or otherwise act in ways that do not serve our interests. As a result, a portfolio company may make decisions that could decrease the value of our portfolio holdings. In addition, we generally are not in a position to control any portfolio company by investing in its debt securities.

**We may have limited access to information about privately held companies in which we invest.**

We invest primarily in privately-held companies. Generally, little public information exists about these companies, and we are required to rely on the ability of our investment professionals to obtain adequate information to evaluate the potential returns from investing in these companies. These companies and their financial information are not subject to the Sarbanes-Oxley Act of 2002 and other rules that govern public companies. If we are unable to uncover

We are a non-diversified investment company within the meaning of the 1940 Act, and therefore we may invest a si



all material information about these companies, we may not make a fully informed investment decision, and we may lose money on our investment.

**Prepayments of our debt investments by our portfolio companies could negatively impact our operating results.**

We are subject to the risk that the investments we make in our portfolio companies may be repaid prior to maturity. When this occurs, we generally reinvest these proceeds in temporary investments, pending their future investment in new portfolio companies. These temporary investments typically have substantially lower yields than the debt being prepaid and we could experience significant delays in reinvesting these amounts. Any future investment in a new portfolio company may also be at lower yields than the debt that was repaid. Consequently, our results of operations could be materially adversely affected if one or more of our portfolio companies elects to prepay amounts owed to us. Additionally, prepayments could negatively impact our return on equity, which could result in a decline in the market price of our common stock.

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**We may be unable to invest the net proceeds raised from offerings and repayments from investments on acceptable terms, which would harm our financial condition and operating results.**

Until we identify new investment opportunities, we intend to either invest the net proceeds of future offerings and repayments from investments in interest-bearing deposits or other short-term instruments or use the net proceeds from such offerings to reduce then-outstanding debt obligations. We cannot assure you that we will be able to find enough appropriate investments that meet our investment criteria or that any investment we complete using the proceeds from an offering will produce a sufficient return.

**Our portfolio companies may incur debt that ranks equal with, or senior to, our investments in such companies.**

We invest primarily in debt securities issued by our portfolio companies. In some cases portfolio companies are permitted to have other debt that ranks equal with, or senior to, the debt securities in which we invest. By their terms, such debt instruments may provide that the holders thereof are entitled to receive payment of interest or principal on or before the dates on which we are entitled to receive payments in respect of the debt securities in which we invest. Also, in the event of insolvency, liquidation, dissolution, reorganization or bankruptcy of a portfolio company, holders of debt instruments ranking senior to our investment in that portfolio company would typically be entitled to receive payment in full before we receive any distribution in respect of our investment. After repaying such senior creditors, such portfolio company may not have any remaining assets to use for repaying its obligation to us. In the case of debt ranking equal with debt securities in which we invest, we would have to share on an equal basis any distributions with other creditors holding such debt in the event of an insolvency, liquidation, dissolution, reorganization or bankruptcy of a portfolio company.

**Second priority liens on collateral securing loans that we make to our portfolio companies may be subject to control by senior creditors with first priority liens. If there is a default, the value of the collateral may not be sufficient to repay in full both the first priority creditors and us.**

Certain loans that we make are secured by a second priority security interest in the same collateral pledged by a portfolio company to secure senior debt owed by the portfolio company to other traditional lenders. Often the senior lender has procured covenants from the portfolio company prohibiting the incurrence of additional secured debt, without the senior lender's consent. Prior to, and as a condition of, permitting the portfolio company to borrow money from us secured by the same collateral pledged to the senior lender, the senior lender will require assurances that it will control the disposition of any collateral in the event of bankruptcy or other default. In many such cases, the senior lender will require us to enter into an intercreditor agreement prior to permitting the portfolio company to borrow from us. Typically, the intercreditor agreements we are requested to execute expressly subordinate our debt instruments to those held by the senior lender and further provide that the senior lender shall control: (1) the commencement of foreclosure or other proceedings to liquidate and collect on the collateral; (2) the nature, timing and conduct of foreclosure or other collection proceedings; (3) the amendment of any collateral document; (4) the release of the security interests in respect of any collateral; and (5) the waiver of defaults under any security agreement. Because of the control we may cede to senior lenders under intercreditor agreements we may enter, we may be unable to realize the proceeds of any collateral securing some of our loans.

Prepayments of our debt investments by our portfolio companies could negatively impact our operating results.

**There may be circumstances where our debt investments could be subordinated to claims of other creditors or we could be subject to lender liability claims.**

Even though we may have structured certain of our investments as senior loans, if one of our portfolio companies were to go bankrupt, depending on the facts and circumstances, including the size of our investment and the extent to which we actually provided managerial assistance to that portfolio company, a bankruptcy court might recharacterize our debt investment and subordinate all or a portion of our claim to that of other creditors. In addition, lenders can be subject to lender liability claims for actions taken by them where they become too involved in the borrower's business or exercise control over the borrower. It is possible that we could become subject to a lender's liability claim, including as a result of actions taken in rendering significant managerial assistance.

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**Our investments in equity securities involve a substantial degree of risk.**

We purchase common stock and other equity securities, including warrants. Although equity securities have historically generated higher average total returns than fixed-income securities over the long term, equity securities have also experienced significantly more volatility in those returns. The equity securities we acquire may fail to appreciate and may decline in value or become worthless, and our ability to recover our investment depends on our portfolio company's success. Investments in equity securities involve a number of significant risks, including the risk of further dilution as a result of additional issuances, inability to access additional capital and failure to pay current distributions. Investments in preferred securities involve special risks, such as the risk of deferred distributions, credit risk, illiquidity and limited voting rights.

**The lack of liquidity in our investments may adversely affect our business.**

We may invest in securities issued by private companies. These securities may be subject to legal and other restrictions on resale or otherwise be less liquid than publicly-traded securities. The illiquidity of these investments may make it difficult for us to sell these investments when desired. In addition, if we are required to liquidate all or a portion of our portfolio quickly, we may realize significantly less than the value at which we had previously recorded these investments. Our investments are usually subject to contractual or legal restrictions on resale or are otherwise illiquid because there is usually no established trading market for such investments. The illiquidity of most of our investments may make it difficult for us to dispose of them at a favorable price, and, as a result, we may suffer losses.

**Our investments in foreign securities may involve significant risks in addition to the risks inherent in U.S. investments.**

Our investment strategy contemplates that a portion of our investments may be in securities of foreign companies.

Investing in foreign companies may expose us to additional risks not typically associated with investing in U.S. companies. These risks include changes in exchange control regulations, political and social instability, expropriation, imposition of foreign taxes, less liquid markets and less available information than is generally the case in the United States, higher transaction costs, less government supervision of exchanges, brokers and issuers, less developed bankruptcy laws, difficulty in enforcing contractual obligations, lack of uniform accounting and auditing standards and greater price volatility.

Although it is anticipated that most of our investments will be denominated in U.S. dollars, our investments that are denominated in a foreign currency will be subject to the risk that the value of a particular currency may change in relation to the U.S. dollar. Among the factors that may affect currency values are trade balances, the level of short-term interest rates, differences in relative values of similar assets in different currencies, long-term opportunities for investment and capital appreciation and political developments.

**The disposition of our investments may result in contingent liabilities.**

We currently expect that a significant portion of our investments will involve lending directly to private companies. In connection with the disposition of an investment in private securities, we may be required to make representations about the business and financial affairs of the portfolio company typical of those made in connection with the sale of a business. We may also be required to indemnify the purchasers of such investment to the extent that any such representations turn out to be inaccurate or with respect to certain potential liabilities. These arrangements may result in contingent liabilities that ultimately yield funding obligations that must be satisfied through our return of certain

distributions previously made to us.

**We may not receive any return on our investment in the CLO Funds in which we have invested and the Asset Manager Affiliates may be unable to raise additional CLO Funds.**

As of December 31, 2016, we had \$54.2 million at fair value invested in the subordinated securities, preferred shares, or other securities issued by the CLO Funds managed by our Asset Manager Affiliates and certain other third party asset managers. Subject to market conditions and legal requirements applicable to us under the 1940 Act, we expect to continue to acquire subordinated securities in the future in CLO Funds managed by our Asset Manager Affiliates and/or third party managers. Subordinated securities are the most junior class of securities issued by the CLO Funds and are subordinated in priority of payment to every other

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class of securities issued by these CLO Funds. Therefore, they only receive cash distributions if the CLO Funds have made all cash interest payments to all other debt securities issued by the CLO Fund. The subordinated securities are also unsecured and rank behind all of the secured creditors, known or unknown, of the CLO Fund, including the holders of the senior securities issued by the CLO Fund. Consequently, to the extent that the value of a CLO Fund's loan investments has been reduced as a result of conditions in the credit markets, or as a result of defaulted loans or individual fund assets, the value of the subordinated securities at their redemption could be reduced. Additionally, the Asset Manager Affiliates may not be able to continue to raise new CLO Funds due to prevailing CLO market conditions, regulatory requirements or other factors.

### **If our Asset Manager Affiliates do not meet certain risk retention requirements, they may not be able to sponsor and manage new CLOs, which would negatively impact our results of operations and financial conditions.**

In October 2014, the SEC, the FDIC, the Federal Reserve and certain other prudential banking regulators finalized regulations that mandate risk retention for securitizations. The rules became effective for CLOs on December 24, 2016. Under the final rules, our Asset Manager Affiliates (directly or through any of their majority-controlled affiliates, including the Company) will be required to hold interests equal to 5% of the fair value of the assets of any CLO sponsored by our Asset Manager Affiliates (unless the CLO invests only in certain qualifying loans which we do not expect will be the case) and would be prohibited from selling or hedging those interests in accordance with the limitations on such sales or hedges set forth in the final rule. Thus, our Asset Manager Affiliates (or any of their majority-controlled affiliates, including the Company, permitted to retain risk on their behalf) will need to have the requisite capital to hold such interests as a condition to their ability to sponsor new CLOs, and the restrictions on selling or hedging such interests may create greater risk with respect to those interests, including, to the extent that we retain risk in the CLOs managed by the Asset Manager Affiliates on their behalf, our ability to sell CLO Fund Securities when advantageous for us to do so. These mandatory investments in such CLOs, or the inability to invest in such CLOs (and thus inability to sponsor them) could each have a material adverse effect upon our business, results of operations or financial condition of the Asset Manager Affiliates, which would, in turn, negatively impact the business results of operations and financial condition. In addition, the application of the risk retention rules to CLOs may have broader effects on the CLO and loan markets in general, potentially resulting in fewer or less desirable investment opportunities for the Company, our Asset Manager Affiliates, and any CLOs that our Asset Manager Affiliates sponsor or in which we otherwise invest.

## **Risks Related to Our Common Stock**

### **We may not be able to pay distributions to our stockholders, our distributions may not grow over time, and a portion of distributions paid to our stockholders may be a return of capital.**

We intend to continue to make distributions on a quarterly basis to our stockholders out of assets legally available for distribution. We may not be able to achieve investment results that will allow us to make a specified level of cash distributions or year-to-year increases in cash distributions. Our ability to pay distributions might be adversely affected by, among other things, the impact of one or more of the risk factors described herein. In addition, the inability to satisfy the asset coverage test applicable to us as a BDC could limit our ability to pay distributions. In addition, due to the asset coverage test applicable to us as a BDC and a covenant that we agreed to in connection with the issuance of the 7.375% Notes Due 2019, we are limited in our ability to make distributions in certain

circumstances. In this regard, we agreed in connection with our issuance of the 7.375% Notes Due 2019 that for the period of time during which the 7.375% Notes Due 2019 are outstanding, we will not violate (regardless of whether we are subject to) Section 18(a)(1)(B) as modified by Section 61(a)(1) of the 1940 Act. These provisions generally prohibit us from declaring any cash dividend or distribution upon our common stock, or purchasing any such common stock if our asset coverage, as defined in the 1940 Act, is below 200% at the time of the declaration of the dividend or distribution or the purchase and after deducting the amount of such dividend, distribution or purchase. Further, if we invest a greater amount of assets in equity securities that do not pay current dividends, it could reduce the amount available for distribution.

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All distributions will be paid at the discretion of our Board of Directors and will depend on our earnings and those of the Asset Manager Affiliates, our financial condition, maintenance of our RIC status, compliance with applicable BDC regulations and such other factors as our Board of Directors may deem relevant from time to time. We cannot assure you that we will pay distributions to our stockholders in the future.

When we make quarterly distributions, we will be required to determine the extent to which such distributions are paid out of current or accumulated earnings, recognized capital gains or capital. To the extent there is a return of capital, investors will be required to reduce their basis in our stock for U.S. federal income tax purposes, which may result in higher tax liability when the shares are sold, even if they have not increased in value or have lost value. Our distributions have over the last several years included a significant return of capital component. For more information about our distributions over the last several years that have included a return of capital component, see Note 8 Distributable Taxable Income to our consolidated financial statements included elsewhere in this Annual Report.

### **Investing in shares of our common stock may involve an above average degree of risk.**

The investments we make in accordance with our investment objective may result in a higher amount of risk, volatility or loss of principal than alternative investment options. Our investments in portfolio companies may be highly speculative, and therefore, an investment in our common stock may not be suitable for investors with lower risk tolerance.

### **Shares of closed-end investment companies, including BDCs, frequently trade at a discount to their net asset value, and we cannot assure you that the market price of our common stock will not decline below the net asset value of the stock.**

We cannot predict the price at which our common stock will trade. Shares of closed-end investment companies frequently trade at a discount to their net asset value and our stock may also be discounted in the market. This characteristic of closed-end investment companies is separate and distinct from the risk that our net asset value per share may decline. We cannot predict whether shares of our common stock will trade above, at or below our net asset value. The risk of loss associated with this characteristic of closed-end investment companies may be greater for investors expecting to sell shares of common stock soon after the purchase of such shares of common stock. In addition, if our common stock trades below its net asset value, we will generally not be able to issue additional shares of our common stock at its market price without first obtaining the approval of our stockholders and our independent directors.

### **Our share price may be volatile and may fluctuate substantially.**

The market price and liquidity of the market for shares of our common stock may be significantly affected by numerous factors, some of which are beyond our control and may not be directly related to our operating performance. These factors include:

- price and volume fluctuations in the overall stock market from time to time;
- significant volatility in the market price and trading volume of securities of BDCs or other companies in our sector, which are not necessarily related to the operating performance of these companies or to us;
- our inability to deploy or invest our capital;

Investing in shares of our common stock may involve an above average degree of risk.



fluctuations in interest rates;  
any shortfall in revenue or net income or any increase in losses from levels expected by investors or securities analysts;

operating performance of companies comparable to us;  
changes in regulatory policies or tax rules, particularly with respect to RICs or BDCs;

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inability to maintain our qualification as a RIC for U.S. federal income tax purposes;  
changes in earnings or variations in operating results;  
changes in the value of our portfolio;  
general economic conditions and trends; and  
departure of key personnel.

**Certain provisions of the Delaware General Corporation Law and our certificate of incorporation and bylaws could deter takeover attempts and have an adverse impact on the price of our common stock.**

The Delaware General Corporation Law, our certificate of incorporation and our bylaws contain provisions that may have the effect of discouraging a third party from making an acquisition proposal for us. These anti-takeover provisions may inhibit a change in control in circumstances that could give the holders of our common stock the opportunity to realize a premium over the market price of our common stock.

## **Risks Related to Our 7.375% Notes Due 2019**

***Our 7.375% Notes Due 2019 and Convertible Notes are unsecured and therefore are effectively subordinated to any secured indebtedness we have currently incurred or may incur in the future.***

Our 7.375% Notes Due 2019 are not secured by any of our assets or any of the assets of our subsidiaries or the Asset Manager Affiliates. As a result, the 7.375% Notes Due 2019 are effectively subordinated to any secured indebtedness we or they have currently incurred and may incur in the future (or any indebtedness that is initially unsecured to which we subsequently grant security) to the extent of the value of the assets securing such indebtedness. In any liquidation, dissolution, bankruptcy or other similar proceeding, the holders of any of our existing or future secured indebtedness and the secured indebtedness of our subsidiaries and the Asset Manager Affiliates may assert rights against the assets pledged to secure that indebtedness in order to receive full payment of their indebtedness before the assets may be used to pay other creditors, including the holders of the 7.375% Notes Due 2019.

***The 7.375% Notes Due 2019 are structurally subordinated to the indebtedness and other liabilities of our subsidiaries and portfolio companies with respect to which we hold equity investments, including the Asset Manager Affiliates.***

The 7.375% Notes Due 2019 are obligations exclusively of KCAP Financial, Inc., and not of any of our subsidiaries or the Asset Manager Affiliates. None of our subsidiaries or the Asset Manager Affiliates are guarantors of the 7.375% Notes Due 2019, and the 7.375% Notes Due 2019 will not be required to be guaranteed by any subsidiary or asset management firm we may acquire or create in the future. Any assets of our subsidiaries and the Asset Manager Affiliates will not be directly available to satisfy the claims of our creditors, including holders of the 7.375% Notes Due 2019. Except to the extent we are a creditor with recognized claims against our subsidiaries, all claims of creditors of our subsidiaries will have priority over our equity interests in such entities (and therefore the claims of our creditors, including holders of the 7.375% Notes Due 2019) with respect to the assets of such entities. Even if we are

recognized as a creditor of one or more of these entities, our claims would still be effectively subordinated to any security interests in the assets of any such entity and to any indebtedness or other liabilities of any such entity senior to our claims. Consequently, the 7.375% Notes Due 2019 are structurally subordinated to all indebtedness and other liabilities of any of our subsidiaries and portfolio companies with respect to which we hold equity investments, including the Asset Manager Affiliates and any subsidiaries of the Asset Manager Affiliates that we may in the future acquire or establish. These entities may incur substantial indebtedness in the future, all of which would be structurally senior to the 7.375% Notes Due 2019.

***The indenture under which the 7.375% Notes Due 2019 are issued contains limited protection for holders of the 7.375% Notes Due 2019.***

The indenture under which the 7.375% Notes Due 2019 are issued offers limited protection to holders of the 7.375% Notes Due 2019. The terms of the indenture and the 7.375% Notes Due 2019 do not restrict our or any of our subsidiaries or the Asset Manager Affiliates' ability to engage in, or otherwise be a party to, a

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variety of corporate transactions, circumstances or events that could have a material adverse impact on your investment in the 7.375% Notes Due 2019. In particular, the terms of the indenture and the 7.375% Notes Due 2019 do not place any restrictions on our or our subsidiaries or the Asset Manager Affiliates' ability to:

issue securities or otherwise incur additional indebtedness or other obligations, including (1) any indebtedness or other obligations that would be equal in right of payment to the 7.375% Notes Due 2019, (2) any indebtedness or other obligations that would be secured and therefore rank effectively senior in right of payment to the 7.375% Notes Due 2019 to the extent of the values of the assets securing such debt, (3) indebtedness of ours that is guaranteed by one or more of our subsidiaries or the Asset Manager Affiliates and which therefore is structurally senior to the 7.375% Notes Due 2019 and (4) securities, indebtedness or obligations issued or incurred by our subsidiaries or the Asset Manager Affiliates that would be senior to our equity interests in those entities and therefore rank structurally senior to the 7.375% Notes Due 2019 with respect to the assets of our subsidiaries and the Asset Manager Affiliates, in each case other than an incurrence of indebtedness or other obligation that would cause a violation of Section 18(a)(1)(A) as modified by Section 61(a)(1) of the 1940 Act or any successor provisions. These provisions generally prohibit us from making additional borrowings, including through the issuance of additional debt or the sale of additional debt securities, unless our asset coverage, as defined in the 1940 Act, equals at least 200% after such borrowings;

pay dividends on, or purchase or redeem or make any payments in respect of, capital stock or other securities ranking junior in right of payment to the 7.375% Notes Due 2019, including subordinated indebtedness, in each case other than dividends, purchases, redemptions or payments that would cause a violation of Section 18(a)(1)(B) as modified by Section 61(a)(1) of the 1940 Act or any successor provisions. These provisions generally prohibit us from declaring any cash dividend or distribution upon any class of our capital stock, or purchasing any such capital stock if our asset coverage, as defined in the 1940 Act, is below 200% at the time of the declaration of the dividend or distribution or the purchase and after deducting the amount of such dividend, distribution or purchase;

sell assets (other than certain limited restrictions on our ability to consolidate, merge or sell all or substantially all of our assets);

enter into transactions with affiliates;

create liens (including liens on the shares of our subsidiaries) or enter into sale and leaseback transactions;

make investments; or

create restrictions on the payment of dividends or other amounts to us from our subsidiaries.

In addition, the indenture does not require us to offer to purchase the 7.375% Notes Due 2019 in connection with a change of control or any other event.

Furthermore, the terms of the indenture and the 7.375% Notes Due 2019 do not protect holders of the 7.375% Notes Due 2019 in the event that we experience changes (including significant adverse changes) in our financial condition, results of operations or credit ratings, if any, as they do not require that we adhere to any financial tests or ratios or specified levels of net worth, revenues, income, cash flow, or liquidity other than as described above. Any changes to the 200% asset coverage ratio in the 1940 Act could affect the 7.375% Notes Due 2019. See Item 1A. Risk Factors - Risks Related to Our Business and Structure - Pending legislation may allow us to incur additional leverage.

Our ability to recapitalize, incur additional debt and take a number of other actions that are not limited by the terms of the 7.375% Notes Due 2019 may have important consequences for you as a holder of the 7.375% Notes Due 2019, including making it more difficult for us to satisfy our obligations with respect to the 7.375% Notes Due 2019 or negatively affecting the trading value of the 7.375% Notes Due 2019.

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Other debt we issue or incur in the future could contain more protections for its holders than the indenture and the 7.375% Notes Due 2019, including additional covenants and events of default. The issuance or incurrence of any such debt with incremental protections could affect the market for and trading levels and prices of the 7.375% Notes Due 2019.

***Even though the 7.375% Notes Due 2019 are listed on the NYSE, an active trading market for the 7.375% Notes Due 2019 may not develop, or if it does develop, it will be sustained, which could limit your ability to sell the 7.375% Notes Due 2019 or affect the market price of the 7.375% Notes Due 2019.***

We cannot provide any assurances that an active trading market will develop for the 7.375% Notes Due 2019 or that, if it does develop, it will be sustained or that you will be able to sell your 7.375% Notes Due 2019. The 7.375% Notes Due 2019 may trade at a discount from the price paid for the notes depending on prevailing interest rates, the market for similar securities, our credit ratings, if any, general economic conditions, our financial condition, performance and prospects and other factors.

Accordingly, we cannot assure you that a liquid trading market will develop for the 7.375% Notes Due 2019, or that, if an active trading market for the 7.375% Notes Due 2019 does develop, it will be sustained, that you will be able to sell your 7.375% Notes Due 2019 at a particular time or that the price you receive when you sell will be favorable. To the extent an active trading market does not develop the liquidity and trading price for the 7.375% Notes Due 2019 may be harmed. Accordingly, you may be required to bear the financial risk of an investment in the 7.375% Notes Due 2019 for an indefinite period of time.

***If we default on our obligations to pay our other indebtedness, we may not be able to make payments on the 7.375% Notes Due 2019.***

Any default under the agreements governing our indebtedness, that is not waived by the required lenders, and the remedies sought by the holders of such indebtedness could make us unable to pay principal, premium, if any, and interest on the 7.375% Notes Due 2019 and substantially decrease the market value of the 7.375% Notes Due 2019. If we are unable to generate sufficient cash flow and are otherwise unable to obtain funds necessary to meet required payments of principal, premium, if any, and interest on our indebtedness, or if we otherwise fail to comply with the various covenants, including financial and operating covenants, in the instruments governing our indebtedness, we could be in default under the terms of the agreements governing such indebtedness. In the event of such default, the holders of such indebtedness could elect to declare all the funds borrowed thereunder to be due and payable, together with accrued and unpaid interest, the lender any debt we may incur in the future could elect to terminate its commitment, cease making further loans and institute foreclosure proceedings against our assets, and we could be forced into bankruptcy or liquidation. If our operating performance declines, we may in the future need to seek to obtain waivers from under any other debt that we may incur in the future to avoid being in default. If we breach our covenants under any debt and seek a waiver, we may not be able to obtain a waiver from the required lenders. If this occurs, we would be in default under any debt, the lender could exercise its rights as described above, and we could be forced into bankruptcy or liquidation. If we are unable to repay debt, lenders having secured obligations could proceed against the collateral securing the debt. Because any future debt we issue will likely have customary cross-default provisions, if such other debt is accelerated, we may be unable to repay or finance the amounts due.

Even though the 7.375% Notes Due 2019 are listed on the NYSE, an active trading market for the 7.375% Notes Due 2019 may not develop, or if it does develop, it will be sustained, which could limit your ability to sell the 7.375% Notes Due 2019 or affect the market price of the 7.375% Notes Due 2019.

Item 1B.

***Unresolved Staff Comments***

None.

Item 2.

***Properties***

We do not own any real estate or other real property. Our wholly-owned portfolio company, Katonah Debt Advisors, is the lessee for our principal headquarters at 295 Madison Avenue, 6<sup>th</sup> Floor, New York, New York 10017. We have entered into an Overhead Allocation Agreement with Katonah Debt Advisors which provides for the sharing of the expenses under the lease agreement.

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Item 3. *Legal Proceedings*  
The Company is not currently a party to any material legal proceedings.

Item 4. *Mine Safety Disclosures*  
Not applicable.

TABLE OF CONTENTSItem 5. *Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities***PRICE RANGE OF COMMON STOCK**

Our common stock is quoted on The NASDAQ Global Select Market under the symbol KCAP. We completed our initial public offering on December 11, 2006 at an initial public offering ( IPO ) price of \$15.00 per share. Prior to such date there was no public market for our common stock.

The following table sets forth the range of high and low closing sales prices per share of our common stock as reported on The NASDAQ Global Select Market in respect of the periods indicated. The stock quotations are interdealer quotations and do not include markups, markdowns or commissions and may not necessarily represent actual transactions.

**Quarterly Stock Prices for 2016 and 2015**

|                | During the Quarter |         | At Quarter End |                    |
|----------------|--------------------|---------|----------------|--------------------|
|                | High               | Low     | Close          | NAV <sup>(1)</sup> |
| 2016:          |                    |         |                |                    |
| Fourth quarter | \$ 4.80            | \$ 3.66 | \$ 3.98        | \$ 5.24            |
| Third quarter  | \$ 4.72            | \$ 3.84 | \$ 4.63        | \$ 5.38            |
| Second quarter | \$ 3.92            | \$ 3.19 | \$ 3.92        | \$ 5.45            |
| First quarter  | \$ 4.02            | \$ 2.68 | \$ 3.60        | \$ 5.50            |
| 2015:          |                    |         |                |                    |
| Fourth quarter | \$ 5.43            | \$ 3.78 | \$ 4.07        | \$ 5.82            |
| Third quarter  | \$ 5.72            | \$ 4.40 | \$ 4.51        | \$ 6.33            |
| Second quarter | \$ 6.40            | \$ 5.56 | \$ 5.98        | \$ 6.96            |
| First quarter  | \$ 7.61            | \$ 6.54 | \$ 6.73        | \$ 7.16            |

(1) Net Asset Value ( NAV ) per share is determined as of the last day in the relevant quarter and therefore may not reflect the NAV per share on the date of the high and low closing sales prices.

We began paying quarterly distributions in our first full quarter of operations following our IPO. See Management's Discussion and Analysis of Financial Condition and Results of Operations and Note 8 Distributable Tax Income from our Notes to the Financial Statements included herein. The table below provides information relating to distributions we paid in respect of the periods indicated.

**Stockholder Distributions**

|                | Distributions | Declaration Date | Record Date             | Pay Date   |
|----------------|---------------|------------------|-------------------------|------------|
| 2016:          |               |                  |                         |            |
| Fourth quarter | \$ 0.12       | 12/14/2016       | 1/6/2017 <sup>(1)</sup> | 1/27/2017  |
| Third quarter  | 0.15          | 9/20/2016        | 10/14/2016              | 10/27/2016 |
| Second quarter | 0.15          | 6/21/2016        | 7/7/2016                | 7/28/2016  |
| First quarter  | 0.15          | 3/18/2016        | 4/7/2016                | 4/28/2016  |



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|                         |         |            |                         |            |
|-------------------------|---------|------------|-------------------------|------------|
| Total declared for 2016 | \$ 0.57 |            |                         |            |
| 2015:                   |         |            |                         |            |
| Fourth quarter          | \$ 0.15 | 12/16/2015 | 1/6/2016 <sup>(1)</sup> | 1/28/2016  |
| Third quarter           | 0.21    | 9/22/2015  | 10/14/2015              | 10/27/2015 |
| Second quarter          | 0.21    | 6/23/2015  | 7/6/2015                | 7/27/2015  |
| First quarter           | 0.21    | 3/24/2015  | 4/6/2015                | 4/27/2015  |
| Total declared for 2015 | \$ 0.78 |            |                         |            |

(1) Since the record date of this distribution is subsequent to year-end, it is a subsequent year tax event.

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The determination of the tax attributes of our distributions is made annually, based upon our taxable income for the full year and distributions paid for the full year. Ordinary dividend distributions from a RIC do not qualify for the tax rate applicable to qualified dividend income from domestic corporations and qualified foreign corporations, except to the extent that the RIC received the income in the form of qualifying dividends from domestic corporations and qualified foreign corporations. For further information about the tax attributes, see Note 8 Distributable Taxable Income of our notes to the financial statements, which can be found elsewhere in this Annual Report.

## **Performance Graph**

The following graph compares the return on our common stock with that of the Russell 2000 Index and the Nasdaq Financial 100 Index (IXF), for the period December 11, 2006 (the date of our initial public offering) to December 31, 2016. The graph assumes that, on December 11, 2006, a person invested \$100 in each of our common stock, the Russell 2000 Index, and the IFX. The graph measures total shareholder return, which takes into account both changes in stock price and dividends. It assumes that dividends are reinvested.

## **Shareholder Return Performance Graph Cumulative Total Return Since Initial Public Offering<sup>(1)</sup> (Through December 31, 2016)**

Total return includes reinvestment of distributions through December 31, 2016. The IXF is an index of diversified financial sector stocks and, as such, the Company believes that it is representative of our industry. The Russell 2000 is a broad based equity market index that tracks companies with a market capitalization that the Company believes are comparable to it.

## **HOLDERS**

As of December 31, 2016, there were 48 shareholders of record of our common stock and approximately 15,870 beneficial shareholders of the Company.

## **SALES OF UNREGISTERED SECURITIES**

During the year ended December 31, 2016, we issued 174,396 shares of common stock pursuant to a dividend reinvestment plan. This issuance was not subject to the registration requirements of the Securities Act. See Note 9 Stockholders Equity, of our Notes to the Consolidated Financial Statements included herein.

TABLE OF CONTENTS**DIVIDEND POLICY**

We intend to continue to make quarterly distributions to our stockholders. Our quarterly distributions, if any, will be determined by our Board of Directors. To maintain our RIC status, we must timely distribute an amount equal to at least 90% of our tax basis ordinary income and realized net short-term capital gains in excess of realized net long-term capital losses, if any, reduced by deductible expenses, out of the assets legally available for distribution, for each year. To avoid certain excise taxes imposed on RICs, we are generally required to distribute during each calendar year an amount at least equal to the sum of (1) 98% of our ordinary income for the calendar year, (2) 98.2% of our capital gains in excess of capital losses for the one-year period ending on October 31 of the calendar year and (3) any ordinary income and net capital gains for preceding years that were not distributed during such years and on which we paid no corporate tax. If this requirement is not met, we will be required to pay a nondeductible excise tax equal to 4% of the amount by which the required distribution amount exceeds the actual distribution for the year. The taxable income on which an excise tax is paid is generally carried forward and distributed to stockholders in the next tax year. Depending on the level of taxable income earned in a tax year, we may choose to carry forward taxable income in excess of current year distributions into the next tax year and pay a 4% excise tax on such income, to the extent required.

We cannot assure you that we will achieve results that will permit the payment of any cash distributions and, because we issued public senior securities, we are prohibited from making distributions if doing so causes us to fail to maintain the asset coverage ratio stipulated by the 1940 Act. Similarly, we may be prohibited from making distributions by the terms of any of our other borrowings.

We maintain an ☐ opt out ☐ dividend reinvestment plan for our common stockholders. As a result, if we declare distributions, then stockholders' cash distributions will be automatically reinvested in additional shares of our common stock, unless they specifically ☐ opt out ☐ of the dividend reinvestment plan so as to receive cash.

**EQUITY COMPENSATION PLAN INFORMATION**

The following table summarizes certain information regarding the Amended and Restated 2006 Equity Incentive Plan (the "Equity Incentive Plan") and the Amended and Restated Non-Employee Director Plan (the "Non-Employee Director Plan") as of December 31, 2016:

| Plan Category | Number of Securities to Be Issued Upon Exercise of Outstanding Options, Warrants and Rights | Weighted Average Exercise Price of Outstanding Options, Warrants and Rights | Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (a)) |
|---------------|---|---|---|
|               | (a)   | (b)   | (c)   |

|   |               |             |                           |
|---|---------------|-------------|---------------------------|
| Equity Compensation Plans Approved by Security Holders <sup>(1)</sup> | 50,000        | \$ 7.72     | 930,171 <sup>(2)(3)</sup> |
| Equity Compensation Plans Not Approved by Security Holders            |               |             |                           |
| <b>Total</b>  | <b>50,000</b> | <b>7.72</b> | <b>930,171</b>            |

(1) The Company's Equity Incentive Plan and Non-Employee Director Plan.

Subject to the following additional limitations: The aggregate number of shares of restricted stock that may be issued under the Equity Incentive Plan may not exceed 10% of the outstanding shares on June 13, 2008, the effective date of the Equity Incentive Plan, plus 10% of the number of shares issued or delivered by the Company (other than pursuant to compensation plans) during the term of the Equity Incentive Plan. No one person may be (2) granted more than 25% of the shares of restricted stock reserved for issuance under the Equity Incentive Plan. In addition, the amount of voting securities that would result from the exercise of all of the Company's outstanding warrants, options and rights, together with any restricted stock issued by the Company, at the time of issuance may not exceed 25% of the outstanding voting securities of the Company, except that if the amount of voting securities that would result from the exercise of all the Company's outstanding warrants, options and rights issued to the

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Company's directors, officers and employees, together with any restricted stock issued by the Company, would exceed 15% of the outstanding voting securities of the Company, the total amount of voting securities that would result from the exercise of all outstanding warrants, options and rights, together with any restricted stock issued by the Company, at the time of issuance may not exceed 20% of the outstanding voting securities of the Company.

The shares issuable under the Company's Equity Incentive Plan may be issued in the form of options, restricted (3) stock or other stock-based awards. The shares issuable under the Company's Non-Employee Director Plan may currently be issued in the form of restricted stock.

## Item 6.

***Selected Financial Data***

The following selected consolidated financial data should be read in conjunction with Part II, Item 7, *Management's Discussion and Analysis of Financial Condition and Results of Operations*, and Part II, Item 8, *Financial Statements and Supplementary Data*, of this Annual Report on Form 10-K. The following selected financial and other data for the years ended December 31, 2016, 2015, 2014, 2013 and 2012 is derived from the audited consolidated financial statements for such years, included in Part II, Item 8, *Financial Statements and Supplementary Data*, of this Annual Report on Form 10-K.

## KCAP FINANCIAL, INC. SELECTED FINANCIAL DATA

|   | Year Ended<br>December 31,<br>2016 | Year Ended<br>December 31,<br>2015 | Year Ended<br>December 31,<br>2014 | Year Ended<br>December 31,<br>2013 | Year Ended<br>December 31,<br>2012 |
|---|------------------------------------|------------------------------------|------------------------------------|------------------------------------|------------------------------------|
| <b>Income Statement Data:</b>                                   |                                    |                                    |                                    |                                    |                                    |
| Interest and related portfolio income:                          |                                    |                                    |                                    |                                    |                                    |
| Interest and Dividends  | \$34,131,571                       | \$39,811,558                       | \$34,802,690                       | \$33,144,195                       | \$29,821,676                       |
| Fees and other income   | 668,527                            | 366,859                            | 934,871                            | 305,376                            | 304,882                            |
| Dividends from Asset Manager Affiliates                         | 1,400,000                          | 5,348,554                          | 5,467,914                          | 5,735,045                          | 1,214,998                          |
| Total interest and related portfolio income                     | 36,200,098                         | 45,526,971                         | 41,205,475                         | 39,184,616                         | 31,341,556                         |
| Expenses:   |                                    |                                    |                                    |                                    |                                    |
| Interest and amortization of debt issuance costs                | 9,110,603                          | 11,727,880                         | 11,538,179                         | 10,116,271                         | 6,976,018                          |
| Compensation  | 4,103,558                          | 3,843,799                          | 4,951,745                          | 4,630,481                          | 3,172,814                          |
| Other   | 4,495,942                          | 5,772,502                          | 4,594,983                          | 4,563,749                          | 4,344,611                          |
| Total operating expenses  | 17,710,103                         | 21,344,181                         | 21,084,907                         | 19,310,501                         | 14,493,443                         |
| <b>Net Investment Income</b>                                    | <b>18,489,995</b>                  | <b>24,182,790</b>                  | <b>20,120,568</b>                  | <b>19,874,115</b>                  | <b>16,848,113</b>                  |
| Realized and unrealized (losses) gains on investments:          |                                    |                                    |                                    |                                    |                                    |
| Net realized (losses) gains                                     | (6,341,678 )                       | (6,647,478 )                       | (11,132,491)                       | (12,627,314)                       | (3,232,974 )                       |
| Net change in unrealized (losses) gains                         | (13,188,048)                       | (36,169,870)                       | 6,045,517                          | 9,976,171                          | 12,510,641                         |
| Total net (losses) gains  | (19,529,726)                       | (42,817,348)                       | (5,086,974 )                       | (2,651,143 )                       | 9,277,667                          |
| Net (decrease) increase in net assets resulting from operations | \$(1,039,731 )                     | \$(18,634,558)                     | \$15,033,594                       | \$17,222,972                       | \$26,125,779                       |
| <b>Per Share:</b>   |                                    |                                    |                                    |                                    |                                    |
| Earnings per common share basic                                 | \$(0.03 )                          | \$(0.50 )                          | \$0.44                             | \$0.53                             | \$1.00                             |
| Earnings per common share diluted                               | \$(0.03 )                          | \$(0.50 )                          | \$0.43                             | \$0.53                             | \$0.95                             |

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|  |         |        |        |        |        |        |
|--|---------|--------|--------|--------|--------|--------|
| Net investment income per share              | basic   | \$0.50 | \$0.65 | \$0.59 | \$0.62 | \$0.65 |
| Net investment income per share              | diluted | \$0.50 | \$0.65 | \$0.58 | \$0.62 | \$0.64 |
| Distributions declared per common share      |         | \$0.57 | \$0.78 | \$1.00 | \$1.06 | \$0.94 |
| Taxable Distributable Income per basic share |         | \$0.40 | \$0.63 | \$0.78 | \$0.70 | \$0.77 |

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|  | Year Ended<br>December 31,<br>2016 | Year Ended<br>December 31,<br>2015 | Year Ended<br>December 31,<br>2014 | Year Ended<br>December 31,<br>2013 | Year Ended<br>December 31,<br>2012 |
|--|------------------------------------|------------------------------------|------------------------------------|------------------------------------|------------------------------------|
| <b>Balance Sheet Data:</b>   |                                    |                                    |                                    |                                    |                                    |
| Investment assets at fair value  | \$366,471,304                      | \$409,570,495                      | \$479,706,494                      | \$440,549,994                      | \$312,044,763                      |
| Total assets   | \$381,371,983                      | \$421,204,697                      | \$505,180,218                      | \$453,340,638                      | \$316,901,184                      |
| Total debt outstanding   | \$175,584,570                      | \$201,103,761                      | \$218,618,014                      | \$186,760,623                      | \$99,040,711                       |
| Stockholders' equity   | \$194,924,925                      | \$216,100,470                      | \$255,316,701                      | \$250,369,693                      | \$207,875,659                      |
| Net asset value per common share   | \$5.24                             | \$5.82                             | \$6.94                             | \$7.51                             | \$7.85                             |
| Common shares outstanding at end of year                                       | 37,178,294                         | 37,100,005                         | 36,775,127                         | 33,332,123                         | 26,470,408                         |
| <b>Other Data:</b>   |                                    |                                    |                                    |                                    |                                    |
| Investments funded <sup>(1)</sup>  | 75,724,590                         | 130,954,741                        | 235,905,130                        | 243,966,586                        | 123,165,150                        |
| Principal collections related to investment repayments or sales <sup>(1)</sup> | 129,191,854                        | 129,793,338                        | 193,554,964                        | 94,197,886                         | 104,556,500                        |
| Number of portfolio investments at year end <sup>(1)</sup>                     | 125                                | 130                                | 141                                | 126                                | 88                                 |
| Weighted average yield of income producing debt investments <sup>(2)</sup>     | 7.0                                | % 7.4                              | % 7.3                              | % 7.3                              | % 7.5                              |

(1) Does not include investments in time deposits or money markets.

(2) Weighted average yield of income producing investments is calculated as the average yield to par outstanding balances for investments in loans, bonds, and mezzanine debt in our Debt Securities portfolio.

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### Item 7. **Management's Discussion and Analysis of Financial Condition and Results of Operations**

*The following discussion should be read in conjunction with our financial statements and related notes and other financial information appearing elsewhere in this annual report. In addition to historical information, the following discussion and other parts of this annual report contain forward-looking information that involves risks and uncertainties. Our actual results could differ materially from those anticipated by such forward-looking information due to the factors discussed under Item 1A. Risk Factors and Note About Forward-Looking Statements appearing elsewhere in this annual report.*

## **GENERAL**

We are an internally managed, non-diversified closed-end investment company that is regulated as a Business Development Company, or BDC under the Investment Company Act of 1940 (the 1940 Act ). We have three principal areas of investments:

First, the Company originates, structures, and invests in senior secured term loans and mezzanine debt primarily in privately-held middle market companies (the Debt Securities Portfolio ). In addition, from time to time the Company may invest in the equity securities of privately held middle market companies.

Second, the Company has invested in asset management companies (Katonah Debt Advisors and Trimaran Advisors, collectively the Asset Manager Affiliates ) that manage collateralized loan obligation funds ( CLO Funds ).

Third, the Company invests in debt and subordinated securities issued by collateralized loan obligation funds ( CLO Fund Securities ). These CLO Fund Securities are primarily managed by our Asset Manager Affiliates, but from time-to-time the Company makes investments in CLO Fund Securities managed by other asset managers. The CLO Funds typically invest in broadly syndicated loans, high-yield bonds and other credit instruments.

The Company may also invest in other investments such as loans to publicly-traded companies, high-yield bonds and distressed debt securities. The Company may also receive warrants or options to purchase common stock in connection with its debt investments.

In our Debt Securities Portfolio, our investment objective is to generate current income and, to a lesser extent, capital appreciation from the investments made by our middle market business in senior secured term loans, mezzanine debt and selected equity investments in privately-held middle market companies. We define the middle market as comprising of companies with earnings before interest, taxes, depreciation and amortization ( EBITDA ) of \$10 million to \$50 million and/or total debt of \$25 million to \$150 million. We primarily invest in first and second lien term loans which, because of their priority in a company's capital structure, we expect will have lower default rates and higher rates of recovery of principal if there is a default and which we expect will create a stable stream of interest income.

The investments in our Debt Securities Portfolio are all or predominantly below investment grade, and have speculative characteristics with respect to the issuer's capacity to pay interest and repay principal. While our primary investment focus is on making loans to, and selected equity investments in, privately-held middle market companies, we may also invest in other investments such as loans to smaller private companies or publicly-traded companies, high-yield bonds and distressed debt securities. We may also receive warrants or options to purchase common stock in connection with our debt investments.

From our Asset Manager Affiliates investment, we expect to receive recurring cash distributions and to generate capital appreciation through the addition of new CLO Funds managed by our Asset Manager Affiliates. We may also seek to monetize our investment in the Asset Manager Affiliates if and when business conditions warrant. The Asset



Manager Affiliates manage CLO Funds that invest in broadly syndicated loans, high-yield bonds and other credit instruments. Collectively, the Asset Manager Affiliates have approximately \$3.0 billion of par value assets under management as of December 31, 2016. The Asset Manager Affiliates are registered under the Investment Advisers Act of 1940, and are each managed independently from KCAP by a separate management team (however, certain of the Company's executive officers also act in similar capacities for one or both of the Asset Manager Affiliates).

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In addition, our investments in CLO Fund Securities, which are primarily made up of a minority investment in the subordinated securities or preferred stock of CLO Funds raised and managed by our Asset Manager Affiliates, are anticipated to provide the Company with recurring cash distributions and complement our investment in the Asset Manager Affiliates.

Subject to market conditions, we intend to grow our entire portfolio of investments by raising additional capital, including through the prudent use of leverage available to us. As a BDC, we are limited in the amount of leverage we can incur under the 1940 Act. We are only allowed to borrow amounts such that our asset coverage, as defined in the 1940 Act, equals at least 200% after such borrowing.

We have elected to be treated for U.S. federal income tax purposes as a RIC and intend to operate in a manner to maintain our RIC status. As a RIC, we intend to distribute to our stockholders substantially all of our net ordinary taxable income and the excess of realized net short-term capital gains over realized net long-term capital losses, if any, for each year. To qualify as a RIC, we must, among other things, meet certain source-of-income and asset diversification requirements. Pursuant to this election, we generally will not have to pay corporate-level U.S. federal income taxes on any income that we timely distribute to our stockholders.

## PORTFOLIO AND INVESTMENT ACTIVITY

Our primary investments are: (1) lending to and investing in middle-market businesses through investments in senior secured loans, junior secured loans, subordinated/mezzanine debt investments, and other equity investments, which may include warrants, (2) our investments in our Asset Manager Affiliates, which manage portfolios of broadly syndicated loans, high-yield bonds and other credit instruments, and (3) CLO Fund Securities.

Total portfolio investment activity (excluding activity in time deposit and money market investments) for the years ended December 31, 2016, December 31, 2015, and December 31, 2014 was as follows:

|                                       | Debt<br>Securities | CLO Fund<br>Securities | Equity<br>Securities | Asset<br>Manager<br>Affiliates | Total<br>Portfolio |
|---------------------------------------|--------------------|------------------------|----------------------|--------------------------------|--------------------|
| Fair Value at December 31, 2013       | \$266,830,427      | 79,452,220             | 11,006,398           | 76,148,000                     | 433,437,045        |
| 2014 Activity:                        |                    |                        |                      |                                |                    |
| Purchases/originations/draws          | 224,513,503        | 22,421,847             | 2,216,847            | 545,979                        | 249,698,176        |
| Pay-downs/pay-offs/sales              | (168,429,374)      | (10,132,500)           | (5,007,311)          | (6,432,086)                    | (190,001,271)      |
| Net accretion (amortization)          | 410,718            | (11,102,015)           |                      |                                | (10,691,297)       |
| Net realized losses                   | (8,823,507)        | 5,575,498              | (7,136,408)          |                                | (10,384,417)       |
| Net increase (decrease) in fair value | 5,641,403          | (8,700,148)            | 7,040,155            | 2,064,107                      | 6,045,517          |
| Fair Value at December 31, 2014       | 320,143,170        | 77,514,902             | 8,119,681            | 72,326,000                     | 478,103,753        |
| 2015 Activity:                        |                    |                        |                      |                                |                    |
| Purchases/originations/draws          | 108,670,472        | 11,952,000             | 1,953,299            |                                | 124,023,641        |
| Pay-downs/pay-offs/sales              | (135,328,386)      | (3,872,700)            | (317,340)            | (3,701,446)                    | (143,219,872)      |
| Net accretion (amortization)          | 1,860,670          | (9,507,050)            |                      |                                | (9,094,250)        |
| Net realized gains (losses)           | 41,580             | (6,246,883)            | 3,015                |                                | (6,202,288)        |
| Net increase (decrease) in fair value | (10,748,262)       | (13,967,887)           | (210,167)            | (11,243,554)                   | (36,169,870)       |

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|                                       |               |              |              |              |               |
|---------------------------------------|---------------|--------------|--------------|--------------|---------------|
| Fair Value at December 31, 2015       | 284,639,244   | 55,872,382   | 9,548,488    | 57,381,000   | 407,441,114   |
| 2016 Activity:                        |               |              |              |              |               |
| Purchases/originations/draws          | 74,584,952    | 10,140,000   |              |              | 84,724,952    |
| Pay-downs/pay-offs/sales              | (123,240,416) | (4,200,000 ) | (4,563,521 ) | (1,250,000 ) | (133,253,937) |
| Net accretion (amortization)          | 407,492       | (2,192,071 ) |              |              | (1,784,579 )  |
| Net realized gains (losses)           | (540,649 )    | (10,111,560) | 4,484,742    |              | (6,167,467 )  |
| Net increase (decrease) in fair value | 2,492,707     | 4,665,599    | (4,413,354 ) | (15,933,000) | (13,188,048 ) |
| Fair Value at December 31, 2016       | \$238,343,330 | \$54,174,350 | \$5,056,355  | \$40,198,000 | \$337,772,035 |

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The level of investment activity for investments funded and principal repayments for our investments can vary substantially from period to period depending on the number and size of investments that we invest in or divest of, and many other factors, including the amount and competition for the debt and equity securities available to middle market companies, the level of merger and acquisition activity for such companies and the general economic environment.

The following table shows the Company's portfolio by security type at December 31, 2016 and December 31, 2015:

| Security Type                           | December 31, 2016   |               |                  | December 31, 2015   |               |                  |
|---|---------------------|---------------|------------------|---------------------|---------------|------------------|
|   | Cost/Amortized Cost | Fair Value    | % <sup>(1)</sup> | Cost/Amortized Cost | Fair Value    | % <sup>(1)</sup> |
| Money Market Accounts <sup>(2)</sup>    | \$28,699,269        | \$28,699,269  | 8                | \$2,129,381         | \$2,129,381   | 1 %              |
| Senior Secured Loan                     | 207,701,078         | 200,322,152   | 55               | 203,819,074         | 194,123,223   | 46               |
| Junior Secured Loan                     | 37,251,776          | 35,444,440    | 10               | 40,221,557          | 37,591,900    | 9                |
| Senior Unsecured Loan                   |                     |               |                  | 23,000,000          | 23,000,000    | 6                |
| First Lien Bond                         | 3,060,919           | 1,089,338     |                  | 3,000,000           | 2,216,700     | 1                |
| Senior Subordinated Bond                |                     |               |                  | 4,466,793           | 4,615,569     | 1                |
| Senior Unsecured Bond                   |                     |               |                  | 11,879,187          | 10,551,724    | 3                |
| Senior Secured Bond                     | 1,506,461           | 1,487,400     |                  | 1,510,560           | 1,503,755     |                  |
| CLO Fund Securities                     | 76,851,317          | 54,174,350    | 15               | 83,214,947          | 55,872,382    | 14               |
| Equity Securities                       | 10,389,007          | 5,056,355     | 1                | 10,467,787          | 9,548,488     | 2                |
| Preferred Securities                    |                     |               |                  | 10,411,673          | 11,036,373    | 3                |
| Asset Manager Affiliates <sup>(3)</sup> | 55,341,230          | 40,198,000    | 11               | 56,591,230          | 57,381,000    | 14               |
| Total                                   | \$420,801,057       | \$366,471,304 | 100 %            | \$450,712,189       | \$409,570,495 | 100 %            |

(1) Represents percentage of total portfolio at fair value

(2) Includes restricted cash held under employee benefit plans.

(3) Represents the equity investment in the Asset Manager Affiliates.

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The industry related information, based on the fair value of the Company's investment portfolio as of December 31, 2016 and December 31, 2015, for our investment portfolio was as follows:

| Industry Classification                               | December 31, 2016   |               |                  |   | December 31, 2015 <sup>(2)</sup> |               |                  |   |
|---|---------------------|---------------|------------------|---|----------------------------------|---------------|------------------|---|
|   | Cost/Amortized Cost | Fair Value    | % <sup>(1)</sup> |   | Cost/Amortized Cost              | Fair Value    | % <sup>(1)</sup> |   |
| Aerospace and Defense                                 | \$8,394,633         | \$8,450,106   | 2                | % | \$6,910,349                      | \$6,383,724   | 1                | % |
| Asset Management Company <sup>(2)</sup>               | 55,341,230          | 40,198,000    | 11               |   | 56,591,230                       | 57,381,000    | 14               |   |
| Related Party Loan                                    |                     |               |                  |   | 23,000,000                       | 23,000,000    | 6                |   |
| Automotive  | 6,322,551           | 6,196,154     | 2                |   | 9,898,494                        | 9,440,866     | 2                |   |
| Banking, Finance, Insurance & Real Estate             | 6,805,514           | 6,782,010     | 2                |   | 6,270,984                        | 6,008,587     | 1                |   |
| Beverage, Food and Tobacco                            | 15,198,830          | 14,703,372    | 4                |   | 17,334,746                       | 16,882,750    | 4                |   |
| Capital Equipment                                     | 6,185,129           | 5,575,048     | 2                |   | 9,519,342                        | 7,846,767     | 2                |   |
| Chemicals, Plastics and Rubber                        | 6,421,909           | 6,444,073     | 2                |   | 3,494,086                        | 3,359,916     | 1                |   |
| CLO Fund Securities                                   | 76,851,317          | 54,174,350    | 15               |   | 83,214,947                       | 55,872,382    | 14               |   |
| Construction & Building                               | 5,919,158           | 5,929,606     | 2                |   | 1,976,345                        | 1,907,614     |                  |   |
| Consumer goods: Durable                               | 12,319,905          | 10,118,736    | 3                |   | 13,983,607                       | 12,753,455    | 3                |   |
| Consumer goods: Non-durable                           | 14,766,390          | 14,452,096    | 4                |   | 20,124,355                       | 19,646,576    | 5                |   |
| Ecological  | 1,741,292           | 1,760,783     |                  |   |                                  |               |                  |   |
| Energy: Oil & Gas                                     | 14,493,835          | 8,805,761     | 2                |   | 14,281,821                       | 10,204,318    | 2                |   |
| Energy: Electricity                                   | 3,904,453           | 3,937,247     | 1                |   | 3,465,576                        | 3,465,000     | 1                |   |
| Environmental Industries                              | 12,279,924          | 12,185,239    | 3                |   | 13,735,492                       | 13,179,657    | 3                |   |
| Forest Products & Paper                               | 4,192,889           | 4,192,907     | 1                |   | 5,888,294                        | 5,883,080     | 1                |   |
| Healthcare & Pharmaceuticals                          | 58,769,668          | 53,594,534    | 15               |   | 58,649,512                       | 55,417,827    | 13               |   |
| High Tech Industries                                  | 9,854,093           | 9,936,109     | 3                |   | 11,727,898                       | 11,662,995    | 3                |   |
| Hotel, Gaming & Leisure                               | 400,000             | 1,000         |                  |   | 400,000                          | 1,000         |                  |   |
| Media: Advertising, Printing & Publishing             | 11,712,682          | 11,453,447    | 3                |   | 11,167,950                       | 10,340,449    | 3                |   |
| Media: Broadcasting & Subscription                    | 8,273,174           | 8,372,984     | 2                |   | 7,428,110                        | 7,406,792     | 2                |   |
| Metals & Mining                                       |                     |               |                  |   | 228,563                          | 991           |                  |   |
| Retail  | 1,415,457           | 759,581       |                  |   | 4,416,709                        | 3,594,599     | 1                |   |
| Services: Business                                    | 16,125,481          | 16,230,486    | 4                |   | 18,206,668                       | 21,022,801    | 5                |   |
| Services: Consumer                                    | 6,212,108           | 6,204,889     | 2                |   | 6,512,029                        | 6,356,054     | 2                |   |
| Telecommunications                                    | 12,809,799          | 12,767,823    | 3                |   | 13,776,871                       | 12,425,489    | 3                |   |
| Time Deposit and Money Market Accounts <sup>(3)</sup> | 28,699,269          | 28,699,269    | 8                |   | 2,129,381                        | 2,129,381     | 1                |   |
| Transportation: Cargo                                 | 7,557,315           | 7,190,135     | 2                |   | 18,232,953                       | 18,865,603    | 5                |   |
| Transportation: Consumer                              | 2,412,614           | 2,324,516     | 1                |   | 2,472,795                        | 2,324,381     | 1                |   |
| Utilities: Electric                                   | 5,420,438           | 5,031,043     | 1                |   | 5,673,082                        | 4,806,441     | 1                |   |
| Total   | \$420,801,057       | \$366,471,304 | 100 %            |   | \$450,712,189                    | \$409,570,495 | 100 %            |   |

(1)

Calculated as a percentage of total portfolio at fair value.

- (2) Represents the equity investment in the Asset Manager Affiliates.
- (3) Includes restricted cash held under employee benefit plans.

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### **Debt Securities Portfolio**

At December 31, 2016 and December 31, 2015, our investments in income producing loans and debt securities, excluding CLO Fund Securities, had a weighted average interest rate of approximately 7.0% and 7.4%, respectively.

The investment portfolio (excluding the Company's investment in Asset Manager Affiliates and CLO Funds) at December 31, 2016 was spread across 27 different industries and 82 different entities with an average balance per entity of approximately \$3.1 million. As of December 31, 2016, all of our portfolio companies were current on their debt service obligations.

We may invest up to 30% of our investment portfolio in Non-qualifying opportunistic investments such as high-yield bonds, debt and equity securities of CLO Funds, foreign investments, and distressed debt or equity securities of large cap public companies. At December 31, 2016 and December 31, 2015, the total amount of non-qualifying assets was approximately 17% and 18%, respectively. The majority of non-qualifying assets were foreign investments which were approximately 14.4% and 13.5% of the Company's total assets, respectively (including the Company's investments in CLO Funds, which are typically domiciled outside the U.S. and represented approximately 14% and 13% of its total assets on such dates, respectively). The investments in our Debt Securities Portfolio are all or predominantly below investment grade, and therefore have speculative characteristics with respect to the issuer's capacity to pay interest and repay principal.

### **Asset Manager Affiliates**

The Asset Manager Affiliates are our wholly-owned asset management companies that manage CLO Funds that invest in broadly syndicated loans, high yield bonds and other credit instruments. The CLO Funds managed by our Asset Manager Affiliates consist primarily of credit instruments issued by corporations. As of December 31, 2016, our Asset Manager Affiliates had approximately \$3.0 billion of par value of assets under management on which they earn management fees, and were valued at approximately \$40.2 million.

All CLO Funds managed by the Asset Manager Affiliates are currently paying all senior and subordinate management fees. In addition, during 2016, our Asset Manager Affiliates received incentive fees from two funds.

### **CLO Fund Securities**

We typically make a minority investment in the subordinated securities or preferred stock of CLO Funds raised and managed by our Asset Manager Affiliates and may selectively invest in securities issued by CLO Funds managed by other asset management companies. As of December 31, 2016, we had approximately \$54 million invested in CLO Fund Securities, issued primarily by funds managed by our Asset Manager Affiliates.

The CLO Funds invest primarily in broadly syndicated non-investment grade loans, high-yield bonds and other credit instruments of corporate issuers. The underlying assets in each of the CLO Fund Securities in which we have an investment are generally diversified secured or unsecured corporate debt.

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Our CLO Fund Securities as of December 31, 2016 and December 31, 2015 are as follows:

| CLO Fund Securities          | Investment              | %(1)  | December 31, 2016          |              | December 31, 2015          |              |
|------------------------------|-------------------------|-------|----------------------------|--------------|----------------------------|--------------|
|                              |                         |       | Cost/<br>Amortized<br>Cost | Fair Value   | Cost/<br>Amortized<br>Cost | Fair Value   |
| Grant Grove CLO, Ltd.(3)     | Subordinated Securities | 22.2% | \$2,485,886                | \$1,000      | \$2,484,943                | \$280,164    |
| Katonah III, Ltd.(3)         | Preferred Shares        | 23.1  | 1,287,155                  | 369,000      | 1,373,132                  | 400,000      |
| Katonah IX CLO Ltd.(2)       | Preferred Shares        | 6.9   |                            |              | 1,140,057                  | 105,000      |
| Katonah X CLO Ltd.(2)        | Subordinated Securities | 33.3  |                            |              | 7,637,499                  | 1,000,000    |
| Katonah 2007-I CLO Ltd.(2)   | Preferred Shares        | 100   | 28,022,646                 | 20,453,099   | 24,312,424                 | 20,295,677   |
| Trimaran CLO VII, Ltd.(2)    | Income Notes            | 10.5  | 1,643,920                  | 1,195,152    | 1,375,013                  | 1,647,272    |
| Catamaran CLO 2012-1 Ltd.(2) | Subordinated Notes      | 24.9  | 5,919,933                  | 2,819,412    | 6,791,980                  | 3,312,940    |
| Catamaran CLO 2013-1 Ltd.(2) | Subordinated Notes      | 23.5  | 5,237,222                  | 4,918,807    | 6,256,090                  | 5,639,106    |
| Dryden 30 Senior Loan Fund   | Subordinated Notes      | 7.5   | 1,343,467                  | 1,895,566    | 1,592,303                  | 1,634,647    |
| Catamaran CLO 2014-1 Ltd.(2) | Subordinated Notes      | 24.9  | 7,818,484                  | 4,546,682    | 8,928,790                  | 5,846,325    |
| Catamaran CLO 2014-1 Ltd.(2) | Class E Notes           | 15.1  | 1,441,727                  | 1,310,000    | 1,428,797                  | 1,170,000    |
| Catamaran CLO 2014-2 Ltd.(2) | Subordinated Notes      | 24.9  | 6,967,560                  | 5,092,087    | 8,024,168                  | 5,751,600    |
| Catamaran CLO 2015-1 Ltd.(2) | Subordinated Notes      | 9.9   | 4,543,317                  | 3,223,255    | 11,869,751                 | 8,789,651    |
| Catamaran CLO 2016-1 Ltd.(2) | Subordinated Notes      | 24.9  | 10,140,000                 | 8,350,290    |                            |              |
| Total                        |                         |       | \$76,851,317               | \$54,174,350 | \$83,214,947               | \$55,872,382 |

(1) Represents percentage of class held.

(2) A CLO Fund managed by an Asset Manager Affiliate.

(3) As of December 31, 2016, this CLO Fund Security was not providing a distribution.

The following tables detail the ten largest portfolio companies (at fair value) as of December 31, 2016:

| Investment                   | December 31, 2016      |               | % of FMV |
|------------------------------|------------------------|---------------|----------|
|                              | Cost/Amortized<br>Cost | Fair Value    |          |
| Asset Manager Affiliates     | \$ 55,341,230          | \$ 40,198,000 | 11 %     |
| US Bank Money Market Account | 28,685,001             | 28,685,001    | 8        |



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|                             |                |                |      |
|-----------------------------|----------------|----------------|------|
| Katonah 2007-I CLO Ltd.     | 28,022,646     | 20,453,099     | 6    |
| Grupo HIMA San Pablo, Inc.  | 9,828,619      | 9,113,125      | 2    |
| Catamaran CLO 2016-1 Ltd.   | 10,140,000     | 8,350,290      | 2    |
| Tank Partners Holdings, LLC | 11,822,180     | 6,552,311      | 2    |
| Roscoe Medical, Inc.        | 6,666,733      | 6,499,000      | 2    |
| Weiman Products, LLC        | 5,462,647      | 5,321,809      | 1    |
| Nielsen & Bainbridge, LLC   | 5,326,136      | 5,199,447      | 1    |
| Catamaran CLO 2014-2 Ltd.   | 6,967,560      | 5,092,087      | 1    |
| Total                       | \$ 168,262,752 | \$ 135,464,169 | 36 % |

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| Investment                      | December 31, 2015   |                |          |
|---------------------------------|---------------------|----------------|----------|
|                                 | Cost/Amortized Cost | Fair Value     | % of FMV |
| Asset Manager Affiliates        | \$ 56,591,230       | \$ 57,381,000  | 14 %     |
| Trimaran Advisors, L.L.C.       | 23,000,000          | 23,000,000     | 6        |
| Katonah 2007-I CLO Ltd.         | 24,312,424          | 20,295,677     | 5        |
| DBI Holding, LLC                | 8,585,578           | 12,975,447     | 3        |
| Crowley Holdings Preferred, LLC | 10,411,673          | 11,036,373     | 3        |
| Grupo HIMA San Pablo, Inc.      | 9,817,315           | 9,917,500      | 2        |
| Catamaran CLO 2015-1 Ltd.       | 11,869,751          | 8,789,651      | 2        |
| Tank Partners Holdings, LLC     | 10,624,515          | 8,177,538      | 2        |
| Weiman Products, LLC            | 6,582,457           | 6,619,805      | 2        |
| Nielsen & Bainbrige, LLC        | 6,803,605           | 6,510,157      | 2        |
| Total                           | \$ 168,598,548      | \$ 164,703,148 | 41 %     |

Excluding the Asset Manager Affiliates and CLO Fund securities, the Company's ten largest portfolio companies represented approximately 13% and 19% of the total fair value of the Company's investments at December 31, 2016 and December 31, 2015, respectively.

## RESULTS OF OPERATIONS

The principal measure of our financial performance is the net increase (decrease) in stockholders' equity resulting from operations, which includes net investment income (loss) and net realized and unrealized appreciation (depreciation).

Net investment income (loss) is the difference between our income from interest, distributions, fees, and other investment income and our operating expenses. Net realized gain (loss) on investments, is the difference between the proceeds received from dispositions of portfolio investments and their amortized cost. Net change in unrealized appreciation (depreciation) on investments is the net change in the fair value of our investment portfolio.

Set forth below is a discussion of our results of operations for December 31, 2016, 2015, and 2014.

### Revenue

|  | For the Years Ended December 31, |              |              |
|--|----------------------------------|--------------|--------------|
|  | 2016                             | 2015         | 2014         |
| <b>Investment Income:</b>  |                                  |              |              |
| Interest from investments in debt securities                       | \$20,828,916                     | \$24,101,257 | \$21,386,432 |
| Interest from cash and time deposits                               | 29,383                           | 10,239       | 3,452        |
| Investment income on CLO Fund Securities managed by affiliates     | 12,642,625                       | 14,691,428   | 12,367,581   |
| Investment income on CLO Fund Securities managed by non-affiliates | 630,647                          | 1,008,634    | 1,045,225    |
| Dividends from Asset Manager Affiliates                            | 1,400,000                        | 5,348,554    | 5,467,914    |
| Capital structuring service fees                                   | 668,527                          | 366,859      | 934,871      |
| Total investment income  | \$36,200,098                     | \$45,526,971 | \$41,205,475 |

Revenues consist primarily of investment income from interest and dividends on our investment portfolio and various ancillary fees related to our investment holdings.

*Interest from Investments in Debt Securities.* We generate interest income from our investments in debt securities that consist primarily of senior and junior secured loans. Our Debt Securities Portfolio is spread across multiple industries and geographic locations, and as such, we are broadly exposed to market conditions and business environments. As a result, although our investments are exposed to market risks, we continuously seek to limit concentration of exposure in any particular sector or issuer.

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*Investment Income on Investments in CLO Fund Securities.* We generate investment income from our investments in the securities (typically preferred shares or subordinated securities) of CLO Funds managed by our Asset Manager Affiliates and select investments in securities issued by CLO Funds managed by other asset management companies. CLO Funds managed by our Asset Manager Affiliates and those managed by non-affiliates invest primarily in broadly syndicated non-investment grade loans, high-yield bonds and other credit instruments of corporate issuers. The Company distinguishes CLO Funds managed by its Asset Manager Affiliates as CLO Fund Securities Managed by Affiliates, in its financial consolidated statements. The underlying assets in each of the CLO Funds in which we have an investment are generally diversified secured or unsecured corporate debt. Our CLO Fund Securities that are subordinated securities or preferred shares ( junior securities ) are subordinated to senior note holders who typically receive a return on their investment at a fixed spread relative to the LIBOR index. The CLO Funds are leveraged funds and any excess cash flow or excess spread (interest earned by the underlying securities in the fund less payments made to senior bond holders and less fund expenses and management fees) is paid to the holders of the CLO Fund's subordinated securities or preferred shares. The level of excess spread from CLO Fund Securities can be impacted by the timing and level of the resetting of the benchmark interest rate for the underlying assets (which reset at various times throughout the quarter) in the CLO Fund and the related CLO Fund note liabilities (which reset at each quarterly distribution date); in periods of short-term and volatile changes in the benchmark interest rate, the levels of excess spread and resulting cash distributions to us can vary significantly.

Interest income on investments in CLO equity investments is recorded using the effective interest method in accordance with the provisions of ASC 325-40, *Beneficial Interests in Securitized Financial Assets* ( ASC 325-40 ), based on the anticipated yield and the estimated cash flows over the projected life of the investment. Yields are revised when there are changes in actual or estimated projected future cash flows due to changes in prepayments and/or re-investments, credit losses or asset pricing. Changes in estimated yield are recognized as an adjustment to the estimated yield prospectively over the remaining life of the investment from the date the estimated yield was changed. Accordingly, investment income recognized on CLO equity securities in the GAAP statement of operations differs from both the tax-basis investment income and from the cash distributions actually received by the Company during the period. As a RIC, the Company anticipates a timely distribution of its tax-basis taxable income.

For non-junior class CLO Fund securities, such as our investment in the Class E notes of Catamaran 2014-1, interest is earned at a fixed spread relative to the LIBOR index.

*Distributions from Asset Manager Affiliates.* We receive cash distributions from our investment in our Asset Manager Affiliates, which are wholly-owned and manage CLO Funds that invest primarily in broadly syndicated non-investment grade loans, high yield bonds and other credit instruments issued by corporations. As managers of CLO Funds, our Asset Manager Affiliates receive contractual and recurring management fees from the CLO Funds for their management and advisory services. In addition, our Asset Manager Affiliates may also earn income related to net interest on assets accumulated for future CLO issuances on which they have taken a first loss position in connection with loan warehouse arrangements for their future CLO Funds. The annual management fees that our Asset Manager Affiliates receive are generally based on a fixed percentage of the par value of assets under management and are recurring in nature for the term of the CLO Fund so long as the Asset Manager Affiliates manage the fund. As a result, the annual management fees earned by our Asset Manager Affiliates generally are not subject to market value fluctuations in the underlying collateral. Our Asset Manager Affiliates may receive incentive fees provided such CLO Funds have achieved a minimum investment return to holders of their subordinated securities or preferred shares as per the terms of each CLO Fund management agreement. During the years ended December 31, 2016 and 2015, the Asset Manager Affiliates received incentive fees from two and three funds, respectively.

The Asset Manager Affiliates are expected to pay future distributions to the Company based upon their after-tax free cash flow, which generally will be dependent upon the maintenance and growth in their assets under management and

related management fees. As a result of tax-basis goodwill amortization and certain other tax-related adjustments, portions of distributions received may be deemed return of capital. As amortizing funds which are paying incentive fees are redeemed, we expect incentive fees available for distribution to diminish. The fair value of our investment in our Asset Manager Affiliates was approximately

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\$40.2 million at December 31, 2016, with an unrealized depreciation for the year ending December 31, 2016 of approximately \$15.9 million. For the years ended December 31, 2016, 2015, and 2014, we recognized dividend income of \$1.4 million, \$5.3 million and \$5.5 million, from the Asset Manager Affiliates, respectively, while cash distributions received were approximately \$2.7 million, \$9.1 million and \$11.9 million for those years, respectively. The difference between cash distributions received and the tax-basis earnings and profits is recorded as an adjustment to the cost basis of the Asset Manager Affiliates investments. For interim periods, the Company estimates the tax attributes of any distributions as being either tax-basis earnings and profits (i.e., dividend income) or return of capital (i.e., adjustment to the Company's cost basis in the Asset Manager Affiliates). The final determination of the tax attributes of distributions from our Asset Manager Affiliates is made on an annual (full calendar year) basis at the end of the year based upon taxable income and distributions for the full-year. Therefore, any estimate of tax attributes of distributions made on a quarterly basis may not be representative of the actual tax attributes of distributions for a full year. CLO Funds typically have automatic orderly wind-down features following an initial period of reinvestment. Thus, with all else being equal, as managed CLO Fund portfolios age, projected future assets under management (and associated management fees) will naturally decline, resulting in a reduction in fair value of our Asset Manager Affiliates. On the other hand, mandates to manage new CLO Fund portfolios will generally result in an increase in the fair value of our investment in our Asset Manager Affiliates. The aggregate of par value of assets under management by our Asset Manager Affiliates was \$3.0 billion and \$2.7 billion as of December 31, 2016 and 2015, respectively.

*Capital Structuring Service Fees.* We may earn ancillary structuring and other fees related to the origination, investment, disposition or liquidation of debt and investment securities.

## **Investment Income**

Investment income for the years ended December 31, 2016, 2015, and 2014 was approximately \$36 million, \$46 million, and \$41 million, respectively. Of these amounts, approximately \$21 million, \$24 million and \$21 million, respectively, was attributable to interest income on our Debt Securities Portfolio.

The weighted average yield on our Debt Securities Portfolio was 7.0% and 7.4% as of December 31, 2016 and 2015, respectively.

Investment income is primarily dependent on the composition and credit quality of our investment portfolio. Generally, our Debt Securities Portfolio is expected to generate predictable, recurring interest income in accordance with the contractual terms of each loan. Corporate equity securities may pay a dividend and may increase in value for which a gain may be recognized; generally such dividend payments and gains are less predictable than interest income on our loan portfolio.

For the years ended December 31, 2016, 2015, and 2014, approximately \$13.3 million, \$15.7 million and \$13.4 million, respectively, of investment income was attributable to investments in CLO Fund Securities. On a tax basis, the Company recognized \$10.1 million, \$14.7 million and \$19.4 million of taxable distributable income on distributions from our CLO Fund Securities during the years ended December 31, 2016, 2015, and 2014, respectively. Distributions from CLO Fund Securities are dependent on the performance of the underlying assets in each CLO Fund; interest payments, principal amortization and prepayments of the underlying loans in each CLO Fund are primary factors which determine the level of distributions on our CLO Fund Securities. The level of excess spread from CLO Fund Securities can be impacted by the timing and level of the resetting of the benchmark interest rate for the underlying assets (which reset at various times throughout the quarter) in the CLO Fund and the related CLO Fund bond liabilities (which reset at each quarterly distribution date); in periods of short-term and volatile changes in the benchmark interest rate, the levels of excess spread and distributions to us can vary significantly.



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|  | For the Years Ended December 31, |               |               |
|--|----------------------------------|---------------|---------------|
|  | 2016                             | 2015          | 2014          |
| <b>Expenses:</b>                                 |                                  |               |               |
| Interest and amortization of debt issuance costs | \$ 9,110,603                     | \$ 11,727,880 | \$ 11,538,179 |
| Compensation                                     | 4,103,558                        | 3,843,799     | 4,951,745     |
| Professional fees                                | 2,391,038                        | 3,520,461     | 2,614,479     |
| Insurance  | 412,764                          | 433,561       | 471,276       |
| Administrative and other                         | 1,692,140                        | 1,818,480     | 1,509,228     |
| Total expenses                                   | \$ 17,710,103                    | \$ 21,344,181 | \$ 21,084,907 |

Because we are internally managed, we directly incur the cost of management and operations. As a result, we pay no investment management fees or other fees to an external advisor. Our expenses consist primarily of interest expense on outstanding borrowings, compensation expense and general and administrative expenses, including professional fees. Interest and compensation expense are typically our largest expenses each period.

*Interest and Amortization of Debt Issuance Costs.* Interest expense is dependent on the average outstanding balance on our borrowings and the base index rate for the period. Debt issuance costs represent fees and other direct costs incurred in connection with the Company's borrowings. These amounts are capitalized and amortized ratably over the expected term of the borrowing.

*Compensation Expense.* Compensation expense includes base salaries, bonuses, stock compensation, employee benefits and employer-related payroll costs. The largest components of total compensation costs are base salaries and bonuses; generally, base salaries are expensed as incurred and annual bonus expenses are estimated and accrued. Our compensation arrangements with our employees contain a profit sharing and/or performance based bonus component. Therefore, as our net revenues increase, our compensation costs may also rise. In addition, our compensation expenses may also increase to reflect increased investment in personnel as we grow our products and businesses.

*Professional Fees and General and Administrative Expenses.* The balance of our expenses includes professional fees (primarily legal, accounting, valuation and other professional services), occupancy costs and general administrative and other costs.

Total expenses for the years ended December 31, 2016, 2015, and 2014 were approximately \$18 million, \$21 million, and \$21 million, respectively. Interest expense and amortization on debt issuance costs for the period was approximately \$9 million, \$12 million, and \$12 million, respectively, on average debt outstanding of \$190 million, \$224 million, and \$197 million, respectively.

For the years ended December 31, 2016, 2015, and 2014, approximately \$4.1 million, \$3.8 million, and \$5.0 million, respectively, of expenses were attributable to employee compensation, including salaries, bonuses, employee benefits, payroll taxes and stock-based compensation expense. For the years ended December 31, 2016, 2015, and 2014, professional fees and insurance expenses totaled approximately \$2.8 million, \$4.0 million and \$3.1 million, respectively. Administrative costs, which include occupancy expense, technology and other office expenses, totaled approximately \$1.7 million, \$1.8 million and \$1.5 million for the years ended December 31, 2016, 2015, and 2014, respectively.



## **Net Investment Income and Net Realized Gains (Losses)**

Net investment income and net realized gains (losses) represents the stockholder's equity before net unrealized appreciation or depreciation on investments. For the years ended December 31, 2016, 2015, and 2014, net investment income and net realized losses were approximately \$12.2 million, \$17.5 million and \$9.0 million, respectively, or \$0.33, \$0.47, and \$0.26 per basic share, respectively. Net investment income represents the income earned on our investments less operating and interest expense before net realized gains or losses and unrealized appreciation or depreciation on investments. Investments are carried at fair value, with changes in fair value recorded as unrealized appreciation (depreciation) in the statement of operations. When an investment is sold or liquidated, any previously recognized unrealized appreciation/depreciation is

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reversed and a corresponding amount is recognized as realized gain (loss). For example, on February 29, 2016, Katonah X CLO Ltd. was fully liquidated and all of its outstanding obligations were satisfied. The Company received approximately \$1.0 million in connection therewith related to its investment in the subordinated securities issued by Katonah X CLO Ltd. Accordingly, the Company recorded a realized loss during the first quarter of 2016 of approximately \$6.6 million on its investment in Katonah X CLO Ltd. and a corresponding unrealized gain of the same amount in order to reverse the approximately \$6.6 million of previously recorded unrealized depreciation with respect to the investment. For the year ended December 31, 2016, GAAP-basis net investment income was approximately \$18.5 million, or \$0.50 per basic share, while tax-basis distributable income was approximately \$14.8 million or \$0.40 per share, respectively.

## Net Unrealized (Depreciation) Appreciation on Investments

|   | For the Years Ended December 31, |                |              |
|---|----------------------------------|----------------|--------------|
|   | 2016                             | 2015           | 2014         |
| <b>Unrealized Gains (Losses) On Investments:</b>              |                                  |                |              |
| Net change in unrealized appreciation (depreciation) on:      |                                  |                |              |
| Debt securities   | \$2,492,707                      | \$(10,748,262) | \$5,641,403  |
| Equity securities   | (4,413,354 )                     | (210,167 )     | 7,040,155    |
| CLO Fund Securities managed by affiliates                     | 4,380,974                        | (12,990,404)   | (11,584,257) |
| CLO Fund Securities managed by non-affiliates                 | 284,625                          | (977,483 )     | 2,884,109    |
| Asset Manager Affiliates investments                          | (15,933,000)                     | (11,243,554)   | 2,064,107    |
| Total net unrealized (loss) gain from investment transactions | \$(13,188,048)                   | \$(36,169,870) | \$6,045,517  |

During the year ended December 31, 2016, our total investments had net unrealized depreciation of approximately \$13.2 million. Included in the net unrealized loss in 2016 are unrealized appreciation on CLO Fund Securities of approximately \$4.7 million and unrealized depreciation of the Asset Manager Affiliates of \$15.9 million, as well as unrealized appreciation on our debt securities of \$2.5 million and unrealized depreciation on equity securities of approximately \$4.4 million. During the year ended December 31, 2015, our total investments had net unrealized depreciation of approximately \$36.2 million, including net unrealized losses of approximately \$14.0 million on CLO Fund Securities and unrealized depreciation of the Asset Manager Affiliates of approximately \$11.2 million, net unrealized depreciation on debt securities of approximately \$10.8 million and net unrealized losses on equity securities of \$210,000. During the year ended December 31, 2014, our total investments had net unrealized appreciation of \$6 million, including approximately \$5.6 million of unrealized gains on debt securities, net unrealized gains of the Asset Manager Affiliates of approximately \$2.1 million, and net unrealized gains on equity securities of \$7 million, offset by net unrealized losses of approximately \$8.7 million related to CLO Fund Securities.

## Net Change in Stockholders' Equity Resulting From Operations

The net decrease in stockholders' equity resulting from operations for the year ended December 31, 2016 was approximately \$1.0 million, or \$0.03 per basic share. Net decrease in stockholders' equity resulting from operations for the year ended December 31, 2015 was approximately \$19 million, or \$0.50 per basic share, and the net increase in stockholders' equity resulting from operations for the year ended December 31, 2014 was approximately \$15 million, or \$0.44 per share.

## **FINANCIAL CONDITION, LIQUIDITY, AND CAPITAL RESOURCES**

Liquidity is a measure of our ability to meet potential cash requirements, including ongoing commitments to repay borrowings, fund and maintain investments, pay distributions to our stockholders and other general business needs. We recognize the need to have funds available for operating our business and to make investments. We seek to have adequate liquidity at all times to cover normal cyclical swings in funding availability and to allow us to meet irregular and unexpected funding requirements. We plan to satisfy our liquidity needs through normal operations with the goal of avoiding unplanned sales of assets or emergency borrowing of funds.

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As of December 31, 2016 and December 31, 2015 the fair value of investments and cash were as follows:

| Security Type            | Investments at Fair Value |                      |
|--------------------------|---------------------------|----------------------|
|                          | December 31,<br>2016      | December 31,<br>2015 |
| Cash                     | \$ 1,307,257              | \$                   |
| Restricted Cash          | 8,528,298                 | 7,138,272            |
| Money Market Accounts    | 28,699,269                | 2,129,381            |
| Senior Secured Loan      | 200,322,152               | 194,123,223          |
| Junior Secured Loan      | 35,444,440                | 37,591,900           |
| Senior Unsecured Loan    |                           | 23,000,000           |
| First Lien Bond          | 1,089,338                 | 2,216,700            |
| Senior Subordinated Bond |                           | 4,615,569            |
| Senior Unsecured Bond    |                           | 10,551,724           |
| Senior Secured Bond      | 1,487,400                 | 1,503,755            |
| CLO Fund Securities      | 54,174,350                | 55,872,382           |
| Equity Securities        | 5,056,355                 | 9,548,488            |
| Preferred                |                           | 11,036,373           |
| Asset Manager Affiliates | 40,198,000                | 57,381,000           |
| Total                    | \$ 376,306,859            | \$ 416,708,767       |

We use borrowed funds, known as leverage, to make investments and to attempt to increase returns to our shareholders by reducing our overall cost of capital. As a BDC, we are limited in the amount of leverage we can incur under the 1940 Act. We are only allowed to borrow amounts such that our asset coverage, as defined in the 1940 Act, equals at least 200% after such borrowing. As of December 31, 2016, we had approximately \$181 million of par value of outstanding borrowings and our asset coverage ratio of total assets to total borrowings was 205%, compliant with the minimum asset coverage level of 200% generally required for a BDC by the 1940 Act. We may also borrow amounts of up to 5% of the value of our total assets for temporary purposes.

On March 15, 2016, the Convertible Notes matured and were repaid in full.

On October 10, 2012, the Company issued \$41.4 million in aggregate principal amount of unsecured 7.375% Notes Due 2019. The net proceeds for the 7.375% Notes Due 2019, following underwriting expenses, were approximately \$39.9 million. Interest on the 7.375% Notes Due 2019 is paid quarterly in arrears on March 30, June 30, September 30 and December 30, at a rate of 7.375%, commencing December 30, 2012. The 7.375% Notes Due 2019 mature on September, 30, 2019, and are senior unsecured obligations of the Company. In addition, due to the coverage test applicable to the Company as a BDC and a covenant that the Company agreed to in connection with the issuance of the 7.375% Notes Due 2019, the Company is limited in its ability to make distributions if its asset coverage, as defined in the 1940 Act, is below 200% at the time of the declaration of the distribution. At December 31, 2016, the Company was in compliance with all of its debt covenants. The indenture governing the 7.375% Notes Due 2019 contains certain restrictive covenants, including compliance with certain provisions of the 1940 Act relating to borrowing and dividends. During the second quarter of 2016, the Company repurchased approximately \$2.4 million par value of the 7.375% notes due 2019 at a weighted average price of \$25.23 per \$25.00 note, resulting in a realized loss on extinguishment of \$71,190. KCAP subsequently surrendered these notes to the Trustee for cancellation. During the third quarter of 2016, \$5.0 million par value of the 7.375% notes due 2019 was redeemed by the Company, resulting in a realized loss on extinguishment of \$88,015. During the fourth quarter of 2016, \$469,000 par value of the 7.375% notes due 2019 was redeemed by the Company, resulting in a realized loss on extinguishment of \$15,000.

On June 18, 2013, KCAP Senior Funding I, LLC, a specialty finance subsidiary of the Company, was capitalized through the issuance of \$140 million of notes (the KCAP Senior Funding I Notes ). The KCAP Senior Funding I Notes are backed by a diversified portfolio of bank loans. The Company invested in the

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most junior class of the notes, issued in the approximate amount of \$35 million, representing the Company's primary exposure to the performance of the assets acquired from the proceeds of the issuance of the KCAP Senior Funding I Notes. On December 8, 2014, the Company completed the sale of additional KCAP Senior Funding I Notes for \$56 million. The issuance of additional notes was pro-rata across all existing classes of notes originally issued. KCAP purchased an additional \$13.9 million in the most junior class of notes. As of December 31, 2016 and 2015, these junior notes eliminate in consolidation and the remaining notes with a par value of \$147.4 million are reflected on our consolidated balance sheet, net of \$2.3 million and \$2.9 million of unamortized discount and \$2.5 million and \$3.1 million of debt offering costs, respectively. The indenture governing the KCAP Senior Funding I Notes contains an event of default that is triggered in the event that certain coverage tests are not met.

On October 6, 2014, the Company priced a follow-on public offering of 3.0 million shares of its common stock at a price of \$8.02 per share. The offering raised net proceeds were approximately \$23.8 million, after deducting underwriting discounts and offering expenses.

Subject to prevailing market conditions, we intend to grow our portfolio of assets by raising additional capital, including through the prudent use of leverage available to us. However, we may face difficulty in obtaining a new debt and equity financing as a result of current market conditions. In this regard, because our common stock has traded at a price below our current net asset value per share and we are limited in our ability to sell our common stock at a price below net asset value per share without stockholder approval (which we currently do not have), we have been and may continue to be limited in our ability to raise equity capital. See Business Regulation Common Stock . From time to time, we may seek to retire, repurchase, or exchange debt securities in open market purchases or by other means dependent on market conditions, liquidity, contractual obligations, and other matters. In addition, we evaluate strategic opportunities available to us and/or the Asset Manager Affiliates, including mergers, divestures, spin-offs, joint ventures and other similar transactions from time to time.

## **Stockholder Distributions**

We intend to continue to make quarterly distributions to our stockholders. To avoid certain excise taxes imposed on RICs, we generally endeavor to distribute during each calendar year an amount at least equal to the sum of:

98% of our ordinary net taxable income for the calendar year;  
98.2% of our capital gains, if any, in excess of capital losses for the one-year period ending on October 31 of the calendar year; and  
any net ordinary income and net capital gains for the preceding year that were not distributed during such year and on which we do not pay corporate tax.  
We may choose to carry forward taxable income in excess of current year distributions into the next tax year and pay a 4% excise tax on such income, to the extent required.

The amount of our declared distributions, as evaluated by management and approved by our Board of Directors, is based primarily on our evaluation of our net investment income, distributable taxable income and the after-tax free cash flow from our Asset Manager Affiliates.

We will be prohibited by the 1940 Act and the indenture governing our 7.375% Notes from making distributions on our common stock if our asset coverage, as defined in the 1940 Act, falls below 200%. In any such event, we would be prohibited from making distributions required in order to maintain our status as a RIC.



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The following table sets forth the quarterly distributions declared by us since 2015.

|                        | Distribution | Declaration Date | Record Date             | Pay Date   |
|------------------------|--------------|------------------|-------------------------|------------|
| 2016:                  |              |                  |                         |            |
| Fourth quarter         | \$ 0.12      | 12/14/2016       | 1/6/2017 <sup>(1)</sup> | 1/27/2017  |
| Third quarter          | 0.15         | 9/20/2016        | 10/14/2016              | 10/27/2016 |
| Second quarter         | 0.15         | 6/21/2016        | 7/7/2016                | 7/28/2016  |
| First quarter          | 0.15         | 3/18/2016        | 4/7/2016                | 4/28/2016  |
| Total declared in 2016 | \$ 0.57      |                  |                         |            |
| 2015:                  |              |                  |                         |            |
| Fourth quarter         | \$ 0.15      | 12/16/2015       | 1/6/2016 <sup>(1)</sup> | 1/28/2016  |
| Third quarter          | 0.21         | 9/22/2015        | 10/14/2015              | 10/27/2015 |
| Second quarter         | 0.21         | 6/23/2015        | 7/6/2015                | 7/27/2015  |
| First quarter          | 0.21         | 3/24/2015        | 4/6/2015                | 4/27/2015  |
| Total declared in 2015 | \$ 0.78      |                  |                         |            |

- (1) Since the record date of this distribution is subsequent to year-end, it is a subsequent year tax event. The following table depicts the composition of shareholder distributions on a per share basis:

|   | Year Ended<br>December 31, |                     |
|---|----------------------------|---------------------|
|   | 2016 <sup>(1)</sup>        | 2015 <sup>(1)</sup> |
| Net investment income   | \$0.50                     | \$ 0.65             |
| Tax Accounting Difference on CLO Equity Investments   | (0.09)                     | (0.03 )             |
| Other tax accounting differences  | (0.01)                     |                     |
| Taxable distributable income  | 0.40                       | 0.63                |
| Cash distributed to the Company by Asset Manager Affiliates in excess of their taxable earnings | 0.03                       | 0.10                |
| Cash received from CLO Equity Investments in excess of taxable earnings                         | 0.11                       | 0.10                |
| Available for distribution <sup>(2)</sup>   | 0.54                       | 0.83                |
| Distributed   | 0.57                       | 0.63                |
| Difference  | \$(0.03)                   | \$ 0.20             |

(1) Table may not foot due to rounding.

- The Available for distribution financial measure is a non-GAAP financial measure that is calculated by including the cash distributed to the Company by the Asset Manager Affiliates in excess of their taxable earnings and cash received from CLO Equity Investments in excess of taxable earnings to the Company's taxable distributable income, which is the most directly comparable GAAP financial measure. In order to reconcile the Available for distribution financial measure to taxable distributable income per share in accordance with GAAP, the \$0.03 and \$0.10 per share of cash distributed to the Company by the Asset Manager Affiliates in excess of their taxable earnings, and the \$0.11 and \$0.10 per share of cash distributed to the Company from CLO Equity Investments in excess of taxable earnings, is subtracted from the Available for distribution financial measure for the year-ended December 31, 2016 and 2015, respectively. The Company's management believes that the presentation of the non-GAAP Available for distribution financial measure provides useful information to investors.



## OFF-BALANCE SHEET ARRANGEMENTS

From time-to-time the Company is a party to financial instruments with off-balance sheet risk in the normal course of business in order to meet the needs of the Company's investment in portfolio companies. Such instruments include commitments to extend credit and may involve, in varying degrees, elements of credit risk in excess of amounts recognized on the Company's balance sheet. Prior to extending such credit,

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the Company attempts to limit its credit risk by conducting extensive due diligence, obtaining collateral where necessary and negotiating appropriate financial covenants. As of December 31, 2016 and December 31, 2015, the Company had \$565,000 and \$360,000 commitments to fund investments, respectively.

## **CONTRACTUAL OBLIGATIONS**

The following table summarizes our contractual cash obligations and other commercial commitments as of December 31, 2016:

| Contractual Obligations    | Payments Due by Period |                       |               |              |  | More than<br>5 years |
|----------------------------|------------------------|-----------------------|---------------|--------------|--|----------------------|
|                            | Total                  | Less than<br>one year | 1 to 3 years  | 3 to 5 years |  |                      |
| Long-term debt obligations | \$ 180,880,925         | \$                    | \$ 33,530,925 | \$           |  | \$ 147,350,000       |

## **CRITICAL ACCOUNTING POLICIES**

The consolidated financial statements are based on the selection and application of critical accounting policies, which require management to make significant estimates and assumptions. Critical accounting policies are those that are both important to the presentation of our financial condition and results of operations and require management's most difficult, complex, or subjective judgments. Our critical accounting policies are those applicable to the basis of presentation, valuation of investments, and certain revenue recognition matters as discussed below. See Note 2 to our consolidated financial statements, contained elsewhere herein: Significant Accounting Policies Investments.

## **Valuation of Portfolio Investments**

The most significant estimate inherent in the preparation of our consolidated financial statements is the valuation of investments and the related amounts of unrealized appreciation and depreciation of investments recorded.

Value, as defined in Section 2(a)(41) of 1940 Act, is (1) the market price for those securities for which a market quotation is readily available and (2) for all other securities and assets, fair value as determined in good faith by our Board of Directors pursuant to procedures approved by our Board of Directors. Our valuation policy is intended to provide a consistent basis for determining the fair value of the portfolio based on the nature of the security, the market for the security and other considerations including the financial performance and enterprise value of the portfolio company. Because of the inherent uncertainty of valuation, the Board of Directors determined values may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

Pursuant to the AICPA Guide, we reflect our investments on our balance sheet at their determined fair value with unrealized gains and losses resulting from changes in fair value reflected as a component of unrealized gains or losses on our statements of operations. Fair value is the amount that would be received to sell the investments in an orderly transaction between market participants at the measurement date (i.e., the exit price).

See Note 4 to the consolidated financial statements for the additional information about the level of market observability associated with investments carried at fair value.

The Company follows the provisions of ASC 820: Fair Value, which among other matters, requires enhanced disclosures about investments that are measured and reported at fair value. This standard defines fair value and establishes a hierarchical disclosure framework which prioritizes and ranks the level of market price observability used in measuring investments at fair value and expands disclosures about assets and liabilities measured at fair value. ASC 820: Fair Value defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. This fair value definition focuses on an exit price in the principal, or most advantageous market, and prioritizes, within a measurement of fair value, the use of market-based inputs (which may be weighted or adjusted for relevance, reliability and specific attributes relative to the subject investment) over entity-specific inputs. Market price observability is affected by a number of factors, including the type of investment and the characteristics specific to the investment. Investments with readily available active quoted prices or for which

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fair value can be measured from actively quoted prices generally will have a higher degree of market price observability and a lesser degree of judgment used in measuring fair value. Subsequent to the adoption of ASC 820: Fair Value, the FASB has issued various staff positions clarifying the initial standard (see Note 2 to the consolidated financial statements: Significant Accounting Policies Investments ).

ASC 820: Fair Value establishes the following three-level hierarchy, based upon the transparency of inputs to the fair value measurement of an asset or liability as of the measurement date:

**Level I** Unadjusted quoted prices are available in active markets for identical investments as of the reporting date. The type of investments included in Level I include listed equities and listed securities. As required by ASC 820: Fair Value, the Company does not adjust the quoted price for these investments, even in situations where the Company holds a large position and a sale could reasonably affect the quoted price.

**Level II** Pricing inputs are other than quoted prices in active markets, which are either directly or indirectly observable as of the reporting date. Such inputs may be quoted prices for similar assets or liabilities, quoted markets that are not active, or other inputs that are observable or can be corroborated by observable market data for substantially the full character of the financial instrument, or inputs that are derived principally from, or corroborated by, observable market information. Investments which are generally included in this category include illiquid debt securities and less liquid, privately held or restricted equity securities, for which some level of recent trading activity has been observed.

**Level III** Pricing inputs are unobservable for the investment and includes situations where there is little, if any, market activity for the investment. The inputs may be based on the Company's own assumptions about how market participants would price the asset or liability or may use Level II inputs, as adjusted, to reflect specific investment attributes relative to a broader market assumption. These inputs into the determination of fair value may require significant management judgment or estimation. Even if observable market data for comparable performance or valuation measures (earnings multiples, discount rates, other financial/valuation ratios, etc.) are available, such investments are grouped as Level III if any significant data point that is not also market observable (private company earnings, cash flows, etc.) is used in the valuation methodology.

In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, an investment's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement. The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and the Company considers factors specific to the investment. The majority of the Company's investments are classified as Level III. The Company evaluates the source of inputs, including any markets in which its investments are trading, in determining fair value. Inputs that are backed by actual transactions, those that are highly correlated to the specific investment being valued and those derived from reliable or knowledgeable sources will tend to have a higher weighting in determining fair value. The Company's fair value determinations may include factors such as an assessment of each underlying investment, its current and prospective operating and financial performance, consideration of financing and sale transactions with third parties, expected cash flows and market-based information, including comparable transactions, performance factors, and other investment or industry specific market data, among other factors.

We have valued our investments, in the absence of observable market prices, using the valuation methodologies described below applied on a consistent basis. For some investments little market activity may exist; management's determination of fair value is then based on the best information available in the circumstances, and may incorporate management's own assumptions and involves a significant degree of management's judgment.

Our investments in CLO Fund Securities are carried at fair value, which is based either on (i) the present value of the net expected cash inflows for interest income and principal repayments from underlying assets and the cash outflows for interest expense, debt paydown and other fund costs for the CLO Funds which are approaching or past the end of their reinvestment period and therefore are selling assets and/or using principal repayments to pay-down CLO Fund debt, and for which there continue to be net cash distributions to the class of securities we own, or (ii) a discounted cash flow model that utilizes prepayment and loss assumptions

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based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow and comparable yields for similar securities or preferred shares to those in which the Company has invested, or (iii) indicative prices provided by the underwriters or brokers who arrange CLO Funds. We recognize unrealized appreciation or depreciation on our investments in CLO Fund Securities as comparable yields in the market change and/or based on changes in net asset values or estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool. As each investment in CLO Fund Securities ages, the expected amount of losses and the expected timing of recognition of such losses in the underlying collateral pool are updated and the revised cash flows are used in determining the fair value of the CLO Fund Securities. We determine the fair value of our investments in CLO Fund Securities on a security-by-security basis.

The Company's investments in its wholly-owned Asset Manager Affiliates are carried at fair value, which is primarily determined utilizing a discounted cash flow model which incorporates different levels of discount rates depending on the hierarchy of fees earned (including the likelihood of realization of senior, subordinate and incentive fees) and prospective modeled performance ( Discounted Cash Flow ). Such valuation takes into consideration an analysis of comparable asset management companies and a percentage of assets under management. The Asset Manager Affiliates are classified as a Level III investment (as described above). Any change in value from period to period is recognized as net change in unrealized appreciation or depreciation.

Fair values of other investments for which market prices are not observable are determined by reference to public market or private transactions or valuations for comparable companies or assets in the relevant asset class and/or industry when such amounts are available. Generally these valuations are derived by multiplying a key performance metric of the investee company or asset (e.g., EBITDA) by the relevant valuation multiple observed for comparable companies or transactions, adjusted by management for differences between the investment and the referenced comparable. Such investments may also be valued at cost for a period of time after an acquisition as the best indicator of fair value. If the fair value of such investments cannot be valued by reference to observable valuation measures for comparable companies, then the primary analytical method used to estimate the fair value is a discounted cash flow method and/or cap rate analysis. A sensitivity analysis is applied to the estimated future cash flows using various factors depending on the investment, including assumed growth rates (in cash flows), capitalization rates (for determining terminal values) and appropriate discount rates to determine a range of reasonable values or to compute projected return on investment.

For bond rated note tranches of CLO Fund securities (those above the junior class) without transactions to support a fair value for the specific CLO Fund and tranche, fair value is based on discounting estimated bond payments at current market yields, which may reflect the adjusted yield on the leveraged loan index for similarly rated tranches, as well as prices for similar tranches for other CLO Funds and also other factors such as indicative prices provided by underwriters or brokers who arrange CLO Funds, and the default and recovery rates of underlying assets in the CLO Fund, as may be applicable. Such model assumptions may vary and incorporate adjustments for risk premiums and CLO Fund specific attributes.

We derive fair value for our illiquid loan investments that do not have indicative fair values based upon active trades primarily by using the Income Approach, and also consider recent loan amendments or other activity specific to the subject asset as described above. Other significant assumptions, such as coupon and maturity, are asset-specific and are noted for each investment in the Schedules of Investments.

The determination of fair value using this methodology takes into consideration a range of factors, including but not limited to the price at which the investment was acquired, the nature of the investment, local market conditions, trading values on public exchanges for comparable securities, current and projected operating performance and financing transactions subsequent to the acquisition of the investment. This valuation methodology involves a

significant degree of Management's judgment.

Our Board of Directors may consider other methods of valuation to determine the fair value of investments as appropriate in conformity with GAAP.

## Interest Income

Interest income, including amortization of premium and accretion of discount and accrual of payment-in-kind ( PIK ) interest, is recorded on the accrual basis to the extent that such amounts are

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expected to be collected. We generally place a loan on non-accrual status and cease recognizing interest income on such loan or security when a loan or security becomes 90 days or more past due or if we otherwise do not expect the debtor to be able to service its debt obligations. For investments with PIK interest, which represents contractual interest accrued and added to the principal balance that generally becomes due at maturity, we will not accrue PIK interest if the portfolio company valuation indicates that the PIK interest is not collectible (i.e. via a partial or full non-accrual). Loans which are on partial or full non-accrual remain in such status until the borrower has demonstrated the ability and intent to pay contractual amounts due, or such loans become current. As of December 31, 2016, two of our investments were on partial non-accrual status, whereby we have recognized income on a portion of contractual PIK amounts due. As of December 31, 2015, there was one issuer on non-accrual status.

## **Investment Income on CLO Fund Securities**

We receive distributions from our investments in the most junior class of securities of CLO Funds (typically preferred shares or subordinated securities) managed by the Asset Manager Affiliates and selective investments in securities issued by funds managed by other asset management companies. Our CLO Fund junior class securities are subordinated to senior note holders who typically receive a return on their investment at a fixed spread relative to the LIBOR index. The CLO Funds are leveraged funds and any excess cash flow or excess spread (interest earned by the underlying securities in the fund less payments made to senior note holders and less fund expenses and management fees) is paid to the holders of the CLO Fund's subordinated securities or preferred shares. The level of excess spread from CLO Fund securities can be impacted from the timing and level of the resetting of the benchmark interest rate for the underlying assets (which reset at various times throughout the quarter) in the CLO Fund and the related CLO Fund note liabilities (which reset at each quarterly distribution date); in periods of short-term and volatile changes in the benchmark interest rate, the levels of excess spread and distributions to us can vary significantly. In addition, the failure of CLO Funds in which we invest to comply with certain financial covenants may lead to the temporary suspension or deferral of cash distributions to us.

GAAP-basis investment income on CLO equity investments is recorded using the effective interest method in accordance with the provisions of ASC 325-40, based on the anticipated yield and the estimated cash flows over the projected life of the investment. Yields are revised when there are changes in actual or estimated projected future cash flows due to changes in prepayments and/or re-investments, credit losses or asset pricing. Changes in estimated yield are recognized as an adjustment to the estimated yield prospectively over the remaining life of the investment from the date the estimated yield was changed. Accordingly, investment income recognized on CLO equity securities in the GAAP statement of operations differs from both the tax-basis investment income and from the cash distributions actually received by the Company during the period.

For non-junior class CLO Fund Securities, such as our investment in the class E notes of Catamaran 2014-1, interest is earned at a fixed spread relative to the LIBOR index.

## **Distributions from Asset Manager Affiliates**

We record distributions from our Asset Manager Affiliates on the declaration date, which represents the ex-dividend date. Distributions in excess of tax-basis earnings and profits are recorded as tax-basis return of capital. For interim periods, the Company estimates the tax attributes of any distributions as being either tax-basis earnings and profits (i.e. dividend income) or return of capital (i.e. adjustment to the Company's cost basis in the Asset Manager Affiliates). The final determination of the tax attributes of distributions from our Asset Manager Affiliates is made on an annual (full calendar year) basis at the end of the year based upon taxable income and distributions for the full-year. Therefore, any estimate of tax attributes of distributions made on a quarterly basis may not be representative of the



actual tax attributes of distributions for a full year.

## **Payment in Kind Interest**

We may have loans in our portfolio that contain a payment-in-kind ( PIK ) provision. PIK interest, computed at the contractual rate specified in each loan agreement, is added to the principal balance of the loan and recorded as interest income. To maintain our RIC status, this non-cash source of income must be distributed to stockholders in the form of cash dividends, even though the Company has not yet collected any cash.

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### **Fee Income**

Fee income includes fees, if any, for due diligence, structuring, commitment and facility fees, and fees, if any, for transaction services and management services rendered by us to portfolio companies and other third parties.

Commitment and facility fees are generally recognized as income over the life of the underlying loan, whereas due diligence, structuring, transaction service and management service fees are generally recognized as income when the services are rendered.

### **Management Compensation**

We may, from time to time, issue stock options or restricted stock, under the Equity Incentive Plan, to officers and employees for services rendered to us. We follow Accounting Standards Codification 718, Compensation – Stock Compensation, a method by which the fair value of options or restricted stock is determined and expensed.

### **United States Federal Income Taxes**

The Company has elected and intends to continue to qualify for the tax treatment applicable to RICs under Subchapter M of the Code and, among other things, intends to make the required distributions to its stockholders as specified therein. In order to qualify as a RIC, the Company is required to timely distribute to its stockholders at least 90% of investment company taxable income, as defined by the Code, for each year. Depending on the level of taxable income earned in a tax year, we may choose to carry forward taxable income in excess of current year distributions into the next tax year and pay a 4% excise tax on such income, to the extent required.

### **Distributions to Shareholders**

The amount of our declared distributions, as evaluated by management and approved by our Board of Directors, is based primarily on our evaluation of net investment income, distributable taxable income and the after-tax free cash flow from our Asset Manager Affiliates.

### **Recent Accounting Pronouncements**

See Note 2 to the financial statements included in this annual report, for a description of recent accounting pronouncements.

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#### ***Quantitative and Qualitative Disclosures about Market Risk***

Our business activities contain elements of market risks. We consider our principal market risks to be fluctuations in interest rates and the valuations of our investment portfolio. Managing these risks is essential to our business. Accordingly, we have systems and procedures designed to identify and analyze our risks, to establish appropriate policies and thresholds and to continually monitor these risks and thresholds by means of administrative and information technology systems and other policies and processes.

### **Interest Rate Risk**

Interest rate risk is defined as the sensitivity of our current and future earnings to interest rate volatility, variability of

spread relationships, the difference in re-pricing intervals between our assets and liabilities and the effect that interest rates may have on our cash flows. Changes in the general level of interest rates can affect our net interest income, which is the difference between the interest income earned on interest earning assets and our interest expense incurred in connection with our interest bearing debt and liabilities. Changes in interest rates can also affect, among other things, our ability to acquire and originate loans and securities and the value of our investment portfolio.

Our investment income is affected by fluctuations in various interest rates, including LIBOR and prime rates. As of December 31, 2016, approximately 98% of our Debt Securities Portfolio were either fixed rate or floating rate with a spread to an interest rate index such as LIBOR or the prime rate. Most of these floating rate loans contain LIBOR floors ranging between 0.75% and 3.0%. We generally expect that future portfolio investments will predominately be floating rate investments. As of December 31, 2016, we had \$181 million of borrowings outstanding at a current weighted average rate of 3.9%.

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Because we borrow money to make investments, our net investment income is dependent upon the difference between our borrowing rate and the rate we earn on the invested proceeds borrowed. In periods of rising or lowering interest rates, the cost of the portion of our debt associated with our 7.375% Notes Due 2019 would remain the same at 7.375%, given that this debt is at a fixed rate. The Notes issued by KCAP Senior Funding are floating rate based upon a LIBOR index plus a spread, which serves as a floor should LIBOR decrease to zero. Accordingly, our interest costs associated with this debt will fluctuate with changes in LIBOR.

Generally we would expect that an increase in the base rate index for our floating rate investment assets would increase our gross investment income and that a decrease in the base rate index for such assets would decrease our gross investment income (in either case, such increase/decrease may be limited by interest rate floors/minimums for certain investment assets).

We have analyzed the potential impact of changes in interest rates on interest income net of interest expense. Assuming that our balance sheet at December 31, 2016 was to remain constant and no actions were taken to alter the existing interest rate sensitivity, the table below illustrates the impact on net investment income on our Debt Securities Portfolio for various hypothetical increases in interest rates:

|                           | Impact on net investment income<br>from a change in interest rates at: |              |              |
|---------------------------|--|--------------|--------------|
|                           | 1%   | 2%           | 3%           |
| Increase in interest rate | \$ 691,095   | \$ 1,455,253 | \$ 2,219,412 |
| Decrease in interest rate | \$ 1,230,445   | \$ 1,230,445 | \$ 1,230,445 |

As shown above, net investment income assuming a 1% increase in interest rates would increase by approximately \$691,000 on an annualized basis, reflecting the impact to investments in our portfolio that are either fixed rate or which have embedded floors that would be unaffected by a 1% change in the underlying interest rate while our interest expense would be increasing. However, if the increase in rates was more significant, such as 2% or 3%, the net effect on net investment income would be an increase of approximately \$1.5 million and \$2.2 million, respectively. Since LIBOR underlying certain investments, as well as certain of our borrowings, is currently low, it is unlikely that the underlying rate will decrease by 1% or 2% or even 3%. If the underlying rate decreased to 0%, it would result in approximately a \$1.2 million increase in net investment income.

Although management believes that this measure is indicative of sensitivity to interest rate changes on our Debt Securities Portfolio, it does not adjust for potential changes in credit quality, size and composition of the assets on the balance sheet and other business developments that could affect a net change in assets resulting from operations or net income. Accordingly, no assurances can be given that actual results would not materially differ from the potential outcome simulated by this estimate.

We did not hold any derivative financial instruments for hedging purposes as of December 31, 2016.

## **Portfolio Valuation**

We carry our investments at fair value, as determined in good faith by our Board of Directors pursuant to a valuation methodology approved by our Board of Directors. Investments for which market quotations are generally readily available are generally valued at such market quotations. Investments for which there is not a readily available market value are valued at fair value as determined in good faith by our Board of Directors under a valuation policy and consistently applied valuation process. However, due to the inherent uncertainty of determining the fair value of

investments that cannot be marked to market, the fair value of our investments may differ materially from the values that would have been used had a ready market existed for such investments. In addition, changes in the market environment and other events that may occur over the life of the investments may cause the value realized on these investments to be different than the valuations that are assigned. The types of factors that we may take into account in fair value pricing of our investments include, as relevant, the nature and realizable value of any collateral, third party valuations, the portfolio company's ability to make payments and its earnings and discounted cash flow, the markets in which the portfolio company does business, comparison to publicly-traded securities, recent sales of or offers to buy comparable companies, and other relevant factors.

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The Company has engaged an independent valuation firm to provide third party valuation consulting services to the Company's Board of Directors. Each quarter, the independent valuation firm will perform third party valuations on the Company's material investments in illiquid securities such that they are reviewed at least once during a trailing 12-month period. These third party valuation estimates were considered as one of the relevant data inputs in the Company's determination of fair value. The Company intends to continue to engage an independent valuation firm in the future to provide certain valuation services, including the review of certain portfolio assets, as part of the quarterly and annual year-end valuation process.

Item 8. ***Financial Statements and Supplementary Data***

Our financial statements are annexed to this Annual Report beginning on page F-1.

Item 9. ***Changes in and Disagreements with Accountants on Accounting and Financial Disclosure***  
None

Item 9A. ***Controls and Procedures***  
**Evaluation of Disclosure Controls and Procedures.**

The Company's management, under the supervision and with the participation of various members of management, including its Chief Executive Officer ( CEO ) and its Chief Financial Officer ( CFO ), has evaluated the effectiveness of its disclosure controls and procedures (as defined in Rule 13a-15(e) or Rule 15d-15(e) of the Exchange Act) as of the end of the period covered by this report. Based upon that evaluation, the Company's CEO and CFO have concluded that the Company's disclosure controls and procedures are effective as of the end of the period covered by this report.

### **Management's Report on Internal Control Over Financial Reporting.**

*General.* The Company's management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) of the Exchange Act. The Company's internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

*Scope of Management's Report on Internal Control Over Financial Reporting.* The Company's internal control over financial reporting includes those policies and procedures that:

Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the Company;

Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that the Company's receipts and expenditures are being made only in accordance with authorizations of the Company's management and directors; and

Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material effect on the Company's financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

*Conclusion.* Management, including the Company's CEO and CFO, assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2016. In making this assessment, management used the

criteria established in the 2013 Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on management's assessment, management concluded, subject to the limitations described under Scope of Management's Report on Internal Control Over Financial Reporting above, that the Company maintained effective internal control over financial reporting as of December 31, 2016.

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**Attestation Report of the Independent Registered Public Accounting Firm.**

The Company's independent registered public accounting firm has audited and issued a report on the Company's internal control over financial reporting, which appears in Item 15 of this report.

**Changes in Internal Control Over Financial Reporting.**

There have been no changes in our internal control over financial reporting during the fourth quarter of 2016 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Item 9B.

None.

*Other Information*



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## PART III

Item 10. ***Directors, Executive Officers and Corporate Governance***

The information required by this item will be contained in the Proxy Statement under the headings Proposal 1: Election of Directors, Control Persons and Principal Stockholders and Corporate Governance Principles and Director Information, to be filed with the Securities and Exchange Commission on or prior to April 30, 2017, and is incorporated herein by reference.

We have adopted a Sarbanes-Oxley Code of Ethics that applies to directors, officers and employees of the Company.

This code of ethics is published on our website at [www.kcapfinancial.com](http://www.kcapfinancial.com). We intend to disclose any future amendments to, or waivers from, this code of ethics within four business days of the waiver or amendment through a website posting.

Item 11. ***Executive Compensation***

The information required by this item will be contained in the Proxy Statement under the headings Proposal 1: Election of Directors, Executive Compensation, Compensation Committee Interlocks and Insider Participation and Compensation Committee Report, to be filed with the Securities and Exchange Commission on or prior to April 30, 2017, and is incorporated herein by reference.

Item 12. ***Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters***

The information required by this item will be contained in the Proxy Statement under the headings Executive Compensation and Control Persons and Principal Stockholders, to be filed with the Securities and Exchange Commission on or prior to April 30, 2017, and is incorporated herein by reference.

Item 13. ***Certain Relationships and Related Transactions, and Director Independence***

The information required by this item will be contained in the Proxy Statement under the headings Transactions with Related Persons and Proposal 1: Election of Directors, to be filed with the Securities and Exchange Commission on or prior to April 30, 2017, and is incorporated herein by reference.

Item 14. ***Principal Accountant Fees and Services***

The information required by this item will be contained in the Proxy Statement under the heading Proposal 2: Ratification of Independent Registered Public Accounting Firm, to be filed with the Securities and Exchange Commission on or prior to April 30, 2017, and is incorporated herein by reference.

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**PART IV**

Item 15. *Exhibits and Financial Statement Schedules*

**(a) Documents filed as part of this report:**

1. For a list of the consolidated financial information included herein, see Index to the Consolidated Financial Statements on page F-1.
  2. For a list of the other financial statements and financial statement schedules included herein, see Index to Other Financial Statements and Financial Statement Schedules on page S-1.
  3. For a list of other exhibits included herein, see Exhibit List on page E-1.
- (b) *Exhibits required by Item 601 of Regulation S-K.* Reference is made to the Exhibit List filed as a part of this report beginning on page E-1. Each of such exhibits is incorporated by reference herein.
- (c) *Other financial statements and financial statement schedules.* Reference is made to the Index to Other Financial Statements and Financial Statement Schedules on page S-1. Each of such documents is incorporated by reference herein.

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# SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

KCAP Financial, Inc.

By

/s/ Dayl W. Pearson

Date: March 9, 2017

**Dayl W. Pearson**

**President and Chief Executive Officer**

\* \* \* \* \*

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

| Signature                     | Title  | Date          |
|-------------------------------|--|---------------|
| /s/ Dayl W. Pearson           | President and Chief Executive Officer (principal executive officer) and Member of the Board of Directors | March 9, 2017 |
| <b>Dayl W. Pearson</b>        |  |               |
| /s/ Edward U. Gilpin          | Chief Financial Officer, Secretary and Treasurer (principal financial and accounting officer)            | March 9, 2017 |
| <b>Edward U. Gilpin</b>       |  |               |
| /s/ Christopher Lacovara      | Member of the Board of Directors   | March 9, 2017 |
| <b>Christopher Lacovara</b>   |  |               |
| /s/ John Ward                 | Member of the Board of Directors   | March 9, 2017 |
| <b>John Ward</b>              |  |               |
| /s/ C. Michael Jacobi         | Member of the Board of Directors   | March 9, 2017 |
| <b>C. Michael Jacobi</b>      |  |               |
| /s/ Albert G. Pastino         | Member of the Board of Directors   | March 9, 2017 |
| <b>Albert G. Pastino</b>      |  |               |
| /s/ C. Turney Stevens, Jr.    | Member of the Board of Directors   | March 9, 2017 |
| <b>C. Turney Stevens, Jr.</b> |  |               |
| /s/ Dean C. Kehler            | Member of the Board of Directors   | March 9, 2017 |
| <b>Dean C. Kehler</b>         |  |               |



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## INDEX TO FINANCIAL STATEMENTS

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# **Report of Independent Registered Public Accounting Firm**

The Board of Directors and Stockholders of  
**KCAP Financial, Inc.**

We have audited the accompanying consolidated balance sheets of KCAP Financial, Inc. (the Company), including the consolidated schedules of investments, as of December 31, 2016 and 2015, and the related consolidated statements of operations, changes in net assets, and cash flows and the financial highlights for each of the three years in the period ended December 31, 2016. These financial statements and financial highlights are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial highlights based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements and financial highlights. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. Our procedures included confirmation of securities owned as of December 31, 2016 and 2015, by correspondence with the custodians and management or agents of the underlying investments. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements and financial highlights referred to above present fairly, in all material respects, the consolidated financial position of KCAP Financial, Inc. at December 31, 2016 and 2015, and the consolidated results of their operations, changes in their net assets, and cash flows and the financial highlights for each of the three years in the period ended December 31, 2016, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), KCAP Financial, Inc.'s internal control over financial reporting as of December 31, 2016, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework) and our report dated March 9, 2017 expressed an unqualified opinion thereon.

/s/ ERNST & YOUNG LLP

New York, New York  
March 9, 2017

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# **REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The Board of Directors and Stockholders of  
**KCAP Financial, Inc.**

We have audited KCAP Financial, Inc.'s internal control over financial reporting as of December 31, 2016, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework), (the COSO criteria). KCAP Financial, Inc.'s management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, KCAP Financial, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2016, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements of KCAP Financial, Inc. and our report dated March 9, 2017 expressed an unqualified opinion thereon.

/s/ ERNST & YOUNG LLP

New York, New York

March 9, 2017

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|   | As of<br>December 31,<br>2016 | As of<br>December 31,<br>2015 |
|---|-------------------------------|-------------------------------|
| <b>ASSETS</b>   |                               |                               |
| Investments at fair value:  |                               |                               |
| Money market accounts (cost: 2016 \$28,699,269; 2015 \$2,129,381)   | \$28,699,269                  | \$2,129,381                   |
| Debt securities (amortized cost: 2016 \$249,520,234;<br>2015 \$298,308,845)   | 238,343,330                   | 284,639,244                   |
| CLO Fund Securities managed by affiliates (amortized cost:<br>2016 \$71,734,809; 2015 \$77,764,568)   | 51,908,784                    | 53,557,570                    |
| CLO Fund Securities managed by non-affiliates (amortized cost:<br>2016 \$5,116,508; 2015 \$5,450,379)   | 2,265,566                     | 2,314,812                     |
| Equity securities (cost: 2016 \$10,389,007; 2015 \$10,467,786)  | 5,056,355                     | 9,548,488                     |
| Asset Manager Affiliates (cost: 2016 \$55,341,230; 2015 \$56,591,230)   | 40,198,000                    | 57,381,000                    |
| Total Investments at Fair Value (cost: 2016 \$420,801,057;<br>2015 \$450,712,189)   | 366,471,304                   | 409,570,495                   |
| Cash  | 1,307,257                     |                               |
| Restricted cash   | 8,528,298                     | 7,138,272                     |
| Interest receivable   | 1,033,917                     | 1,812,624                     |
| Receivable for open trades  | 2,950,658                     |                               |
| Due from affiliates   | 612,854                       | 2,117,095                     |
| Other assets  | 467,695                       | 566,211                       |
| Total Assets  | \$381,371,983                 | \$421,204,697                 |
| <b>LIABILITIES</b>  |                               |                               |
| Notes issued by KCAP Senior Funding I, LLC (net of discount and<br>offering costs of: 2016 \$2,286,425 and \$2,459,156, respectively;<br>2015 \$2,907,595 and \$3,126,009, respectively)                                | \$142,604,419                 | \$141,316,396                 |
| 7.375% Notes Due 2019 (net of offering costs of: 2016 \$550,774;<br>2015 \$890,344)   | 32,980,151                    | 40,509,656                    |
| Convertible Notes (net of offering costs of: 2015 \$21,291)   |                               | 19,277,709                    |
| Payable for open trades   | 7,884,943                     |                               |
| Accounts payable and accrued expenses   | 2,047,405                     | 2,218,065                     |
| Accrued interest payable  | 930,086                       | 1,228,068                     |
| Due to affiliates   | 54                            | 554,333                       |
| Total Liabilities   | 186,447,058                   | 205,104,227                   |
| <b>COMMITMENTS AND CONTINGENCIES (Note 8)</b>   |                               |                               |
| <b>STOCKHOLDERS' EQUITY</b>   |                               |                               |
| Common stock, par value \$0.01 per share, 100,000,000 common shares<br>authorized; 37,282,296 issued, and 37,178,294 outstanding at December<br>31, 2016, and 37,136,353 issued, and 37,100,005 outstanding at December | 371,783                       | 371,000                       |

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|  |               |               |
|--|---------------|---------------|
| Capital in excess of par value               | 353,404,155   | 361,962,511   |
| Excess distribution of net investment income | (14,630,319 ) | (21,638,184 ) |
| Accumulated net realized losses              | (88,491,896 ) | (82,054,107 ) |
| Net unrealized depreciation on investments   | (55,728,798 ) | (42,540,750 ) |
| Total Stockholders' Equity                   | 194,924,925   | 216,100,470   |
| Total Liabilities and Stockholders' Equity   | \$381,371,983 | \$421,204,697 |
| NET ASSET VALUE PER COMMON SHARE             | \$5.24        | \$5.82        |

See accompanying notes to financial statements.

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TABLE OF CONTENTS**KCAP FINANCIAL, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS**

|   | For the Years Ended December 31, |                        |                      |
|---|----------------------------------|------------------------|----------------------|
|   | 2016                             | 2015                   | 2014                 |
| <b>Investment Income:</b>   |                                  |                        |                      |
| Interest from investments in debt securities  | \$20,828,916                     | \$24,101,257           | \$21,386,432         |
| Interest from cash and time deposits  | 29,383                           | 10,239                 | 3,452                |
| Investment income on CLO Fund Securities managed by affiliates                              | 12,642,625                       | 14,691,428             | 12,367,581           |
| Investment income on CLO Fund Securities managed by non-affiliates                          | 630,647                          | 1,008,634              | 1,045,225            |
| Dividends from Asset Manager Affiliates   | 1,400,000                        | 5,348,554              | 5,467,914            |
| Capital structuring service fees  | 668,527                          | 366,859                | 934,871              |
| Total investment income   | 36,200,098                       | 45,526,971             | 41,205,475           |
| <b>Expenses:</b>  |                                  |                        |                      |
| Interest and amortization of debt issuance costs  | 9,110,603                        | 11,727,880             | 11,538,179           |
| Compensation  | 4,103,558                        | 3,843,799              | 4,951,745            |
| Professional fees   | 2,391,038                        | 3,520,461              | 2,614,479            |
| Insurance   | 412,764                          | 433,561                | 471,276              |
| Administrative and other  | 1,692,140                        | 1,818,480              | 1,509,228            |
| Total expenses  | 17,710,103                       | 21,344,181             | 21,084,907           |
| <b>Net Investment Income</b>  | <b>18,489,995</b>                | <b>24,182,790</b>      | <b>20,120,568</b>    |
| <b>Realized And Unrealized Gains (Losses) On Investments:</b>                               |                                  |                        |                      |
| Net realized losses from investment transactions  | (6,167,467 )                     | (6,202,289 )           | (10,384,415 )        |
| Net change in unrealized (depreciation) appreciation on:                                    |                                  |                        |                      |
| Debt securities   | 2,492,707                        | (10,748,262)           | 5,641,403            |
| Equity securities   | (4,413,354 )                     | (210,167 )             | 7,040,155            |
| CLO Fund Securities managed by affiliates   | 4,380,974                        | (12,990,404)           | (11,584,257)         |
| CLO Fund Securities managed by non-affiliates   | 284,625                          | (977,483 )             | 2,884,109            |
| Asset Manager Affiliates investments  | (15,933,000)                     | (11,243,554)           | 2,064,107            |
| Total net (depreciation) appreciation from investment transactions                          | (13,188,048)                     | (36,169,870)           | 6,045,517            |
| Net realized and unrealized loss on investments   | (19,355,515)                     | (42,372,159)           | (4,338,898 )         |
| Realized losses on extinguishments of debt  | (174,211 )                       | (445,189 )             | (748,076 )           |
| <b>Net (Decrease) Increase In Stockholders' Equity Resulting From Operations</b>            | <b>\$ (1,039,731 )</b>           | <b>\$ (18,634,558)</b> | <b>\$ 15,033,594</b> |
| Net (Decrease) Increase in Stockholders' Equity Resulting from Operations per Common Share: |                                  |                        |                      |
| Basic:  | \$ (0.03 )                       | \$ (0.50 )             | \$ 0.44              |
| Diluted:  | \$ (0.03 )                       | \$ (0.50 )             | \$ 0.43              |
| Net Investment Income Per Common Share:   |                                  |                        |                      |

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|   |            |            |            |
|---|------------|------------|------------|
| Basic:  | \$0.50     | \$0.65     | \$0.59     |
| Diluted:  | \$0.50     | \$0.65     | \$0.58     |
| Weighted Average Shares of Common Stock<br>Outstanding    Basic   | 37,149,663 | 36,964,444 | 34,248,346 |
| Weighted Average Shares of Common Stock<br>Outstanding    Diluted | 37,149,663 | 36,964,444 | 34,259,977 |

See accompanying notes to financial statements.

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TABLE OF CONTENTS**KCAP FINANCIAL, INC.****CONSOLIDATED STATEMENTS OF CHANGES IN NET ASSETS**

|  | Years Ended December 31, |               |               |
|--|--------------------------|---------------|---------------|
|  | 2016                     | 2015          | 2014          |
| <b>Operations:</b>   |                          |               |               |
| Net investment income  | \$18,489,995             | \$24,182,790  | \$20,120,568  |
| Net realized losses from investment transactions   | (6,167,467 )             | (6,202,289 )  | (10,384,415 ) |
| Realized losses from extinguishments of debt   | (174,211 )               | (445,189 )    | (748,076 )    |
| Net change in unrealized (depreciation) appreciation from investments  | (13,188,048 )            | (36,169,870 ) | 6,045,517     |
| Net (decrease)/increase in stockholders' equity resulting from operations  | (1,039,731 )             | (18,634,558 ) | 15,033,594    |
| <b>Stockholder distributions:</b>  |                          |               |               |
| Distributions of ordinary income   | (14,761,679 )            | (22,985,978 ) | (26,807,154 ) |
| Return of capital  | (7,307,578 )             |               | (7,972,633 )  |
| Net decrease in net assets resulting from stockholder distributions  | (22,069,257 )            | (22,985,978 ) | (34,779,787 ) |
| <b>Capital share transactions:</b>   |                          |               |               |
| Issuance of common stock for:  |                          |               |               |
| Common stock withheld for payroll taxes upon vesting of restricted stock   | (247,926 )               | (220,301 )    |               |
| Dividend reinvestment plan   | 638,016                  | 1,051,795     | 724,935       |
| Issuance of Common Stock   |                          |               | 23,772,408    |
| Conversion of Convertible Notes  |                          |               | (927,413 )    |
| Stock based compensation   | 1,543,353                | 1,572,811     | 1,123,271     |
| Net increase in net assets resulting from capital share transactions   | 1,933,443                | 2,404,305     | 24,693,201    |
| Net assets at beginning of period  | 216,100,470              | 255,316,701   | 250,369,693   |
| Net assets at end of period (including accumulated undistributed net investment income of \$0, \$0, and \$0 in 2016, 2015, and 2014, respectively. | \$194,924,925            | \$216,100,470 | \$255,316,701 |
| Net asset value per common share   | \$5.24                   | \$5.82        | \$6.94        |
| Common shares outstanding at end of period   | 37,178,294               | 37,100,005    | 36,775,127    |

See accompanying notes to financial statements.

TABLE OF CONTENTS**KCAP FINANCIAL, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS**

|  | Years Ended December 31, |                 |               |
|--|--------------------------|-----------------|---------------|
|  | 2016                     | 2015            | 2014          |
| <b>OPERATING ACTIVITIES:</b>   |                          |                 |               |
| Net (decrease) increase in stockholder's equity resulting from operations  | \$(1,039,731 )           | \$(18,634,558 ) | \$ 15,033,594 |
| Adjustments to reconcile net increase (decrease) in stockholder's equity resulting from operations to net cash provided by/(used in) operating activities: |                          |                 |               |
| Net realized losses on investment transactions   | 6,167,467                | 6,202,289       | 10,384,415    |
| Net change in unrealized losses (gains) from investments   | 13,188,048               | 36,169,870      | (6,045,517 )  |
| Purchases of investments   | (110,229,217)            | (112,647,477)   | (249,264,398) |
| Proceeds from sales and redemptions of investments   | 133,253,936              | 132,764,940     | 195,511,479   |
| Net accretion of discount on debt securities   | 1,784,579                | 9,094,250       | 10,691,298    |
| Amortization of original issue discount on indebtedness  | 621,171                  | 604,811         | 449,568       |
| Amortization of debt issuance costs  | 845,793                  | 1,181,866       | 1,109,081     |
| Realized losses on extinguishments of debt   | 174,211                  | 445,189         | 748,076       |
| Payment-in-kind interest income  | (1,065,339 )             | (1,447,865 )    | (433,778 )    |
| Stock-based compensation expense   | 1,543,353                | 1,572,811       | 1,123,271     |
| Changes in operating assets and liabilities:   |                          |                 |               |
| Increase (Decrease) in payable for open trades   | 7,884,943                | (18,293,725 )   | 14,313,725    |
| Decrease (Increase) in interest and dividends receivable   | 778,707                  | (63,803 )       | 283,737       |
| (Increase) Decrease in accounts receivable   |                          | (591 )          | 325,259       |
| Increase in receivable for open trades   | (2,950,658 )             |                 |               |
| Decrease (Increase) in other assets  | 98,516                   | (793,461 )      | (644,715 )    |
| Decrease (Increase) in due from affiliates   | 1,504,241                | 910,315         | (227,409 )    |
| (Decrease) Increase in due to affiliates   | (554,279 )               | 523,333         | 31,000        |
| (Decrease) Increase in accounts payable and accrued expenses   | (170,660 )               | (56,086 )       | 5,558         |
| Decrease in accrued interest payable   | (297,982 )               | (338,186 )      | (62,444 )     |
| Net cash provided by (used in) operating activities  | 51,537,099               | 37,193,922      | (6,668,200 )  |
| <b>FINANCING ACTIVITIES:</b>   |                          |                 |               |
| Proceeds from issuance of common stock   |                          |                 | 23,772,408    |
| Debt issuance costs  |                          | (19,136 )       | (678,201 )    |
| Issuance of restricted shares  | 60                       | 1,921           |               |
| Forfeitures of restricted shares   | (345 )                   | (109 )          |               |
| Distributions to stockholders  | (21,431,241 )            | (31,016,373 )   | (33,307,511 ) |
| Proceeds from issuance of debt, net of discount  |                          |                 | 41,203,652    |
| Repurchase of Convertible Notes  | (19,299,000 )            | (19,348,000 )   | (11,288,413 ) |

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|  |               |               |               |
|--|---------------|---------------|---------------|
| Repurchase of 7.375% Notes Due 2019                                      | (7,861,364 )  |               |               |
| Common Stock withheld for payroll taxes upon vesting of restricted stock | (247,926 )    | (220,301 )    |               |
| (Increase) Decrease in restricted cash                                   | (1,390,026 )  | 12,187,278    | (15,246,612 ) |
| Net cash (used in) provided by financing activities                      | (50,229,842 ) | (38,414,720 ) | 4,455,323     |
| CHANGE IN CASH   | 1,307,257     | (1,220,798 )  | (2,212,877 )  |
| CASH, BEGINNING OF YEAR  |               | 1,220,798     | 3,433,675     |
| CASH, END OF YEAR  | \$ 1,307,257  | \$            | \$ 1,220,798  |
| Supplemental Information:  |               |               |               |
| Interest paid during the period  | \$ 7,902,774  | \$ 10,279,221 | \$ 9,966,425  |
| Issuance of common stock under the dividend reinvestment plan            | \$ 638,016    | \$ 1,051,795  | \$ 724,935    |

See accompanying notes to financial statements.

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As of December 31, 2016****Debt Securities Portfolio**

| Portfolio Company/Principal Business   | Investment Interest Rate <sup>(1)</sup> /Maturity  | Principal   | Amortized Cost | Fair Value <sup>(2)</sup> |
|--|--|-------------|----------------|---------------------------|
| 1A Smart Start LLC <sup>(8), (9)</sup><br><i>Consumer goods: Non-durable</i>                               | Senior Secured Loan Initial Term Loan (First Lien) 5.8% Cash, 1.0% Libor Floor, Due 2/22 | \$2,970,000 | \$2,946,408    | \$2,919,807               |
| 4L Technologies Inc. (fka Clover Holdings, Inc.) <sup>(8), (9)</sup><br><i>Consumer goods: Non-durable</i> | Senior Secured Loan Term Loan 5.5% Cash, 1.0% Libor Floor, Due 5/20                      | 2,720,465   | 2,705,259      | 2,606,194                 |
| Advanced Lighting Technologies, Inc. <sup>(8), (9), (14)</sup><br><i>Consumer goods: Durable</i>           | First Lien Bond 12.500% 6/2019 00753CAG7 5.3% Cash, 7.3% PIK, Due 6/19                   | 3,060,919   | 3,060,919      | 1,089,338                 |
| Advantage Sales & Marketing Inc. <sup>(8)</sup><br><i>Services: Business</i>                               | Junior Secured Loan Term Loan (Second Lien) 7.5% Cash, 1.0% Libor Floor, Due 7/22        | 1,000,000   | 1,001,753      | 995,300                   |
| Alere Inc. (fka IM US Holdings, LLC) <sup>(9)</sup><br><i>Healthcare &amp; Pharmaceuticals</i>             | Senior Secured Loan B Term Loan 4.3% Cash, 1.0% Libor Floor, Due 6/22                    | 3,030,277   | 3,024,429      | 3,034,489                 |
| American Seafoods Group LLC <sup>(8), (9)</sup><br><i>Beverage, Food and Tobacco</i>                       | Senior Secured Loan Term Loan (First Lien) 6.0% Cash, 1.0% Libor Floor, Due 8/21         | 3,853,704   | 3,838,792      | 3,874,899                 |
| Anaren, Inc. <sup>(8), (9)</sup><br><i>Aerospace and Defense</i>   | Senior Secured Loan Term Loan (First Lien) 5.5% Cash, 1.0% Libor Floor, Due 2/21         | 1,871,912   | 1,860,822      | 1,864,237                 |
| Apco Holdings, Inc. <sup>(8), (9)</sup><br><i>Services: Business</i>                                       | Senior Secured Loan Initial Term Loan 7.0% Cash, 1.0% Libor Floor, Due 1/22              | 3,867,838   | 3,769,454      | 3,900,714                 |
| API Technologies Corp. <sup>(8), (9)</sup><br><i>High Tech Industries</i>                                  | Senior Secured Loan Initial Term Loan 7.5% Cash, 1.0% Libor Floor, Due 4/22              | 3,482,500   | 3,420,642      | 3,480,759                 |
| Aristotle Corporation, The <sup>(8), (9)</sup><br><i>Consumer goods: Non-durable</i>                       | Senior Secured Loan Term Loan 5.5% Cash, 1.0% Libor                                      | 3,665,860   | 3,652,075      | 3,604,274                 |



|  |   |           |           |           |
|--|---|-----------|-----------|-----------|
|  | Floor,<br>Due 6/21  |           |           |           |
| Asurion, LLC (fka Asurion Corporation) <sup>(8), (9)</sup><br><i>Banking, Finance, Insurance &amp; Real Estate</i> | Senior Secured Loan Incremental Tranche B-4 Term Loan 5.0% Cash, 1.0% Libor Floor, Due 8/22 | 876,911   | 873,399   | 889,736   |
| Asurion, LLC (fka Asurion Corporation) <sup>(8), (9)</sup><br><i>Banking, Finance, Insurance &amp; Real Estate</i> | Senior Secured Loan Replacement B-2 Term Loan 4.0% Cash, 0.8% Libor Floor, Due 7/20         | 187,812   | 188,275   | 189,719   |
| Avalign Technologies, Inc. <sup>(8)</sup><br><i>Healthcare &amp; Pharmaceuticals</i>                               | Junior Secured Loan Initial Term Loan (Second Lien) 9.5% Cash, 1.0% Libor Floor, Due 7/22   | 1,000,000 | 992,078   | 985,000   |
| Avalign Technologies, Inc. <sup>(8), (9)</sup><br><i>Healthcare &amp; Pharmaceuticals</i>                          | Senior Secured Loan Initial Term Loan (First Lien) 5.5% Cash, 1.0% Libor Floor, Due 7/21    | 2,925,000 | 2,913,921 | 2,915,640 |
| Bankruptcy Management Solutions, Inc. <sup>(8)</sup><br><i>Services: Business</i>                                  | Senior Secured Loan Term B Loan 7.0% Cash, 1.0% Libor Floor, Due 6/18                       | 665,654   | 665,654   | 655,935   |
| BarBri, Inc. (Gemini Holdings, Inc.) <sup>(8), (9)</sup><br><i>Services: Consumer</i>                              | Senior Secured Loan Term Loan 4.5% Cash, 1.0% Libor Floor, Due 7/19                         | 2,619,636 | 2,614,056 | 2,578,508 |
| BBB Industries US Holdings, Inc. <sup>(8), (9)</sup><br><i>Automotive</i>  | Senior Secured Loan Initial Term Loan (First Lien) 6.0% Cash, 1.0% Libor Floor, Due 11/21   | 2,947,500 | 2,906,715 | 2,800,125 |
| Bestop, Inc. <sup>(8), (9)</sup><br><i>Automotive</i>  | Senior Secured Loan Delayed Draw Term Loan 6.3% Cash, 1.0% Libor Floor, Due 7/21            | 34,660    | 32,776    | 34,466    |
| Bestop, Inc. <sup>(8), (9)</sup><br><i>Automotive</i>  | Senior Secured Loan First Amendment Term Loan 6.3% Cash, 1.0% Libor Floor, Due 7/21         | 500,000   | 495,290   | 497,200   |

See accompanying notes to financial statements.

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| Portfolio Company/Principal Business   | Investment Interest Rate <sup>(1)</sup> /Maturity   | Principal   | Amortized Cost | Fair Value <sup>(2)</sup> |
|--|---|-------------|----------------|---------------------------|
| Bestop, Inc. <sup>(8), (9)</sup><br><i>Automotive</i>  | Senior Secured Loan Term<br>Loan 6.3% Cash, 1.0% Libor<br>Floor,<br>Due 7/21                      | \$1,520,000 | \$1,498,330    | \$1,452,512               |
| Carolina Beverage Group LLC <sup>(8)</sup><br><i>Beverage, Food and Tobacco</i>  | Senior Secured<br>Bond 10.625% 08/2018<br>143818AA0 144A 10.6%<br>Cash,<br>Due 8/18               | 1,500,000   | 1,506,461      | 1,487,400                 |
| CCS Intermediate Holdings,<br>LLC <sup>(8), (9)</sup><br><i>Healthcare &amp; Pharmaceuticals</i>   | Senior Secured Loan Initial<br>Term Loan (First Lien) 5.0%<br>Cash, 1.0% Libor Floor, Due<br>7/21 | 2,932,500   | 2,922,875      | 2,470,338                 |
| Cengage Learning, Inc. <sup>(8), (9)</sup><br><i>Media: Advertising, Printing &amp; Publishing</i>   | Senior Secured Loan 2016<br>Refinancing Term Loan<br>5.3% Cash, 1.0% Libor<br>Floor, Due 6/23     | 3,793,913   | 3,788,981      | 3,702,043                 |
| Checkout Holding Corp. (fka<br>Catalina Marketing) <sup>(8), (9)</sup><br><i>Media: Advertising, Printing &amp; Publishing</i>                           | Senior Secured Loan Term<br>B Loan (First Lien) 4.5%<br>Cash, 1.0% Libor Floor, Due<br>4/21       | 975,000     | 972,021        | 853,125                   |
| CHS/Community Health<br>Systems, Inc. <sup>(9)</sup><br><i>Healthcare &amp; Pharmaceuticals</i>  | Senior Secured<br>Loan Incremental 2021<br>Term H Loan 4.0% Cash,<br>1.0% Libor Floor, Due 1/21   | 2,878,621   | 2,853,070      | 2,796,465                 |
| Consolidated Communications,<br>Inc. <sup>(9)</sup><br><i>Telecommunications</i>   | Senior Secured Loan Initial<br>Term Loan 4.0% Cash, 1.0%<br>Libor Floor, Due 10/23                | 2,067,444   | 2,062,450      | 2,067,444                 |
| CRGT Inc. <sup>(8), (9)</sup><br><i>High Tech Industries</i>   | Senior Secured Loan Term<br>Loan 7.5% Cash, 1.0% Libor<br>Floor,<br>Due 12/20                     | 3,224,017   | 3,190,360      | 3,224,339                 |
| CSM Bakery Solutions Limited<br>(fka CSM Bakery Supplies<br>Limited) <sup>(8)</sup><br><i>Beverage, Food and Tobacco</i>                                 | Junior Secured Loan Term<br>Loan (Second Lien) 8.8%<br>Cash, 1.0% Libor Floor, Due<br>7/21        | 3,000,000   | 3,011,328      | 2,463,000                 |
| CT Technologies Intermediate<br>Holdings, Inc. (Smart Holdings<br>Corp.) (aka HealthPort) <sup>(8), (9)</sup><br><i>Healthcare &amp; Pharmaceuticals</i> | Senior Secured Loan New<br>Term Loan Facility 5.3%<br>Cash, 1.0% Libor Floor, Due<br>12/21        | 2,940,225   | 2,917,719      | 2,818,941                 |
| Drew Marine Group Inc. <sup>(8)</sup><br><i>Transportation: Cargo</i>  | Junior Secured Loan Term<br>Loan (Second Lien) 8.0%<br>Cash, 1.0% Libor Floor, Due<br>5/21        | 2,500,000   | 2,496,331      | 2,380,000                 |
|  |   | 2,796,756   | 2,814,422      | 2,826,122                 |

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|  |   |           |           |           |
|--|---|-----------|-----------|-----------|
| Eastern Power, LLC (Eastern Covert Midco, LLC) (aka TPF II LC, LLC) <sup>(8), (9)</sup><br><i>Utilities: Electric</i>      | Senior Secured Loan Term Loan 5.0% Cash, 1.0% Libor Floor,<br>Due 10/21               |           |           |           |
| Electric Lightwave Holdings, Inc. (f.k.a. Integra Telecom Holdings, Inc.) <sup>(8), (9)</sup><br><i>Telecommunications</i> | Senior Secured Loan Term B-1 Loan 5.3% Cash, 1.0% Libor Floor, Due 8/20               | 2,932,538 | 2,924,968 | 2,945,734 |
| ELO Touch Solutions, Inc. <sup>(8), (9)</sup><br><i>High Tech Industries</i>   | Senior Secured Loan Term Loan (First Lien) 8.5% Cash, 1.5% Libor Floor, Due 6/18      | 1,420,897 | 1,397,046 | 1,380,544 |
| Empower Payments Acquisition, Inc. <sup>(8), (9)</sup><br><i>Services: Business</i>  | Senior Secured Loan Term Loan 6.5% Cash, 1.0% Libor Floor,<br>Due 11/23               | 3,000,000 | 2,940,565 | 2,940,000 |
| EWT Holdings III Corp. (fka WTG Holdings III Corp.) <sup>(8), (9)</sup><br><i>Ecological</i>                               | Senior Secured Loan Term Loan (First Lien) 4.8% Cash, 1.0% Libor Floor, Due 1/21      | 1,745,501 | 1,741,292 | 1,760,783 |
| Fender Musical Instruments Corporation <sup>(8), (9)</sup><br><i>Consumer goods: Durable</i>                               | Senior Secured Loan Initial Loan 5.8% Cash, 1.3% Libor Floor,<br>Due 4/19             | 1,339,534 | 1,345,751 | 1,322,254 |
| FHC Health Systems, Inc. <sup>(8), (9)</sup><br><i>Healthcare &amp; Pharmaceuticals</i>                                    | Senior Secured Loan Initial Term Loan 5.0% Cash, 1.0% Libor Floor, Due 12/21          | 3,838,768 | 3,811,221 | 3,742,799 |
| First American Payment Systems, L.P. <sup>(8)</sup><br><i>Banking, Finance, Insurance &amp; Real Estate</i>                | Junior Secured Loan Term Loan (Second Lien) 10.8% Cash, 1.3% Libor Floor,<br>Due 4/19 | 1,796,448 | 1,783,840 | 1,742,555 |
| Getty Images, Inc. <sup>(8), (9)</sup><br><i>Media: Advertising, Printing &amp; Publishing</i>                             | Senior Secured Loan Initial Term Loan 4.8% Cash, 1.3% Libor Floor, Due 10/19          | 2,140,569 | 2,147,692 | 1,874,775 |
| GI Advo Opco, LLC <sup>(8)</sup><br><i>Healthcare &amp; Pharmaceuticals</i>  | Senior Secured Loan Term Loan 5.5% Cash, 1.0% Libor Floor,<br>Due 11/21               | 247,500   | 245,474   | 223,913   |

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| Portfolio Company/Principal Business  | Investment Interest Rate <sup>(1)</sup> /Maturity   | Principal   | Amortized Cost | Fair Value <sup>(2)</sup> |
|---|---|-------------|----------------|---------------------------|
| GI Advo Opco, LLC <sup>(8), (9)</sup><br><i>Healthcare &amp; Pharmaceuticals</i>  | Senior Secured<br>Loan Term Loan 5.5% Cash, 1.0% Libor Floor, Due 11/21                       | \$2,722,500 | \$2,700,224    | \$2,463,046               |
| GK Holdings, Inc. (aka Global Knowledge) <sup>(8)</sup><br><i>Services: Business</i>  | Junior Secured<br>Loan Initial Term Loan (Second Lien) 10.5% Cash, 1.0% Libor Floor, Due 1/22 | 1,500,000   | 1,478,209      | 1,465,650                 |
| GK Holdings, Inc. (aka Global Knowledge) <sup>(8), (9)</sup><br><i>Services: Business</i>                                     | Senior Secured<br>Loan Initial Term Loan (First Lien) 6.5% Cash, 1.0% Libor Floor, Due 1/21   | 2,450,000   | 2,433,329      | 2,446,080                 |
| Global Tel*Link Corporation <sup>(8)</sup><br><i>Telecommunications</i>   | Junior Secured<br>Loan Term Loan (Second Lien) 9.0% Cash, 1.3% Libor Floor, Due 11/20         | 4,000,000   | 3,957,505      | 3,894,500                 |
| Gold Standard Baking, Inc. <sup>(8), (9)</sup><br><i>Beverage, Food and Tobacco</i>   | Senior Secured<br>Loan Term Loan 5.3% Cash, 1.0% Libor Floor, Due 4/21                        | 2,462,500   | 2,453,554      | 2,461,269                 |
| Grande Communications Networks LLC <sup>(8), (9)</sup><br><i>Telecommunications</i>   | Senior Secured<br>Loan Initial Term Loan 4.5% Cash, 1.0% Libor Floor, Due 5/20                | 3,860,145   | 3,864,877      | 3,860,145                 |
| Grupo HIMA San Pablo, Inc. <sup>(8)</sup><br><i>Healthcare &amp; Pharmaceuticals</i>  | Senior Secured<br>Loan Term B Loan (First Lien) 8.5% Cash, 1.5% Libor Floor, Due 1/18         | 2,887,500   | 2,875,001      | 2,743,125                 |
| Grupo HIMA San Pablo, Inc. <sup>(8)</sup><br><i>Healthcare &amp; Pharmaceuticals</i>  | Junior Secured<br>Loan Term Loan (Second Lien) 13.8% Cash, Due 7/18                           | 7,000,000   | 6,953,618      | 6,370,000                 |
| Gymboree Corporation., The <sup>(8), (9)</sup><br><i>Retail</i>   | Senior Secured<br>Loan Term Loan 5.0% Cash, 1.5% Libor Floor, Due 2/18                        | 1,421,105   | 1,415,457      | 759,581                   |
| Hargray Communications Group, Inc. (HCP Acquisition LLC) <sup>(8), (9)</sup><br><i>Media: Broadcasting &amp; Subscription</i> | Senior Secured<br>Loan Term B-1 Loan 4.8% Cash, 1.0% Libor Floor, Due 6/19                    | 2,887,075   | 2,860,733      | 2,926,166                 |
| Harland Clarke Holdings Corp. (fka Clarke American Corp.) <sup>(8), (9)</sup><br><i>Media: Advertising, Printing &amp;</i>    | Senior Secured<br>Loan Tranche B-3 Term Loan 7.0% Cash, 1.5%                                  | 1,697,272   | 1,690,708      | 1,703,637                 |

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|   |   |           |           |           |
|---|---|-----------|-----------|-----------|
| <i>Publishing</i>   | Libor Floor, Due 5/18   |           |           |           |
| Harland Clarke Holdings Corp.<br>(fka Clarke American Corp.)(8), (9)                | Senior Secured<br>Loan Tranche B-4 Term   | 1,387,500 | 1,384,229 | 1,391,545 |
| <i>Media: Advertising, Printing &amp; Publishing</i>                                | Loan 7.0% Cash, 1.0%<br>Libor Floor, Due 8/19   |           |           |           |
| Harland Clarke Holdings Corp.<br>(fka Clarke American Corp.)(8), (9)                | Senior Secured<br>Loan Tranche B-5 Term   | 1,385,417 | 1,369,287 | 1,395,980 |
| <i>Media: Advertising, Printing &amp; Publishing</i>                                | Loan 7.0% Cash, 1.0%<br>Libor Floor, Due 12/19  |           |           |           |
| Highland Acquisition Holdings,<br>LLC (aka HealthSun Health Plans,<br>Inc.)(8), (9) | Senior Secured<br>Loan Term Loan B 6.5%<br>Cash, 1.0% Libor Floor,<br>Due 11/22                         | 2,000,000 | 1,903,216 | 1,910,000 |
| <i>Healthcare &amp; Pharmaceuticals</i>   | Junior Secured<br>Loan Initial Term Loan<br>(Second Lien) 10.5%<br>Cash, 1.0% Libor Floor,<br>Due 11/24 | 1,600,000 | 1,552,544 | 1,524,640 |
| Hoffmaster Group, Inc.(8)   | Senior Secured<br>Loan Initial Term Loan<br>(First Lien) 5.5% Cash,<br>1.0% Libor Floor, Due<br>11/23   | 2,666,667 | 2,640,345 | 2,668,267 |
| <i>Forest Products &amp; Paper</i>  | Senior Secured<br>Loan Term Loan 6.0%<br>Cash, 1.0% Libor Floor,<br>Due 6/22                            | 2,925,000 | 2,898,235 | 2,925,000 |
| Industrial Services Acquisition,<br>LLC (aka Evergreen/NAIC)(8), (9)                | Senior Secured<br>Loan Initial Term Loan<br>(First Lien) 6.0% Cash,<br>1.0% Libor Floor, Due<br>10/21   | 1,950,120 | 1,936,641 | 1,943,100 |
| <i>Environmental Industries</i>   | Senior Secured<br>Loan Initial Term Loan<br>5.5% Cash, 1.0% Libor<br>Floor, Due 8/21                    | 1,394,077 | 1,389,440 | 1,411,851 |
| Kellermeyer Bergensons Services,<br>LLC(8), (9)                                     | Senior Secured<br>Loan Term Loan (First<br>Lien) 5.5% Cash, 1.0%<br>Libor Floor, Due 9/22               | 1,850,467 | 1,846,044 | 1,850,467 |
| <i>Services: Business</i>   | Senior Secured<br>Loan Initial Term Loan<br>6.5% Cash, 1.0% Libor<br>Floor, Due 12/22                   | 1,342,500 | 1,331,454 | 1,342,366 |
| Key Safety Systems, Inc.(8), (9)  |   |           |           |           |
| <i>Automotive</i>   |   |           |           |           |
| Landslide Holdings, Inc.(8), (9)  |   |           |           |           |
| <i>High Tech Industries</i>   |   |           |           |           |
| MB Aerospace ACP Holdings II<br>Corp.(8), (9)                                       |   |           |           |           |
| <i>Aerospace and Defense</i>  |   |           |           |           |

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| Portfolio Company/Principal Business  | Investment Interest Rate <sup>(1)</sup> /Maturity  | Principal   | Amortized Cost | Fair Value <sup>(2)</sup> |
|---|--|-------------|----------------|---------------------------|
| Medrisk, Inc. <sup>(8), (9)</sup><br><i>Healthcare &amp; Pharmaceuticals</i>                              | Senior Secured<br>Loan Term Loan 6.3%<br>Cash, 1.0% Libor Floor,<br>Due 2/23                             | \$1,985,000 | \$1,967,461    | \$1,985,000               |
| MGOC, Inc. (fka Media General, Inc.) <sup>(9)</sup><br><i>Media: Broadcasting &amp; Subscription</i>      | Senior Secured<br>Loan Term B Loan 4.0%<br>Cash, 1.0% Libor Floor,<br>Due 7/20                           | 2,417,989   | 2,419,940      | 2,417,989                 |
| National Home Health Care Corp. <sup>(8)</sup><br><i>Healthcare &amp; Pharmaceuticals</i>                 | Junior Secured<br>Loan Term Loan (Second Lien) 11.8% Cash, 1.0%<br>Libor Floor, Due 12/22                | 1,500,000   | 1,477,675      | 1,477,500                 |
| National Home Health Care Corp. <sup>(8), (9)</sup><br><i>Healthcare &amp; Pharmaceuticals</i>            | Senior Secured<br>Loan Term Loan (First Lien) 5.5% Cash, 1.0%<br>Libor Floor, Due 12/21                  | 3,000,000   | 2,970,280      | 2,970,000                 |
| Nellson Nutraceutical, LLC <sup>(8), (9)</sup><br><i>Beverage, Food and Tobacco</i>                       | Senior Secured<br>Loan Term A-1 Loan<br>(First Lien) 6.0% Cash,<br>1.0% Libor Floor, Due<br>12/21        | 2,350,684   | 2,335,796      | 2,350,449                 |
| Nellson Nutraceutical, LLC <sup>(8), (9)</sup><br><i>Beverage, Food and Tobacco</i>                       | Senior Secured<br>Loan Term A-2 Loan<br>(First Lien) 6.0% Cash,<br>1.0% Libor Floor, Due<br>12/21        | 2,066,562   | 2,052,899      | 2,066,355                 |
| Nielsen & Bainbridge, LLC <sup>(8), (9)</sup><br><i>Consumer goods: Durable</i>                           | Senior Secured<br>Loan Term Loan (First Lien) 6.2% Cash, 1.0%<br>Libor Floor, Due 8/20                   | 5,361,360   | 5,326,136      | 5,199,447                 |
| NM Z Parent Inc. (aka Zep, Inc.) <sup>(8), (9)</sup><br><i>Chemicals, Plastics and Rubber</i>             | Senior Secured<br>Loan 2016 Term Loan<br>5.0% Cash, 1.0% Libor<br>Floor, Due 6/22                        | 3,447,500   | 3,459,466      | 3,481,630                 |
| Novitex Acquisition, LLC (fka ARSloane Acquisition, LLC) <sup>(8), (9)</sup><br><i>Services: Business</i> | Senior Secured<br>Loan Tranche B-2 Term<br>Loan (First Lien) 8.0%<br>Cash, 1.3% Libor Floor,<br>Due 7/20 | 1,941,336   | 1,899,875      | 1,882,707                 |
| Onex Carestream Finance LP <sup>(8)</sup><br><i>Healthcare &amp; Pharmaceuticals</i>                      | Junior Secured<br>Loan Term Loan (Second Lien) 9.5% Cash, 1.0%<br>Libor Floor, Due 12/19                 | 1,932,311   | 1,932,311      | 1,647,295                 |
| Onex Carestream Finance LP <sup>(8), (9)</sup><br><i>Healthcare &amp; Pharmaceuticals</i>                 | Senior Secured<br>Loan Term Loan (First  | 1,750,135   | 1,753,387      | 1,704,920                 |

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|   |  |             |             |             |
|---|--|-------------|-------------|-------------|
|   | Lien 2013) 5.0% Cash,<br>1.0% Libor Floor, Due<br>6/19   |             |             |             |
| Otter Products, LLC (OtterBox<br>Holdings, Inc.)( <sup>(8)</sup> , <sup>(9)</sup><br><i>Consumer goods: Durable</i>                     | Senior Secured<br>Loan Term B Loan 5.8%<br>Cash, 1.0% Libor Floor,<br>Due 6/20                       | 2,600,266   | 2,587,099   | 2,507,697   |
| PGX Holdings, Inc. ( <sup>(8)</sup> , <sup>(9)</sup><br><i>Services: Consumer</i>   | Senior Secured<br>Loan Initial Term Loan<br>(First Lien) 6.3% Cash,<br>1.0% Libor Floor, Due<br>9/20 | 3,620,714   | 3,598,052   | 3,626,381   |
| Playpower, Inc. ( <sup>(8)</sup> , <sup>(9)</sup><br><i>Construction &amp; Building</i>   | Senior Secured<br>Loan Initial Term Loan<br>(First Lien) 5.8% Cash,<br>1.0% Libor Floor, Due<br>6/21 | 1,970,000   | 1,958,956   | 1,969,606   |
| PrimeLine Utility Services LLC<br>(fka FR Utility Services LLC)( <sup>(8)</sup> , <sup>(9)</sup><br><i>Energy: Electricity</i>          | Senior Secured<br>Loan Initial Term Loan<br>6.5% Cash, 1.0% Libor<br>Floor, Due 11/22                | 3,935,672   | 3,904,453   | 3,937,247   |
| Priority Payment Systems<br>Holdings, LLC( <sup>(8)</sup> , <sup>(9)</sup><br><i>Banking, Finance, Insurance &amp;<br/>Real Estate</i>  | Senior Secured<br>Loan Initial Term Loan<br>7.0% Cash, 1.0% Libor<br>Floor, Due 1/23                 | 4,000,000   | 3,960,000   | 3,960,000   |
| PSC Industrial Holdings Corp. ( <sup>(8)</sup> , <sup>(9)</sup><br><i>Environmental Industries</i>                                      | Senior Secured<br>Loan Term Loan (First<br>Lien) 5.8% Cash, 1.0%<br>Libor Floor, Due 12/20           | 2,974,300   | 2,953,559   | 2,941,583   |
| Q Holding Company (fka<br>Lexington Precision<br>Corporation)( <sup>(8)</sup> , <sup>(9)</sup><br><i>Chemicals, Plastics and Rubber</i> | Senior Secured<br>Loan Term B Loan 6.0%<br>Cash, 1.0% Libor Floor,<br>Due 12/21                      | 2,992,366   | 2,962,443   | 2,962,443   |
| Quad-C JH Holdings Inc. (aka<br>Joerns Healthcare)( <sup>(8)</sup> , <sup>(9)</sup><br><i>Healthcare &amp; Pharmaceuticals</i>          | Senior Secured<br>Loan Term Loan A 6.0%<br>Cash, 1.0% Libor Floor,<br>Due 5/20                       | 3,900,079   | 3,883,565   | 3,666,075   |
| Ravn Air Group, Inc. ( <sup>(8)</sup> , <sup>(9)</sup><br><i>Transportation: Consumer</i>   | Senior Secured<br>Loan Initial Term Loan<br>5.3% Cash, 1.0% Libor<br>Floor, Due 7/21                 | 2,421,875   | 2,412,614   | 2,324,516   |
| Roscoe Medical, Inc. ( <sup>(8)</sup><br><i>Healthcare &amp; Pharmaceuticals</i>  | Junior Secured<br>Loan Term Loan (Second<br>Lien) 11.3% Cash, Due<br>9/19                            | 6,700,000   | 6,666,733   | 6,499,000   |
| Sandy Creek Energy Associates,<br>L.P. ( <sup>(8)</sup> , <sup>(9)</sup><br><i>Utilities: Electric</i>                                  | Senior Secured<br>Loan Term Loan 5.0%<br>Cash, 1.0% Libor Floor,<br>Due 11/20                        | 2,613,239   | 2,606,016   | 2,204,921   |
| Stafford Logistics, Inc.(dba Custom<br>Ecology, Inc.)( <sup>(8)</sup> , <sup>(9)</sup>  | Senior Secured<br>Loan Term Loan 7.5%  | \$2,709,639 | \$2,694,201 | \$2,677,395 |

*Environmental Industries*

Cash, 1.0% Libor Floor,  
Due 8/21

See accompanying notes to financial statements.

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| Portfolio Company/Principal Business  | Investment Interest Rate <sup>(1)</sup> /Maturity   | Principal  | Amortized Cost | Fair Value <sup>(2)</sup> |
|---|---|------------|----------------|---------------------------|
| Tank Partners Holdings, LLC <sup>(8)</sup> ,<br><sup>(14)</sup><br><i>Energy: Oil &amp; Gas</i>                       | Senior Secured<br>Loan 10.0%<br>Cash, 4.0% PIK,<br>3.0% Libor Floor,<br>Due 8/19                        | 10,750,808 | 10,656,975     | 6,550,311                 |
| Terra Millennium Corporation <sup>(8)</sup> ,<br><sup>(9)</sup><br><i>Construction &amp; Building</i>                 | Senior Secured<br>Loan First Out Term<br>Loan 7.3% Cash,<br>1.0% Libor Floor,<br>Due 10/22              | 4,000,000  | 3,960,202      | 3,960,000                 |
| TronAir Parent Inc. <sup>(8)</sup> , <sup>(9)</sup><br><i>Aerospace and Defense</i>                                   | Senior Secured<br>Loan Initial Term<br>Loan (First Lien)<br>5.8% Cash, 1.0%<br>Libor Floor, Due<br>9/23 | 3,960,000  | 3,923,893      | 3,959,208                 |
| TRSO I, Inc. <sup>(8)</sup><br><i>Energy: Oil &amp; Gas</i>   | Junior Secured<br>Loan Term Loan<br>(Second Lien) 14.0%<br>Cash, 1.0% Libor<br>Floor, Due 12/19         | 1,000,000  | 991,495        | 1,000,000                 |
| U.S. Shipping Corp (fka U.S.<br>Shipping Partners LP) <sup>(8)</sup> , <sup>(9)</sup><br><i>Transportation: Cargo</i> | Senior Secured<br>Loan Tranche B-2<br>Term Loan 5.3%<br>Cash, 1.0% Libor<br>Floor, Due 6/21             | 1,392,213  | 1,391,361      | 1,312,857                 |
| USJ-IMECO Holding Company,<br>LLC <sup>(8)</sup> , <sup>(9)</sup><br><i>Transportation: Cargo</i>                     | Senior Secured<br>Loan Term Loan<br>7.0% Cash, 1.0%<br>Libor Floor,<br>Due 4/20                         | 3,679,796  | 3,669,622      | 3,497,278                 |
| Verdesian Life Sciences, LLC <sup>(8)</sup> ,<br><sup>(9)</sup><br><i>Environmental Industries</i>                    | Senior Secured<br>Loan Initial Term<br>Loan 6.0% Cash,<br>1.0% Libor Floor,<br>Due 7/20                 | 3,766,302  | 3,733,929      | 3,641,261                 |
| Weiman Products, LLC <sup>(8)</sup><br><i>Consumer goods: Non-durable</i>   | Senior Secured<br>Loan Term Loan<br>5.8% Cash, 1.0%<br>Libor Floor,<br>Due 11/18                        | 916,023    | 912,479        | 889,000                   |
| Weiman Products, LLC <sup>(8)</sup> , <sup>(9)</sup><br><i>Consumer goods: Non-durable</i>                            | Senior Secured<br>Loan Term Loan<br>5.8% Cash, 1.0%   | 4,567,552  | 4,550,168      | 4,432,809                 |

|   |   |                      |                      |                      |
|---|---|----------------------|----------------------|----------------------|
| WideOpenWest Finance, LLC <sup>(8), (9)</sup><br><i>Media: Broadcasting &amp; Subscription</i>              | Libor Floor,<br>Due 11/18<br>Senior Secured<br>Loan New Term B<br>Loan 4.5% Cash,<br>1.0% Libor Floor,<br>Due 8/23<br>Junior Secured<br>Loan Initial Term<br>Loan (Second Lien)<br>10.0% Cash, 1.0%<br>Libor Floor, Due<br>9/24 | 2,992,500            | 2,992,500            | 3,028,829            |
| WireCo WorldGroup Inc. <sup>(8)</sup><br><i>Capital Equipment</i>   | Senior Secured<br>Loan Initial Term<br>Loan (First Lien)<br>6.5% Cash, 1.0%<br>Libor Floor, Due<br>9/23   | 3,000,000            | 2,956,358            | 3,000,000            |
| WireCo WorldGroup Inc.<br>(WireCo WorldGroup Finance<br>LP) <sup>(8), (9)</sup><br><i>Capital Equipment</i> |   | 1,745,625            | 1,728,771            | 1,763,780            |
| <b>Total Investment in Debt<br/>Securities (122% of net asset<br/>value at fair value)</b>                  |   | <b>\$251,222,570</b> | <b>\$249,520,234</b> | <b>\$238,343,330</b> |

See accompanying notes to financial statements.

TABLE OF CONTENTS**Equity Securities Portfolio**

| Portfolio Company/Principal Business   | Investment                      | Percentage<br>Interest/Shares | Amortized<br>Cost | Fair<br>Value <sup>(2)</sup> |
|--|---------------------------------|-------------------------------|-------------------|------------------------------|
| Aerostructures Holdings L.P. <sup>(5), (8)</sup><br><i>Aerospace and Defense</i>   | Partnership<br>Interests        | 1.2 %                         | \$ 1,000,000      | \$ 100,549                   |
| Aerostructures Holdings L.P. <sup>(5), (8)</sup><br><i>Aerospace and Defense</i>   | Series A Preferred<br>Interests | 1.2 %                         | 250,960           | 1,183,746                    |
| Caribe Media Inc. (fka Caribe<br>Information Investments Incorporated) <sup>(5), (8)</sup><br><i>Media: Advertising, Printing &amp;<br/>Publishing</i> | Common                          | 1.3 %                         | 359,765           | 532,342                      |
| DBI Holding LLC <sup>(5), (8)</sup><br><i>Services: Business</i>   | Class A Warrants                | 3.2 %                         | 1                 | 1,000                        |
| eInstruction Acquisition, LLC <sup>(5), (8)</sup><br><i>Healthcare, Education and Childcare</i>  | Membership Units                | 1.1 %                         | 1,079,617         | 1,000                        |
| FP WRCA Coinvestment Fund VII,<br>Ltd. <sup>(3), (5)</sup><br><i>Capital Equipment</i>   | Class A Shares                  | 1,500                         | 1,500,000         | 811,268                      |
| Perseus Holding Corp. <sup>(5), (8)</sup><br><i>Hotel, Gaming &amp; Leisure</i>  | Common                          | 0.2 %                         | 400,000           | 1,000                        |
| Roscoe Investors, LLC <sup>(5), (8)</sup><br><i>Healthcare &amp; Pharmaceuticals</i>   | Class A Units                   | 1.6 %                         | 1,000,000         | 1,169,000                    |
| Tank Partners Holdings, LLC <sup>(5), (8), (11)</sup><br><i>Energy: Oil &amp; Gas</i>  | Unit                            | 5.8 %                         | 980,000           | 1,000                        |
| Tank Partners Holdings, LLC <sup>(5), (8)</sup><br><i>Energy: Oil &amp; Gas</i>  | Warrants                        | 1.3 %                         | 185,205           | 1,000                        |
| TRSO II, Inc. <sup>(5), (8)</sup><br><i>Energy: Oil &amp; Gas</i>  | Common Stock                    | 5.4 %                         | 1,680,161         | 1,253,450                    |
| New Millennium Holdco, Inc.<br>(Millennium Health, LLC) <sup>(5), (8)</sup><br><i>Healthcare &amp; Pharmaceuticals</i>                                 | Common                          | 0.2 %                         | 1,953,299         | 1,000                        |
| <b>Total Investment in Equity<br/>Securities (3% of net asset value at fair<br/>value)</b>   |                                 |                               | \$ 10,389,007     | \$ 5,056,355                 |

See accompanying notes to financial statements.

TABLE OF CONTENTS**CLO Fund Securities****CLO Subordinated Securities, Preferred Shares and Income Notes Investments**

| Portfolio Company                                      | Investment <sup>(12)</sup>                                      | Percentage Amortized<br>Ownership Cost |                     | Fair Value <sup>(2)</sup> |
|--|---|--|---------------------|---------------------------|
| Grant Grove CLO, Ltd. <sup>(3), (13)</sup>             | Subordinated Securities, effective interest 0.1%, 1/21 maturity | 22.2 %                                 | \$2,485,886         | \$1,000                   |
| Katonah III, Ltd. <sup>(3), (13)</sup>                 | Preferred Shares, effective interest 0.1%, 5/15 maturity        | 23.1 %                                 | 1,287,155           | 369,000                   |
| Katonah 2007-I CLO Ltd. <sup>(3), (6)</sup>            | Preferred Shares, effective interest 30.8%, 4/22 maturity       | 100 %                                  | 28,022,646          | 20,453,099                |
| Trimaran CLO VII, Ltd. <sup>(3), (6), (13)</sup>       | Income Notes, effective interest 47.9%, 6/21 maturity           | 10.5 %                                 | 1,643,920           | 1,195,152                 |
| Catamaran CLO 2012-1 Ltd. <sup>(3), (6)</sup>          | Subordinated Notes, effective interest 3.1%, 12/23 maturity     | 24.9 %                                 | 5,919,933           | 2,819,412                 |
| Catamaran CLO 2013- 1 Ltd. <sup>(3), (6)</sup>         | Subordinated Notes, effective interest 14.9%, 1/25 maturity     | 23.5 %                                 | 5,237,222           | 4,918,807                 |
| Catamaran CLO 2014-1 Ltd. <sup>(3), (6)</sup>          | Subordinated Notes, effective interest 10.0%, 4/26 maturity     | 24.9 %                                 | 7,818,484           | 4,546,682                 |
| Catamaran CLO 2014-2 Ltd. <sup>(3), (6)</sup>          | Subordinated Notes, effective interest 10.9%, 10/26 maturity    | 24.9 %                                 | 6,967,560           | 5,092,087                 |
| Dryden 30 Senior Loan Fund <sup>(3)</sup>              | Subordinated Notes, effective interest 36.2%, 11/25 maturity    | 7.5 %                                  | 1,343,467           | 1,895,566                 |
| Catamaran CLO 2015-1 Ltd. <sup>(3), (6)</sup>          | Subordinated Notes, effective interest 9.5%, 4/27 maturity      | 9.9 %                                  | 4,543,317           | 3,223,255                 |
| Catamaran CLO 2016-1 Ltd. <sup>(3), (6)</sup>          | Subordinated Notes, effective interest 13.9%, 1/29 maturity     | 24.9 %                                 | 10,140,000          | 8,350,290                 |
| <b>Total Investment in CLO Subordinated Securities</b> |   |  | <b>\$75,409,590</b> | <b>\$52,864,350</b>       |

## CLO Rated-Note Investments

| Portfolio Company  | Investment   | Percentage Amortized<br>Ownership | Cost         | Fair Value <sup>(2)</sup> |
|--|--|-----------------------------------|--------------|---------------------------|
| CRMN 2014 1A <sup>(8), (6)</sup>   | Float 04/2026 E<br>14889FAC7, 6.6%,<br>4/26 maturity | 15.1 %                            | \$1,441,727  | \$1,310,000               |
| <b>Total Investment in CLO<br/>Rated-Note</b>  |  |                                   | \$1,441,727  | \$1,310,000               |
| Total Investment in CLO Fund<br>Securities (28% of net asset value at<br>fair value) |  |                                   | \$76,851,317 | \$54,174,350              |

## Asset Manager Affiliates

| Portfolio Company/Principal Business  | Investment                  | Percentage<br>Ownership | Cost         | Fair Value <sup>(2)</sup> |
|---|-----------------------------|-------------------------|--------------|---------------------------|
| Asset Manager Affiliates <sup>(8), (10)</sup>   | Asset Management<br>Company | 100 %                   | \$55,341,230 | \$40,198,000              |
| Total Investment in Asset Manager<br>Affiliates (21% of net asset value at fair<br>value) |                             |                         | \$55,341,230 | \$40,198,000              |

See accompanying notes to financial statements.

TABLE OF CONTENTS**Time Deposits and Money Market Account**

| Time Deposit and Money Market Accounts  | Investment           | Yield | Par/Amortized Cost | Fair Value <sup>(2)</sup> |
|---|----------------------|-------|--------------------|---------------------------|
| JP Morgan Business Money Market Account <sup>(7), (8)</sup>                                       | Money Market Account | 0.1 % | \$ 14,268          | \$ 14,268                 |
| US Bank Money Market Account <sup>(8)</sup>   | Money Market Account | 0.1 % | 28,685,001         | 28,685,001                |
| Total Investment in Time Deposit and Money Market Accounts (15% of net asset value at fair value) |                      |       | \$ 28,699,269      | \$ 28,699,269             |
| Total Investments <sup>(4)</sup> (188% of net asset value at fair value)                          |                      |       | \$ 420,801,057     | \$ 366,471,304            |

(1) A majority of the variable rate loans in the Company's investment portfolio bear interest at a rate that may be determined by reference to either LIBOR or an alternate Base Rate (commonly based on the Federal Funds Rate or the Prime Rate), which typically resets semi-annually, quarterly, or monthly at the borrower's option. The Borrower may also elect to have multiple interest reset periods for each loan. For each such loan, the Company has provided the weighted average annual stated interest rate in effect at December 31, 2016. As noted in the table above, 93% (based on par) of debt securities contain LIBOR floors which range between 0.75% and 3.0%.

(2) Reflects the fair market value of all investments as of December 31, 2016, as determined by the Company's Board of Directors.

(3) Non-U.S. company or principal place of business outside the U.S.

The aggregate cost of investments for federal income tax purposes is approximately \$429 million. The aggregate gross unrealized appreciation is approximately \$2.1 million, the aggregate gross unrealized depreciation is approximately \$65.0 million, and the net unrealized depreciation is approximately \$62.9 million.

(5) Non-income producing.

(6) An affiliate CLO Fund managed by an Asset Manager Affiliate (as such term is defined in the notes to the financial statements).

(7) Money market account holding restricted cash and security deposits for employee benefit plans.

(8) Qualified asset for purposes of section 55(a) of the Investment Company Act of 1940.

(9) As of December 31, 2016, this investment is owned by KCAP Senior Funding I, LLC and was pledged to secure KCAP Senior Funding I, LLC's obligation.

Other than the Asset Manager Affiliate, which we are deemed to control, we do not control and are not an affiliate of any of our portfolio companies, each as defined in the Investment Company Act of 1940 (the 1940 Act). In general, under the 1940 Act, we would be presumed to control a portfolio company if we owned 25% or more of its voting securities and would be an affiliate of a portfolio company if we owned 5% or more of its voting securities.

(11) Non-voting.

CLO Subordinated Investments are entitled to periodic distributions which are generally equal to the remaining cash flow of the payments made by the underlying fund's investments less contractual payments to debt holders and fund expenses. The estimated annualized effective yield indicated is based upon a current projection of the amount and timing of these distributions. Such projections are updated on a quarterly basis and the estimated effective yield is adjusted prospectively.

(13) Notice of redemption has been received for this transaction.

(14)

Loan or security was on partial non-accrual status, whereby we have recognized income on a portion of contractual PIK amounts due.

See accompanying notes to financial statements.

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As of December 31, 2015****Debt Securities Portfolio**

| Portfolio Company/Principal Business  | Investment Interest Rate <sup>(1)</sup> /Maturity  | Principal   | Amortized Cost | Fair Value <sup>(2)</sup> |
|---|--|-------------|----------------|---------------------------|
| 1A Smart Start LLC <sup>(9), (10)</sup><br><i>Consumer goods: Non-durable</i>                               | Senior Secured Loan Initial Term Loan (First Lien) 5.8% Cash, 1.0% Libor Floor, Due 2/22 | \$3,000,000 | \$2,971,523    | \$2,903,100               |
| 4L Technologies Inc. (fka Clover Holdings, Inc.) <sup>(9), (10)</sup><br><i>Consumer goods: Non-durable</i> | Senior Secured Loan Term Loan 5.5% Cash, 1.0% Libor Floor, Due 5/20                      | 2,765,000   | 2,744,921      | 2,596,059                 |
| Advanced Lighting Technologies, Inc. <sup>(9), (10)</sup><br><i>Consumer goods: Durable</i>                 | First Lien Bond 10.5% 06/2019 00753CAE2 10.5% Cash, Due 6/19                             | 3,000,000   | 3,000,000      | 2,216,700                 |
| Advantage Sales & Marketing Inc. <sup>(9)</sup><br><i>Services: Business</i>                                | Junior Secured Loan Term Loan (Second Lien) 7.5% Cash, 1.0% Libor Floor, Due 7/22        | 1,000,000   | 1,002,069      | 915,700                   |
| Alere Inc. (fka IM US Holdings, LLC) <sup>(10)</sup><br><i>Healthcare &amp; Pharmaceuticals</i>             | Senior Secured Loan B Term Loan 4.3% Cash, 1.0% Libor Floor, Due 6/22                    | 2,553,466   | 2,555,910      | 2,536,179                 |
| American Seafoods Group LLC <sup>(9), (10)</sup><br><i>Beverage, Food and Tobacco</i>                       | Senior Secured Loan Term Loan (First Lien) 6.0% Cash, 1.0% Libor Floor, Due 8/21         | 3,990,000   | 3,971,219      | 3,937,332                 |
| Anaren, Inc. <sup>(9), (10)</sup><br><i>Aerospace and Defense</i>   | Senior Secured Loan Term Loan (First Lien)   | 1,891,210   | 1,877,288      | 1,839,202                 |



|  |  |           |           |           |
|--|--|-----------|-----------|-----------|
|  | 5.5% Cash, 1.0% Libor<br>Floor,<br>Due 2/21<br>Senior Secured<br>Loan Term Loan  |           |           |           |
| Aristotle Corporation, The <sup>(9), (10)</sup><br><i>Consumer goods: Non-durable</i>                                      | 5.5% Cash, 1.0% Libor<br>Floor,<br>Due 6/21<br>Senior Secured Loan   | 3,980,000 | 3,961,696 | 3,870,152 |
| Asurion, LLC (fka Asurion<br>Corporation) <sup>(9), (10)</sup><br><i>Banking, Finance, Insurance &amp;<br/>Real Estate</i> | Incremental Tranche B-1<br>Term Loan<br>5.0% Cash, 1.3% Libor<br>Floor,<br>Due 5/19<br>Senior Secured Loan                 | 917,632   | 918,953   | 862,290   |
| Asurion, LLC (fka Asurion<br>Corporation) <sup>(9), (10)</sup><br><i>Banking, Finance, Insurance &amp;<br/>Real Estate</i> | Incremental Tranche B-4<br>Term Loan<br>5.0% Cash, 1.0% Libor<br>Floor,<br>Due 8/22<br>Junior Secured<br>Loan Initial Term | 896,048   | 891,815   | 821,676   |
| Avalign Technologies, Inc. <sup>(9)</sup><br><i>Healthcare &amp; Pharmaceuticals</i>                                       | Loan (Second Lien)<br>9.3% Cash, 1.0% Libor<br>Floor,<br>Due 7/22<br>Senior Secured<br>Loan Initial Term                   | 1,000,000 | 990,643   | 952,400   |
| Avalign Technologies, Inc. <sup>(9), (10)</sup><br><i>Healthcare &amp; Pharmaceuticals</i>                                 | Loan (First Lien)<br>5.5% Cash, 1.0% Libor<br>Floor,<br>Due 7/21<br>Senior Secured<br>Loan Term B Loan                     | 2,925,000 | 2,911,472 | 2,831,108 |
| Bankruptcy Management Solutions,<br>Inc. <sup>(9)</sup><br><i>Services: Business</i>                                       | 7.0% Cash, 1.0% Libor<br>Floor,<br>Due 6/18<br>Senior Secured<br>Loan Term Loan  | 682,722   | 682,722   | 651,590   |
| BarBri, Inc. (Gemini Holdings,<br>Inc.) <sup>(9), (10)</sup><br><i>Services: Consumer</i>                                  | 4.5% Cash, 1.0% Libor<br>Floor,<br>Due 7/19<br>Senior Secured<br>Loan Initial Term   | 2,731,875 | 2,723,758 | 2,542,829 |
| BBB Industries US Holdings,<br>Inc. <sup>(9), (10)</sup><br><i>Automotive</i>  | Loan (First Lien)<br>6.0% Cash, 1.0% Libor<br>Floor,<br>Due 11/21<br>Senior Secured Loan U.S.                              | 2,977,500 | 2,927,766 | 2,833,985 |
| Bellisio Foods, Inc. <sup>(9), (10)</sup><br><i>Beverage, Food and Tobacco</i>   | Term B<br>Loans  | 1,936,011 | 1,929,952 | 1,886,836 |

|  |   |        |        |        |
|--|---|--------|--------|--------|
| Bestop, Inc. <sup>(9), (10)</sup><br><i>Automotive</i> | 5.3% Cash, 1.0% Libor<br>Floor,<br>Due 8/19<br>Senior Secured<br>Loan Revolving<br>Loan |        |        |        |
|  | 6.3% Cash, 1.0% Libor<br>Floor,<br>Due 7/20   | 40,000 | 34,509 | 36,984 |

See accompanying notes to financial statements.

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| Portfolio Company/Principal Business   | Investment Interest Rate <sup>(1)</sup> /Maturity  | Principal   | Amortized Cost | Fair Value <sup>(2)</sup> |
|--|--|-------------|----------------|---------------------------|
| Bestop, Inc. <sup>(9), (10)</sup><br><i>Automotive</i>   | Senior Secured<br>Loan Term Loan<br>6.3% Cash, 1.0% Libor<br>Floor,<br>Due 7/21  | \$1,580,000 | \$1,557,976    | \$1,460,868               |
| Carolina Beverage Group LLC <sup>(9)</sup><br><i>Beverage, Food and Tobacco</i>  | Senior Secured<br>Bond 10.625%<br>08/2018 143818AA0<br>144A<br>10.6% Cash, Due 8/18<br>Senior Secured<br>Loan Initial Term<br>Loan (First Lien)<br>5.0% Cash, 1.0% Libor<br>Floor,<br>Due 7/21 | 1,500,000   | 1,510,560      | 1,503,752                 |
| CCS Intermediate Holdings, LLC <sup>(9), (10)</sup><br><i>Healthcare &amp; Pharmaceuticals</i>   | Senior Secured<br>Loan Term Loan<br>7.0% Cash, 1.0% Libor<br>Floor,<br>Due 3/20  | 2,962,500   | 2,950,638      | 2,549,824                 |
| Cengage Learning Acquisitions, Inc. (fka TL Acquisitions, Inc.) <sup>(9), (10)</sup><br><i>Media: Advertising, Printing &amp; Publishing</i> | Senior Secured<br>Loan Term I Loan<br>3.5% Cash, 0.8% Libor<br>Floor,<br>Due 1/23  | 2,979,950   | 2,974,534      | 2,912,901                 |
| Charter Communications Operating, LLC (aka CCO Safari LLC) <sup>(10)</sup><br><i>Media: Broadcasting &amp; Subscription</i>                  | Senior Secured<br>Loan Term B Loan<br>(First Lien)<br>4.5% Cash, 1.0% Libor<br>Floor,<br>Due 4/21  | 1,000,000   | 1,001,223      | 1,000,420                 |
| Checkout Holding Corp. (fka Catalina Marketing) <sup>(9), (10)</sup><br><i>Media: Advertising, Printing &amp; Publishing</i>                 | Senior Secured<br>Loan Incremental<br>2021 Term H Loan<br>4.0% Cash, 1.0% Libor<br>Floor,<br>Due 1/21  | 985,000     | 981,284        | 792,925                   |
| CHS/Community Health Systems, Inc. <sup>(10)</sup><br><i>Healthcare &amp; Pharmaceuticals</i>  | Senior Secured<br>Loan Initial<br>Term Loan<br>4.3% Cash, 1.0% Libor<br>Floor,<br>Due 12/20  | 1,994,987   | 1,992,571      | 1,967,915                 |
| Consolidated Communications, Inc. <sup>(10)</sup><br><i>Telecommunications</i>   |  | 2,962,217   | 2,971,404      | 2,947,421                 |
|  |  | 3,912,342   | 3,861,177      | 3,750,762                 |

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|   |  |            |            |            |
|---|--|------------|------------|------------|
| CRGT Inc. <sup>(9), (10)</sup><br><i>High Tech Industries</i>   | Senior Secured<br>Loan Term Loan<br>7.5% Cash, 1.0% Libor<br>Floor,<br>Due 12/20<br>Preferred<br>Stock 12.000%<br>12/2049 Series A |            |            |            |
| Crowley Holdings Preferred,<br>LLC <sup>(9)</sup><br><i>Transportation: Cargo</i>   | Income<br>Preferred Securities<br>10.0% Cash, 2.0% PIK,<br>Due 12/49   | 10,411,673 | 10,411,673 | 11,036,373 |
| Crowne Group, LLC <sup>(9), (10)</sup><br><i>Automotive</i>   | Senior Secured<br>Loan Term Loan<br>(First Lien)<br>6.0% Cash, 1.0% Libor<br>Floor,<br>Due 9/20                                    | 3,950,000  | 3,902,980  | 3,664,810  |
| CSM Bakery Solutions Limited<br>(fka CSM Bakery Supplies<br>Limited) <sup>(9)</sup><br><i>Beverage, Food and Tobacco</i>                                  | Junior Secured<br>Loan Term Loan<br>(Second Lien)<br>8.8% Cash, 1.0% Libor<br>Floor,<br>Due 7/21                                   | 3,000,000  | 3,013,843  | 2,827,500  |
| CT Technologies Intermediate<br>Holdings, Inc. (Smart Holdings<br>Corp.) (aka HealthPort) <sup>(9), (10)</sup><br><i>Healthcare &amp; Pharmaceuticals</i> | Senior Secured<br>Loan Term Loan<br>5.3% Cash, 1.0% Libor<br>Floor,<br>Due 12/21   | 2,970,075  | 2,942,705  | 2,877,260  |
| DBI Holding LLC <sup>(9)</sup><br><i>Services: Business</i>   | Senior Unsecured<br>Bond 09/2019<br>PIK Note 0.0% Cash,<br>16.0% PIK,<br>Due 9/19  | 4,043,719  | 3,859,845  | 4,043,722  |
| DBI Holding LLC <sup>(9)</sup><br><i>Services: Business</i>   | Senior Subordinated<br>Bond 09/2019<br>Senior Subordinated<br>Note<br>12.0% Cash, 4.0% PIK,<br>Due 9/19                            | 4,481,135  | 4,466,793  | 4,615,571  |
| DJO Finance LLC <sup>(9), (10)</sup><br><i>Healthcare &amp; Pharmaceuticals</i>   | Senior Secured<br>Loan Initial<br>Term Loan<br>4.3% Cash, 1.0% Libor<br>Floor,<br>Due 6/20   | 1,500,000  | 1,490,906  | 1,464,375  |
| Drew Marine Group Inc. <sup>(9)</sup><br><i>Transportation: Cargo</i>   | Junior Secured<br>Loan Term Loan<br>(Second Lien)<br>8.0% Cash, 1.0% Libor<br>Floor,   | 2,500,000  | 2,495,491  | 2,495,000  |

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|  |                       |           |           |           |
|--|-----------------------|-----------|-----------|-----------|
|  | Due 5/21              |           |           |           |
|  | Senior Secured        |           |           |           |
|  | Loan    Term Loan     |           |           |           |
| ELO Touch Solutions, Inc. <sup>(9), (10)</sup> | (First Lien)          |           |           |           |
| High Tech Industries                           | 8.0% Cash, 1.5% Libor | 1,552,326 | 1,507,787 | 1,546,893 |
|  | Floor,                |           |           |           |
|  | Due 6/18              |           |           |           |

See accompanying notes to financial statements.

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| Portfolio Company/Principal Business  | Investment<br>Interest Rate <sup>(1)</sup> /Maturity  | Principal   | Amortized<br>Cost | Fair<br>Value <sup>(2)</sup> |
|---|---|-------------|-------------------|------------------------------|
| EWT Holdings III Corp. (fka WTG Holdings III Corp.) <sup>(9)</sup><br><i>Environmental Industries</i>       | Junior Secured<br>Loan Term Loan<br>(Second Lien)<br>8.5% Cash, 1.0% Libor<br>Floor,<br>Due 1/22  | \$4,000,000 | \$3,984,890       | \$3,658,400                  |
| Fender Musical Instruments Corporation <sup>(9), (10)</sup><br><i>Consumer goods: Durable</i>               | Senior Secured<br>Loan Initial Loan<br>5.8% Cash, 1.3% Libor<br>Floor,<br>Due 4/19                | 1,434,249   | 1,443,868         | 1,421,699                    |
| FHC Health Systems, Inc. <sup>(9), (10)</sup><br><i>Healthcare &amp; Pharmaceuticals</i>                    | Senior Secured<br>Loan Initial<br>Term Loan<br>5.0% Cash, 1.0% Libor<br>Floor,<br>Due 12/21       | 3,877,839   | 3,844,406         | 3,703,336                    |
| First American Payment Systems, L.P. <sup>(9)</sup><br><i>Banking, Finance, Insurance &amp; Real Estate</i> | Junior Secured<br>Loan Term Loan<br>(Second Lien)<br>10.8% Cash, 1.3%<br>Libor Floor,<br>Due 4/19 | 2,796,448   | 2,768,177         | 2,639,288                    |
| Getty Images, Inc. <sup>(9), (10)</sup><br><i>Media: Advertising, Printing &amp; Publishing</i>             | Senior Secured<br>Loan Initial<br>Term Loan<br>4.8% Cash, 1.3% Libor<br>Floor,<br>Due 10/19       | 2,162,867   | 2,172,647         | 1,373,421                    |
| GI Advo Opco, LLC <sup>(9)</sup><br><i>Healthcare &amp; Pharmaceuticals</i>                                 | Senior Secured<br>Loan Term Loan<br>5.5% Cash, 1.0% Libor<br>Floor,<br>Due 11/21                  | 250,000     | 247,534           | 247,500                      |
| GI Advo Opco, LLC <sup>(9), (10)</sup><br><i>Healthcare &amp; Pharmaceuticals</i>                           | Senior Secured<br>Loan Term Loan<br>5.5% Cash, 1.0% Libor<br>Floor,<br>Due 11/21                  | 2,750,000   | 2,722,890         | 2,722,500                    |
| GK Holdings, Inc. (aka Global Knowledge) <sup>(9)</sup><br><i>Services: Business</i>                        | Junior Secured<br>Loan Initial<br>Term Loan (Second<br>Lien)<br>10.5% Cash, 1.0%<br>Libor Floor,  | 1,500,000   | 1,473,884         | 1,382,550                    |

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|  |   |           |           |           |
|--|---|-----------|-----------|-----------|
| GK Holdings, Inc. (aka Global Knowledge) <sup>(9), (10)</sup><br><i>Services: Business</i>                                     | Due 1/22<br>Senior Secured<br>Loan Initial<br>Term Loan (First Lien)<br>6.5% Cash, 1.0% Libor<br>Floor,<br>Due 1/21 | 2,475,000 | 2,453,994 | 2,345,805 |
|  | Junior Secured<br>Loan Term Loan<br>(Second Lien)<br>9.0% Cash, 1.3% Libor<br>Floor,<br>Due 11/20                   |           |           |           |
| Global Tel*Link Corporation <sup>(9)</sup><br><i>Telecommunications</i>  | Senior Secured<br>Loan Term Loan<br>5.3% Cash, 1.0% Libor<br>Floor,<br>Due 4/21                                     | 4,000,000 | 3,946,567 | 2,760,000 |
|  | Senior Secured<br>Loan Initial<br>Term Loan<br>4.5% Cash, 1.0% Libor<br>Floor,<br>Due 5/20                          |           |           |           |
| Gold Standard Baking, Inc. <sup>(9), (10)</sup><br><i>Beverage, Food and Tobacco</i>   | Senior Secured Loan<br>U.S. Tranche B Term<br>Loan<br>3.4% Cash, Due 2/21   | 2,487,500 | 2,476,361 | 2,408,149 |
|  | Senior Secured<br>Loan Term B Loan<br>(First Lien)<br>8.5% Cash, 1.5% Libor<br>Floor,<br>Due 1/18                   |           |           |           |
| Grande Communications Networks LLC <sup>(9), (10)</sup><br><i>Telecommunications</i>   | Junior Secured<br>Loan Term Loan<br>(Second Lien)<br>13.8% Cash, Due 7/18   | 3,900,092 | 3,906,280 | 3,841,591 |
|  | Senior Secured<br>Loan Term Loan<br>5.0% Cash, 1.5% Libor<br>Floor,<br>Due 2/18                                     |           |           |           |
| Grifols Worldwide Operations Limited <sup>(10)</sup><br><i>Healthcare &amp; Pharmaceuticals</i>                                | Senior Secured<br>Loan Initial<br>Term Loan<br>5.3% Cash, 1.0% Libor<br>Floor,<br>Due 6/19                          | 997,462   | 995,001   | 989,732   |
|  | Senior Secured<br>Loan Term B Loan<br>(First Lien)<br>8.5% Cash, 1.5% Libor<br>Floor,<br>Due 1/18                   |           |           |           |
| Grupo HIMA San Pablo, Inc. <sup>(9)</sup><br><i>Healthcare &amp; Pharmaceuticals</i>   | Junior Secured<br>Loan Term Loan<br>(Second Lien)<br>13.8% Cash, Due 7/18   | 2,917,500 | 2,893,169 | 2,917,500 |
|  | Senior Secured<br>Loan Term Loan<br>5.0% Cash, 1.5% Libor<br>Floor,<br>Due 2/18                                     |           |           |           |
| Grupo HIMA San Pablo, Inc. <sup>(9)</sup><br><i>Healthcare &amp; Pharmaceuticals</i>   | Senior Secured<br>Loan Initial<br>Term Loan<br>5.3% Cash, 1.0% Libor<br>Floor,<br>Due 6/19                          | 7,000,000 | 6,924,146 | 7,000,000 |
|  | Senior Secured<br>Loan Term Loan<br>5.0% Cash, 1.5% Libor<br>Floor,<br>Due 2/18                                     |           |           |           |
| Gymboree Corporation., The <sup>(9), (10)</sup><br><i>Retail</i>   | Senior Secured<br>Loan Initial<br>Term Loan<br>5.3% Cash, 1.0% Libor<br>Floor,<br>Due 6/19                          | 1,421,105 | 1,410,511 | 734,001   |
|  | Senior Secured<br>Loan Term Loan<br>5.0% Cash, 1.5% Libor<br>Floor,<br>Due 2/18                                     |           |           |           |
| Hargray Communications Group, Inc. (HCP Acquisition LLC) <sup>(9), (10)</sup><br><i>Media: Broadcasting &amp; Subscription</i> | Senior Secured<br>Loan Term Loan<br>5.0% Cash, 1.5% Libor<br>Floor,<br>Due 2/18                                     | 2,895,294 | 2,878,392 | 2,893,267 |
|  | Senior Secured<br>Loan Term Loan<br>5.0% Cash, 1.5% Libor<br>Floor,<br>Due 2/18                                     |           |           |           |
| Harland Clarke Holdings Corp. (fka Clarke American Corp.) <sup>(9), (10)</sup>   | Senior Secured<br>Loan Tranche B-3  | 3,281,250 | 3,259,381 | 3,271,078 |
|  |   |           |           |           |

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|   |  |           |           |           |
|---|--|-----------|-----------|-----------|
| <i>Media: Advertising, Printing &amp; Publishing</i>                              | Term Loan<br>7.0% Cash, 1.5% Libor<br>Floor,<br>Due 5/18<br>Senior Secured |           |           |           |
| Harland Clarke Holdings Corp. (fka<br>Clarke American Corp.) <sup>(9), (10)</sup> | Loan Tranche B-4<br>Term Loan  |           |           |           |
| <i>Media: Advertising, Printing &amp; Publishing</i>                              | 6.0% Cash, 1.0% Libor<br>Floor,<br>Due 8/19                                | 1,425,000 | 1,420,339 | 1,421,580 |

See accompanying notes to financial statements.

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| Portfolio Company/Principal Business   | Investment Interest Rate <sup>(1)</sup> /Maturity               | Principal   | Amortized Cost | Fair Value <sup>(2)</sup> |
|--|---|-------------|----------------|---------------------------|
|  | Junior Secured Loan Initial Term                                |             |                |                           |
| Hoffmaster Group, Inc. <sup>(9)</sup><br><i>Forest Products &amp; Paper</i>                  | Loan (Second Lien)<br>10.0% Cash, 1.0% Libor Floor,<br>Due 5/21 | \$2,000,000 | \$1,977,018    | \$1,995,600               |
|  | Senior Secured Loan Initial Term                                |             |                |                           |
| Hoffmaster Group, Inc. <sup>(9), (10)</sup><br><i>Forest Products &amp; Paper</i>            | Loan (First Lien)<br>5.3% Cash, 1.0% Libor Floor,<br>Due 5/20   | 3,940,000   | 3,911,276      | 3,887,480                 |
|  | Senior Secured Loan Term Loan                                   |             |                |                           |
| Hunter Defense Technologies, Inc. <sup>(9), (10)</sup><br><i>Aerospace and Defense</i>       | (First Lien)<br>6.5% Cash, 1.0% Libor Floor,<br>Due 8/19        | 2,812,500   | 2,792,045      | 2,616,469                 |
|  | Senior Secured Loan Term B-1                                    |             |                |                           |
| Integra Telecom Holdings, Inc. <sup>(9), (10)</sup><br><i>Telecommunications</i>             | Loan 5.3% Cash, 1.0% Libor Floor,<br>Due 8/20                   | 2,962,386   | 2,952,620      | 2,876,477                 |
|  | Senior Secured Loan Term Loan                                   |             |                |                           |
| International Architectural Products, Inc. <sup>(7), (9)</sup><br><i>Metals &amp; Mining</i> | 0.0% Cash, 3.3% PIK, 2.5% Libor Floor, Due 5/15                 | 247,636     | 228,563        | 991                       |
|  | Senior Secured Loan Initial Term                                |             |                |                           |
| Kellermeyer Bergensons Services, LLC <sup>(9), (10)</sup><br><i>Services: Business</i>       | Loan (First Lien)<br>6.0% Cash, 1.0% Libor Floor,<br>Due 10/21  | 1,980,000   | 1,963,471      | 1,856,844                 |
|  | Senior Secured Loan Initial                                     |             |                |                           |
| Key Safety Systems, Inc. <sup>(9), (10)</sup><br><i>Automotive</i>                           | Term Loan<br>4.8% Cash, 1.0% Libor Floor,<br>Due 8/21           | 1,481,250   | 1,475,263      | 1,444,219                 |
|  | Senior Secured Loan Dollar                                      |             |                |                           |
| Kinetic Concepts, Inc. <sup>(9), (10)</sup><br><i>Healthcare &amp; Pharmaceuticals</i>       | Term E-1 Loan<br>4.5% Cash, 1.0% Libor Floor,                   | 2,962,216   | 2,957,007      | 2,864,700                 |

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|  |   |           |           |           |
|--|---|-----------|-----------|-----------|
| Landslide Holdings, Inc. (Crimson Acquisition Corp.) <sup>(9), (10)</sup><br><i>High Tech Industries</i>       | Due 5/18<br>Senior Secured<br>Loan New Term<br>Loan (First Lien)<br>5.0% Cash, 1.0% Libor<br>Floor,<br>Due 2/20 |           |           |           |
|  |   | 3,421,556 | 3,428,320 | 3,417,450 |
| MB Aerospace ACP Holdings II Corp. <sup>(9), (10)</sup><br><i>Aerospace and Defense</i>                        | Senior Secured<br>Loan Initial<br>Term Loan<br>6.5% Cash, 1.0% Libor<br>Floor,<br>Due 12/22                     |           |           |           |
|  |   | 1,000,000 | 990,055   | 990,000   |
| Medical Specialties Distributors, LLC <sup>(9), (10)</sup><br><i>Healthcare &amp; Pharmaceuticals</i>          | Senior Secured<br>Loan Term Loan<br>6.5% Cash, 1.0% Libor<br>Floor,<br>Due 12/19                                |           |           |           |
|  |   | 3,920,000 | 3,894,315 | 3,918,040 |
| MGOC, Inc. (fka Media General, Inc.) <sup>(10)</sup><br><i>Media: Broadcasting &amp; Subscription</i>          | Senior Secured<br>Loan Term B Loan<br>4.0% Cash, 1.0% Libor<br>Floor,<br>Due 7/20                               |           |           |           |
|  |   | 2,717,813 | 2,720,620 | 2,690,635 |
| Nellson Nutraceutical, LLC <sup>(9), (10)</sup><br><i>Beverage, Food and Tobacco</i>                           | Senior Secured<br>Loan Term A-1<br>Loan (First Lien)<br>6.0% Cash, 1.0% Libor<br>Floor,<br>Due 12/21            |           |           |           |
|  |   | 2,374,598 | 2,356,528 | 2,295,761 |
| Nellson Nutraceutical, LLC <sup>(9), (10)</sup><br><i>Beverage, Food and Tobacco</i>                           | Senior Secured<br>Loan Term A-2<br>Loan (First Lien)<br>6.0% Cash, 1.0% Libor<br>Floor,<br>Due 12/21            |           |           |           |
|  |   | 2,092,907 | 2,076,283 | 2,023,422 |
| New Millennium Holdco, Inc. (Millennium Health, LLC) <sup>(9)</sup><br><i>Healthcare &amp; Pharmaceuticals</i> | Senior Secured<br>Loan Closing Date<br>Term Loan<br>7.5% Cash, 1.0% Libor<br>Floor,<br>Due 12/20                |           |           |           |
|  |   | 1,016,626 | 1,016,626 | 889,548   |
| Nielsen & Bainbrige, LLC <sup>(9)</sup><br><i>Consumer goods: Durable</i>                                      | Senior Secured<br>Loan Term Loan<br>(First Lien)<br>6.0% Cash, 1.0% Libor<br>Floor,<br>Due 8/20                 |           |           |           |
|  |   | 990,004   | 982,260   | 943,870   |
| Nielsen & Bainbrige, LLC <sup>(9)</sup><br><i>Consumer goods: Durable</i>                                      | Junior Secured<br>Loan Term Loan<br>(Second Lien)<br>10.3% Cash, 1.0% Libor                                     |           |           |           |
|  |   | 2,091,954 | 2,065,884 | 1,956,814 |

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|   |                       |           |           |           |
|---|-----------------------|-----------|-----------|-----------|
|   | Floor,                |           |           |           |
|   | Due 8/21              |           |           |           |
|   | Senior Secured        |           |           |           |
|   | Loan Term Loan        |           |           |           |
| Nielsen & Bainbrige, LLC <sup>(9)</sup> , <sup>(10)</sup> | (First Lien)          |           |           |           |
| <i>Consumer goods: Durable</i>                            | 6.0% Cash, 1.0% Libor | 3,785,896 | 3,755,461 | 3,609,473 |
|   | Floor,                |           |           |           |
|   | Due 8/20              |           |           |           |

See accompanying notes to financial statements.

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| Portfolio Company/Principal Business   | Investment Interest Rate <sup>(1)</sup> /Maturity  | Principal   | Amortized Cost | Fair Value <sup>(2)</sup> |
|--|--|-------------|----------------|---------------------------|
| NM Z Parent Inc. (aka Zep, Inc.) <sup>(9)</sup> ,<br><sup>(10)</sup><br><i>Chemicals, Plastics and Rubber</i>                  | Senior Secured<br>Loan Initial<br>Term Loan<br>5.8% Cash, 1.0%<br>Libor Floor,<br>Due 6/22                     | \$3,482,500 | \$3,494,086    | \$3,359,916               |
| Novitex Acquisition, LLC (fka<br>ARSloane Acquisition, LLC) <sup>(9)</sup> , <sup>(10)</sup><br><i>Services: Business</i>      | Senior Secured<br>Loan Tranche B-2<br>Term Loan (First<br>Lien)<br>7.5% Cash, 1.3%<br>Libor Floor,<br>Due 7/20 | 972,650     | 965,333        | 893,865                   |
| Onex Carestream Finance LP <sup>(9)</sup><br><i>Healthcare &amp; Pharmaceuticals</i>   | Junior Secured<br>Loan Term Loan<br>(Second Lien)<br>9.5% Cash, 1.0%<br>Libor Floor,<br>Due 12/19              | 1,932,311   | 1,932,311      | 1,823,329                 |
| Onex Carestream Finance LP <sup>(9)</sup> , <sup>(10)</sup><br><i>Healthcare &amp; Pharmaceuticals</i>                         | Senior Secured<br>Loan Term Loan<br>(First Lien 2013)<br>5.0% Cash, 1.0%<br>Libor Floor,<br>Due 6/19           | 1,856,203   | 1,861,076      | 1,681,414                 |
| Otter Products, LLC (OtterBox<br>Holdings, Inc.) <sup>(9)</sup> , <sup>(10)</sup><br><i>Consumer goods: Durable</i>            | Senior Secured<br>Loan Term B Loan<br>5.8% Cash, 1.0%<br>Libor Floor,<br>Due 6/20                              | 2,754,168   | 2,736,134      | 2,604,892                 |
| PGX Holdings, Inc. <sup>(9)</sup> , <sup>(10)</sup><br><i>Services: Consumer</i>   | Senior Secured<br>Loan Initial Term<br>Loan (First Lien)<br>5.8% Cash, 1.0%<br>Libor Floor,<br>Due 9/20        | 3,818,571   | 3,788,271      | 3,813,225                 |
| Playpower, Inc. <sup>(9)</sup> , <sup>(10)</sup><br><i>Construction &amp; Building</i>   | Senior Secured<br>Loan Initial Term<br>Loan (First Lien)<br>5.8% Cash, 1.0%<br>Libor Floor,<br>Due 6/21        | 1,990,000   | 1,976,345      | 1,907,614                 |
| PrimeLine Utility Services LLC<br>(fka FR Utility Services LLC) <sup>(9)</sup> , <sup>(10)</sup><br><i>Energy: Electricity</i> | Senior Secured<br>Loan Initial<br>Term Loan  | 3,500,000   | 3,465,576      | 3,465,000                 |

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|   |  |            |            |           |
|---|--|------------|------------|-----------|
| PSC Industrial Holdings Corp. <sup>(9), (10)</sup><br><i>Environmental Industries</i>                                   | 6.5% Cash, 1.0%<br>Libor Floor,<br>Due 11/22<br>Senior Secured<br>Loan Term Loan<br>(First Lien) | 3,004,650  | 2,978,349  | 3,000,744 |
|   | 5.8% Cash, 1.0%<br>Libor Floor,<br>Due 12/20<br>Senior Secured<br>Loan Term<br>Loan A            |            |            |           |
| Quad-C JH Holdings Inc. (aka<br>Joerns Healthcare) <sup>(9), (10)</sup><br><i>Healthcare &amp; Pharmaceuticals</i>      | 6.0% Cash, 1.0%<br>Libor Floor,<br>Due 5/20<br>Senior Secured<br>Loan Initial<br>Term Loan       | 3,940,026  | 3,918,354  | 3,937,662 |
|   | 5.5% Cash, 1.0%<br>Libor Floor,<br>Due 7/21<br>Junior Secured<br>Loan Term Loan<br>(Second Lien) |            |            |           |
| Ravn Air Group, Inc. <sup>(9), (10)</sup><br><i>Transportation: Consumer</i>  | 11.3% Cash, Due 9/19<br>Senior Secured<br>Loan Term B Loan                                       | 2,484,375  | 2,472,795  | 2,324,381 |
|   | 3.8% Cash, 0.8%<br>Libor Floor,<br>Due 7/21<br>Senior Secured<br>Loan Term Loan                  |            |            |           |
| Roscoe Medical, Inc. <sup>(9)</sup><br><i>Healthcare &amp; Pharmaceuticals</i>  | 5.0% Cash, 1.0%<br>Libor Floor,<br>Due 11/20<br>Senior Secured<br>Loan Term Loan                 | 6,700,000  | 6,654,533  | 6,235,020 |
|   | 5.0% Cash, 1.0%<br>Libor Floor,<br>Due 11/20<br>Senior Secured<br>Loan Term Loan                 |            |            |           |
| Rovi Solutions Corporation/Rovi<br>Guides, Inc. <sup>(10)</sup><br><i>High Tech Industries</i>                          | 5.0% Cash, 1.0%<br>Libor Floor,<br>Due 11/20<br>Senior Secured<br>Loan Term Loan                 | 2,962,406  | 2,930,614  | 2,947,890 |
|   | 5.0% Cash, 1.0%<br>Libor Floor,<br>Due 11/20<br>Senior Secured<br>Loan Term Loan                 |            |            |           |
| Sandy Creek Energy Associates,<br>L.P. <sup>(9), (10)</sup><br><i>Utilities: Electric</i>                               | 5.0% Cash, 1.0%<br>Libor Floor,<br>Due 11/20<br>Senior Secured<br>Loan Term Loan                 | 2,708,992  | 2,699,558  | 1,907,130 |
|   | 5.0% Cash, 1.0%<br>Libor Floor,<br>Due 11/20<br>Senior Secured<br>Loan Term Loan                 |            |            |           |
| Stafford Logistics, Inc.(dba Custom<br>Ecology, Inc.) <sup>(9), (10)</sup><br><i>Environmental Industries</i>           | 5.0% Cash, 1.0%<br>Libor Floor,<br>Due 11/20<br>Senior Secured<br>Loan Term Loan                 | 2,854,780  | 2,835,003  | 2,736,307 |
|   | 5.0% Cash, 1.0%<br>Libor Floor,<br>Due 11/20<br>Senior Secured<br>Loan Term Loan                 |            |            |           |
| Sun Products Corporation, The (fka<br>Huish Detergents Inc.) <sup>(9), (10)</sup><br><i>Consumer goods: Non-durable</i> | 5.5% Cash, 1.3%<br>Libor Floor,<br>Due 3/20<br>Senior Secured<br>Loan Loan                       | 3,882,654  | 3,863,759  | 3,657,460 |
|   | 5.5% Cash, 1.3%<br>Libor Floor,<br>Due 3/20<br>Senior Secured<br>Loan Loan                       |            |            |           |
| Tank Partners Holdings, LLC <sup>(9)</sup><br><i>Energy: Oil &amp; Gas</i>  | 6.6% Cash, 3.5% PIK,<br>3.0% Libor<br>Floor, Due 8/19  | 10,759,919 | 10,624,515 | 8,177,538 |
|   | 6.6% Cash, 3.5% PIK,<br>3.0% Libor<br>Floor, Due 8/19  |            |            |           |

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|  |  |            |            |            |
|--|--|------------|------------|------------|
| TPF II Power, LLC (TPF II Covert<br>Midco, LLC) <sup>(9), (10)</sup><br><i>Utilities: Electric</i> | Senior Secured<br>Loan    Term Loan                  |            |            |            |
|  | 5.5% Cash, 1.0%<br>Libor Floor,<br>Due 10/21         | 2,950,953  | 2,973,524  | 2,899,311  |
| Trimaran Advisors, L.L.C. <sup>(9)</sup><br><i>Related Party Loan</i>                              | Senior Unsecured<br>Loan                             |            |            |            |
|  | Revolving Credit<br>Facility<br>9.0% Cash, Due 11/17 | 23,000,000 | 23,000,000 | 23,000,000 |

See accompanying notes to financial statements.

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| Portfolio Company/Principal Business  | Investment Interest Rate <sup>(1)</sup> /Maturity  | Principal    | Amortized Cost | Fair Value <sup>(2)</sup> |
|---|--|--------------|----------------|---------------------------|
| TRSO I, Inc. <sup>(9)</sup><br><i>Energy: Oil &amp; Gas</i>   | Junior Secured Loan Term Loan (Second Lien)<br>11.0% Cash, 1.0%<br>Libor Floor,<br>Due 12/17 | \$ 1,000,000 | \$ 992,101     | \$ 950,300                |
| TWCC Holding Corp. <sup>(9), (10)</sup><br><i>Media: Broadcasting &amp; Subscription</i>  | Senior Secured Loan Term B-1<br>Loan<br>5.8% Cash, 0.8%<br>Libor Floor,<br>Due 2/20          | 822,470      | 827,875        | 822,470                   |
| U.S. Shipping Corp (fka U.S. Shipping Partners LP) <sup>(9), (10)</sup><br><i>Transportation: Cargo</i>                         | Senior Secured Loan Tranche B-2<br>Term Loan<br>5.3% Cash, 1.0%<br>Libor Floor,<br>Due 6/21  | 1,411,023    | 1,409,966      | 1,405,802                 |
| USJ-IMECO Holding Company, LLC <sup>(9), (10)</sup><br><i>Transportation: Cargo</i>   | Senior Secured Loan Term Loan<br>7.0% Cash, 1.0%<br>Libor Floor,<br>Due 4/20                 | 3,930,000    | 3,915,823      | 3,928,428                 |
| Vantiv, LLC (fka Fifth Third Processing Solutions, LLC) <sup>(10)</sup><br><i>Banking, Finance, Insurance &amp; Real Estate</i> | Senior Secured Loan Term B Loan<br>3.8% Cash, 0.8%<br>Libor Floor,<br>Due 6/21               | 1,688,507    | 1,692,039      | 1,685,333                 |
| Verdesian Life Sciences, LLC <sup>(9), (10)</sup><br><i>Environmental Industries</i>  | Senior Secured Loan Initial<br>Term Loan<br>6.0% Cash, 1.0%<br>Libor Floor,<br>Due 7/20      | 3,981,279    | 3,937,250      | 3,784,206                 |
| Vestcom International, Inc. (fka Vector Investment Holdings, Inc.) <sup>(9), (10)</sup><br><i>Retail</i>                        | Senior Secured Loan Term Loan<br>5.3% Cash, 1.0%<br>Libor Floor,<br>Due 9/21                 | 2,989,755    | 3,006,198      | 2,860,598                 |
| Weiman Products, LLC <sup>(9)</sup><br><i>Consumer goods: Non-durable</i>   | Senior Secured Loan Term Loan<br>6.3% Cash, 1.0%<br>Libor Floor,<br>Due 11/18                | 1,106,050    | 1,099,501      | 1,105,829                 |

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|   |                     |               |               |               |
|---|---------------------|---------------|---------------|---------------|
| Weiman Products, LLC <sup>(9), (10)</sup><br><i>Consumer goods: Non-durable</i> | Senior Secured      |               |               |               |
|   | Loan    Term Loan   |               |               |               |
|   | 6.3% Cash, 1.0%     | 5,515,079     | 5,482,956     | 5,513,976     |
|   | Libor Floor,        |               |               |               |
|   | Due 11/18           |               |               |               |
| WireCo WorldGroup Inc. <sup>(9)</sup><br><i>Capital Equipment</i>               | Senior Unsecured    |               |               |               |
|   | Bond                | 5,000,000     | 4,975,822     | 4,067,500     |
|   | 9.0% Cash, Due 5/17 |               |               |               |
| WireCo WorldGroup Inc. <sup>(9), (10)</sup><br><i>Capital Equipment</i>         | Senior Unsecured    |               |               |               |
|   | Bond                | 3,000,000     | 3,043,520     | 2,440,500     |
|   | 9.0% Cash, Due 5/17 |               |               |               |
| Total Investment in Debt  |                     |               |               |               |
| Securities (132% of net asset   |                     | \$299,940,657 | \$298,308,845 | \$284,639,244 |
| value at fair value)  |                     |               |               |               |

See accompanying notes to financial statements.

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| Portfolio Company/Principal Business  | Investment                   | Percentage Interest/Shares | Amortized Cost | Fair Value <sup>(2)</sup> |
|---|------------------------------|----------------------------|----------------|---------------------------|
| Aerostructures Holdings L.P. <sup>(5), (9)</sup><br><i>Aerospace and Defense</i>  | Partnership Interests        | 1.2 %                      | \$ 1,000,000   | \$ 1,000                  |
| Aerostructures Holdings L.P. <sup>(5), (9)</sup><br><i>Aerospace and Defense</i>  | Series A Preferred Interests | 1.2 %                      | 250,960        | 937,053                   |
| Caribe Media Inc. (fka Caribe Information Investments Incorporated) <sup>(5), (9)</sup><br><i>Media: Advertising, Printing &amp; Publishing</i> | Common                       | 1.3 %                      | 359,765        | 568,544                   |
| DBI Holding LLC <sup>(5), (9)</sup><br><i>Services: Business</i>  | Class A Warrants             | 3.2 %                      | 258,940        | 4,316,159                 |
| eInstruction Acquisition, LLC <sup>(5), (9)</sup><br><i>Services: Business</i>  | Membership Units             | 1.1 %                      | 1,079,617      | 1,000                     |
| FP WRCA Coinvestment Fund VII, Ltd. <sup>(3), (5)</sup><br><i>Capital Equipment</i>   | Class A Shares               | 1,500                      | 1,500,000      | 1,338,767                 |
| Perseus Holding Corp. <sup>(5), (9)</sup><br><i>Hotel, Gaming &amp; Leisure</i>   | Common                       | 0.2 %                      | 400,000        | 1,000                     |
| Roscoe Investors, LLC <sup>(5), (9)</sup><br><i>Healthcare &amp; Pharmaceuticals</i>  | Class A Units                | 1.6 %                      | 1,000,000      | 863,000                   |
| Tank Partners Holdings, LLC <sup>(5), (9), (12)</sup><br><i>Energy: Oil &amp; Gas</i>   | Unit                         | 5.8 %                      | 980,000        | 1,000                     |
| Tank Partners Holdings, LLC <sup>(5), (9)</sup><br><i>Energy: Oil &amp; Gas</i>   | Warrants                     | 1.3 %                      | 185,205        | 1,000                     |
| TRSO II, Inc. <sup>(5), (9)</sup><br><i>Energy: Oil &amp; Gas</i>   | Common Stock                 | 5.4 %                      | 1,500,000      | 1,074,480                 |
| New Millennium Holdco, Inc. (Millennium Health, LLC) <sup>(5), (9)</sup><br><i>Healthcare &amp; Pharmaceuticals</i>                             | Common                       | 0.2 %                      | 1,953,299      | 445,485                   |
| Total Investment in Equity Securities<br>(4% of net asset value at fair value)  |                              |                            | \$ 10,467,786  | \$ 9,548,488              |

See accompanying notes to financial statements.

TABLE OF CONTENTS**CLO Fund Securities****CLO Subordinated Securities, Preferred Shares and Income Notes Investments**

| Portfolio Company                             | Investment <sup>(13)</sup>   | Percentage Amortized<br>Ownership Cost |             | Fair Value <sup>(2)</sup> |
|---|--|--|-------------|---------------------------|
| Grant Grove CLO, Ltd. <sup>(3)</sup>          | Subordinated Securities,<br>effective interest 9.6%,<br>1/21 maturity  | 22.2 %                                 | \$2,484,943 | \$280,164                 |
| Katonah III, Ltd. <sup>(3)</sup>              | Preferred Shares,<br>effective interest N/M, 5/15 maturity             | 23.1 %                                 | 1,373,132   | 400,000                   |
| Katonah IX CLO Ltd <sup>(3), (6), (14)</sup>  | Preferred Shares,<br>effective interest 2.2%, 1/19 maturity            | 6.9 %                                  | 1,140,057   | 105,000                   |
| Katonah X CLO Ltd <sup>(3), (6), (14)</sup>   | Subordinated Securities,<br>effective interest 12.8%,<br>4/20 maturity | 33.3 %                                 | 7,637,499   | 1,000,000                 |
| Katonah 2007-I CLO Ltd. <sup>(3), (6)</sup>   | Preferred Shares,<br>effective interest 27.0%, 4/22 maturity           | 100 %                                  | 24,312,424  | 20,295,677                |
| Trimaran CLO VII, Ltd. <sup>(3), (6)</sup>    | Income Notes,<br>effective interest 50.8%, 6/21 maturity               | 10.5 %                                 | 1,375,013   | 1,647,272                 |
| Catamaran CLO 2012-1 Ltd. <sup>(3), (6)</sup> | Subordinated Notes,<br>effective interest 2.8%, 12/23 maturity         | 24.9 %                                 | 6,791,980   | 3,312,940                 |
| Catamaran CLO 2013-1 Ltd. <sup>(3), (6)</sup> | Subordinated Notes,<br>effective interest 12.9%, 1/25 maturity         | 23.5 %                                 | 6,256,090   | 5,639,106                 |
| Catamaran CLO 2014-1 Ltd. <sup>(3), (6)</sup> | Subordinated Notes,<br>effective interest 8.4%, 4/26 maturity          | 24.9 %                                 | 8,928,790   | 5,846,325                 |

|   |   |        |            |            |
|---|---|--------|------------|------------|
| Dryden 30 Senior Loan Fund <sup>(3)</sup>       | Subordinated Notes,<br>effective<br>interest 29.4%, 11/25<br>maturity | 7.5 %  | 1,592,303  | 1,634,647  |
| Catamaran CLO 2014-2 Ltd. <sup>(3), (6)</sup>   | Subordinated Notes,<br>effective<br>interest 8.8%, 10/26<br>maturity  | 24.9 % | 8,024,168  | 5,751,600  |
| Catamaran CLO 2015-1 Ltd. <sup>(3), (6)</sup>   | Subordinated Notes,<br>effective<br>interest 10.1%, 4/27<br>maturity  | 24.0 % | 11,869,751 | 8,789,651  |
| Total Investment in CLO Subordinated Securities |   |        | 81,786,150 | 54,702,382 |

## CLO Rated-Note Investments

| Portfolio Company  | Investment   | Percentage<br>Ownership | Amortized<br>Cost | Fair Value <sup>(2)</sup> |
|--|--|-------------------------|-------------------|---------------------------|
| Catamaran CLO 2014-1 Ltd. <sup>(3), (6)</sup>  | Float 04/2026 E<br>Par Value of 1,525,000<br>6.1% Cash, 4/26<br>maturity | 15 %                    | 1,428,797         | 1,170,000                 |
| Total Investment in CLO<br>Rated-Note  |  |                         | 1,428,797         | 1,170,000                 |
| Total Investment in CLO<br>Fund Securities (26% of net asset value<br>at fair value) |  |                         | 83,214,947        | 55,872,382                |

## Asset Manager Affiliates

| Portfolio Company/Principal Business  | Investment                  | Percentage<br>Ownership | Cost       | Fair Value <sup>(2)</sup> |
|---|-----------------------------|-------------------------|------------|---------------------------|
| Asset Manager Affiliates <sup>(9), (11)</sup>   | Asset Management<br>Company | 100 %                   | 56,591,230 | 57,381,000                |
| Total Investment in Asset Manager<br>Affiliates (27% of net asset value at fair<br>value) |                             |                         | 56,591,230 | 57,381,000                |

See accompanying notes to financial statements.

TABLE OF CONTENTS**Time Deposits and Money Market Account**

| Time Deposit and Money Market Accounts   | Investment           | Yield  | Amortized Cost | Fair Value <sup>(2)</sup> |
|--|----------------------|--------|----------------|---------------------------|
| JP Morgan Business Money Market Account <sup>(8), (9)</sup>                                      | Money Market Account | 0.10 % | \$249,247      | \$249,247                 |
| US Bank Money Market Account <sup>(9)</sup>  | Money Market Account | 0.02 % | 1,880,134      | 1,880,134                 |
| Total Investment in Time Deposit and Money Market Accounts (1% of net asset value at fair value) |                      |        | 2,129,381      | 2,129,381                 |
| Total Investments <sup>(4)</sup> (190% of net asset value at fair value)                         |                      |        | \$450,712,189  | \$409,570,495             |

A majority of the variable rate loans in the Company's investment portfolio bear interest at a rate that may be determined by reference to either LIBOR or an alternate Base Rate (commonly based on the Federal Funds Rate or the Prime Rate), which typically resets semi-annually, quarterly, or monthly at the borrower's option. The Borrower may also elect to have multiple interest reset periods for each loan. For each such loan, the Company has provided the weighted average annual stated interest rate in effect at December 31, 2015. As noted in the table above, 77% (based on par) of debt securities contain LIBOR floors which range between 0.75% and 3.0%.

(2) Reflects the fair market value of all investments as of December 31, 2015, as determined by the Company's Board of Directors.

(3) Non-U.S. company or principal place of business outside the U.S.

The aggregate cost of investments for federal income tax purposes is approximately \$471 million. The aggregate gross unrealized appreciation is approximately \$7.0 million, the aggregate gross unrealized depreciation is approximately \$68.2 million, and the net unrealized depreciation is approximately \$61.2 million.

(5) Non-income producing.

(6) An affiliate CLO Fund managed by an Asset Manager Affiliate (as such term is defined in the notes to the consolidated financial statements).

(7) Loan or debt security is on non-accrual status and therefore is considered non-income producing.

(8) Money market account holding restricted cash and security deposits for employee benefit plans.

(9) Qualified asset for purposes of section 55(a) of the Investment Company Act of 1940.

(10) As of December 31, 2015, this investment is owned by KCAP Senior Funding I, LLC and was pledged to secure KCAP Senior Funding I, LLC's obligation.

Other than the Asset Manager Affiliate, which we are deemed to control, we do not control and are not an affiliate of any of our portfolio companies, each as defined in the Investment Company Act of 1940 (the 1940 Act). In general, under the 1940 Act, we would be presumed to control a portfolio company if we owned 25% or more of its voting securities and would be an affiliate of a portfolio company if we owned 5% or more of its voting securities.

(12) Non-voting.

CLO Subordinated Investments are entitled to periodic distributions which are generally equal to the remaining cash flow of the payments made by the underlying fund's investments less contractual payments to debt holders and fund expenses. The estimated annualized effective yield indicated is based upon a current projection of the amount and timing of these distributions. Such projections are updated on a quarterly basis and the estimated effective yield is adjusted prospectively.

(14) Notice of redemption has been received for this transaction.

See accompanying notes to financial statements.

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TABLE OF CONTENTS**KCAP FINANCIAL, INC.****FINANCIAL HIGHLIGHTS  
(\$ per share)**

|  | For the Years Ended December 31, |   |               |    |               |    |               |    |               |   |
|--|----------------------------------|---|---------------|----|---------------|----|---------------|----|---------------|---|
|  | 2016                             |   | 2015          |    | 2014          |    | 2013          |    | 2012          |   |
| <b>Per Share Data:</b>   |                                  |   |               |    |               |    |               |    |               |   |
| Net asset value, at beginning of period  | \$5.82                           |   | \$6.94        |    | \$7.51        |    | \$7.85        |    | \$7.85        |   |
| Net investment income <sup>(1)</sup>   | 0.50                             |   | 0.65          |    | 0.59          |    | 0.62          |    | 0.65          |   |
| Net realized losses from investment transactions <sup>(1)</sup>                    | (0.17                            | ) | (0.17         | )  | (0.30         | )  | (0.37         | )  | (0.12         | ) |
| Realized losses from extinguishments of debt <sup>(1)</sup>                        |                                  |   | (0.01         | )  | (0.02         | )  | (0.02         | )  |               |   |
| Net change in unrealized (depreciation)/appreciation of investments <sup>(1)</sup> | (0.36                            | ) | (0.97         | )  | 0.17          |    | 0.31          |    | 0.39          |   |
| Net (decrease)/increase in net assets resulting from operations                    | (0.03                            | ) | (0.50         | )  | 0.44          |    | 0.54          |    | 0.92          |   |
| Net decrease in net assets resulting from distributions:                           |                                  |   |               |    |               |    |               |    |               |   |
| Distribution of ordinary income  | (0.40                            | ) | (0.63         | )  | (0.78         | )  | (0.62         | )  | (0.65         | ) |
| Return of capital  | (0.19                            | ) |               |    | (0.22         | )  | (0.43         | )  | (0.29         | ) |
| Net decrease in net assets resulting from stockholder distributions                | (0.59                            | ) | (0.63         | )  | (1.00         | )  | (1.05         | )  | (0.94         | ) |
| Net increase/(decrease) in net assets relating to capital share transactions       |                                  |   |               |    |               |    |               |    |               |   |
| Offering of common stock   |                                  |   |               |    | 0.02          |    | 0.14          |    |               |   |
| Common stock withheld for payroll taxes upon vesting of restricted stock           | 0.01                             |   |               |    |               |    |               |    |               |   |
| Dividend reinvestment plan   | (0.01                            | ) |               |    |               |    | 0.02          |    | 0.02          |   |
| Stock based compensation   | 0.04                             |   | 0.01          |    | (0.03         | )  | 0.01          |    |               |   |
| Net increase (decrease) in net assets relating to capital share transactions       | 0.04                             |   | 0.01          |    | (0.01         | )  | 0.17          |    | 0.02          |   |
| Net asset value, end of period   | \$5.24                           |   | \$5.82        |    | \$6.94        |    | \$7.51        |    | \$7.85        |   |
| Total net asset value return <sup>(2)</sup>  | 0.2                              | % | (7.2          | )% | 5.7           | %  | 9.1           | %  | 11.9          | % |
| <b>Ratio/Supplemental Data:</b>  |                                  |   |               |    |               |    |               |    |               |   |
| Per share market value at beginning of period                                      | \$4.07                           |   | \$6.82        |    | \$8.07        |    | \$9.19        |    | \$6.31        |   |
| Per share market value at end of period  | \$3.98                           |   | \$4.07        |    | \$6.82        |    | \$8.07        |    | \$9.19        |   |
| Total market return <sup>(3)</sup>   | 12.3                             | % | (31.2         | )% | (3.1          | )% | (0.7          | )% | 60.5          | % |
| Shares outstanding at end of period  | 37,178,294                       |   | 37,100,005    |    | 36,775,127    |    | 33,332,123    |    | 26,470,408    |   |
| Net assets at end of period  | \$194,924,925                    |   | \$216,100,470 |    | \$255,316,701 |    | \$250,369,693 |    | \$207,875,659 |   |

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|   |               |   |               |   |               |   |               |   |              |   |
|---|---------------|---|---------------|---|---------------|---|---------------|---|--------------|---|
| Portfolio turnover rate <sup>(4)</sup>                              | 34.3          | % | 32.5          | % | 45.8          | % | 45.5          | % | 39.2         | % |
| Average par debt outstanding  | \$189,836,675 |   | \$224,498,433 |   | \$196,622,077 |   | \$150,828,586 |   | \$80,758,743 |   |
| Asset coverage ratio  | 205           | % | 202           | % | 211           | % | 226           | % | 305          | % |
| Ratio of net investment income to average net assets <sup>(5)</sup> | 9.0           | % | 9.8           | % | 7.9           | % | 7.8           | % | 8.3          | % |
| Ratio of total expenses to average net assets <sup>(5)</sup>        | 8.6           | % | 8.6           | % | 8.2           | % | 7.5           | % | 7.2          | % |
| Ratio of interest expense to average net assets <sup>(5)</sup>      | 4.4           | % | 4.7           | % | 4.5           | % | 3.9           | % | 3.4          | % |
| Ratio of non-interest expenses to average net assets <sup>(5)</sup> | 4.2           | % | 3.9           | % | 3.7           | % | 3.6           | % | 3.7          | % |

(1) Based on weighted average number of common shares outstanding for the period.

(2) Total net asset value return (not annualized) equals the change in the net asset value per share over the beginning of period net asset value per share plus distributions, divided by the beginning net asset value per share.

(3) Total market return equals the change in the ending market price over the beginning of period price per share plus distributions, divided by the beginning price.

(4) Not annualized. Portfolio turnover rate equals the year-to-date sales and paydowns over the average of the invested assets at fair value.

(5)

Annualized

See accompanying notes to financial statements.

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## KCAP Financial, Inc.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## 1. ORGANIZATION

KCAP Financial, Inc. ( "KCAP" or the "Company" ) is an internally managed, non-diversified closed-end investment company that is regulated as a business development company ( "BDC" ) under the Investment Company Act of 1940 (the "1940 Act" ). The Company was formed as a Delaware limited liability company on August 8, 2006 and, prior to the issuance of shares of the Company's common stock in its initial public offering ( "IPO" ), converted to a corporation incorporated in Delaware on December 11, 2006. Prior to its IPO, the Company did not have material operations. The Company's IPO of 14,462,000 shares of common stock raised net proceeds of approximately \$200 million. Prior to the IPO, the Company issued 3,484,333 shares to affiliates of Kohlberg & Co., L.L.C., a leading middle market private equity firm, in exchange for the contribution to the Company of their ownership interests in Katonah Debt Advisors, L.L.C., and related affiliates (collectively, "Katonah Debt Advisors" ) and in securities issued by collateralized loan obligation funds ( "CLO Funds" ) managed by Katonah Debt Advisors and two other asset managers.

On April 28, 2008, the Company completed a rights offering that resulted in the issuance of 3.1 million shares of the Company's common stock, and net proceeds of \$27 million.

On February 29, 2012, the Company purchased Trimaran Advisors, L.L.C. ( "Trimaran Advisors" ), an asset manager similar to Katonah Debt Advisors, for total consideration of \$13.0 million in cash and 3,600,000 shares of the Company's common stock. Contemporaneously with the acquisition of Trimaran Advisors, the Company acquired from Trimaran Advisors equity interests in certain CLO Funds managed by Trimaran Advisors for an aggregate purchase price of \$12.0 million in cash.

On February 14, 2013, the Company completed a public offering of 5,232,500 shares of common stock, which included the underwriters' full exercise of their option to purchase up to 682,500 shares of common stock, at a price of \$9.75 per share, raising approximately \$51.0 million in gross proceeds. In conjunction with this offering, the Company also sold 200,000 shares of common stock to a member of its Board of Directors, at a price of \$9.31125 per share, raising approximately \$1.9 million in gross proceeds.

On October 6, 2014, the Company completed a follow-on public offering of 3.0 million shares of its common stock at a price of \$8.02 per share. The offering raised net proceeds of approximately \$23.8 million, after deducting underwriting discounts and offering expenses.

As of December 31, 2016, Katonah Debt Advisors and Trimaran Advisors, as well as affiliated management companies Katonah 2007-1 Management, L.L.C., and Trimaran Advisors Management, L.L.C. (collectively the "Asset Manager Affiliates" ), had approximately \$3.0 billion of par value assets under management. The Asset Manager Affiliates are each managed independently from KCAP by a separate management team (however, certain of the Company's executive officers also act in similar capacities for one or both of the Asset Manager Affiliates). The Asset Manager Affiliates provide investment management services to CLO Funds, making day-to-day investment decisions concerning the assets of the CLO Funds. The Asset Manager Affiliates do not have any investments in the CLO Funds they manage; however, KCAP holds investments in a portion of the securities issued by the CLO Funds managed by the Asset Manager Affiliates.



The Company has three principal areas of investment:

First, the Company originates, structures, and invests in senior secured term loans and mezzanine debt primarily in privately-held middle market companies (the Debt Securities Portfolio ). In addition, from time to time the Company may invest in the equity securities of privately held middle market companies.

Second, the Company has invested in the Asset Manager Affiliates, which manage CLO Funds.

Third, the Company invests in debt and subordinated securities issued by CLO Funds ( CLO Fund Securities ). These CLO Fund Securities are primarily managed by our Asset Manager Affiliates, but from time-to-time the Company makes investments in CLO Fund Securities managed by other asset managers. The CLO Funds typically invest in broadly syndicated loans, high-yield bonds and other credit instruments.

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## KCAP Financial, Inc.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## 1. ORGANIZATION (continued)

The Company may also invest in other investments such as loans to publicly-traded companies, high-yield bonds and distressed debt securities. The Company may also receive warrants or options to purchase common stock in connection with its debt investments.

The Company has 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 qualify as a RIC, the Company must, among other things, meet certain source-of-income, and asset diversification and annual distribution requirements. As a RIC, the Company generally will not have to pay corporate-level U.S. federal income taxes on any income that it distributes in a timely manner to its stockholders.

## 2. SIGNIFICANT ACCOUNTING POLICIES

### Basis of Presentation

The accompanying consolidated financial statements have been prepared on the accrual basis of accounting in conformity with accounting principles generally accepted in the United States of America ( GAAP ).

The consolidated financial statements reflect all adjustments, both normal and recurring which, in the opinion of management, are necessary for the fair presentation of the Company's results of operations and financial condition for the periods presented. Furthermore, the preparation of the consolidated financial statements requires the Company to make significant estimates and assumptions including with respect to the fair value of investments that do not have a readily available market value. Actual results could differ from those estimates, and the differences could be material.

Certain prior-year amounts have been reclassified to conform to the current year presentation.

The Company consolidates the financial statements of its wholly-owned special purpose financing subsidiaries KCAP Funding, Kolhberg Capital Funding LLC I, KCAP Senior Funding I, LLC and KCAP Senior Funding I Holdings, LLC in its consolidated financial statements as they are operated solely for investment activities of the Company. The creditors of KCAP Senior Funding I, LLC have received security interests in the assets owned by KCAP Senior Funding I, LLC and such assets are not intended to be available to the creditors of KCAP Financial, Inc., or any other affiliate.

In accordance with Article 6 of Regulation S-X under the Securities Act of 1933, as amended (the Securities Act ), and the Securities Exchange Act of 1934, as amended (the Exchange Act ), the Company does not consolidate portfolio company investments, including those in which it has a controlling interest (e.g., the Asset Manager Affiliates), unless the portfolio company is another investment company.

The Asset Manager Affiliates are subject to Accounting Standards Codification Topic 810, Consolidation and although the Company cannot consolidate the financial statements of portfolio company investments, this guidance

impacts the Company's required disclosures relating to the Asset Manager Affiliates. The Asset Manager Affiliates qualify as a significant subsidiary and, as a result, the Company is required to include additional financial information regarding the Asset Manager Affiliates in its filings with the SEC. This additional financial information regarding the Asset Manager Affiliates does not directly impact the financial position or results of operations of the Company.

In addition, in accordance with Regulation S-X promulgated by the SEC, additional financial information with respect to one of the CLO Funds in which the Company has an investment, Katonah 2007-I CLO Ltd. (Katonah 2007-I CLO), is required to be included in the Company's SEC filings. The additional financial information regarding the Asset Manager Affiliates and Katonah 2007-I CLO (pursuant to Rule 3-09), immediately follows these consolidated financial statements. Summarized financial information regarding Katonah X CLO (pursuant to Rule 4-08 (g)) is set forth in Note 5.

Stockholder distributions on the Statement of Changes in Net Assets reflect the estimated allocation, between net investment income and return of capital, of distributions made during the reporting period,

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**KCAP Financial, Inc.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**2. SIGNIFICANT ACCOUNTING POLICIES (continued)**

excluding the distribution declared in a quarter with a record date occurring after the quarter-end. The determination of the tax character of distributions is made on an annual (full calendar-year) basis at the end of the year based upon our taxable income for the full year and the distributions paid during the full year. Therefore, an estimate of tax attributes made on a quarterly basis may not be representative of the actual tax attributes of distributions for a full year.

It is the Company's primary investment objective to generate current income and capital appreciation by lending directly to privately-held middle market companies. During the year ended December 31, 2016, the Company provided approximately \$76.7 million to portfolio companies to support their growth objectives. None of this support was contractually obligated. See also Note 8 Commitments and Contingencies. As of December 31, 2016, the Company held loans it made to 96 investee companies with aggregate principal amounts of approximately \$246.7 million. The details of such loans have been disclosed on the consolidated schedule of investments as well as in Note 4 Investments. In addition to providing loans to investee companies, from time to time the Company assists investee companies in securing financing from other sources by introducing such investee companies to sponsors or by, among other things, leading a syndicate of lenders to provide the investee companies with financing. During the year ended December 31, 2016, the Company did not engage in any such or similar activities.

In August 2014, the FASB issued Accounting Standards Update (ASU) 2014-15, Presentation of Financial Statements - Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern (ASU 2014-15). The standard requires management to evaluate, at each interim and annual reporting period, whether there are conditions or events that raise substantial doubt about the entity's ability to continue as a going concern within one year after the date the financial statements are issued, and provide related disclosures. ASU 2014-15 is effective for annual periods ending after December 15, 2016, and for annual and interim periods thereafter. We have adopted ASU 2014-15, and there was no material impact on our financial statements.

In April 2015, the FASB issued Accounting Standards Update 2015-03, Interest - Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs. Under this guidance, debt issuance costs related to a recognized debt liability are to be presented as a direct deduction from the debt liability rather than as an asset on the balance sheet, consistent with debt discounts. For public business entities, the final guidance was effective for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. Early adoption was permitted. The Company adopted the new guidance beginning the first quarter of 2016.

The following table presents the impact of the Accounting Standards Update 2015-03 on our Consolidated Balance Sheet at December 31, 2015:

**CONSOLIDATED BALANCE SHEET**

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As of December 31, 2015

| As originally<br>reported | Impact of<br>adoption | Balance Sheet<br>after adjustment |
|---------------------------|-----------------------|-----------------------------------|
|---------------------------|-----------------------|-----------------------------------|

**ASSETS**

Other assets

|              |                 |            |
|--------------|-----------------|------------|
| \$ 4,603,855 | \$ (4,037,644 ) | \$ 566,211 |
|--------------|-----------------|------------|

**LIABILITIES**

Notes issued by KCAP Senior Funding I, LLC

|                |                 |                |
|----------------|-----------------|----------------|
| \$ 144,442,405 | \$ (3,126,009 ) | \$ 141,316,396 |
|----------------|-----------------|----------------|

7.375% Notes Due 2019

|               |               |               |
|---------------|---------------|---------------|
| \$ 41,400,000 | \$ (890,344 ) | \$ 40,509,656 |
|---------------|---------------|---------------|

Convertible Notes

|               |              |               |
|---------------|--------------|---------------|
| \$ 19,299,000 | \$ (21,291 ) | \$ 19,277,709 |
|---------------|--------------|---------------|

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**KCAP Financial, Inc.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**2. SIGNIFICANT ACCOUNTING POLICIES (continued)**

FASB issued Accounting Standards Update 2014-09, Revenue from Contracts with Customers, which updated accounting guidance for all revenue recognition arising from contracts with customers, and also affects entities that enter into contracts to provide goods or services to their customers (unless the contracts are in the scope of other US GAAP requirements). This update provides a model for the measurement and recognition of gains and losses on the sale of certain nonfinancial assets, such as property and equipment, including real estate. The FASB also issued ASU 2015-14, Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date, which deferred the effective date of the standard for one year. As a result, the guidance is effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2017. Management is still evaluating the effect of the new standard.

In March 2016, the FASB issued ASU 2016-09 Compensation – Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting ( ASU 2016-09 ). The amendments in ASU 2016-09 affect all entities that issue share-based payment awards to their employees and involve multiple aspects of the accounting for share-based payment transactions, including income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. For public business entities, ASU 2016-09 is effective for annual periods beginning after December 15 2016, and interim periods within those annual periods. Early adoption is permitted. We do not expect to adopt ASU 2016-09 early. Management is still evaluating the effect of the new standard.

In November 2016, the FASB issued Accounting Standards Update 2016-18, Restricted Cash ( ASU 2016-18 ) which requires entities to show the changes in the total cash, cash equivalents, restricted cash and restricted cash equivalents in the statement of cash flows. The guidance is effective for fiscal years beginning after December 15, 2017, and interim periods within those years. Early adoption is permitted, and entities will be required to apply the guidance retrospectively when adopted. Management is still evaluating the effect of the new standard.

**Investments**

Investment transactions are recorded on the applicable trade date. Realized gains or losses are determined using the specific identification method.

*Valuation of Portfolio Investments.* The Company's Board of Directors is ultimately and solely responsible for making a good faith determination of the fair value of portfolio investments on a quarterly basis. Debt and equity securities for which market quotations are readily available are generally valued at such market quotations. Debt and equity securities that are not publicly traded or whose market price is not readily available are valued by the Board of Directors based on detailed analyses prepared by management and, in certain circumstances, third parties with valuation expertise. Valuations are conducted by management on 100% of the investment portfolio at the end of each quarter. The Company follows the provisions of ASC 820: Fair Value Measurements and Disclosures ( ASC 820: Fair Value ). This standard defines fair value, establishes a framework for measuring fair value, and expands disclosures about assets and liabilities measured at fair value. ASC 820: Fair Value defines fair value as the price that would be

received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Subsequent to the adoption of ASC 820: Fair Value, the FASB has issued various staff positions clarifying the initial standard as noted below.

The FASB issued guidance that clarified and required disclosures about fair value measurements. These include requirements to disclose the amounts and reasons for significant transfers between Level I and Level II, as well as significant transfers in and out of Level III of the fair value hierarchy (see Note 4 Investments Fair Value Measurements for further information relating to Level I, Level II and Level III). The guidance also required that purchases, sales, issuances and settlements be presented gross in the Level III reconciliation.

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**KCAP Financial, Inc.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**2. SIGNIFICANT ACCOUNTING POLICIES (continued)**

ASC 820: Fair Value requires the disclosure in interim and annual periods of the inputs and valuation techniques used to measure fair value and a discussion of changes in valuation techniques and related inputs, if any, during the period.

The Company utilizes an independent valuation firm to provide an annual third-party review of the Company's CLO Securities fair value model relative to its functionality, model inputs and calculations as a reasonable method to determine fair values of CLO Securities, in the absence of Level I or Level II trading activity or observable market inputs. The independent valuation firm's 2016 annual review concluded that the Company's model appropriately factors in all the necessary inputs required to build an equity cash flow model for CLO Securities fair for value purposes and that the inputs were being employed correctly.

The Company utilizes an independent valuation firm to provide third party valuation consulting services. Each quarter the independent valuation firm will perform third party valuations of the Company's investments in material illiquid securities such that they are reviewed at least once during a trailing 12-month period. These third party valuation estimates are considered as one of the relevant data points in the Company's determination of fair value. The Company intends to continue to engage an independent valuation firm in the future to provide certain valuation services, including the review of certain portfolio assets, as part of the quarterly and annual year-end valuation process.

The Board of Directors may consider other methods of valuation than those set forth below to determine the fair value of Level III investments as appropriate in conformity with GAAP. Due to the inherent uncertainty of determining the fair value of investments that do not have a readily available market value, the fair value of the Company's investments may differ materially from the values that would have been used had a readily available market existed for such investments. Further, such investments may be generally subject to legal and other restrictions on resale or otherwise be less liquid than publicly traded securities. In addition, changes in the market environment and other events may occur over the life of the investments that may cause the value realized on such investments to be different from the currently assigned valuations.

The majority of the Company's investment portfolio is composed of debt and equity securities with unique contract terms and conditions and/or complexity that requires a valuation of each individual investment that considers multiple levels of market and asset specific inputs, which may include historical and forecasted financial and operational performance of the individual investment, projected cash flows, market multiples, comparable market transactions, the priority of the security compared with those of other securities for such issuers, credit risk, interest rates, and independent valuations and reviews.

*Debt Securities.* To the extent that the Company's investments are exchange traded and are priced or have sufficient price indications from normal course trading at or around the valuation date (financial reporting date), such pricing will be used to determine the fair value of the investments. Valuations from third party pricing services may be used as an indication of fair value, depending on the volume and reliability of the valuation, sufficient and reasonable correlation of bid and ask quotes, and, most importantly, the level of actual trading activity. However, if the Company has been unable to identify directly comparable market indices or other market guidance that correlate directly to the



types of investments the Company owns, the Company will determine fair value using alternative methodologies such as available market data, as adjusted, to reflect the types of assets the Company owns, their structure, qualitative and credit attributes and other asset-specific characteristics.

The Company derives fair value for its illiquid investments that do not have indicative fair values based upon active trades primarily by using a present value technique that discounts the estimated contractual cash flows for the subject assets with discount rates imputed by broad market indices, bond spreads and yields for comparable issuers relative to the subject assets (the Income Approach ). The Company also considers, among other things, recent loan amendments or other activity specific to the subject asset. Discount rates applied to estimated contractual cash flows for an underlying asset vary by specific investment, industry,

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**KCAP Financial, Inc.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**2. SIGNIFICANT ACCOUNTING POLICIES (continued)**

priority and nature of the debt security (such as the seniority or security interest of the debt security) and are assessed relative to two indices, a leveraged loan index and a high-yield bond index, at the valuation date. The Company has identified these two indices as benchmarks for broad market information related to its loan and debt securities. Because the Company has not identified any market index that directly correlates to the loan and debt securities held by the Company and therefore uses these benchmark indices, these market indices may require significant adjustment to better correlate such market data for the calculation of fair value of the investment under the Income Approach. Such adjustments require judgment and may be material to the calculation of fair value. Further adjustments to the discount rate may be applied to reflect other market conditions or the perceived credit risk of the borrower. When broad market indices are used as part of the valuation methodology, their use is subject to adjustment for many factors, including priority, collateral used as security, structure, performance and other quantitative and qualitative attributes of the asset being valued. The resulting present value determination is then weighted along with any quotes from observable transactions and broker/pricing quotes. If such quotes are indicative of actual transactions with reasonable trading volume at or near the valuation date that are not liquidation or distressed sales, relatively more reliance will be put on such quotes to determine fair value. If such quotes are not indicative of market transactions or are insufficient as to volume, reliability, consistency or other relevant factors, such quotes will be compared with other fair value indications and given relatively less weight based on their relevancy. Other significant assumptions, such as coupon and maturity, are asset-specific and are noted for each investment in the Schedules of Investments.

*Equity Securities.* The Company's equity securities in portfolio companies for which there is no liquid public market are carried at fair value based on the enterprise value of the portfolio company, which is determined using various factors, including EBITDA (earnings before interest, taxes, depreciation and amortization) and discounted cash flows from operations, less capital expenditures and other pertinent factors, such as recent offers to purchase a portfolio company's securities or other liquidation events. The determined fair values are generally discounted to account for restrictions on resale and minority ownership positions. In the event market quotations are readily available for the Company's equity securities in public companies, those investments may be valued using the Market Approach (as defined below). In cases where the Company receives warrants to purchase equity securities, a market standard Black-Scholes model is utilized.

The significant inputs used to determine the fair value of equity securities include prices, EBITDA and cash flows after capital expenditures for similar peer comparables and the investment entity itself. Equity securities are classified as Level III, when there is limited activity or less transparency around inputs to the valuation given the lack of information related to such equity investments held in nonpublic companies. Significant assumptions observed for comparable companies are applied to relevant financial data for the specific investment. Such assumptions, such as model discount rates or price/earnings multiples, vary by the specific investment, equity position and industry and incorporate adjustments for risk premiums, liquidity and company specific attributes. Such adjustments require judgment and may be material to the calculation of fair value.

*Asset Manager Affiliates.* The Company's investments in its wholly-owned asset management companies, the Asset Manager Affiliates, are carried at fair value, which is primarily determined utilizing the Discounted Cash Flow

approach (as defined below), which incorporates different levels of discount rates depending on the hierarchy of fees earned (including the likelihood of realization of senior, subordinate and incentive fees) and prospective modeled performance. Such valuation takes into consideration an analysis of comparable asset management companies and the amount of assets under management. The Asset Manager Affiliates are classified as a Level III investment. Any change in value from period to period is recognized as net change in unrealized appreciation or depreciation.

*CLO Fund Securities.* The Company typically makes a minority investment in the most junior class of securities of CLO Funds raised and managed by the Asset Manager Affiliates and may selectively invest in securities issued by funds managed by other asset management companies. The investments held by CLO Funds generally relate to non-investment grade credit instruments issued by corporations.

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**KCAP Financial, Inc.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**2. SIGNIFICANT ACCOUNTING POLICIES (continued)**

The Company's investments in CLO Fund securities are carried at fair value, which is based either on (i) the present value of the net expected cash inflows for interest income and principal repayments from underlying assets and cash outflows for interest expense, debt pay-down and other fund costs for the CLO Funds that are approaching or past the end of their reinvestment period and therefore are selling assets and/or using principal repayments to pay down CLO

Fund debt (or will begin to do so shortly), and for which there continue to be net cash distributions to the class of securities owned by the Company, a Discounted Cash Flow approach, (ii) a discounted cash flow model that utilizes prepayment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow and comparable yields for similar securities or preferred shares to those in which the Company has invested, or (iii) indicative prices provided by the underwriters or brokers who arrange CLO

Funds, a Market Approach. The Company recognizes unrealized appreciation or depreciation on the Company's investments in CLO Fund securities as comparable yields in the market change and/or based on changes in net asset values or estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool. As each investment in CLO Fund securities ages, the expected amount of losses and the expected timing of recognition of such losses in the underlying collateral pool are updated and the revised cash flows are used in determining the fair value of the CLO Fund investment. The Company determines the fair value of its investments in CLO Fund securities on a security-by-security basis.

Due to the individual attributes of each CLO Fund security, they are classified as a Level III investment unless specific trading activity can be identified at or near the valuation date. When available, observable market information will be identified, evaluated and weighted accordingly in the application of such data to the present value models and fair value determination. Significant assumptions to the present value calculations include default rates, recovery rates, prepayment rates, investment/reinvestment rates and spreads and the discount rate by which to value the resulting underlying cash flows. Such assumptions can vary significantly, depending on market data sources which often vary in depth and level of analysis, understanding of the CLO market, detailed or broad characterization of the CLO market and the application of such data to an appropriate framework for analysis. The application of data points are based on the specific attributes of each individual CLO Fund security's underlying assets, historic, current and prospective performance, vintage, and other quantitative and qualitative factors that would be evaluated by market participants. The Company evaluates the source of market data for reliability as an indicative market input, consistency amongst other inputs and results and also the context in which such data is presented.

For rated note tranches of CLO Fund securities (those above the junior class) without transactions to support a fair value for the specific CLO Fund and tranche, fair value is based on discounting estimated bond payments at current market yields, which may reflect the adjusted yield on the leveraged loan index for similarly rated tranches, as well as prices for similar tranches for other CLO Funds and also other factors such as indicative prices provided by underwriters or brokers who arrange CLO Funds, and the default and recovery rates of underlying assets in the CLO Fund, as may be applicable. Such model assumptions may vary and incorporate adjustments for risk premiums and CLO Fund specific attributes.

**Cash.** The Company defines cash as demand deposits. The Company places its cash with financial institutions and, at times, cash held in checking accounts may exceed the Federal Deposit Insurance Corporation insured limit.

**Restricted Cash.** Restricted cash and cash equivalents (e.g., money market funds) consists of cash held for reinvestment and quarterly interest and principal distribution (if any) to holders of notes issued by KCAP Senior Funding I, LLC.

**Time Deposits and Money Market Accounts.** Time deposits primarily represent investments of cash held in demand deposit accounts. Money market accounts primarily represent short term interest-bearing deposit accounts and also includes restricted cash held under employee benefit plans.

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# KCAP Financial, Inc.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### 2. SIGNIFICANT ACCOUNTING POLICIES (continued)

**Interest Income.** Interest income, including the amortization of premium and accretion of discount and accrual of payment-in-kind ( PIK ) interest, is recorded on the accrual basis to the extent that such amounts are expected to be collected. The Company generally places a loan or security on non-accrual status and ceases recognizing interest income on such loan or security when a loan or security becomes 90 days or more past due or if the Company otherwise does not expect the debtor to be able to service its debt obligations. For investments with PIK interest, which represents contractual interest accrued and added to the principal balance that generally becomes due at maturity, we will not accrue PIK interest if the portfolio company valuation indicates that the PIK interest is not collectible (i.e. via a partial or full non-accrual). Loans which are on partial or full non-accrual remain in such status until the borrower has demonstrated the ability and intent to pay contractual amounts due, or such loans become current. As of December 31, 2016, two of our investments were on partial non-accrual status, whereby we have recognized income on a portion of contractual PIK amounts due. As of December 31, 2015, there was one issuer on non-accrual status.

**Distributions from Asset Manager Affiliates.** The Company records distributions from our Asset Manager Affiliates on the declaration date, which represents the ex-dividend date. Distributions in excess of tax-basis earnings and profits of the distributing affiliate company are recognized as tax-basis return of capital. For interim periods, the Company estimates the tax attributes of any distributions as being either tax-basis earnings and profits (i.e., dividend income) or return of capital (i.e., adjustment to the Company's cost basis in the Asset Manager Affiliates). The final determination of the tax attributes of distributions from our Asset Manager Affiliates is made on an annual (full calendar year) basis at the end of the year based upon taxable income and distributions for the full-year. Therefore, any estimate of tax attributes of distributions made on a quarterly basis may not be representative of the actual tax attributes of distributions for a full year.

**Investment Income on CLO Fund Securities.** The Company generates investment income from its investments in the most junior class of securities of CLO Funds (typically preferred shares or subordinated securities) managed by the Asset Manager Affiliates and select investments in securities issued by funds managed by other asset management companies. The Company's CLO Fund junior class securities are subordinated to senior note holders who typically receive a stated interest rate of return based on a floating rate index, such as the London Interbank Offered Rate ( LIBOR ) on their investment. The CLO Funds are leveraged funds and any excess cash flow or excess spread (interest earned by the underlying securities in the fund less payments made to senior note holders and less fund expenses and management fees) is paid to the holders of the CLO Fund's subordinated securities or preferred shares.

GAAP-basis investment income on CLO equity investments is recorded using the effective interest method in accordance with the provisions of ASC 325-40, based on the anticipated yield and the estimated cash flows over the projected life of the investment. Yields are revised when there are changes in actual or estimated projected future cash flows due to changes in prepayments and/or re-investments, credit losses or asset pricing. Changes in estimated yield are recognized as an adjustment to the estimated yield prospectively over the remaining life of the investment from the date the estimated yield was changed. Accordingly, investment income recognized on CLO equity securities in the GAAP statement of operations differs from both the tax-basis investment income and from the cash distributions

actually received by the Company during the period.

For non-junior class CLO Fund securities, such as the Company's investment in the Class E Notes of the Catamaran 2014-1 CLO, interest is earned at a fixed spread relative to the LIBOR index.

***Capital Structuring Service Fees.*** The Company may earn ancillary structuring and other fees related to the origination, investment, disposition or liquidation of debt and investment securities. Generally, the Company will capitalize loan origination fees, then amortize these fees into interest income over the term of the loan using the effective interest rate method, recognize prepayment and liquidation fees upon receipt and equity structuring fees as earned, which generally occurs when an investment transaction closes.

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## KCAP Financial, Inc.

# NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## 2. SIGNIFICANT ACCOUNTING POLICIES (continued)

**Debt Issuance Costs.** Debt issuance costs represent fees and other direct costs incurred in connection with the Company's borrowings. These amounts are capitalized and amortized using the effective interest method over the expected term of the borrowing.

**Extinguishment of debt.** The Company must derecognize a liability if and only if it has been extinguished through delivery of cash, delivery of other financial assets, delivery of goods or services, or reacquisition by the Company of its outstanding debt securities whether the securities are cancelled or held. If the debt contains a cash conversion option, the Company must allocate the consideration transferred and transaction costs incurred to the extinguishment of the liability component and the reacquisition of the equity component and recognize a gain or loss in the statement of operations.

**Expenses.** The Company is internally managed and expenses costs, as incurred, with regard to the running of its operations. Primary operating expenses include employee salaries and benefits, the costs of identifying, evaluating, negotiating, closing, monitoring and servicing the Company's investments and related overhead charges and expenses, including rental expense, and any interest expense incurred in connection with borrowings. The Company and the Asset Manager Affiliates share office space and certain other operating expenses. The Company has entered into an Overhead Allocation Agreement with the Asset Manager Affiliates which provides for the sharing of such expenses based on an allocation of office lease costs and the ratable usage of other shared resources.

**Shareholder Distributions.** Distributions to common stockholders are recorded on the ex-dividend date. The amount of distributions, if any, is determined by the Board of Directors each quarter.

The Company has adopted a dividend reinvestment plan that provides for reinvestment of its distributions on behalf of its stockholders, unless a stockholder opts out of the plan to receive cash in lieu of having their cash distributions automatically reinvested in additional shares of the Company's common stock.

## 3. EARNINGS (LOSSES) PER SHARE

In accordance with the provisions of ASC 260, Earnings per Share (ASC 260), basic earnings per share is computed by dividing earnings available to common shareholders by the weighted average number of shares outstanding during the period. Other potentially dilutive common shares, and the related impact to earnings, are considered when calculating earnings per share on a diluted basis.



TABLE OF CONTENTS**KCAP Financial, Inc.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****3. EARNINGS (LOSSES) PER SHARE (continued)**

The following information sets forth the computation of basic and diluted net increase (decrease) in stockholders equity per share for the years ended December 31, 2016, 2015, and 2014:

|   | For the Years ended December 31, |                |              |
|---|----------------------------------|----------------|--------------|
|   | 2016                             | 2015           | 2014         |
| Net (decrease)/increase in net assets resulting from operations   | \$(1,039,731 )                   | \$(18,634,558) | \$15,033,594 |
| Net increase/(decrease) in net assets allocated to unvested share awards  | 14,520                           | 332,869        | (201,239 )   |
| Net (decrease)/increase in net assets available to common stockholders  | \$(1,025,211 )                   | \$(18,301,689) | \$14,832,355 |
| Weighted average number of common shares outstanding for basic shares computation                               | 37,149,663                       | 36,964,444     | 34,248,346   |
| Effect of dilutive securities stock options   |                                  |                | 11,631       |
| Weighted average number of common and common stock equivalent shares outstanding for diluted shares computation | 37,149,663                       | 36,964,444     | 34,259,977   |
| Net increase in net assets per basic common shares:   |                                  |                |              |
| Net increase in net assets from operations  | \$(0.03 )                        | \$(0.50 )      | \$0.44       |
| Net increase in net assets per diluted shares:  |                                  |                |              |
| Net increase in net assets from operations  | \$(0.03 )                        | \$(0.50 )      | \$0.43       |

Share-based awards that contain non-forfeitable rights to dividends or dividend equivalents, whether paid or unpaid, are participating securities and included in the computation of both basic and diluted earnings per share. Grants of restricted stock awards to the Company's employees and directors are considered participating securities when there are earnings in the period and the earnings per share calculations include outstanding unvested restricted stock awards in the basic weighted average shares outstanding calculation.

There were 50,000 options to purchase shares of common stock considered for the computation of the diluted per share information for the year ended December 31, 2016. Since the effects are anti-dilutive for both periods, the options were not included in the computation. For the year ended December 31, 2016 and 2015, the company purchased 67,654 and 36,348 shares, respectively, of common stock in connection with the vesting of employee's restricted stock, such shares are treated as treasury shares and reduce the weighted average shares outstanding in the computation of earnings per share. For the year ended December 31, 2014, options to purchase 11,631 shares of common stock was included in the computation of diluted earnings per share.

The Company's Convertible Notes were included in the computation of the diluted net increase or decrease in net assets resulting from operations per share by application of the if-converted method for periods when the Convertible Notes were outstanding. Under the if-converted method, interest charges applicable to the convertible notes for the period are added to reported net increase or decrease in net assets resulting from operations and the full amount of shares (pro-rata if not outstanding for the full period) that would be issued are added to weighted average basic shares.

Convertible notes are considered anti-dilutive only when its interest per share upon conversion exceeds the basic net increase or decrease in net assets resulting from operations per share. For the year ended December 31, 2015, the effects of the Convertible Notes are anti-dilutive. The Convertible Notes matured and were repaid in March 2016.

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The following table shows the Company's portfolio by security type at December 31, 2016 and December 31, 2015:

| Security Type                           | December 31, 2016   |               |                  | December 31, 2015   |               |                  |
|---|---------------------|---------------|------------------|---------------------|---------------|------------------|
|   | Cost/Amortized Cost | Fair Value    | % <sup>(1)</sup> | Cost/Amortized Cost | Fair Value    | % <sup>(1)</sup> |
| Money Market Accounts <sup>(2)</sup>    | \$28,699,269        | \$28,699,269  | 8 %              | \$2,129,381         | \$2,129,381   | 1 %              |
| Senior Secured Loan                     | 207,701,078         | 200,322,152   | 55               | 203,819,074         | 194,123,223   | 46               |
| Junior Secured Loan                     | 37,251,776          | 35,444,440    | 10               | 40,221,557          | 37,591,900    | 9                |
| Senior Unsecured Loan                   |                     |               |                  | 23,000,000          | 23,000,000    | 6                |
| First Lien Bond                         | 3,060,919           | 1,089,338     |                  | 3,000,000           | 2,216,700     | 1                |
| Senior Subordinated Bond                |                     |               |                  | 4,466,793           | 4,615,569     | 1                |
| Senior Unsecured Bond                   |                     |               |                  | 11,879,187          | 10,551,724    | 3                |
| Senior Secured Bond                     | 1,506,461           | 1,487,400     |                  | 1,510,560           | 1,503,755     |                  |
| CLO Fund Securities                     | 76,851,317          | 54,174,350    | 15               | 83,214,947          | 55,872,382    | 14               |
| Equity Securities                       | 10,389,007          | 5,056,355     | 1                | 10,467,787          | 9,548,488     | 2                |
| Preferred Securities                    |                     |               |                  | 10,411,673          | 11,036,373    | 3                |
| Asset Manager Affiliates <sup>(3)</sup> | 55,341,230          | 40,198,000    | 11               | 56,591,230          | 57,381,000    | 14               |
| Total                                   | \$420,801,057       | \$366,471,304 | 100 %            | \$450,712,189       | \$409,570,495 | 100 %            |

(1) Represents percentage of total portfolio at fair value.

(2) Includes restricted cash held under employee benefit plans.

(3) Represents the equity investment in the Asset Manager Affiliates.

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The industry related information, based on the fair value of the Company's investment portfolio as of December 31, 2016 and December 31, 2015 for the Company's investment portfolio was as follows:

| Industry Classification                   | December 31, 2016   |             |                  |   | December 31, 2015 <sup>(2)</sup> |             |                  |   |
|---|---------------------|-------------|------------------|---|----------------------------------|-------------|------------------|---|
|   | Cost/Amortized Cost | Fair Value  | % <sup>(1)</sup> |   | Cost/Amortized Cost              | Fair Value  | % <sup>(1)</sup> |   |
| Aerospace and Defense                     | \$8,394,633         | \$8,450,106 | 2                | % | \$6,910,349                      | \$6,383,724 | 1                | % |
| Asset Management Company <sup>(2)</sup>   | 55,341,230          | 40,198,000  | 11               |   | 56,591,230                       | 57,381,000  | 14               |   |
| Related Party Loan                        |                     |             |                  |   | 23,000,000                       | 23,000,000  | 6                |   |
| Automotive                                | 6,322,551           | 6,196,154   | 2                |   | 9,898,494                        | 9,440,866   | 2                |   |
| Banking, Finance, Insurance & Real Estate | 6,805,514           | 6,782,010   | 2                |   | 6,270,984                        | 6,008,587   | 1                |   |
| Beverage, Food and Tobacco                | 15,198,830          | 14,703,372  | 4                |   | 17,334,746                       | 16,882,750  | 4                |   |
| Capital Equipment                         | 6,185,129           | 5,575,048   | 2                |   | 9,519,342                        | 7,846,767   | 2                |   |
| Chemicals, Plastics and Rubber            | 6,421,909           | 6,444,073   | 2                |   | 3,494,086                        | 3,359,916   | 1                |   |
| CLO Fund Securities                       | 76,851,317          | 54,174,350  | 15               |   | 83,214,947                       | 55,872,382  | 14               |   |
| Construction & Building                   | 5,919,158           | 5,929,606   | 2                |   | 1,976,345                        | 1,907,614   |                  |   |
| Consumer goods: Durable                   | 12,319,905          | 10,118,736  | 3                |   | 13,983,607                       | 12,753,455  | 3                |   |
| Consumer goods: Non-durable               | 14,766,390          | 14,452,096  | 4                |   | 20,124,355                       | 19,646,576  | 5                |   |
| Ecological                                | 1,741,292           | 1,760,783   |                  |   |                                  |             |                  |   |
| Energy: Oil & Gas                         | 14,493,835          | 8,805,761   | 2                |   | 14,281,821                       | 10,204,318  | 2                |   |
| Energy: Electricity                       | 3,904,453           | 3,937,247   | 1                |   | 3,465,576                        | 3,465,000   | 1                |   |
| Environmental Industries                  | 12,279,924          | 12,185,239  | 3                |   | 13,735,492                       | 13,179,657  | 3                |   |
| Forest Products & Paper                   | 4,192,889           | 4,192,907   | 1                |   | 5,888,294                        | 5,883,080   | 1                |   |
| Healthcare & Pharmaceuticals              | 58,769,668          | 53,594,534  | 15               |   | 58,649,512                       | 55,417,827  | 13               |   |
| High Tech Industries                      | 9,854,093           | 9,936,109   | 3                |   | 11,727,898                       | 11,662,995  | 3                |   |
| Hotel, Gaming & Leisure                   | 400,000             | 1,000       |                  |   | 400,000                          | 1,000       |                  |   |
| Media: Advertising, Printing & Publishing | 11,712,682          | 11,453,447  | 3                |   | 11,167,950                       | 10,340,449  | 3                |   |
| Media: Broadcasting & Subscription        | 8,273,174           | 8,372,984   | 2                |   | 7,428,110                        | 7,406,792   | 2                |   |
| Metals & Mining                           |                     |             |                  |   | 228,563                          | 991         |                  |   |
| Retail                                    | 1,415,457           | 759,581     |                  |   | 4,416,709                        | 3,594,599   | 1                |   |
| Services: Business                        | 16,125,481          | 16,230,486  | 4                |   | 18,206,668                       | 21,022,801  | 5                |   |
| Services: Consumer                        | 6,212,108           | 6,204,889   | 2                |   | 6,512,029                        | 6,356,054   | 2                |   |

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|  |               |               |      |               |               |      |
|--|---------------|---------------|------|---------------|---------------|------|
| Telecommunications                                       | 12,809,799    | 12,767,823    | 3    | 13,776,871    | 12,425,489    | 3    |
| Time Deposit and Money<br>Market Accounts <sup>(3)</sup> | 28,699,269    | 28,699,269    | 8    | 2,129,381     | 2,129,381     | 1    |
| Transportation: Cargo                                    | 7,557,315     | 7,190,135     | 2    | 18,232,953    | 18,865,603    | 5    |
| Transportation: Consumer                                 | 2,412,614     | 2,324,516     | 1    | 2,472,795     | 2,324,381     | 1    |
| Utilities: Electric                                      | 5,420,438     | 5,031,043     | 1    | 5,673,082     | 4,806,441     | 1    |
| Total  | \$420,801,057 | \$366,471,304 | 100% | \$450,712,189 | \$409,570,495 | 100% |

- (1) Calculated as a percentage of total portfolio at fair value.  
(2) Represents the equity investment in the Asset Manager Affiliates.  
(3) Includes restricted cash held under employee benefit plans.

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TABLE OF CONTENTS**KCAP Financial, Inc.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****4. INVESTMENTS (continued)**

The Company may invest up to 30% of the investment portfolio in non-qualifying opportunistic investments, including investments in debt and equity securities of CLO Funds, distressed debt or debt and equity securities of large cap public companies. Within this 30% of the portfolio, the Company also may invest in debt of middle market companies located outside of the United States.

At December 31, 2016 and December 31, 2015, the total amount of non-qualifying assets was approximately 17% and 18% of total assets, respectively. The majority of non-qualifying assets were foreign investments which were approximately 14% and 13% of the Company's total assets, respectively (including the Company's investments in CLO Funds, which are typically domiciled outside the U.S. and represented approximately 14% and 13% of its total assets on such dates, respectively).

The following tables detail the ten largest portfolio investments (at fair value) as of December 31, 2016:

| Investment                   | December 31, 2016   |                |          |
|------------------------------|---------------------|----------------|----------|
|                              | Cost/Amortized Cost | Fair Value     | % of FMV |
| Asset Manager Affiliates     | \$ 55,341,230       | \$ 40,198,000  | 11 %     |
| US Bank Money Market Account | 28,685,001          | 28,685,001     | 8        |
| Katonah 2007-I CLO Ltd.      | 28,022,646          | 20,453,099     | 6        |
| Grupo HIMA San Pablo, Inc.   | 9,828,619           | 9,113,125      | 2        |
| Catamaran CLO 2016-1 Ltd.    | 10,140,000          | 8,350,290      | 2        |
| Tank Partners Holdings, LLC  | 11,822,180          | 6,552,311      | 2        |
| Roscoe Medical, Inc.         | 6,666,733           | 6,499,000      | 2        |
| Weiman Products, LLC         | 5,462,647           | 5,321,809      | 1        |
| Nielsen & Bainbridge, LLC    | 5,326,136           | 5,199,447      | 1        |
| Catamaran CLO 2014-2 Ltd.    | 6,967,560           | 5,092,087      | 1        |
| Total                        | \$ 168,262,752      | \$ 135,464,169 | 36 %     |

| Investment                      | December 31, 2015   |               |          |
|---------------------------------|---------------------|---------------|----------|
|                                 | Cost/Amortized Cost | Fair Value    | % of FMV |
| Asset Manager Affiliates        | \$ 56,591,230       | \$ 57,381,000 | 14 %     |
| Trimaran Advisors, L.L.C.       | 23,000,000          | 23,000,000    | 6        |
| Katonah 2007-I CLO Ltd.         | 24,312,424          | 20,295,677    | 5        |
| DBI Holding, LLC                | 8,585,578           | 12,975,447    | 3        |
| Crowley Holdings Preferred, LLC | 10,411,673          | 11,036,373    | 3        |
| Grupo HIMA San Pablo, Inc.      | 9,817,315           | 9,917,500     | 2        |

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|                             |                |                |      |
|-----------------------------|----------------|----------------|------|
| Catamaran CLO 2015-1 Ltd.   | 11,869,751     | 8,789,651      | 2    |
| Tank Partners Holdings, LLC | 10,624,515     | 8,177,538      | 2    |
| Weiman Products, LLC        | 6,582,457      | 6,619,805      | 2    |
| Nielsen & Bainbrige, LLC    | 6,803,605      | 6,510,157      | 2    |
| Total                       | \$ 168,598,548 | \$ 164,703,148 | 41 % |

Excluding the Asset Manager Affiliates and CLO Fund securities, the Company's ten largest portfolio companies represented approximately 13% and 19% of the total fair value of the Company's investments at December 31, 2016 and December 31, 2015, respectively.

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**KCAP Financial, Inc.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**4. INVESTMENTS (continued)**

**Investments in CLO Fund Securities**

The Company typically makes a minority investment in the most junior class of securities (typically preferred shares or subordinated securities) of CLO Funds managed by the Asset Manager Affiliates and may selectively invest in securities issued by CLO funds managed by other asset management companies. These securities also are entitled to recurring distributions which generally equal the net remaining cash flow of the payments made by the underlying CLO Fund's securities less contractual payments to senior bond holders, management fees and CLO Fund expenses. CLO Funds invest primarily in broadly syndicated non-investment grade loans, high-yield bonds and other credit instruments of corporate issuers. The underlying assets in each of the CLO Funds in which the Company has an investment are generally diversified secured or unsecured corporate debt. The CLO Funds are leveraged funds and any excess cash flow or excess spread (interest earned by the underlying securities in the fund less payments made to senior bond holders, fund expenses and management fees) is paid to the holders of the CLO Fund's subordinated securities or preferred shares.

In May and August 2014, the Company purchased \$11.1 million and \$9.9 million of the par value of the Subordinated Notes of Catamaran 2014-1 CLO ( Catamaran 2014-1 ) and 2014-2 CLO ( Catamaran 2014-2 ), respectively. Both are managed by Trimaran Advisors.

In May 2015, the Company purchased \$11.9 million of the par value of the Subordinated Notes of Catamaran 2015-1 CLO ( Catamaran 2015-1 ) managed by Trimaran Advisors.

On February 29, 2016, Katonah X CLO Ltd. was fully liquidated and all of its outstanding obligations were satisfied. The Company received approximately \$1.0 million in connection therewith related to its investment in the subordinated securities issued by Katonah X CLO Ltd. Accordingly, the Company recorded a realized loss during the first quarter of 2016 of approximately \$6.6 million on its investment in Katonah X CLO Ltd. and a corresponding unrealized gain of the same amount in order to reverse the approximately \$6.6 million of previously recorded unrealized depreciation with respect to the investment.

In June 2016, the Company sold \$7.0 million par value of the Subordinated Notes of Catamaran 2015-1 for \$4.2 million.

In December 2016, the Company purchased \$10.1 million of the par value of the Subordinated Notes of Catamaran 2016-1 CLO ( Catamaran 2016-1 ) managed by Trimaran Advisors.

All CLO Funds managed by the Asset Manager Affiliates are currently making quarterly distributions to the Company with respect to its interests in the CLO Funds and are paying all senior and subordinate management fees to the Asset Manager Affiliates. With the exception of Katonah III, Ltd. and Grant Grove CLO, Ltd. (which have been called), all third-party managed CLO Funds are making distributions to the Company.



## Fair Value Measurements

The Company follows the provisions of ASC 820: Fair Value, which among other matters, requires enhanced disclosures about investments that are measured and reported at fair value. This standard defines fair value and establishes a hierarchical disclosure framework which prioritizes and ranks the level of market price observability used in measuring investments at fair value and expands disclosures about assets and liabilities measured at fair value. ASC 820: Fair Value defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. This fair value definition focuses on an exit price in the principal, or most advantageous market, and prioritizes, within a measurement of fair value, the use of market-based inputs (which may be weighted or adjusted for relevance, reliability and specific attributes relative to the subject investment) over entity-specific inputs. Market price observability is affected by a number of factors, including the type of investment and the characteristics specific to the investment. Investments with readily available active quoted prices or for which fair value can be measured from actively quoted prices generally will have a higher degree of market price

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**KCAP Financial, Inc.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**4. INVESTMENTS (continued)**

observability and a lesser degree of judgment used in measuring fair value. Subsequent to the adoption of ASC 820: Fair Value, the FASB has issued various staff positions clarifying the initial standard (see Note 2 Significant Accounting Policies Investments ).

ASC 820: Fair Value establishes the following three-level hierarchy, based upon the transparency of inputs to the fair value measurement of an asset or liability as of the measurement date:

Level I Unadjusted quoted prices are available in active markets for identical investments as of the reporting date. The type of investments included in Level I include listed equities and listed securities. As required by ASC 820: Fair Value, the Company does not adjust the quoted price for these investments, even in situations where the Company holds a large position and a sale could reasonably affect the quoted price.

Level II Pricing inputs are other than quoted prices in active markets, which are either directly or indirectly observable as of the reporting date. Such inputs may be quoted prices for similar assets or liabilities, quoted markets that are not active, or other inputs that are observable or can be corroborated by observable market data for substantially the full character of the financial instrument, or inputs that are derived principally from, or corroborated by, observable market information. Investments which are generally included in this category include illiquid debt securities and less liquid, privately held or restricted equity securities for which some level of recent trading activity has been observed.

Level III Pricing inputs are unobservable for the investment and includes situations where there is little, if any, market activity for the investment. The inputs may be based on the Company's own assumptions about how market participants would price the asset or liability or may use Level II inputs, as adjusted, to reflect specific investment attributes relative to a broader market assumption. These inputs into the determination of fair value may require significant management judgment or estimation. Even if observable market data for comparable performance or valuation measures (earnings multiples, discount rates, other financial/valuation ratios, etc.) are available, such investments are grouped as Level III if any significant data point that is not also market observable (private company earnings, cash flows, etc.) is used in the valuation methodology.

In certain cases, the inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, an investment's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement. The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and the Company considers factors specific to the investment. A majority of the Company's investments are classified as Level III. The Company evaluates the source of inputs, including any markets in which its investments are trading, in determining fair value. Inputs that are highly correlated to the specific investment being valued and those derived from reliable or knowledgeable sources will tend to have a higher weighting in determining fair value. The Company's fair value determinations may include factors such as an assessment of each underlying investment, its current and prospective operating and financial performance, consideration of financing and sale transactions with third parties, expected cash flows and market-based information,

including comparable transactions, performance factors, and other investment or industry specific market data, among other factors.

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The following table summarizes the fair value of investments by the above ASC 820: Fair Value fair value hierarchy levels as of December 31, 2016 and December 31, 2015, respectively:

|                          | As of December 31, 2016 |                |                | Total          |
|--------------------------|-------------------------|----------------|----------------|----------------|
|                          | Level I                 | Level II       | Level III      |                |
| Money market accounts    | \$                      | \$ 28,699,269  | \$             | \$ 28,699,269  |
| Debt securities          |                         | 84,601,585     | 153,741,745    | 238,343,330    |
| CLO fund securities      |                         |                | 54,174,350     | 54,174,350     |
| Equity securities        |                         |                | 5,056,355      | 5,056,355      |
| Asset Manager Affiliates |                         |                | 40,198,000     | 40,198,000     |
| Total                    | \$                      | \$ 113,300,854 | \$ 253,170,450 | \$ 366,471,304 |

|                          | As of December 31, 2015 |                |                | Total          |
|--------------------------|-------------------------|----------------|----------------|----------------|
|                          | Level I                 | Level II       | Level III      |                |
| Money market accounts    | \$                      | \$ 2,129,381   | \$             | \$ 2,129,381   |
| Debt securities          |                         | 101,238,779    | 183,400,465    | 284,639,244    |
| CLO fund securities      |                         |                | 55,872,382     | 55,872,382     |
| Equity securities        |                         | 445,485        | 9,103,003      | 9,548,488      |
| Asset Manager Affiliates |                         |                | 57,381,000     | 57,381,000     |
| Total                    | \$                      | \$ 103,813,645 | \$ 305,756,850 | \$ 409,570,495 |

As a BDC, the Company is required to invest primarily in the debt and equity of non-public companies for which there is little, if any, market-observable information. As a result, a significant portion of the Company's investments at any given time will likely be deemed Level III investments. Investment values derived by a third party pricing service are generally deemed to be Level III values. For those that have observable trades, the Company considers them to be Level II.

Values derived for debt and equity securities using comparable public/private companies generally utilize market-observable data from such comparables and specific, non-public and non-observable financial measures (such as earnings or cash flows) for the private, underlying company/issuer. Such non-observable company/issuer data is typically provided on a monthly or quarterly basis, is certified as correct by the management of the company/issuer and/or audited by an independent accounting firm on an annual basis. Since such private company/issuer data is not publicly available it is not deemed market-observable data and, as a result, such investment values are grouped as Level III assets.

Values derived for the Asset Manager Affiliates using comparable public/private companies utilize market-observable data and specific, non-public and non-observable financial measures (such as assets under management, historical and prospective earnings) for the Asset Manager Affiliates. The Company recognizes that comparable asset managers may not be fully comparable to the Asset Manager Affiliates and typically identifies a range of performance measures and/or adjustments within the comparable population with which to determine value. Since any such ranges and adjustments are entity specific they are not considered market-observable data and thus require a Level III grouping. Illiquid investments that have values derived through the use of discounted cash flow models and residual enterprise value models are grouped as Level III assets.

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The Company's policy for determining transfers between levels is based solely on the previously defined three-level hierarchy for fair value measurement. Transfers between the levels of the fair value hierarchy are separately noted in the tables below and the reason for such transfer described in each table's respective footnotes. Certain information relating to investments measured at fair value for which the Company has used unobservable inputs to determine fair value is as follows:

|   | Year Ended December 31, 2016 |                     |                   |                         |                 |
|---|------------------------------|---------------------|-------------------|-------------------------|-----------------|
|   | Debt Securities              | CLO Fund Securities | Equity Securities | Asset Manager Affiliate | Total           |
| Balance, December 31, 2015  | \$183,400,465                | \$55,872,382        | \$9,103,003       | \$57,381,000            | \$305,756,850   |
| Transfers out of Level III <sup>(1)</sup>   | (14,855,471 )                |                     |                   |                         | (14,855,471 )   |
| Transfers into Level III <sup>(2)</sup>   | 22,107,141                   |                     | 445,485           |                         | 22,552,626      |
| Net accretion   | 318,999                      | (2,192,069 )        |                   |                         | (1,873,070 )    |
| Purchases   | 33,641,315                   | 10,140,000          | 180,161           |                         | 43,961,476      |
| Sales/Paydowns/Return of Capital  | (66,559,349 )                | (4,200,000 )        | (4,743,682)       | (1,250,000 )            | (76,753,031 )   |
| Total realized gain/(loss) included in earnings   | (366,924 )                   | (10,111,560)        | 4,484,742         |                         | (5,993,742 )    |
| Total unrealized gain (loss) included in earnings   | (3,944,431 )                 | 4,665,597           | (4,413,354)       | (15,933,000)            | (19,625,188 )   |
| Balance, December 31, 2016  | \$153,741,745                | \$54,174,350        | \$5,056,355       | \$40,198,000            | \$253,170,450   |
| Changes in unrealized gains (losses) included in earnings related to investments still held at reporting date | \$(6,969,509 )               | \$4,665,597         | \$(4,413,354)     | \$(15,933,000)          | \$(22,650,266 ) |

(1) Transfers out of Level III represent a transfer of \$14,855,471 relating to debt securities for which pricing inputs, other than their quoted prices in active markets were observable as of December 31, 2016.

(2) Transfers into Level III represent a transfer of \$22,107,141 relating to debt securities for which pricing inputs, other than their quoted prices in active markets were unobservable as of December 31, 2016.

|   | Year Ended December 31, 2015 |                     |                   |                         |               |
|---|------------------------------|---------------------|-------------------|-------------------------|---------------|
|   | Debt Securities              | CLO Fund Securities | Equity Securities | Asset Manager Affiliate | Total         |
| Balance, December 31, 2014                | \$171,018,343                | \$77,514,902        | \$8,119,681       | \$72,326,000            | \$328,978,926 |
| Transfers out of Level III <sup>(1)</sup> | (30,472,595 )                |                     |                   |                         | (30,472,595 ) |
| Transfers into Level III <sup>(2)</sup>   | 34,013,134                   |                     |                   |                         | 34,013,134    |
| Net accretion                             | 300,255                      | (9,507,048 )        |                   |                         | (9,206,793 )  |

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|   |                |                |             |                |                 |
|---|----------------|----------------|-------------|----------------|-----------------|
| Purchases   | 990,000        | 11,952,000     |             |                | 12,942,000      |
| Sales/Paydowns/Return of Capital  |                | (3,872,700 )   | (317,340 )  | (3,701,446 )   | (7,891,486 )    |
| Total realized gain included in earnings  | 99,145         | (6,246,883 )   | 3,015       |                | (6,144,723 )    |
| Total unrealized gain (loss) included in earnings   | 7,452,183      | (13,967,889)   | 1,297,647   | (11,243,554)   | (16,461,613 )   |
| Balance, December 31, 2015  | \$183,400,465  | \$55,872,382   | \$9,103,003 | \$57,381,000   | \$305,756,850   |
| Changes in unrealized gains (losses) included in earnings related to investments still held at reporting date | \$(7,109,531 ) | \$(20,760,499) | \$1,297,647 | \$(11,243,554) | \$(23,254,223 ) |

(1) Transfers out of Level III represent a transfer of \$30,472,595 relating to debt securities for which pricing inputs, other than their quoted prices in active markets were observable as of December 31, 2015.

(2) Transfers into Level III represent a transfer of \$34,013,134 relating to debt securities for which pricing inputs, other than their quoted prices in active markets were unobservable as of December 31, 2015.

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As of December 31, 2016, the Company's Level II portfolio investments were valued by a third party pricing services for which the prices are not adjusted and for which inputs are observable or can be corroborated by observable market data for substantially the full character of the financial instrument, or by inputs that are derived principally from, or corroborated by, observable market information. The fair value of the Company's Level II portfolio investments was \$113,300,854 as of December 31, 2016.

As of December 31, 2016, the Company's Level III portfolio investments had the following valuation techniques and significant inputs:

| Type                               | Fair Value     | Primary Valuation Methodology | Unobservable Inputs               | Range of Inputs (Weighted Average) |
|------------------------------------|----------------|-------------------------------|-----------------------------------|------------------------------------|
| <b>Debt Securities</b>             | \$ 7,639,648   | Enterprise Value              | Average EBITDA Multiple           | 5.3x                               |
|                                    | \$ 146,102,097 | Income Approach               | Implied Discount Rate             | 5.6% 21.5% (9.15)%                 |
| <b>Equity Securities</b>           | \$ 5,050,355   | Enterprise Value              | Average EBITDA Multiple/WAAC      | 4.8x/7.4% 14.1x/13.9% (9.3x/12.0)% |
|                                    | \$ 6,000       | Options Value                 | Qualitative Inputs <sup>(1)</sup> |                                    |
| <b>CLO Fund Securities</b>         | \$ 45,824,290  | Discounted Cash Flow          | Discount Rate                     | 11.8% 13.0% (13.0)%                |
|                                    |                |                               | Probability of Default            | 2.0% 2.5% (2.0)%                   |
|                                    |                |                               | Loss Severity                     | 25.0% 25.9% (25.9)%                |
|                                    |                |                               | Recovery Rate                     | 74.1% 75% (74.2)%                  |
|                                    |                |                               | Prepayment Rate                   | 25.0% 29.1% (25.1)%                |
|                                    | \$ 8,350,290   | Market Approach               | 3 <sup>rd</sup> Party Quote       | 82.35% (82.35)%                    |
| <b>Asset Manager Affiliate</b>     | \$ 40,198,000  | Discounted Cash Flow          | Discount Rate                     | 2.5% 13.0% (7.6)%                  |
| <b>Total Level III Investments</b> | \$ 253,170,450 |                               |                                   |                                    |

(1) The qualitative inputs used in the fair value measurements of the Debt Securities include estimates of the distressed liquidation value of the pledged collateral.



As of December 31, 2015, the Company's Level III portfolio investments had the following valuation techniques and significant inputs:

| Type                               | Fair Value     | Primary Valuation Methodology | Unobservable Inputs               | Range of Inputs (Weighted Average) |
|------------------------------------|----------------|-------------------------------|-----------------------------------|------------------------------------|
| <b>Debt Securities</b>             | \$ 2,216,700   | Enterprise Value              | Average EBITDA Multiple           | 7.2x                               |
|                                    | \$ 181,182,774 | Income Approach               | Implied Discount Rate             | 4.9% 27.1% (10.46)%                |
|                                    | \$ 991         | Options Value                 | Qualitative Inputs <sup>1</sup>   |                                    |
| <b>Equity Securities</b>           | \$ 9,100,003   | Enterprise Value              | Average EBITDA Multiple/WAAC      | 4.8x/6.9% 12.9x/13.4% (6.8x/12.0)% |
|                                    | \$ 3,000       | Options Value                 | Qualitative Inputs <sup>(1)</sup> |                                    |
| <b>CLO Fund Securities</b>         | \$ 55,872,382  | Discounted Cash Flow          | Discount Rate                     | 11.3% 15.0% (14.9)%                |
|                                    |                |                               | Probability of Default            | 2.0% 2.5% (2.1)%                   |
|                                    |                |                               | Loss Severity                     | 25.0% 25.9% (25.7)%                |
|                                    |                |                               | Recovery Rate                     | 74.1% 75% (74.3)%                  |
|                                    |                |                               | Prepayment Rate                   | 7.9% 32.0% (25.3)%                 |
| <b>Asset Manager Affiliate</b>     | \$ 57,381,000  | Discounted Cash Flow          | Discount Rate                     | 2.4% 15.0% (8.6)%                  |
| <b>Total Level III Investments</b> | \$ 305,756,850 |                               |                                   |                                    |

(1) The qualitative inputs used in the fair value measurements of the Debt Securities include estimates of the distressed liquidation value of the pledged collateral.

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**KCAP Financial, Inc.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**4. INVESTMENTS (continued)**

The significant unobservable inputs used in the fair value measurement of the Company's debt securities may include, among other things, broad market indices, the comparable yields of similar investments in similar industries, effective discount rates, average EBITDA multiples, and weighted average cost of capital. Significant increases or decreases in such comparable yields would result in a significantly lower or higher fair value measurement.

The significant unobservable inputs used in the fair value measurement of the Company's equity securities include the EBITDA multiple of similar investments in similar industries and the weighted average cost of capital. Significant increases or decreases in such inputs would result in a significantly lower or higher fair value measurement.

Significant unobservable input used in the fair value measurement of the Company's CLO Fund securities include default rates, recovery rates, prepayment rates, spreads, and the discount rate by which to value the resulting underlying cash flows. Such assumptions can vary significantly, depending on market data sources which often vary in depth and level of analysis, understanding of the CLO market, detailed or broad characterization of the CLO market and the application of such data to an appropriate framework for analysis. The application of data points are based on the specific attributes of each individual CLO Fund security's underlying assets, historic, current and prospective performance, vintage, and other quantitative and qualitative factors that would be evaluated by market participants. The Company evaluates the source of market data for reliability as an indicative market input, consistency amongst other inputs and results and also the context in which such data is presented. Significant increases or decreases in probability of default and loss severity inputs in isolation would result in a significantly lower or higher fair value measurement. In general, a change in the assumption of the probability of default is accompanied by a directionally similar change in the assumption used for the loss severity in an event of default. Significant increases or decreases in the discount rate in isolation would result in a significantly lower or higher fair value measurement.

The significant unobservable inputs used in the fair value measurement of the Asset Manager Affiliates is the discount rate used to present value prospective cash flows. Prospective revenues are generally based on a fixed percentage of the par value of CLO Fund assets under management and are recurring in nature for the term of the CLO Fund so long as the Asset Manager Affiliates manage the fund. As a result, the fees earned by the Asset Manager Affiliates are generally not subject to market value fluctuations in the underlying collateral. The discounted cash flow model incorporates different levels of discount rates depending on the hierarchy of fees earned (including the likelihood of realization of senior, subordinate and incentive fees) and prospective modeled performance. Significant increases or decreases in such discount rate would result in a significantly lower or higher fair value measurement.

**5. ASSET MANAGER AFFILIATES**

**Wholly-Owned Asset Managers**

The Asset Manager Affiliates are wholly-owned portfolio companies. The Asset Manager Affiliates manage CLO Funds primarily for third party investors that invest in broadly syndicated loans, high yield bonds and other credit

instruments issued by corporations. At December 31, 2016, the Asset Manager Affiliates had approximately \$3.0 billion of par value of assets under management, respectively, and the Company's 100% equity interest in the Asset Manager Affiliates had a fair value of approximately \$40.2 million, respectively.

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**KCAP Financial, Inc.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**5. ASSET MANAGER AFFILIATES (continued)**

As a manager of the CLO Funds, the Asset Manager Affiliates receive contractual and recurring management fees from the CLO Funds for their management and advisory services. The annual fees which the Asset Manager Affiliates receive are generally based on a fixed percentage of assets under management (at par value and not subject to changes in market value), and the Asset Manager Affiliates generate net income equal to the amount by which their fee income exceeds their operating expenses, including compensation of their employees and income taxes. The management fees the Asset Manager Affiliates receive have three components – a senior management fee, a subordinated management fee and an incentive fee. Currently, all CLO Funds managed by the Asset Manager Affiliates are paying both their senior and subordinated management fees on a current basis.

For the years ended December 31, 2016, 2015, and 2014, the Asset Manager Affiliates declared cash distributions of \$2.7 million, \$9.1 million, and \$11.9 million to the Company, respectively. Any distributions from the Asset Manager Affiliates out of their estimated tax-basis earnings and profits are recorded as Dividends from Asset Manager Affiliates on the Company's statement of operations. The Company recognized \$1.4 million, \$5.3 million, and \$5.5 million of Dividends from Asset Manager Affiliates in the Statement of Operations in 2016, 2015, and 2014, respectively. The difference between cash distributions received and the tax-basis earnings and profits of the distributing affiliate, are recorded as an adjustment to the cost basis in the Asset Manager Affiliate (i.e., tax-basis return of capital). Distributions receivable, if any, are reflected in the Due from Affiliates account on the consolidated balance sheets.

The tax attributes of distributions received from the Asset Manager Affiliates are determined on an annual basis. The Company makes an estimate of the tax-basis earnings and profits of the Asset Manager Affiliates on a quarterly basis, and any quarterly distributions received in excess of the estimated earnings and profits are recorded as return of capital (reduction in the cost basis of the investment in Asset Manager Affiliate).

The Asset Manager Affiliates' fair value is determined quarterly. The valuation is primarily determined utilizing a discounted cash flow model. See Note 2 – Significant Accounting Policies and Note 4 – Investments for further information relating to the Company's valuation methodology.

On February 18, 2015, the FASB issued Accounting Standards Update 2015-2 (ASU 2015-2), which updated consolidation standards under ASC Topic 810, Consolidation. Under this update, a new consolidation analysis is required for VIEs and will limit the circumstances in which investment managers and similar entities are required to consolidate the entities that they manage. The FASB decided to eliminate some of the criteria under which their management fees are considered a variable interest and limit the circumstances in which variable interests in a VIE held by related parties of a reporting enterprise require the reporting enterprise to consolidate the VIE. The guidance was effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2015, early adoption was permitted. The Asset Manager Affiliates adopted ASU 2015-2 in 2016 which resulted in the deconsolidation of the CLO Funds. Prior year amounts have been restated to reflect the retrospective adoption of ASU 2015-2.

In accordance with Rules 3-09, Rule 4-08(g) and 1-02 of Regulation S-X, additional financial information with respect to the Asset Manager Affiliates and with respect to two of the CLO Funds in which the Company had an investment, Katonah 2007-I CLO and Katonah X CLO are required to be included in the Company's SEC filings. The additional financial information regarding the Asset Manager Affiliates and Katonah 2007-I CLO (pursuant to Rule 3-09) immediately follow these financial statements. The additional information regarding Katonah X CLO (pursuant to Rule 4-08(g)) is set forth below. This additional financial information regarding the Asset Manager Affiliates, Katonah 2007-I CLO and Katonah X CLO does not directly impact the financial position, results of operations, or cash flows of the Company

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TABLE OF CONTENTS**KCAP Financial, Inc.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****5. ASSET MANAGER AFFILIATES (continued)****Katonah X CLO Ltd.**

## Summarized Balance Sheet Information

|                                       | As of<br>December 31,<br>2016 | As of<br>December 31,<br>2015 |
|---------------------------------------|-------------------------------|-------------------------------|
| Cash                                  |                               | 198,102                       |
| Receivable for investments sold       |                               | 4,178,443                     |
| Total assets                          |                               | 4,816,030                     |
| CLO Debt at fair value <sup>(1)</sup> |                               | 3,000,000                     |
| Total liabilities                     |                               | 4,816,030                     |

(1) Includes subordinated securities of approximately \$3.0 million as of December 31, 2015.

**Katonah X CLO Ltd.**

## Summarized Statements of Operations Information

|  | Year Ended<br>December 31,<br>2016 | Year Ended<br>December 31,<br>2015 | Year Ended<br>December 31,<br>2014 |
|--|------------------------------------|------------------------------------|------------------------------------|
| Interest income from investments                 | \$                                 | \$ 7,619,817                       | \$ 12,441,502                      |
| Total income                                     |                                    | 7,823,471                          | 13,170,483                         |
| Interest expense                                 |                                    | 10,194,889                         | 8,945,449                          |
| Total expenses                                   |                                    | 16,241,895                         | 13,136,542                         |
| Net realized and unrealized losses               |                                    | 1,383,719                          | (10,998,445 )                      |
| Decrease in net assets resulting from operations |                                    | (7,034,705 )                       | (10,964,505 )                      |

On February 29, 2016, Katonah X CLO Ltd. was fully liquidated and all of its outstanding obligations were satisfied.

The Company received approximately \$1.0 million in connection therewith related to its investment in the subordinated securities issued by Katonah X CLO Ltd. Accordingly, the Company recorded a realized loss during the first quarter of 2016 of approximately \$6.6 million on its investment in Katonah X CLO Ltd. and a corresponding unrealized gain of the same amount in order to reverse the approximately \$6.6 million of previously recorded unrealized depreciation with respect to the investment.

As separately regarded entities for tax purposes, the Asset Manager Affiliates are taxed at normal corporate rates. In order to maintain the Company's RIC status, any tax-basis dividends paid by the Asset Manager Affiliates to the Company would generally need to be distributed to the Company's shareholders. Generally, such tax-basis dividends of the Asset Manager Affiliates' income which was distributed to the Company's shareholders will be considered as qualified dividends for tax purposes. The Asset Manager Affiliates' taxable net income will differ from U.S. GAAP net income because of deferred tax temporary differences and permanent tax adjustments. Deferred tax temporary differences may include differences for the recognition and timing of amortization and depreciation, compensation related expenses, and net loss carryforward, among other things. Permanent differences may include adjustments, limitations or disallowances for meals and entertainment expenses, penalties, tax goodwill amortization and net operating loss carryforward.

Goodwill amortization for tax purposes was created upon the purchase of 100% of the equity interests in Katonah Debt Advisors prior to the Company's IPO in exchange for shares of the Company's stock valued at \$33 million. Although this transaction was a stock transaction rather than an asset purchase and thus no goodwill was recognized for U.S. GAAP purposes, such exchange was considered an asset purchase under Section 351(a) of the Code. At the time of the transfer, Katonah Debt Advisors had equity of approximately \$1 million resulting in tax goodwill of approximately \$32 million which is being amortized for tax purposes on a straight-line basis over 15 years.

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TABLE OF CONTENTS**KCAP Financial, Inc.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****5. ASSET MANAGER AFFILIATES (continued)**

Additional goodwill amortization for tax purposes was created upon the purchase of 100% of the equity interests in Trimaran Advisors by one of KCAP's affiliates, in exchange for shares of the Company's stock valued at \$25.5 million and cash of \$13.0 million. The transaction was considered an asset purchase under Section 351(a) of the code and resulted in tax goodwill of approximately \$22.8 million which is being amortized for tax purposes on a straight-line basis over 15 years.

During the second quarter of 2016, KCAP contributed 100% of its ownership interests in Katonah Debt Advisors and Trimaran Advisors Management to Commodore Holdings, a wholly-owned subsidiary of KCAP. These transactions simplify the tax structure of the AMAs and facilitate the consolidation of tax basis goodwill deductions for the AMAs, which may impact the tax character of distributions from the AMAs.

**Related Party Transactions**

On February 26, 2013, the Company entered into a senior credit agreement (the Trimaran Credit Facility) with Trimaran Advisors, pursuant to which Trimaran Advisors may borrow from time to time up to \$20 million from the Company in order to provide capital necessary to support one or more of Trimaran Advisors' warehouse lines of credit and/or working capital in connection with Trimaran Advisors' warehouse activities. The Trimaran Credit Facility expires on November 20, 2017 and bears interest at an annual rate of 9.0%. Outstanding borrowings on the Trimaran Credit Facility are callable by the Company at any time. On April 15, 2013, the Trimaran Credit Facility was amended and upsized from \$20 million to \$23 million. At December 31, 2016 there were no loans outstanding under the Trimaran Credit Facility. At December 31, 2015 the par value of the outstanding loan was \$23 million. For the years ended December 31, 2016 and 2015, the Company recognized interest income of approximately \$1.8 million and \$1.7 million, respectively, related to the Trimaran Credit Facility.

**6. BORROWINGS**

The Company's debt obligations consist of the following:

|  | As of<br>December 31,<br>2016 | As of<br>December 31,<br>2015 |
|--|-------------------------------|-------------------------------|
| Notes issued by KCAP Senior Funding I, LLC (net of discount and offering costs of: 2016 \$2,286,425 and \$2,459,156, respectively; 2015 \$2,907,595 and \$3,126,009, respectively) | 142,604,419                   | 141,316,396                   |
| 7.375% Notes Due 2019 (net of offering costs of: 2016 \$550,774; 2015 \$890,344)   | \$32,980,151                  | \$40,509,656                  |
|  |                               | 19,277,709                    |



Convertible Notes, due March 15, 2016 (net of offering costs  
of: 2015 \$21,291)

\$175,584,570 \$201,103,761

The weighted average stated interest rate and weighted average maturity on all our debt outstanding as of December 31, 2016 were 3.9% and 6.7 years, respectively, and as of December 31, 2015 were 4.08% and 6.8 years, respectively.

### **KCAP Senior Funding I, LLC (Debt Securitization)**

On June 18, 2013, the Company completed the sale of notes in a \$140,000,000 debt securitization financing transaction. The notes offered in this transaction (the KCAP Senior Funding I Notes ) were issued by KCAP Senior Funding I, LLC, a newly formed special purpose vehicle (the Issuer ), in which KCAP Senior Funding I Holdings, LLC, a wholly-owned subsidiary of the Company (the Depositor ), owns all of the KCAP Senior Funding I Subordinated Notes (as defined below), and are backed by a diversified portfolio of bank loans. The indenture governing the KCAP Senior Funding I Notes contains an event of default that is triggered in the event that certain coverage tests are not met.

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**KCAP Financial, Inc.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**6. BORROWINGS (continued)**

The secured notes (the KCAP Senior Funding I Secured Notes ) were issued as Class A senior secured floating rate notes which have an initial face amount of \$77,250,000, are rated AAA (sf)/Aaa (sf) by Standard & Poor's Ratings Services and Moody's Investors Service, Inc., respectively, and bear interest at the three-month LIBOR plus 1.50%, Class B senior secured floating rate notes which have an initial face amount of \$9,000,000, are rated AA (sf)/Aa2 (sf) by Standard & Poor's Ratings Services and Moody's Investors Service, Inc., respectively, and bear interest at three-month LIBOR plus the 3.25%, Class C secured deferrable floating rate notes which have an initial face amount of \$10,000,000, are rated A (sf)/A2 (sf) by Standard & Poor's Ratings Services and Moody's Investors Service, Inc., respectively, and bear interest at three-month LIBOR plus 4.25%, and Class D secured deferrable floating rate notes which have an initial face amount of \$9,000,000, are rated BBB (sf)/Baa2 (sf) by Standard & Poor's Ratings Services and Moody's Investors Service, Inc., respectively, and bear interest at three-month LIBOR plus 5.25%. The Depositor retained all of the subordinated notes of the Issuer (the KCAP Senior Funding I Subordinated Notes ), which have an initial face amount of \$34,750,000. The KCAP Senior Funding I Subordinated Notes do not bear interest and are not rated. Both the KCAP Senior Funding I Secured Notes and the KCAP Senior Funding I Subordinated Notes have a stated maturity on the payment date occurring on July 20, 2024, and are subject to a two year non-call period. The Issuer has a four year reinvestment period. The stated interest rate re-sets on a quarterly basis based upon the then-current level of the benchmark three-month LIBOR.

On December 8, 2014, the Company completed the sale of additional notes ( Additional Issuance Securities ) in a \$56,000,000 increase to the collateralized loan obligation transaction that originally closed on June 18, 2013 (the Original Closing Date ). The issuance of additional notes was proportional across all existing classes of notes issued on the Original Closing Date.

Each class of secured Additional Issuance Securities (all such classes, collectively, the Additional Issuance Offered Securities ) was issued as a pari passu sub-class of an existing class of notes issued on the Original Closing Date. Accordingly, the ratings given by Standard & Poor's Ratings Services and Moody's Investors Service, Inc. to each existing class of notes issued on the Original Closing Date will apply to each class of Additional Issuance Offered Securities that constitutes a related pari passu sub-class of such existing class of notes issued on the Original Closing Date.

The Additional Issuance Offered Securities were issued as Class A-2 senior secured floating rate notes which have an initial face amount of \$30,900,000, have a rating of AAA (sf)/Aaa (sf) by Standard & Poor's Ratings Services and Moody's Investors Service, Inc., respectively, and bear interest at the three-month LIBOR plus 1.50%, Class B-2 senior secured floating rate notes which have an initial face amount of \$3,600,000, a rating of AA (sf)/Aa2 (sf) by Standard & Poor's Ratings Services and Moody's Investors Service, Inc., respectively, and bear interest at three-month LIBOR plus 3.25%, Class C-2 secured deferrable floating rate notes which have an initial face amount of \$4,000,000, a rating of A (sf)/A2 (sf) by Standard & Poor's Ratings Services and Moody's Investors Service, Inc., respectively, and bear interest at three-month LIBOR plus 4.25%, and Class D-2 secured deferrable floating rate notes which have an initial face amount of \$3,600,000, a rating of BBB (sf)/Baa2 (sf) by Standard & Poor's Ratings Services and Moody's Investors Service, Inc., respectively, and bear interest at three-month LIBOR plus 5.25%. The Depositor retained all

of the subordinated Additional Issuance Securities of the Issuer (the Additional Issuance Subordinated Notes ), which have an initial face amount of \$13,900,000. The Additional Issuance Subordinated Notes do not bear interest and are not rated. The Additional Issuance Securities have a stated maturity date of July 20, 2024 and are subject to a non-call period until the payment date on the Additional Issuance Securities occurring in July 2015. The Issuer has a reinvestment period to and including the payment date on the Additional Issuance Securities occurring in July 2017, or such earlier date as is provided in the indenture relating to the Additional Issuance Securities. In connection with the Additional Issuance Offered Securities, the Company incurred issuance costs and OID costs of approximately \$679,000 and \$896,000, respectively.

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**KCAP Financial, Inc.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**6. BORROWINGS (continued)**

As part of this transaction, the Company entered into a master loan sale agreement with the Depositor and the Issuer under which the Company sold or contributed certain bank loans to the Depositor, and the Depositor sold such loans to the Issuer in exchange for a combination of cash and the issuance of the KCAP Senior Funding I Subordinated Notes to the Depositor.

In connection with the issuance and sale of the KCAP Senior Funding I Notes, the Company has made customary representations, warranties and covenants in the purchase agreement by and between the Company, the Depositor, the Issuer and Guggenheim Securities, LLC, which served as the initial purchaser of the KCAP Senior Funding I Secured Notes. The KCAP Senior Funding I Secured Notes are the secured obligations of the Issuer, and an indenture governing the KCAP Senior Funding I Notes includes customary covenants and events of default. The KCAP Senior Funding I Notes were sold in a private placement transaction and have not been, and will not be, registered under the Securities Act of 1933, as amended, or any state blue sky laws and may not be offered or sold in the United States absent registration with the Securities and Exchange Commission or an applicable exemption from registration.

The Company serves as collateral manager to the Issuer under a collateral management agreement, which contains customary representations, warranties and covenants. Under the collateral management agreement, the Company will perform certain investment management functions, including supervising and directing the investment and reinvestment of the Issuer's assets, as well as perform certain administrative and advisory functions.

In addition, because each of the Issuer and the Depositor are consolidated subsidiaries, the Company did not recognize any gain or loss on the transfer of any of our portfolio assets to such vehicles in connection with the issuance and sale of the KCAP Senior Funding I Notes.

As of December 31, 2016, there were 77 investments in portfolio companies with a total fair value of approximately \$190.4 million plus cash of \$8.5 million, collateralizing the secured notes of the Issuer. At December 31, 2016, there were unamortized issuance costs of approximately \$2.5 million, and unamortized original issue discount, (OID) of approximately \$2.3 million included in Notes issued by KCAP Senior Funding I, LLC liabilities in the accompanying consolidated balance sheet. The pool of loans in the securitization must meet certain requirements, including asset mix and concentration, collateral coverage, term, agency rating, minimum coupon, minimum spread and sector diversity requirements.

For the years ended December 31, 2016, 2015, and 2014, interest expense, including the amortization of deferred debt issuance costs and the discount on the face amount of the notes was approximately \$5.6 million, \$5.0 million and \$3.8 million, respectively, consisting of stated interest expense of approximately \$4.4 million, \$3.8 million and \$2.8 million, respectively, accreted discount of approximately \$621,000, \$605,000 and \$450,000, respectively, and deferred debt issuance costs of approximately \$667,000, \$649,000 and \$525,000, respectively. As of December 31, 2016 the stated interest charged under the securitization was based on current three month LIBOR at the reset date, which was 0.88%. The classes, stated interest rates, spread over LIBOR, and stated interest expense are as follows:

|                                       | Stated<br>Interest<br>Rate <sup>(1)</sup> |   | LIBOR<br>Spread<br>(basis points) | Interest<br>Expense <sup>(1)</sup> |
|---------------------------------------|---|---|-----------------------------------|------------------------------------|
| KCAP Senior Funding LLC Class A Notes | 2.38                                      | % | 150                               | \$ 2,573,970                       |
| KCAP Senior Funding LLC Class B Notes | 4.13                                      | % | 325                               | 520,380                            |
| KCAP Senior Funding LLC Class C Notes | 5.13                                      | % | 425                               | 718,200                            |
| KCAP Senior Funding LLC Class D Notes | 6.13                                      | % | 525                               | 772,380                            |
| Total                                 |   |   |                                   | \$ 4,584,930                       |

(1) Stated Interest Rate (and thus periodic interest expense), will vary based upon prevailing 3 month LIBOR as of the reset date.

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The amounts, ratings and interest rates (expressed as a spread to LIBOR) of the Class A, B, C, and D are as follows:

| Description                            | Class A Notes                      | Class B Notes                      | Class C Notes                          | Class D Notes                          |
|--|------------------------------------|------------------------------------|--|--|
| Type                                   | Senior<br>Secured<br>Floating Rate | Senior<br>Secured<br>Floating Rate | Secured<br>Deferrable<br>Floating Rate | Secured<br>Deferrable<br>Floating Rate |
| Amount Outstanding                     | \$ 108,150,000                     | \$ 12,600,000                      | \$ 14,000,000                          | \$ 12,600,000                          |
| Moody's Rating ( <i>sf</i> )           | Aaa                                | Aa2                                | A2                                     | Baa2                                   |
| Standard & Poor's Rating ( <i>sf</i> ) | AAA                                | AA                                 | A                                      | BBB                                    |
| Interest Rate                          | LIBOR +<br>1.50 %                  | LIBOR +<br>3.25 %                  | LIBOR +<br>4.25 %                      | LIBOR +<br>5.25 %                      |
| Stated Maturity                        | July, 2024<br>B, C, D              | July, 2024<br>C, D                 | July, 2024<br>D and                    | July, 2024<br>Subordinated             |
| Junior Classes                         | and<br>Subordinated                | and<br>Subordinated                | Subordinated                           |  |

(1) Three month LIBOR, which was .88% as of the last reset date.

The Company's outstanding principal amounts, carrying values and fair values of the Class A, B, C and D Notes are as follows:

|                                       | As of December 31, 2016 |                   |                |
|---------------------------------------|-------------------------|-------------------|----------------|
|                                       | Principal<br>Amount     | Carrying<br>Value | Fair<br>Value  |
| KCAP Senior Funding LLC Class A Notes | \$ 108,150,000          | \$ 104,666,900    | \$ 107,338,875 |
| KCAP Senior Funding LLC Class B Notes | 12,600,000              | 12,194,202        | 12,615,750     |
| KCAP Senior Funding LLC Class C Notes | 14,000,000              | 13,549,113        | 14,000,000     |
| KCAP Senior Funding LLC Class D Notes | 12,600,000              | 12,194,204        | 12,379,500     |
| Total                                 | \$ 147,350,000          | \$ 142,604,419    | \$ 146,334,125 |

*Fair Value of KCAP Senior Funding I.* The Company carries the KCAP Senior Funding I Notes at cost, net of unamortized discount and offering costs of approximately \$4.7 million and \$6.0 million, respectively. The fair value of the KCAP Senior Funding I Notes was approximately \$146.3 million and \$143.8 million at December 31, 2016 and 2015, respectively. The fair values were determined based on third party indicative values. The KCAP Senior Funding I L.L.C. Notes are categorized as Level III under ASC 820: Fair Value.

### **7.375% Notes Due 2019**

On October 10, 2012, the Company issued \$41.4 million in aggregate principal amount of unsecured 7.375% Notes Due 2019. The net proceeds for these Notes, after the payment of underwriting expenses, were approximately \$39.9 million. Interest on the 7.375% Notes Due 2019 is paid quarterly in arrears on March 30, June 30, September 30 and

December 30, at a rate of 7.375%, commencing December 30, 2012. The 7.375% Notes Due 2019 mature on September, 30, 2019 and are unsecured obligations of the Company. The 7.375% Notes Due 2019 are subject to redemption in whole or in part at any time or from time to time, at the option of the Company, on or after September 30, 2015, at a redemption price per security equal to 100% of the outstanding principal amount thereof plus accrued and unpaid interest payments otherwise payable for the then-current quarterly interest period accrued to the date fixed for redemption. In addition, due to the asset coverage test applicable to the Company as a BDC and a covenant that the Company agreed to in connection with the issuance of the 7.375% Notes Due 2019, the Company is limited in its ability to make distributions in certain circumstances. The indenture governing the 7.375% Notes Due 2019 contains certain restrictive covenants, including compliance with certain provisions of the 1940 Act relating to borrowing and dividends. At December 31, 2016, the Company was in compliance with all of its debt covenants.

For the years ended December 31, 2016, 2015 and 2014, interest expense related to the 7.375% Notes Due 2019 was approximately \$2.9 million, \$3.1 million and \$3.1 million, respectively.

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**KCAP Financial, Inc.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**6. BORROWINGS (continued)**

In connection with the issuance of the 7.375% Notes Due 2019, the Company incurred approximately \$1.5 million of debt offering costs which are being amortized over the expected term of the facility on an effective yield method, of which approximately \$551,000 remains to be amortized, and is included on the consolidated balance sheets as a reduction in the related debt liability.

During the second quarter of 2016, the Company repurchased approximately \$2.4 million par value of the 7.375% notes due 2019 at a weighted average price of \$25.23 per \$25.00 note, resulting in a realized loss on extinguishment of \$71,190. KCAP subsequently surrendered these notes to the Trustee for cancellation.

During the third quarter of 2016, \$5.0 million par value of the 7.375% notes due 2019 was redeemed by the Company, resulting in a realized loss on extinguishment of \$88,015.

During the fourth quarter of 2016, approximately \$469,000 par value of the 7.375% notes due 2019 was redeemed by the Company, resulting in a realized loss on extinguishment of \$15,006.

*Fair Value of 7.375% Notes Due 2019.* The 7.375% Notes Due 2019 were issued in a public offering on October 10, 2012 and are carried at cost. For the years ended December 31, 2016 and 2015, the fair value of the Company's outstanding 7.375% Notes Due 2019 was approximately \$34.2 million and \$41.1 million, respectively. The fair value was determined based on the closing price on December 31, 2016 and 2015 for the 7.375% Notes Due 2019. The 7.375% Notes Due 2019 are categorized as Level I under the ASC 820 Fair Value.

**Convertible Notes**

On March 16, 2011, the Company issued \$55 million in aggregate principal amount of unsecured 8.75% convertible notes due March 2016 ( Convertible Notes ). On March 23, 2011, pursuant to an over-allotment option, the Company issued an additional \$5 million of such Convertible Notes for a total of \$60 million in aggregate principal amount. The net proceeds from the sale of the Convertible Notes, after the payment of underwriting expenses, were approximately \$57.7 million. Interest on the Convertible Notes is due semi-annually in arrears on March 15 and September 15, at a rate of 8.75%, commencing September 15, 2011. The Convertible Notes matured and were repaid on March 15, 2016. The Convertible Notes were senior unsecured obligations of the Company.

In connection with the issuance of the Convertible Notes, the Company incurred approximately \$2.4 million of debt offering costs, which were amortized over the term of the Convertible Notes on an effective yield method. On April 4, 2013, approximately \$9 million of the Company's 8.75% Convertible Notes were converted at a price per share of \$8.159 into 1,102,093 shares of KCAP common stock. On September 4, 2013, the Company purchased \$2.0 million face value of its own Convertible Notes at a price of \$114.50, plus accrued interest. KCAP subsequently surrendered these notes to the trustee for cancellation effective September 13, 2013. During 2015, the Company repurchased approximately \$19.3 million face value of its own Convertible Notes at a price ranging from \$101.500 to \$102.375.

KCAP subsequently surrendered these notes to the Trustee for cancellation. Due to the cash conversion option



embedded in the Convertible Notes, the Company applied the guidance in ASC 470-20-40, Debt with Conversion and Other Options and realized a loss on the extinguishment of this debt. The indenture governing the Convertible Notes contains certain restrictive covenants, including compliance with certain provisions of the 1940 Act and conditions governing the undertaking of new debt. The Convertible Notes matured and were fully repaid on March 15, 2016.

For the years ended the years ended December 31, 2016, 2015, and 2014, interest expense related to the Convertible Notes was \$378,000, \$3.1 million and \$4.1 million, respectively.

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TABLE OF CONTENTS**KCAP Financial, Inc.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****6. BORROWINGS (continued)**

*Fair Value of Convertible Notes.* The Company carries the Convertible Notes at cost. The Convertible Notes were issued in a private placement and there was no active trading of these notes. The estimated fair value of the Company's outstanding Convertible Notes was approximately \$19.5 million at December 31, 2015. The fair value was determined based on an indicative closing price as of that date. The Convertible Notes are categorized as Level III following ASC 820: Fair Value.

**7. DISTRIBUTABLE TAXABLE INCOME**

Effective December 11, 2006, the Company elected to be treated as a RIC under the Code and adopted a December 31 tax-calendar year end. As a RIC, the Company is not subject to federal income tax on the portion of its taxable income and gains distributed currently to its stockholders as a dividend. The Company's quarterly distributions, if any, are determined by the Board of Directors. The Company anticipates distributing substantially all of its taxable income and gains, within the Subchapter M rules, and thus the Company anticipates that it will not incur any federal or state income tax at the RIC level. As a RIC, the Company is also subject to a federal excise tax based on distributive requirements of its taxable income on a calendar year basis (e.g., calendar year 2016). Depending on the level of taxable income earned in a tax year, the Company may choose to carry forward taxable income in excess of current year distributions into the next tax year and pay a 4% excise tax on such income, to the extent required.

Book and tax basis differences relating to stockholder dividends and distributions and other permanent book and tax differences are typically reclassified among the Company's capital accounts. In addition, the character of income and gains to be distributed is determined in accordance with income tax regulations that may differ from GAAP; accordingly at calendar years ended December 31, 2016 and 2015, the Company reclassified for book purposes amounts arising from permanent book/tax differences related to the tax treatment of return of capital distributions and non-deductible expenses, as follows:

|   | Year Ended December 31, |               |
|---|-------------------------|---------------|
|   | 2016                    | 2015          |
| Capital in excess of par value                  | \$(10,491,016)          | \$(2,850,376) |
| Accumulated undistributed net investment income | \$10,587,127            | \$2,744,870   |
| Accumulated net realized losses                 | \$(96,111)              | \$105,506     |

The following reconciles net increase in net assets resulting from operations to taxable income for the year ended December 31, 2016 and 2015:

| Year Ended   | Year Ended   |
|--------------|--------------|
| December 31, | December 31, |
| 2016         | 2015         |

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|   |                |                |
|---|----------------|----------------|
| Net decrease in net assets resulting from operations  | \$(1,039,731 ) | \$(18,634,558) |
| Net change in unrealized appreciation from investments  | 13,188,048     | 36,169,870     |
| Net realized losses   | 6,341,678      | 6,647,477      |
| Book tax differences on CLO equity investments  | (3,193,602 )   | (991,297 )     |
| Other book tax differences  | (534,714 )     | 142,721        |
| Taxable income before deductions for distributions  | \$14,761,679   | \$23,334,213   |
| Taxable income before deductions for distributions per weighted average basic shares for the period | \$0.40         | \$0.63         |

Dividends from Asset Manager Affiliates are recorded based upon a quarterly estimate of tax-basis earnings and profits of each Asset Manager Affiliate. Distributions in excess of the estimated tax-basis quarterly earnings and profits of each distributing Asset Manager Affiliate are recognized as tax-basis return of capital. The actual tax-basis earnings and profits and resulting dividend and/or return of capital for the year will be determined at the end of the tax year for each distributing Asset Manager Affiliate. For years ended

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TABLE OF CONTENTS**KCAP Financial, Inc.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****7. DISTRIBUTABLE TAXABLE INCOME (continued)**

the years ended December 31, 2016, 2015, and 2014, the Asset Manager Affiliates declared cash distributions of approximately \$2.7 million \$9.1 million, and \$11.9 million to the Company, respectively. The Company recognized approximately \$1.4 million, \$5.3 million, and \$5.5 million, respectively, of dividends from Asset Manager Affiliates in the Statement of Operations for the years ended the years ended December 31, 2016, 2015, and 2014. The difference of \$1.3 million, \$3.8 million, and \$6.4 million, respectively, between cash distributions received and the tax-basis earnings and profits of the distributing affiliate, are recorded as an adjustment to the cost basis in the Asset Manager Affiliate (i.e. tax-basis return of capital), for the years ended the years ended December 31, 2016, 2015, and 2014, respectively.

Distributions to shareholders that exceed tax-basis distributable income (tax-basis net investment income and realized gains, if any) are reported as distributions of paid-in capital (i.e., return of capital). The tax character of distributions is made on an annual (full calendar-year) basis. The determination of the tax attributes of our distributions is made at the end of the year based upon our taxable income for the full year and the distributions paid during the full year.

Therefore, a determination of tax attributes made on a quarterly basis may not be representative of the actual tax attributes of distributions for a full year.

|                                 | Year Ended December 31, |               |               |
|---------------------------------|-------------------------|---------------|---------------|
|                                 | 2016                    | 2015          | 2014          |
| <i>Distributions paid from:</i> |                         |               |               |
| Ordinary income                 | \$ 14,761,679           | \$ 22,985,978 | \$ 26,807,154 |
| Return of Capital               | 7,307,578               |               | 7,972,633     |
| Total                           | \$ 22,069,257           | \$ 22,985,978 | \$ 34,779,787 |

As of December 31, 2016 and 2015, the components of accumulated earnings on a tax basis were as follows:

|                               | Year Ended December 31, |                  |
|-------------------------------|-------------------------|------------------|
|                               | 2016                    | 2015             |
| Distributable ordinary income | \$                      | \$ 348,235       |
| Capital loss carryforward     | \$ (91,050,249 )        | \$ (83,133,721 ) |
| Other temporary differences   | \$ (1,059,735 )         | \$ (1,609,485 )  |
| Net unrealized depreciation   | \$ (66,741,029 )        | \$ (61,838,068 ) |

At December 31, 2016, the Company had a net capital loss carryforward of approximately \$91.1 million to offset net capital gains, to the extent provided by federal tax law. \$0.6 million of net capital loss carryforward expired in 2016.

\$13.5 million and \$17.9 million of net capital loss carryforward is subject to expiration in 2017 and 2018, respectively. \$59.7 million of the net capital loss carryforward is not subject to expiration under the RIC

Modernization Act of 2010.

On December 14, 2016, the Company's Board of Directors declared a distribution to shareholders of \$0.12 per share for a total of approximately \$4.4 million. The record date was January 6, 2017 and the distribution was paid on January 27, 2017.

The Company adopted Financial Accounting Standards Board ASC Topic 740 Accounting for Uncertainty in Income Taxes (ASC 740) as of January 1, 2007. ASC 740 provides guidance for how uncertain tax positions should be recognized, measured, presented, and disclosed in the consolidated financial statements. ASC 740 requires the evaluation of tax positions taken or expected to be taken in the course of preparing the Company's tax returns to determine whether the tax positions are more-likely-than-not of being sustained by the applicable tax authority. The Company recognizes the tax benefits of uncertain tax positions only where the position is more likely than not to be sustained assuming examination by tax authorities. Management has analyzed the Company's tax positions, and has concluded that no liability for unrecognized tax benefits should be recorded related to uncertain tax positions taken on returns filed for open tax years (the last three

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**KCAP Financial, Inc.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**7. DISTRIBUTABLE TAXABLE INCOME (continued)**

fiscal years) or expected to be taken in the Company's current year tax return. The Company identifies its major tax jurisdictions as U.S. Federal and New York State, and the Company is not aware of any tax positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will change materially in the next 12 months. Management's determinations regarding ASC 740 may be subject to review and adjustment at a later date based upon factors including, but not limited to, an ongoing analysis of tax laws, regulations and interpretations thereof.

**8. COMMITMENTS AND CONTINGENCIES**

From time-to-time the Company is a party to financial instruments with off-balance sheet risk in the normal course of business in order to meet the needs of the Company's investment in portfolio companies. Such instruments include commitments to extend credit and may involve, in varying degrees, elements of credit risk in excess of amounts recognized on the Company's balance sheet. Prior to extending such credit, the Company attempts to limit its credit risk by conducting extensive due diligence, obtaining collateral where necessary and negotiating appropriate financial covenants. As of December 31, 2016 and December 31, 2015, the Company had \$565,000 and \$360,000 commitments to fund investments, respectively.

**9. STOCKHOLDERS' EQUITY**

During the years ended December 31, 2016 and December 31, 2015, the Company issued 174,396 and 175,922 shares, respectively, of common stock under its dividend reinvestment plan. For the year ended December 31, 2016, the Company issued 6,000 shares of restricted stock, 34,453 shares were forfeited, and 260,607 shares vested. On October 6, 2014, the Company priced a follow-on public offering of 3.0 million shares of its common stock at a price of \$8.02 per share. The offering raised net proceeds were approximately \$23.8 million, after deducting underwriting discounts and offering expenses. The total number of shares of the Company's common stock outstanding as of December 31, 2016 and 2015 was 37,178,294 and 37,100,005, respectively. During the year ended December 31, 2016, the Company repurchased 67,654 shares at an aggregate cost of approximately \$248,000 in connection with the vesting of restricted stock awards.

**10. EQUITY INCENTIVE PLAN**

The Company has an equity incentive plan, established in 2006 and as amended in 2008, 2014 and most recently in June 2015 (the "Equity Incentive Plan"). The Company reserved 2,000,000 shares of common stock for issuance under the Equity Incentive Plan. The purpose of the Equity Incentive Plan is to provide officers and employees of the Company with additional incentives and align the interests of its employees with those of its shareholders. Options granted under the Equity Incentive Plan are exercisable at a price equal to the fair market value (market closing price) of the shares on the day the option is granted. Restricted stock granted under the Equity Incentive Plan is granted at a price equal to the fair market value (market closing price) of the shares on the day such restricted stock is granted.

Vesting of restricted stock awarded under the 2008 amendment of the Equity Incentive Plan will occur in two equal installments of 50%, on each of the third and fourth anniversaries of the grant date; vesting of restricted stock subsequent to the 2014 amendment of the Equity Incentive Plan will vest in four equal installments of 25%, on each of the first four anniversaries of the grant date.

### **Stock Options**

On June 20, 2014, the Company's Board of Directors approved the amended and restated the Non-Employee Director Plan (the Non-Employee Director Plan), which was approved by shareholders on June 10, 2011. Accordingly, the annual grant of options to non-employee directors has been discontinued and replaced with an annual grant of shares of restricted stock as partial annual compensation for the services of the non-employee directors.

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TABLE OF CONTENTS**KCAP Financial, Inc.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****10. EQUITY INCENTIVE PLAN (continued)**

Information with respect to options granted, exercised and forfeited under the Equity Incentive Plan for the period January 1, 2015 through December 31, 2016 is as follows:

|  | Shares | Weighted<br>Average<br>Exercise<br>Price<br>per Share | Weighted<br>Average<br>Contractual<br>Remaining<br>Term<br>(years) | Aggregate<br>Intrinsic<br>Value <sup>(1)</sup> |
|--|--------|---|--|--|
| Options outstanding at January 1, 2015   | 50,000 | \$ 7.72   |  |  |
| Granted                                  |        | \$  |  |  |
| Exercised                                |        | \$  |  |  |
| Forfeited                                |        | \$  |  |  |
| Options outstanding at December 31, 2015 | 50,000 | \$ 7.72   |  |  |
| Granted                                  |        | \$  |  |  |
| Exercised                                |        | \$  |  |  |
| Forfeited                                |        | \$  |  |  |
| Outstanding at December 31, 2016         | 50,000 | \$  | 2.4  | \$   |
| Total vested at December 31, 2016        | 50,000 | \$ 7.72   | 2.4  |  |

(1) Represents the difference between the market value of shares of the Company and the exercise price of the options. The Company uses a Binary Option Pricing Model (American, call option) to establish the expected value of all stock option grants. For the years ended December 31, 2016, 2015 and 2014 the Company did not recognize any non-cash compensation expense related to stock options. At December 31, 2016, the Company had no remaining compensation costs related to unvested stock based awards.

**Restricted Stock**

Awards of restricted stock granted under the Non-Employee Director Plan vest as follows: 50% of the shares vest on the grant date and the remaining 50% of the shares vest on the earlier of:

- (i) the first anniversary of such grant, or
- (ii) the date immediately preceding the next annual meeting of shareholders.

On May 5, 2013, the Company's Board of Directors approved the grant of 240,741 shares of restricted stock to the employees of the Company as partial compensation for their services. 50% of such awards will vest on the third anniversary of the grant date and the remaining 50% of the shares will vest on the fourth anniversary of the grant date.



On June 14, 2013, 5,000 shares of restricted stock were awarded to the Company's Board of Directors.

On May 5, 2014, 5,000 shares of restricted stock were awarded to the Company's Board of Directors.

On June 20, 2014, the Company's Board of Directors approved the grant of 355,289 shares of restricted stock to the employees of the Company as partial compensation for their services. 25% of such awards will vest on each of the first four anniversaries of the grant date.

On May 21, 2015, 6,000 shares of restricted stock were awarded to the Company's Board of Directors.

On May 3, 2016, 6,000 shares of restricted stock were awarded to the Company's Board of Directors.

On June 16, 2015, the Company received exemptive relief to repurchase shares of its common stock from its employees in connection with certain equity compensation plan arrangements. During the years ended December 31, 2016 and 2015, the Company repurchased 67,654 and 36,348 shares, respectively, of common stock at an aggregate cost of approximately \$248,000 and \$220,000, respectively, in connection with the

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# KCAP Financial, Inc.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### 10. EQUITY INCENTIVE PLAN (continued)

vesting of employee's restricted stock, which is reflected as Treasury Stock at cost on the Consolidated Balance Sheet. These shares are not available to be reissued under the Company's Equity Incentive Plan.

On June 23, 2015, the Company's Board of Directors approved the grant of 190,166 shares, with a fair value of approximately \$1.2 million, of restricted stock to the employees of the Company as partial compensation for their services. 25% of such awards will vest on each of the first four anniversaries of the grant date.

On June 23, 2015, the Company's Board of Directors also voted to amend the Equity Incentive Plan to specify that shares repurchased by the Company to satisfy employee tax withholding requirements would not be returned to the plan reserve and could not be reissued under the Company's Equity Incentive Plan.

Information with respect to restricted stock granted, exercised and forfeited under the Plan for the period January 1, 2015 through December 31, 2016 is as follows:

|  | Non-Vested<br>Restricted<br>Shares |
|--|------------------------------------|
| Non-vested shares outstanding at January 1, 2015   | 619,785                            |
| Granted  | 196,166                            |
| Vested   | (104,550 )                         |
| Forfeited  | (10,862 )                          |
| Non-vested shares outstanding at December 31, 2015 | 700,539                            |
| Granted  | 6,000                              |
| Vested   | (260,607 )                         |
| Forfeited  | (34,453 )                          |
| Non-vested shares outstanding at December 31, 2016 | 411,479                            |

For the year ended December 31, 2016, non-cash compensation expense related to restricted stock was approximately \$1.6 million; of this amount approximately \$659,000 was expensed at the Company and approximately \$909,000 was a reimbursable expense allocated to the Asset Manager Affiliates. For the year ended December 31, 2015, non-cash compensation expense related to restricted stock was approximately \$1.6 million; of this amount approximately \$676,000 was expensed at the Company and approximately \$897,000 was a reimbursable expense allocated to the Asset Manager Affiliates. For the year ended December 31, 2014, non-cash compensation expense related to restricted stock was approximately \$1.1 million; of this amount approximately \$534,000 was expensed at the Company and approximately \$589,000 was a reimbursable expense allocated to the Asset Manager Affiliates.

Distributions are paid on all outstanding shares of restricted stock, whether or not vested. In general, shares of unvested restricted stock are forfeited upon the recipient's termination of employment. At December 31, 2016 and 2015, the Company had approximately \$1.8 million and \$3.6 million of total unrecognized compensation cost related

to non-vested restricted share awards, respectively. That cost is expected to be recognized over the remaining weighted average period of 1.5 years.

## 11. OTHER EMPLOYEE COMPENSATION

The Company adopted a 401(k) plan ( 401K Plan ) effective January 1, 2007. The 401K Plan is open to all full time employees. The 401K Plan permits an employee to defer a portion of their total annual compensation up to the Internal Revenue Service annual maximum based on age and eligibility. The Company makes contributions to the 401K Plan of up to 2% of the Internal Revenue Service s annual maximum eligible compensation, which fully vests at the time of contribution. Approximately \$19,000, \$25,000 and \$38,000 was expensed during the years ended December 31, 2016, 2015, and 2014, respectively, related to the 401K Plan.

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TABLE OF CONTENTS**KCAP Financial, Inc.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****11. OTHER EMPLOYEE COMPENSATION (continued)**

The Company has also adopted a deferred compensation plan ( Profit-Sharing Plan ) effective January 1, 2007. Employees are eligible for the Profit-Sharing Plan provided that they are employed and working with the Company to participate in at least 100 days during the year and remain employed as of the last day of the year. Employees do not make contributions to the Profit-Sharing Plan. On behalf of the employee, the Company may contribute to the Profit-Sharing Plan 1) up to 8.0% of all compensation up to the Internal Revenue Service annual maximum and 2) up to 5.7% excess contributions on any incremental amounts above the social security wage base limitation and up to the Internal Revenue Service annual maximum. Employees vest 100% in the Profit-Sharing Plan after five years of service. Approximately \$184,000, \$151,000 and \$244,000 was expensed during the years ended December 31, 2016, 2015, and 2014, respectively, related to the Profit-Sharing Plan.

**12. SELECTED QUARTERLY DATA (Unaudited)**

|   | Q1 2016       | Q2 2016     | Q3 2016     | Q4 2016     |
|---|---------------|-------------|-------------|-------------|
| Total interest and related portfolio income                                       | \$9,510,321   | \$9,579,400 | \$9,018,789 | \$8,091,587 |
| Net investment income   | \$4,764,770   | \$5,108,020 | \$4,523,027 | \$4,094,177 |
| Net (decrease) increase in net assets resulting from operations                   | \$(6,842,699) | \$3,007,484 | \$2,716,613 | \$78,869    |
| Net (decrease) increase in net assets resulting from operations per share basic   | \$(0.18 )     | \$0.08      | \$0.07      | \$          |
| Net (decrease) increase in net assets resulting from operations per share diluted | \$(0.18 )     | \$0.08      | \$0.07      | \$          |
| Net investment income per share basic   | \$0.13        | \$0.14      | \$0.12      | \$0.11      |
| Net investment income per share diluted   | \$0.13        | \$0.14      | \$0.12      | \$0.11      |

  

|   | Q1 2015      | Q2 2015      | Q3 2015        | Q4 2015        |
|---|--------------|--------------|----------------|----------------|
| Total interest and related portfolio income   | \$12,342,129 | \$11,171,386 | \$11,779,348   | \$10,234,108   |
| Net investment income   | \$6,506,948  | \$5,832,252  | \$6,541,080    | \$5,302,509    |
| Net increase (decrease) in net assets resulting from operations                             | \$7,672,290  | \$1,232,705  | \$(16,050,865) | \$(11,488,691) |
| Net increase (decrease) in net assets resulting from operations per share basic and diluted | \$0.21       | \$0.03       | \$(0.43 )      | \$(0.31 )      |
| Net increase (decrease) in net assets resulting from operations per share diluted           | \$0.20       | \$0.03       | \$(0.43 )      | \$(0.31 )      |
| Net investment income per share basic   | \$0.18       | \$0.16       | \$0.18         | \$0.14         |
| Net investment income per share diluted   | \$0.18       | \$0.16       | \$0.18         | \$0.14         |

## 13. SUBSEQUENT EVENTS

On January 26, 2017, Trimaran Advisors, LLC drew \$10 million under the Trimaran Credit Facility.

The Company has evaluated events and transactions occurring subsequent to December 31, 2016 for items that should potentially be recognized or disclosed in these financial statements. Other than described above, management has determined that there are no material subsequent events that would require adjustment to, or disclosure in, these consolidated financial statements.

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## KATONAH 2007-I CLO LTD.

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## IMPORTANT NOTE

In accordance with certain SEC rules, KCAP Financial, Inc. (the Company ) is providing additional information regarding the following three portfolio companies: Katonah Debt Advisers, L.L.C., Trimaran Advisors, L.L.C. (collectively the Asset Manager Affiliates), Katonah 2007-I CLO Ltd and Katonah X CLO Ltd. However, pursuant to SEC rules, the Company does not consolidate portfolio company investments, including those in which it has a controlling interest. As a result, the additional financial information regarding these entities does not directly impact the Company s financial position, results of operations or cash flows.

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## **Report of Independent Auditors**

The Board of Directors and Shareholders of  
Asset Manager Affiliates

We have audited the accompanying combined financial statements of Asset Manager Affiliates, which comprise the combined balance sheets, as of December 31, 2016 and 2015, and the related combined statements of operations, changes in member's equity, and cash flows for each of the three years in the period ended December 31, 2016, and the related notes to the combined financial statements.

### **Management's Responsibility for the Financial Statements**

Management is responsible for the preparation and fair presentation of these financial statements in conformity with U.S. generally accepted accounting principles; this includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free of material misstatement, whether due to fraud or error.

### **Auditor's Responsibility**

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

### **Opinion**

In our opinion, the financial statements referred to above present fairly, in all material respects, the combined financial position of Asset Manager Affiliates at December 31, 2016 and 2015, and the combined results of their operations and their cash flows for each of the three years in the period ended December 31, 2016, in conformity with U.S. generally accepted accounting principles.

## **Adoption of ASU No. 2015-02 Consolidation (Topic 810): Amendments to the Consolidation Analysis**

As discussed in Note 2 to the combined financial statements, Asset Manager Affiliates deconsolidated the collateralized loan obligation funds as a result of the adoption of the amendments to Accounting Standards Codification resulting from Accounting Standards Update 2015-2, Consolidation (Topic 810) effective January 1, 2016. Our opinion is not modified with respect to this matter.

/s/ Ernst & Young LLP

New York, NY

March 9, 2017

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# ASSET MANAGER AFFILIATES

## COMBINED BALANCE SHEETS

|  | As of<br>December 31,<br>2016 | As of<br>December 31,<br>2015 |
|--|-------------------------------|-------------------------------|
| <b>ASSETS</b>  |                               |                               |
| Investments, at fair value (cost: 2016 \$0; 2015 \$22,000,000) | \$                            | \$ 23,089,679                 |
| Cash   | 3,425,709                     | 4,085,464                     |
| Accrued management fees receivable                             | 2,176,833                     | 3,422,409                     |
| Due from affiliates  | 86,615                        | 643,352                       |
| Intangible assets  | 23,157,541                    | 24,467,705                    |
| Other assets   | 2,760,726                     | 2,805,977                     |
| Total assets   | \$ 31,607,424                 | \$ 58,514,586                 |
| <b>LIABILITIES</b>   |                               |                               |
| Debt, at fair value  | \$                            | \$ 23,000,000                 |
| Accrued interest payable                                       |                               | 178,250                       |
| Accounts payable and accrued expenses                          | 3,431,496                     | 4,297,851                     |
| Due to affiliates  | 612,983                       | 2,117,095                     |
| Deferred tax liability   | 2,575,140                     | 649,970                       |
| Total liabilities  | 6,619,619                     | 30,243,166                    |
| Commitments and Contingencies                                  |                               |                               |
| <b>MEMBER'S EQUITY</b>   |                               |                               |
| Member's contributions   | 52,519,916                    | 52,519,916                    |
| Accumulated deficit  | (27,532,111 )                 | (24,248,496 )                 |
| Total member's equity  | 24,987,805                    | 28,271,420                    |
| Total liabilities and member's equity                          | \$ 31,607,424                 | \$ 58,514,586                 |

See accompanying notes to combined financial statements.

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# ASSET MANAGER AFFILIATES

## COMBINED STATEMENTS OF OPERATIONS

|                                   | For the Years Ended December 31, |               |               |
|-----------------------------------|----------------------------------|---------------|---------------|
|                                   | 2016                             | 2015          | 2014          |
| <b>Revenues</b>                   |                                  |               |               |
| Management and Incentive Fees     | \$ 12,835,603                    | \$ 22,617,240 | \$ 27,467,068 |
| Investment Income                 | 1,024,760                        | 2,787,334     | 4,049,281     |
| <b>Total revenues</b>             | 13,860,363                       | 25,404,574    | 31,516,349    |
| <b>Expenses</b>                   |                                  |               |               |
| Interest expense                  | 1,821,517                        | 1,726,781     | 2,033,473     |
| Compensation                      | 7,596,726                        | 9,441,607     | 8,921,240     |
| Insurance                         | 408,959                          | 450,460       | 460,969       |
| Professional fees                 | 980,605                          | 903,119       | 1,070,993     |
| Amortization of intangible assets | 1,310,164                        | 2,308,123     | 5,290,437     |
| Administrative and other          | 2,457,029                        | 2,391,184     | 2,296,193     |
| <b>Total expenses</b>             | 14,575,000                       | 17,221,274    | 20,073,305    |
| <b>(Loss)/income before tax</b>   | (714,637 )                       | 8,183,300     | 11,443,044    |
| Income tax (benefit) expense      | (81,022 )                        | 5,642,225     | 4,153,598     |
| <b>Net (loss)/income</b>          | \$ (633,615 )                    | \$ 2,541,075  | \$ 7,289,446  |

See accompanying notes to combined financial statements.

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TABLE OF CONTENTS**ASSET MANAGER AFFILIATES****COMBINED STATEMENTS OF CHANGES IN  
MEMBER'S EQUITY**

|                                   | Member's<br>Contributions | Accumulated<br>Earnings<br>(Deficit) | Total Member's<br>Equity |
|-----------------------------------|---------------------------|--------------------------------------|--------------------------|
| <b>Total at January 1, 2014</b>   | <b>\$ 51,984,116</b>      | <b>\$ (13,129,017 )</b>              | <b>\$ 38,855,099</b>     |
| Net income                        |                           | 7,289,446                            | 7,289,446                |
| Distributions                     |                           | (11,900,000 )                        | (11,900,000 )            |
| Contributions                     | 535,800                   |                                      | 535,800                  |
| <b>Total at December 31, 2014</b> | <b>52,519,916</b>         | <b>(17,739,571 )</b>                 | <b>34,780,345</b>        |
| Net income                        |                           | 2,541,075                            | 2,541,075                |
| Distributions                     |                           | (9,050,000 )                         | (9,050,000 )             |
| <b>Total at December 31, 2015</b> | <b>52,519,916</b>         | <b>(24,248,496 )</b>                 | <b>28,271,420</b>        |
| Net loss                          |                           | (633,615 )                           | (633,615 )               |
| Distributions                     |                           | (2,650,000 )                         | (2,650,000 )             |
| <b>Total at December 31, 2016</b> | <b>\$ 52,519,916</b>      | <b>\$ (27,532,111 )</b>              | <b>\$ 24,987,805</b>     |

See accompanying notes to combined financial statements.

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# ASSET MANAGER AFFILIATES

## COMBINED STATEMENTS OF CASH FLOWS

|   | Years Ended December 31, |                     |                    |
|---|--------------------------|---------------------|--------------------|
|   | 2016                     | 2015                | 2014               |
| <b>OPERATING ACTIVITIES:</b>  |                          |                     |                    |
| Net (loss) income   | \$(633,615 )             | \$2,541,075         | \$7,289,446        |
| <b>Adjustments to reconcile net (loss) income to net cash provided by (used in) operating activities:</b> |                          |                     |                    |
| Deferred taxes  | 1,925,170                | 4,226,118           | (1,008,957 )       |
| Amortization of intangible assets   | 1,310,164                | 2,308,123           | 5,290,437          |
| Accretion of interest income  | (1,016,614 )             | (1,089,679 )        | (506,854 )         |
| <b>Changes in operating assets and liabilities:</b>   |                          |                     |                    |
| Decrease (increase) in accrued management fees  | 1,245,576                | 3,236,504           | (3,536,430 )       |
| Decrease (increase) in due from affiliates  | 556,737                  | (389,848 )          | (178,450 )         |
| Decrease (increase) in other assets   | 45,251                   | (2,341,414 )        | (99,598 )          |
| (Decrease) increase in accounts payable and accrued expenses  | (866,355 )               | (5,505,086 )        | 2,497,387          |
| (Decrease) increase in accrued interest payable   | (178,250 )               |                     | 11,333             |
| (Decrease) increase in due to affiliates  | (1,504,112 )             | 1,889,707           | 227,387            |
| Net cash provided by operating activities   | 883,952                  | 4,875,500           | 9,985,701          |
| <b>Investing activities:</b>  |                          |                     |                    |
| Purchase of investment  | (7,000,000 )             | (22,000,000)        | (22,000,000)       |
| Proceeds from sales/redemptions of investment   | 31,106,293               | 22,506,850          | 23,000,000         |
| Net cash provided by investing activities   | 24,106,293               | 506,850             | 1,000,000          |
| <b>Financing Activities:</b>  |                          |                     |                    |
| Member's contributions  |                          |                     | 535,800            |
| Member's distributions  | (2,650,000 )             | (9,050,000 )        | (11,900,000)       |
| Debt offering proceeds  | 7,000,000                | 36,000,000          | 47,500,000         |
| Repayments of Debt  | (30,000,000)             | (36,000,000)        | (47,500,000)       |
| Net cash used in financing activities   | (25,650,000)             | (9,050,000 )        | (11,364,200)       |
| <b>CHANGE IN CASH</b>   | <b>(659,755 )</b>        | <b>(3,667,650 )</b> | <b>(378,499 )</b>  |
| <b>CASH, BEGINNING OF YEAR</b>  | <b>4,085,464</b>         | <b>7,753,114</b>    | <b>8,131,613</b>   |
| <b>CASH, END OF YEAR</b>  | <b>\$3,425,709</b>       | <b>\$4,085,464</b>  | <b>\$7,753,114</b> |
| <b>Supplemental Information:</b>  |                          |                     |                    |
| Cash paid for interest  | \$1,999,767              | \$1,817,480         | \$2,022,132        |
| Cash paid for taxes   | \$170,000                | \$5,477,493         | \$2,978,613        |
| <b>Non-cash transactions:</b>   |                          |                     |                    |
| Member's contributions  | \$                       | \$                  | \$535,800          |

See accompanying notes to combined financial statements.



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# **ASSET MANAGER AFFILIATES**

## **NOTES TO FINANCIAL STATEMENTS**

### **1. ORGANIZATION**

Katonah Debt Advisors, L.L.C. ( *Katonah Debt Advisors* ), a registered investment adviser under the Investment Advisors Act of 1940 ( *the IA Act of 1940* ), is a wholly-owned portfolio company of KCAP Financial, Inc. ( *KCAP Financial* or the *Company* ), which is an internally managed, non-diversified closed-end publicly traded investment company that is regulated as a business development company ( *BDC* ) under the Investment Company Act of 1940 ( *the 1940 Act* ). Katonah Debt Advisors manages collateralized loan obligation funds ( *CLO Funds* ) which invest in broadly syndicated loans, high-yield bonds and other credit instruments. On February 29, 2012, KCAP Financial, through its newly formed wholly-owned subsidiary Commodore Holdings LLC ( *Commodore* ) purchased Trimaran Advisors, L.L.C. ( *Trimaran Advisors* ), a registered investment adviser and CLO manager similar to Katonah Debt Advisors, for total consideration of \$13.0 million in cash and 3,600,000 shares of KCAP Financial's common stock.

Contemporaneous with the acquisition of Trimaran Advisors, KCAP Financial acquired from Trimaran Advisors equity interests in certain CLO Funds managed by Trimaran Advisors for an aggregate purchase price of \$12.0 million in cash. As of December 31, 2016, Commodore and its wholly-owned subsidiaries Katonah Debt Advisors, Trimaran Advisors and Trimaran Advisors Management, L.L.C., as well as affiliated management companies Katonah 2007-1 Management, L.L.C., and Katonah X Management, L.L.C. (collectively, the *Asset Manager Affiliates* ) had approximately \$3.0 billion of par value assets under management. The Asset Manager Affiliates are each managed independently from KCAP Financial by a separate management team. The Asset Manager Affiliates provide investment management services to CLO Funds, making day-to-day investment decisions concerning the assets of the CLO Funds. The Asset Manager Affiliates do not have any investment interests in the CLO Funds they manage; however, KCAP Financial holds investments in a portion of the securities issued by the CLO Funds managed by the Asset Manager Affiliates.

### **2. SIGNIFICANT ACCOUNTING POLICIES**

#### **Basis of Accounting and Presentation**

The combined financial statements have been prepared in accordance with Accounting Principles Generally Accepted in the United States ( *U.S. GAAP* ) and include the financial statements of the Asset Manager Affiliates. The Asset Manager Affiliates provide investment management services to various CLO Funds, making day-to-day investment decisions concerning the assets of the CLO Funds. The Asset Manager Affiliates are all under the common control of the Company and have similar business characteristics; therefore they report on a combined basis for financial reporting purposes.

In the opinion of management, the combined financial statements reflect all adjustments, consisting of normal recurring accruals, which are necessary for the fair presentation of the financial condition and results of operations for the periods presented. All significant intercompany transactions, balances, revenues and expenses are eliminated upon combination. Certain prior-year amounts have been reclassified to conform to the current year presentation.

Furthermore, the preparation of the financial statements requires management to make significant estimates and assumptions including the fair value of investments that do not have a readily available market value. Actual results

could differ from those estimates, and the differences could be material.

In August 2014, the FASB issued Accounting Standards Update ( ASU ) 2014-15, Presentation of Financial Statements – Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern ( ASU 2014-15 ). The standard requires management to evaluate, at each interim and annual reporting period, whether there are conditions or events that raise substantial doubt about the entity's ability to continue as a going concern within one year after the date the financial statements are issued, and provide related disclosures. ASU 2014-15 is effective for annual periods ending after December 15, 2016, and for annual and interim periods thereafter.

We have adopted ASU 2014-15, and there was no material impact on our financial statements.

On February 18, 2015, the FASB issued Accounting Standards Update 2015-2 ( ASU 2015-2 ), which updated consolidation standards under ASC Topic 810, Consolidation . Under this update, a new

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## **ASSET MANAGER AFFILIATES**

### **NOTES TO FINANCIAL STATEMENTS**

#### **2. SIGNIFICANT ACCOUNTING POLICIES (continued)**

consolidation analysis is required for variable interest entities ( VIEs ), which limits the circumstances in which investment managers and similar entities are required to consolidate the entities that they manage. ASU 2015-02 eliminates some of the criteria under which the fees of investment managers and similar entities are considered a variable interest and limit the circumstances in which variable interests in a VIE held by related parties of a reporting enterprise require the reporting enterprise to consolidate the VIE. During 2016, the AMAs adopted ASU 2015-02 on a retrospective basis for all periods presented. The consolidated financial statements and related note disclosures have been adjusted for the impact of the adoption. The adoption did not result in a cumulative effect adjustment to the AMA s accumulated deficit.

Prior to the adoption of ASU 2015-02, during the years ended December 31, 2015 and 2014, the AMAs consolidated several managed CLO Funds, collectively referred to as the previously consolidated CLO Funds . The financial results of the previously consolidated CLO Funds were included in the AMA s consolidated financial statements based on the then existing consolidation guidance. The adoption of ASU 2015-02 resulted in the deconsolidation of the previously consolidated CLO Funds as the AMAs determined that under ASU 2015-02, it was not the primary beneficiary of these entities. The fee arrangements with these entities are both commensurate with the level of effort required for the services provided and include only customary terms and the AMAs do not hold other interests in these entities that could absorb losses or receive benefits that could potentially be significant to these entities. Under ASU 2015-02, the AMAs and their related parties under common control as a group, where applicable, do not have the obligation to absorb losses or the right to receive benefits from these entities that could potentially be significant to these entities. Therefore, the AMAs no longer consider these fee arrangements to be variable interests.

The effect of the deconsolidation of these previously consolidated CLO Funds as of and for the year ended December 31, 2015, was a decrease in total assets and total liabilities of \$2.7 billion; and an increase in total member s equity of \$67.5 million; and a decrease in total revenues and total expenses of \$108.2 million and \$157.5 million, respectively, and an increase in income before tax of \$64.5 million. The effect of the deconsolidation for the year ended December 31, 2014, was a decrease in total revenues and total expenses of \$94.7 million and \$154.8 million, respectively, and an increase in income before tax of \$87.3 million.

The FASB issued Accounting Standards Update 2014-09, Revenue from Contracts with Customers, which updated accounting guidance for all revenue recognition arising from contracts with customers, and also affects entities that enter into contracts to provide goods or services to their customers (unless the contracts are in the scope of other US GAAP requirements). This update provides a model for the measurement and recognition of gains and losses on the sale of certain nonfinancial assets, such as property and equipment, including real estate. The FASB also issued ASU 2015-14, Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date, which deferred the effective date of the standard for one year. As a result, the guidance is effective for public business entities for annual and interim periods in fiscal years beginning after December 15, 2017. Management is still evaluating the effect of the new standard.



On February 25, 2016, the FASB issued Accounting Standards Update 2016-02, Leases (Topic 842). This update will require organizations to recognize leased assets and liabilities on the balance sheet for the rights and obligations created by those leases. The recognition, measurement, presentation and cash flows arising from a lease by a lessee will primarily depend on its classification as a finance or operating lease. The ASU will require that both types of leases to be recognized on the balance sheet. For public business entities, this guidance is effective for fiscal years beginning after December 15, 2018. Management is still evaluating the effect of the new standard.

***Investments at Fair Value.*** Investment transactions are recorded on the applicable trade date. Realized gains or losses are determined using the specific identification method. Investments held by the Asset Manager Affiliates are stated at fair value. Accounting Standards Codification ( ASC ) 820 Fair Value Measurements and Disclosures ( ASC 820: Fair Value ), requires, among other things, disclosures about assets and liabilities that are measured and reported at fair value. Investments are generally comprise of

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## ASSET MANAGER AFFILIATES

### NOTES TO FINANCIAL STATEMENTS

#### 2. SIGNIFICANT ACCOUNTING POLICIES (continued)

investments in first loss position in facilities which warehouse assets for a new CLO. Fair value is determined via a present value analysis of estimated future cash flows and is deemed to be a Level III asset as defined in ASC 820: Fair Value. The Asset Manager Affiliates' assessment of the significance of a particular input to the Fair Value measurement in its entirety requires judgment and considers factors specific to the financial instrument.

***Hierarchy of Fair Value Inputs.*** The provisions of ASC 820: Fair Value establish a hierarchy that prioritizes inputs to valuation techniques used to measure fair value and require companies to disclose the fair value of their financial instruments according to the fair value hierarchy (i.e., Level I, II and III inputs, as defined). The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. Additionally, companies are required to provide additional disclosure regarding instruments in the Level III category (which have inputs to the valuation techniques that are unobservable and require significant management judgment), including a reconciliation of the beginning and ending balances separately for each major category of assets and liabilities.

Assets and liabilities measured and reported at fair value are classified and disclosed in one of the following categories:

**Level I Inputs:**

Quoted prices (unadjusted) in active markets for identical assets or liabilities at the reporting date.

Level I assets may include listed mutual funds, ETFs, equities and certain derivatives.

**Level II Inputs:**

Quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities that are not active; quotes from pricing services or brokers, for which the Asset Manager Affiliates can determine that orderly transactions took place at the quoted price or that the inputs used to arrive at the price were observable; and inputs other than quoted prices that are observable, such as models or other valuation methodologies.

Level II assets in this category may include debt securities, bank loans, short-term floating rate notes and asset-backed securities, restricted public securities valued at a discount, as well as over-the-counter derivatives, including interest and inflation rate swaps and foreign currency exchange contracts that have inputs to the valuations that generally can be corroborated by observable market data.

**Level III Inputs:**

Unobservable inputs for the valuation of the asset or liability, which may include non-binding broker quotes. Level III assets include investments for which there is little, if any, market activity. These inputs require significant management judgment or estimation.

Level III assets in this category may include general and limited partnership interests in private equity funds, funds of private equity funds, real estate funds, hedge funds, and funds of hedge funds, direct private equity investments held within consolidated funds, bank loans, bonds issued by CLO Funds and certain held for sale real estate disposal assets.

Level III liabilities included in this category include borrowings of consolidated collateralized loan obligation funds and are valued based upon non-binding broker quotes or discounted cash flow models based on a discount margin calculation.

**Significance of Inputs:**

The Asset Manager Affiliates' assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and considers factors specific to the financial instrument.

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## ASSET MANAGER AFFILIATES

### NOTES TO FINANCIAL STATEMENTS

#### 2. SIGNIFICANT ACCOUNTING POLICIES (continued)

*Valuation of Portfolio Investments.* Debt and equity securities for which market quotations are readily available are generally valued at such market quotations. Debt and equity securities that are not publicly traded or whose market price is not readily available are valued based on detailed analyses prepared by management, and, in certain circumstances, may utilize third parties with valuation expertise. The Asset Manager Affiliates follow the provisions of ASC 820: Fair Value which defines fair value, establishes a framework for measuring fair value, and expands disclosures about assets and liabilities measured at fair value. ASC 820: Fair Value defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Subsequent to the adoption of ASC 820: Fair Value, the FASB has issued various staff positions clarifying the initial standard as noted below.

ASC 820: Fair value requires the disclosure of the inputs and valuation techniques used to measure fair value and a discussion of changes in valuation techniques and related inputs, if any, during the period.

*Cash.* The Asset Manager Affiliates define cash as demand deposits. The Asset Manager Affiliates place their cash with financial institutions and, at times, cash held in these accounts may exceed the Federal Deposit Insurance Corporation insured limit.

*Other Assets.* Other assets are generally comprised of prepaid expenses and current income taxes receivable (if any). Prepaid expenses are amortized over their terms or expected useful life.

*Interest Income.* Interest income is recorded on the accrual basis on interest-bearing assets. Investment income on residual beneficial interest in warehouse facilities is recognized using the effective interest method under ASC 325-40.

*Management Fees.* As a manager of CLO Funds, the Asset Manager Affiliates receive contractual and recurring management fees (and may receive one-time structuring fees) from the CLO Funds for their management and advisory services. The periodic fees which the Asset Manager Affiliates receive are generally based on a fixed percentage of assets under management (at par value and not subject to changes in market value). The periodic management fees the Asset Manager Affiliates receive have two components a senior management fee and a subordinated management fee.

*Incentive Fees.* As a manager of CLO Funds, the Asset Manager Affiliates may receive incentive fees upon exceeding specified relative and/or absolute investment return thresholds. Such fees are recorded upon completion of the measurement period, which varies by CLO Fund.

*Distributions to Member.* Distributions to the Asset Manager Affiliates sole member are recognized on the ex-dividend date. Generally, distributions have been declared and paid on a quarterly basis.

*Expenses.* The Asset Manager Affiliates expense costs, as incurred, with regard to the running of their operations. Primary operating expenses include employee compensation and benefits, the costs of identifying, evaluating, monitoring and servicing the CLO Fund investments managed by the Asset Manager Affiliates, and related overhead

charges and expenses, including rental expense. The Asset Manager Affiliates share office space and certain other operating expenses. Katonah Debt Advisors has entered into an Overhead Allocation Agreement with its sole member, KCAP Financial. Trimaran Advisors has entered into such an allocation agreement with Katonah Debt Advisors. The Agreements provide for the sharing of such expenses based on an equal sharing of office lease costs and the ratable usage of other shared resources. Katonah Debt Advisors accounts for its operating leases, which may include escalations, in accordance with ASC 840-10, Leases, and expenses the lease payments associated with operating leases evenly during the lease term (including rent-free periods), beginning on the commencement of the lease term.

***Interest Expenses.*** Interest expense related to borrowings of the Asset Manager Affiliates is recorded on an accrual basis pursuant to the terms of the related borrowing agreements. Interest is accrued and generally paid quarterly.

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## ASSET MANAGER AFFILIATES

### NOTES TO FINANCIAL STATEMENTS

#### 2. SIGNIFICANT ACCOUNTING POLICIES (continued)

**Income Taxes.** The Asset Manager Affiliates account for income taxes under the liability method prescribed by ASC 740, Income Taxes ( ASC 740 ). Deferred income tax assets and liabilities are recognized for the future tax consequences attributable to temporary differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases using currently enacted tax rates in effect for the year in which the differences are expected to reverse. The effect of a change in tax rates on deferred income tax assets and liabilities is recognized in income in the period that includes the enactment date.

Management periodically assesses the recoverability of its deferred income tax assets based upon expected future earnings, taxable income in prior carryback years, future deductibility of the asset, changes in applicable tax laws and other factors. If management determines that it is not more likely than not that the deferred tax asset will be fully recoverable in the future, a valuation allowance will be established for the difference between the asset balance and the amount expected to be recoverable in the future. This allowance will result in a charge to income tax expense on the combined statements of operations. The Asset Manager Affiliate record their income taxes receivables and payables based upon their estimated income tax liability.

ASC 740 clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements by prescribing a threshold for measurement and recognition in the financial statements of an asset or liability resulting from a tax position taken or expected to be taken in an income tax return. ASC 740 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition.

#### 3. CLO FUNDS

A CLO Fund generally refers to a special purpose vehicle that owns a portfolio of investments and issues various tranches of debt and subordinated securities to finance the purchase of those investments. Investments purchased by the CLO Funds are governed by extensive investment guidelines, including limits on exposure to any single industry or issuer and limits on the ratings of the CLO Fund's assets. The CLO Funds managed by the Asset Manager Affiliates have a defined investment period during which they are allowed to make investments or reinvest capital as it becomes available.

The Asset Manager Affiliates manage CLO Funds primarily for third party investors. The CLO Funds invest in broadly syndicated loans, high yield bonds and other credit instruments issued by corporations. At December 31, 2016 and 2015, the Asset Manager Affiliates had approximately \$3.0 billion and \$2.7 billion of par value of assets under management, respectively.

The CLO Funds are primarily financed via capital contributed by subordinated noteholders and debt holders. Other than any investment in warehouse facilities in connection with the formation of a new CLO Fund, the Asset Manager Affiliates' risk with respect to each investment in the CLO Funds they manage is limited to any uncollected management fees (as the Asset Manager Affiliates have no investment in the CLO Funds they have no exposure or

benefits in the ownership of the CLO Funds securities).

CLO Funds are investment vehicles created for the sole purpose of issuing collateralized loan instruments that offer investors the opportunity for returns that vary with the risk level of their investment. The securities issued by the CLO Funds are backed by diversified collateral asset portfolios consisting primarily of loans. For managing the collateral for the CLO Fund entities, the Asset Manager Affiliates earn investment management fees, including senior and subordinated management fees, as well as contingent incentive fees. For the years ending December 31, 2016, 2015 and 2014, management fee revenues included incentive fees earned of approximately \$983,000, \$8.0 million, and \$12.0 million, respectively. The Asset Manager Affiliates have no investment in the CLO Funds they manage.

However, their sole direct or indirect shareholder, KCAP Financial, has invested in certain of the CLO Funds, generally taking a portion of the unrated, junior subordinated position (generally subordinated to other interests in the entities and entitle KCAP Financial and other subordinated tranche investors to receive the residual cash flows, if any, from the entities).

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# **ASSET MANAGER AFFILIATES**

## **NOTES TO FINANCIAL STATEMENTS**

### **4. BUSINESS COMBINATION**

On February 29, 2012, KCAP Financial and Commodore Holdings, L.L.C. ( Commodore ), a newly-formed, wholly-owned subsidiary of KCAP Financial, acquired all of the outstanding equity interests in Trimaran Advisors for \$13.0 million in cash and 3,600,000 shares of KCAP Financial's common stock, which were valued at the opening price on the closing date of the acquisition. Contemporaneously with the acquisition, KCAP Financial acquired the equity interests in four CLO Funds managed by Trimaran Advisors, at fair value, for \$12.0 million in cash. The aggregate purchase price was \$50.6 million.

In accordance with the purchase agreement, Commodore was deemed the acquirer of Trimaran Advisors and accounted for the acquisition as a business combination. The assets acquired (no liabilities were assumed) by Commodore through this acquisition were pushed-down to Trimaran. The purchase price allocation included the fair value of the identifiable intangible assets acquired, which consist of four CLO management contracts, of approximately \$15.7 million, resulting in goodwill of \$22.8 million which is included in Intangible Assets at December 31, 2016 and 2015, respectively. The CLO management contracts are being amortized over the estimated lives of the contracts (3 to 5 years). For the years ended December 31, 2016, 2015 and 2014, the Company recognized amortization expense of approximately \$1.3 million, \$2.3 million and \$5.3 million, respectively, relating to the management contracts, which resulted in a net carrying amount of approximately \$328,000, \$1.6 million and \$3.9 million as of December 31, 2016, 2015 and 2014, respectively. Additionally, one managed CLO Fund was called in 2015 and as a result, the remaining unamortized intangible asset of \$599,000 was fully expensed. During 2014, two managed CLO Funds were called, and as a result the remaining unamortized intangible asset of \$1.7 million was fully expensed. The unamortized balance of approximately \$328,000 relating to another managed CLO Fund, Trimaran VII CLO Ltd., will be fully amortized in 2017 in connection with its full liquidation.

Commodore, a taxable entity (corporation), has recognized the acquisition as an asset acquisition for tax purposes. The book and tax basis of the intangible assets and goodwill were identical; accordingly, Trimaran did not provide for any deferred taxes at the closing date of the acquisition. The tax basis of the intangible assets and goodwill will be amortized over 15 years, which gives rise to deferred taxes.

### **5. INCOME TAXES**

The Asset Manager Affiliates are taxed at normal corporate rates.

For tax purposes, the Asset Manager Affiliates taxable net income will differ from GAAP net income because of deferred tax timing adjustments and permanent tax adjustments. Deferred tax timing adjustments may include differences for the recognition and timing of depreciation, bonuses to employees and restricted stock expense. Permanent differences may include adjustments, limitations or disallowances for meals and entertainment expenses, penalties, and tax goodwill amortization.



Goodwill amortization for tax purposes was created upon the purchase of 100% of the equity interests in Katonah Debt Advisors by its sole member, KCAP Financial, in exchange for shares of the KCAP Financial's stock valued at \$33 million. Although this transaction was a stock transaction rather than an asset purchase and thus no goodwill was recognized for GAAP purposes, such exchange was considered an asset purchase under Section 351(a) of the Internal Revenue Code (the "Code"). At the time of the transfer, Katonah Debt Advisors had equity of approximately \$1 million resulting in tax goodwill of approximately \$32 million which is being amortized for tax purposes on a straight-line basis over 15 years, which accounts for an annual difference between GAAP income and taxable income by approximately \$2 million per year over such period. As of December 31, 2016, there was approximately \$10.8 million of remaining unamortized tax-basis goodwill from the KDA acquisition.

As discussed in Note 4, additional goodwill amortization for tax purposes was created upon the purchase of Trimaran Advisors. The transaction was considered an asset purchase and resulted in tax goodwill of approximately \$22.8 million which is being amortized for tax purposes on a straight-line basis over 15 years, which accounts for an annual difference between GAAP income and taxable income by approximately

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# ASSET MANAGER AFFILIATES

## NOTES TO FINANCIAL STATEMENTS

### 5. INCOME TAXES (continued)

\$1.5 million per year over such period. As of December 31, 2016, there was approximately \$7.5 million of remaining unamortized tax-basis goodwill from the Trimaran Advisors acquisition.

During the second quarter of 2016, KCAP contributed 100% of its ownership interests in Katonah Debt Advisors and Trimaran Advisors Management to Commodore Holdings. These transactions simplify the tax structure of the Asset Manager Affiliates and facilitate the consolidation of tax basis goodwill deductions for the Asset Manager Affiliates, which may impact the tax character of distributions from the Asset Manager Affiliates.

The components of income tax expense (benefit) for the years ended December 31, 2016, 2015, and 2014 are as follows:

|   | For the year ended December 31, |              |              |
|---|---------------------------------|--------------|--------------|
|   | 2016                            | 2015         | 2014         |
| Current income tax (benefit) expense:           |                                 |              |              |
| Federal   | \$ (1,957,900)                  | \$ 1,290,664 | \$ 2,792,440 |
| State & local                                   | (48,292 )                       | 125,443      | 2,370,115    |
| Total net current income tax (benefit) expense  | (2,006,192)                     | 1,416,107    | 5,162,555    |
| Deferred income tax expense (benefit):          |                                 |              |              |
| Federal   | 2,011,068                       | 3,250,138    | (590,934 )   |
| State & local                                   | (85,898 )                       | 975,980      | (418,023 )   |
| Total net deferred income tax expense (benefit) | 1,925,170                       | 4,226,118    | (1,008,957)  |
| Total income tax (benefit) expense              | \$ (81,022 )                    | \$ 5,642,225 | \$ 4,153,598 |

The Asset Manager Affiliates' effective income tax rate was (11.3)%, 68.9% and 36.3% for tax years 2016, 2015 and 2014, respectively. The difference between the Company's reported provision for income taxes and the U.S. federal statutory rate of 35% is primarily due to tax goodwill amortization, and a change in the deferred tax valuation allowance during the year.

Deferred income taxes are provided for the effects of temporary differences between the tax basis of an asset or liability and its reported amount in the combined financial statements. These temporary differences result in taxable or deductible amounts in future years.

The components of deferred income tax assets and liabilities are shown below:

|                             | For the year ended December 31, |      |
|-----------------------------|---------------------------------|------|
|                             | 2016                            | 2015 |
| Deferred income tax assets: |                                 |      |

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|  |                |              |
|--|----------------|--------------|
| Net operating loss and tax credit carryforward | \$ 44,125      | \$           |
| Restricted stock                               | 322,008        | 481,847      |
| Intangible depreciation/amortization           | 3,522,391      | 3,524,376    |
| Compensation                                   | 715,400        | 1,092,024    |
| Other  | 73,228         | 79,399       |
| Less: Valuation allowance                      | (4,677,152)    | (3,630,872)  |
| Total deferred tax assets                      |                | 1,546,774    |
| Deferred income tax liabilities:               |                |              |
| Goodwill Amortization                          | (2,575,140)    | (2,144,287)  |
| Other  |                | (52,457)     |
| Total deferred tax liabilities                 | (2,575,140)    | (2,196,744)  |
| Net deferred tax liabilities                   | \$ (2,575,140) | \$ (649,970) |

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# ASSET MANAGER AFFILIATES

## NOTES TO FINANCIAL STATEMENTS

### 5. INCOME TAXES (continued)

The ultimate realization of deferred income tax assets is dependent upon the generation of future taxable income during the periods in which the temporary differences become deductible. If it is not more likely than not that some portion or all of the gross deferred income tax assets will be realized in future years, a valuation allowance is recorded.

At December 31, 2016, the Asset Manager Affiliates had approximately \$1,754 and \$765,528 of net operating loss carryforwards available to offset future state and local taxable income, respectively. Such net operating loss carryforwards will expire in 2036. At December 31, 2015, the Asset Manager Affiliates had no federal or state net loss carryovers available to offset future taxable income.

ASC 740 provides guidance for how uncertain tax positions should be recognized, measured, presented, and disclosed in the financial statements. ASC 740 requires the evaluation of tax positions taken or expected to be taken in the course of preparing the tax returns to determine whether the tax positions are more-likely-than-not of being sustained by the applicable tax authority. Tax positions not deemed to meet the more-likely-than-not threshold are recorded as a tax benefit or expense in the current year. The Asset Manager Affiliates has not recorded a liability for any unrecognized tax benefits nor are they aware of any tax positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will change materially in the next 12 months.

Management's determinations regarding ASC 740 may be subject to review and adjustment at a later date based upon factors including, but not limited to, an ongoing analysis of tax laws, regulations and interpretations thereof. With a few exceptions, the Asset Manager Affiliates are no longer subject to U.S. federal, state and local tax examinations by tax authorities for years prior to 2013.

### 6. COMMITMENTS AND CONTINGENCIES

The Asset Manager Affiliates have commitments under lease obligations.

Rent expense was approximately \$361,000, \$360,000, and \$277,000 for the years ended December 31, 2016, 2015 and 2014, respectively.

The following table summarizes minimum future lease payments as of December 31, 2016:

| Contractual Obligations     | 2017       | 2018       | 2019       | 2020       | 2021       | More than<br>5 years |
|-----------------------------|------------|------------|------------|------------|------------|----------------------|
| Operating lease obligations | \$ 369,432 | \$ 369,432 | \$ 387,391 | \$ 400,218 | \$ 400,218 | \$ 967,194           |

## **7. MEMBER S EQUITY**

As of December 31, 2016, the membership interests of the Asset Manager Affiliates are held solely by KCAP Financial. KCAP Financial owns 100% of Commodore Holdings, which wholly owns Katonah Debt Advisors, Trimaran Advisors, and Trimaran Advisors Management. Katonah 2007-1 Management, LLC, and Katonah X Management, LLC are wholly-owned by Katonah Management Holdings, LLC, which is wholly-owned by KCAP Financial.

## **8. OTHER EMPLOYEE COMPENSATION**

The Asset Manager Affiliates adopted a 401(k) plan ( 401K Plan ) effective January 1, 2007 that it shares with its sole shareholder, KCAP Financial. The 401K Plan is open to all full time employees. The 401K Plan permits an employee to defer a portion of his or her total annual compensation up to the Internal Revenue Service annual maximum based on age and eligibility. The Asset Manager Affiliates make contributions to the 401K Plan of up to 2.67% of the employee s first 74.9% of maximum eligible compensation, which vests 20% per year over five years. For the year ended December 31, 2016, 2015 and 2014, Asset Manager Affiliates made contributions to the 401K Plan of approximately \$36,000, \$38,000 and \$38,000 respectively.

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## **ASSET MANAGER AFFILIATES**

### **NOTES TO FINANCIAL STATEMENTS**

#### **8. OTHER EMPLOYEE COMPENSATION (continued)**

The Asset Manager Affiliates also adopted a deferred compensation plan ( Profit-Sharing Plan ) effective January 1, 2007. Employees are eligible for the Profit-Sharing Plan provided that they are employed and working with the Asset Manager Affiliates for at least 100 days during the year and remain employed as of the last day of the year. Employees do not make contributions to the Profit-Sharing Plan. The Asset Manager Affiliates may contribute to the Profit-Sharing Plan 1) up to 8.0% of all compensation up to the Internal Revenue Service annual maximum and 2) up to 5.7% excess contributions on any incremental amounts above the social security wage base limitation and up to the Internal Revenue Service annual maximum. Employees vest 100% in the Profit-Sharing Plan after five years of service. For the years ended December 31, 2016, 2015 and 2014, the Asset Manager Affiliates made contributions of approximately \$371,000, \$394,000 and \$396,000 to the Profit-Sharing Plan, respectively.

Certain employees of Asset Manager Affiliates may receive restricted stock grants in the stock of Asset Manager Affiliates sole member, KCAP Financial. For the years ended December 31, 2016, 2015 and 2014, compensation expense of approximately \$909,000, \$897,000 and \$589,000, respectively, was recorded as expense in the combined Statement of Operations related to an allocated expense for a grant of restricted stock of KCAP Financial.

#### **9. RELATED PARTY TRANSACTION**

On February 26, 2013, the Company entered into a senior credit agreement (the Trimaran Credit Facility ) with Trimaran Advisors, pursuant to which Trimaran Advisors may borrow from time to time up to \$20 million from the Company in order to provide capital necessary to support one or more of Trimaran Advisors warehouse lines of credit and/or working capital in connection with Trimaran Advisors warehouse activities. The Trimaran Credit Facility expires on November 20, 2017 and bears interest at an annual rate of 9.0%. On April 15, 2013, the Trimaran Credit Facility was amended and increased from \$20 million to \$23 million. At December 31, 2016, there was no loan outstanding under the Trimaran Credit Facility. At December 31, 2015, there was \$23 million outstanding under the Trimaran Credit Facility. Interest expense on this facility was \$1.8 million, \$1.7 million and \$2.0 million for the years ending December 31, 2016, 2015 and 2014, respectively.

#### **10. SUBSEQUENT EVENTS**

In January 2017, the trustees of Trimaran CLO VII, Ltd. (Trimaran VII) received notice that the holders of a majority of the income notes issued by Trimaran VII had exercised their right of optional redemption. As a result, Trimaran Advisors expects to receive incentive fees of approximately \$2 to \$3 million upon the final liquidation of Trimaran VII, which is expected to be completed in 2017.

On January 26, 2017, Trimaran Advisors, LLC drew \$10 million under the Trimaran Credit Facility.

The Company has evaluated events and transactions occurring subsequent to the balance sheet date of December 31, 2016 for items that should potentially be recognized or disclosed in these financial statements. Other than described

above, management has determined that there are no material subsequent events that would require adjustment to, or disclosure in, these combined financial statements.

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## **Report of Independent Auditors**

The Board of Directors and Shareholders of  
Katonah 2007-I CLO Ltd.

We have audited the accompanying financial statements of Katonah 2007-I CLO Ltd. (the Fund ), which comprise the statements of net assets, including the schedules of investments, as of December 31, 2016 and 2015, and the related statements of operations, changes in net assets, and cash flows for each of the three years in the period ended December 31, 2016, and the related notes to the financial statements.

### **Management's Responsibility for the Financial Statements**

Management is responsible for the preparation and fair presentation of these financial statements in conformity with U.S. generally accepted accounting principles; this includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free of material misstatement, whether due to fraud or error.

### **Auditor's Responsibility**

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

### **Opinion**

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Katonah 2007-I CLO Ltd. at December 31, 2016 and 2015, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2016, in conformity with U.S. generally accepted accounting principles.

/s/ Ernst & Young LLP



New York, NY

March 9, 2017

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TABLE OF CONTENTS**KATONAH 2007-I CLO LTD.****STATEMENTS OF NET ASSETS**

|                                       | As of<br>December 31,<br>2016 | As of<br>December 31,<br>2015 |
|---------------------------------------|-------------------------------|-------------------------------|
| <b>ASSETS</b>                         |                               |                               |
| Investments at fair value:            |                               |                               |
| Debt securities                       | \$ 170,702,652                | \$ 234,403,150                |
| Equity securities                     | 150,524                       | 2,830                         |
| CLO rated notes                       | 5,831,800                     | 12,360,525                    |
| Total investments at fair value       | 176,684,976                   | 246,766,505                   |
| Cash                                  | 34,982,770                    | 17,301,178                    |
| Accrued interest receivable           | 492,417                       | 501,574                       |
| Receivable for open trades            |                               | 820,593                       |
| Total assets                          | \$ 212,160,163                | \$ 265,389,850                |
| <b>LIABILITIES</b>                    |                               |                               |
| CLO Fund liabilities at fair value    | \$ 208,812,164                | \$ 261,433,473                |
| Accrued interest payable              | 1,518,793                     | 1,565,632                     |
| Payable for open trades               |                               | 6,006,038                     |
| Accounts payable and accrued expenses | 132,967                       | 154,079                       |
| Due to affiliates                     | 30                            | 3,889                         |
| Total liabilities                     | 210,463,954                   | 269,163,111                   |
| Commitments and Contingencies         |                               |                               |
| <b>NET ASSETS</b>                     |                               |                               |
| Total net assets                      | \$ 1,696,209                  | \$ (3,773,261 )               |

See accompanying notes to the financial statements.

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**KATONAH 2007-I CLO LTD.**

**STATEMENTS OF OPERATIONS**

|  | For the Years Ended December 31, |                   |                       |
|--|----------------------------------|-------------------|-----------------------|
|  | 2016                             | 2015              | 2014                  |
| <b>Income</b>  |                                  |                   |                       |
| Interest income from investments                                   | \$9,381,680                      | \$10,178,631      | \$11,690,586          |
| Interest income from cash and time deposits                        | 18,324                           | 1,288             | 1,922                 |
| Other income   | 367,266                          | 425,490           | 32,346                |
| <b>Total income</b>  | <b>9,767,270</b>                 | <b>10,605,409</b> | <b>11,724,854</b>     |
| <b>Expenses</b>  |                                  |                   |                       |
| Interest expense   | 8,798,483                        | 9,146,858         | 10,736,878            |
| Management fees  | 659,347                          | 714,061           | 805,526               |
| Trustee fees   | 75,663                           | 77,443            | 109,164               |
| Professional fees  | 166,488                          | 180,463           | 178,954               |
| Administrative and other   | 80,425                           | 86,528            | 125,224               |
| <b>Total expenses</b>  | <b>9,780,406</b>                 | <b>10,205,353</b> | <b>11,955,746</b>     |
| Net realized and unrealized gains (losses)                         | 5,482,606                        | (387,924 )        | (9,089,440 )          |
| <b>Increase (Decrease) in net assets resulting from operations</b> | <b>\$5,469,470</b>               | <b>\$12,132</b>   | <b>\$(9,320,332 )</b> |

See accompanying notes to the financial statements.

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**KATONAH 2007-I CLO LTD.**

**STATEMENTS OF CHANGES IN NET ASSETS**

|  |                     |
|--|---------------------|
|  | Net Assets          |
| <b>Balance at January 1, 2014</b>                | <b>\$ 5,534,939</b> |
| Decrease in net assets resulting from operations | (9,320,332 )        |
| <b>Balance at December 31, 2014</b>              | <b>(3,785,393 )</b> |
| Increase in net assets resulting from operations | 12,132              |
| <b>Balance at December 31, 2015</b>              | <b>(3,773,261 )</b> |
| Increase in net assets resulting from operations | 5,469,470           |
| <b>Balance at December 31, 2016</b>              | <b>\$ 1,696,209</b> |

See accompanying notes to the financial statements.

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TABLE OF CONTENTS**KATONAH 2007-I CLO LTD.****STATEMENTS OF CASH FLOWS**

|   | Years Ended December 31, |                   |                     |
|---|--------------------------|-------------------|---------------------|
|   | 2016                     | 2015              | 2014                |
| <b>OPERATING ACTIVITIES:</b>  |                          |                   |                     |
| Increase (Decrease) in net assets resulting from operations   | \$5,469,470              | 12,132            | \$(9,320,332 )      |
| <b>Adjustments to reconcile increase (decrease) in net assets resulting from operations to net cash provided by operating activities:</b> |                          |                   |                     |
| Net realized and unrealized (gains) losses on investments   | (7,040,542 )             | 6,651,428         | 5,807,622           |
| Change in unrealized losses (gains) on debt   | 1,557,935                | (6,263,504 )      | 3,281,818           |
| Purchase of investments   | (82,554,227 )            | (93,243,381 )     | (29,960,071 )       |
| Proceeds from sale and redemption of investments  | 159,676,298              | 113,199,395       | 61,206,288          |
| <b>Changes in operating assets and liabilities:</b>   |                          |                   |                     |
| Decrease in accrued interest receivable   | 9,157                    | 129,814           | 43,523              |
| (Decrease) increase in accounts payable and accrued expenses  | (21,112 )                | (30,556 )         | 3,621               |
| Decrease (increase) in receivable for open trades   | 820,593                  | (820,593 )        |                     |
| (Decrease) increase in due to affiliates  | (3,859 )                 | (6,964 )          | 6,745               |
| Decrease in due from affiliates   |                          |                   | 10,852              |
| (Decrease) increase in payable for open trades  | (6,006,038 )             | 6,006,038         | (4,013,750 )        |
| Decrease in accrued interest payable  | (46,839 )                | (270,176 )        | (254,559 )          |
| Net cash provided by operating activities   | 71,860,836               | 25,363,633        | 26,811,757          |
| <b>Cash used in Financing Activities:</b>   |                          |                   |                     |
| Repayments of Debt  | (54,179,244 )            | (23,002,449 )     | (27,132,006)        |
|   | (54,179,244 )            | (23,002,449 )     | (27,132,006)        |
| <b>CHANGE IN CASH</b>   | <b>17,681,592</b>        | <b>2,361,184</b>  | <b>(320,249 )</b>   |
| <b>CASH, BEGINNING OF YEAR</b>  | <b>17,301,178</b>        | <b>14,939,994</b> | <b>15,260,243</b>   |
| <b>CASH, END OF YEAR</b>  | <b>\$34,982,770</b>      | <b>17,301,178</b> | <b>\$14,939,994</b> |
| <b>Supplemental Information:</b>  |                          |                   |                     |
| Interest paid   | \$8,751,644              | 9,417,035         | \$10,991,437        |

See accompanying notes to the financial statements.

TABLE OF CONTENTS**Katonah 2007-I CLO Ltd.****SCHEDULE OF INVESTMENTS  
As of December 31, 2016****Debt Securities Portfolio**

| Portfolio Company/Principal Business  | Investment<br>Interest Rate/Maturity                     | Principal   | Cost        | Fair Value  |
|---|--|-------------|-------------|-------------|
| Advantage Sales & Marketing Inc.<br><i>Services: Business</i>                     | Initial Term Loan<br>(First Lien)<br>4.3% Cash, Due 7/21 | \$1,478,170 | \$1,465,743 | \$1,485,930 |
| Aramark Corporation<br><i>Diversified/Conglomerate Service</i>                    | U.S. Term F Loan<br>3.5% Cash, Due 2/21                  | 2,500,766   | 2,434,568   | 2,527,775   |
| Ascena Retail Group, Inc. (Anntaylor<br>Retail, Inc.)<br><i>Retail Stores</i>     | Tranche B Term<br>Loan<br>5.3% Cash, Due 8/22            | 1,847,840   | 1,727,053   | 1,807,880   |
| Aspect Software, Inc.<br><i>Electronics</i>                                       | Term Loan (First<br>Lien)<br>11.3% Cash, Due<br>5/20     | 1,987,421   | 1,982,675   | 1,990,730   |
| Asurion, LLC (fka Asurion Corporation)<br><i>Insurance</i>                        | Replacement B-2<br>Term Loan<br>4.0% Cash, Due 7/20      | 434,119     | 417,800     | 438,528     |
| Avis Budget Car Rental, LLC<br><i>Personal Transportation</i>                     | Tranche B Term<br>Loan<br>3.3% Cash, Due 3/19            | 4,747,663   | 4,764,002   | 4,761,527   |
| Berry Plastics Corporation<br><i>Containers, Packaging and Glass</i>              | Term G Loan<br>3.5% Cash, Due 1/21                       | 2,591,612   | 2,487,866   | 2,612,138   |
| Burlington Coat Factory Warehouse<br>Corporation<br><i>Retail Stores</i>          | Term B-4 Loan<br>3.5% Cash, Due 8/21                     | 2,321,888   | 2,286,350   | 2,342,611   |
| Capital Automotive L.P.<br><i>Finance</i>   | Tranche B-1 Term<br>Loan Facility<br>4.0% Cash, Due 4/19 | 1,447,883   | 1,444,407   | 1,464,852   |
| Capsugel Holdings US, Inc.<br><i>Healthcare, Education and Childcare</i>          | New Dollar Term<br>Loan<br>4.0% Cash, Due 7/21           | 713,586     | 712,640     | 716,783     |
| Cedar Fair, L.P.<br><i>Leisure, Amusement, Motion Pictures,<br/>Entertainment</i> | U.S. Term Facility<br>3.3% Cash, Due 3/20                | 956,905     | 955,817     | 964,383     |
| Change Healthcare Holdings, Inc. (fka<br>Emdeon Inc.)                             | Term B-2 Loan<br>3.8% Cash, Due                          | 173,151     | 173,481     | 173,692     |

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|  |                        |           |           |           |
|--|------------------------|-----------|-----------|-----------|
| <i>Electronics</i>   | 11/18                  |           |           |           |
| Charter Communications Operating, LLC (aka CCO Safari LLC)     | Term F Loan            |           |           |           |
| <i>Broadcasting and Entertainment</i>                          | 3.0% Cash, Due 1/21    | 1,468,488 | 1,462,213 | 1,477,461 |
|  | Incremental 2018       |           |           |           |
| CHS/Community Health Systems, Inc.                             | Term F Loan            |           |           |           |
| <i>Healthcare, Education and Childcare</i>                     | 4.2% Cash, Due 12/18   | 1,034,498 | 493,113   | 1,020,057 |
|  | Incremental 2019       |           |           |           |
| CHS/Community Health Systems, Inc.                             | Term G Loan            |           |           |           |
| <i>Healthcare, Education and Childcare</i>                     | 3.8% Cash, Due 12/19   | 1,019,212 | 1,017,557 | 991,505   |
|  | Incremental 2021       |           |           |           |
| CHS/Community Health Systems, Inc.                             | Term H Loan            |           |           |           |
| <i>Healthcare, Education and Childcare</i>                     | 4.0% Cash, Due 1/21    | 2,073,288 | 2,055,059 | 2,014,117 |
| Ciena Corporation  | Term Loan              |           |           |           |
| <i>Electronics</i>   | 3.8% Cash, Due 7/19    | 2,947,236 | 2,958,279 | 2,965,656 |
| Commscope, Inc.  | Tranche 4 Term         |           |           |           |
| <i>Telecommunications</i>                                      | Loan                   | 111,875   | 111,920   | 112,679   |
|  | 3.3% Cash, Due 1/18    |           |           |           |
| Container Store, Inc., The                                     | Term Facility          |           |           |           |
| <i>Retail Stores</i>   | 4.3% Cash, Due 4/19    | 1,660,005 | 1,662,549 | 1,524,441 |
| CSM Bakery Solutions Limited (fka CSM Bakery Supplies Limited) | Term Loan (First Lien) |           |           |           |
| <i>Beverage, Food and Tobacco</i>                              | 5.0% Cash, Due 7/20    | 3,000,000 | 2,914,353 | 2,725,500 |
| Cyanco Intermediate Corp.                                      | Term Loan              |           |           |           |
| <i>Chemicals, Plastics and Rubber</i>                          | 5.5% Cash, Due 5/20    | 621,075   | 627,103   | 624,569   |
|  | Initial Term Loan      |           |           |           |
| David s Bridal, Inc.   | 5.3% Cash, Due 10/19   | 473,111   | 471,233   | 419,690   |
| <i>Retail Stores</i>   |                        |           |           |           |
| Delta 2 (Lux) S.a r.l (aka Formula One)                        | Facility B3 (USD)      |           |           |           |
| <i>Leisure, Amusement, Motion Pictures, Entertainment</i>      | 5.1% Cash, Due 7/21    | 3,421,774 | 3,404,142 | 3,461,603 |
|  | Loan                   |           |           |           |
| Dex Media, Inc.  | 11.0% Cash, Due 7/21   | 217,160   | 212,886   | 217,974   |
| <i>Printing and Publishing</i>                                 |                        |           |           |           |
|  | Tranche B Term         |           |           |           |
| E.W. Scripps Company, The                                      | Loan                   |           |           |           |
| <i>Broadcasting and Entertainment</i>                          | 3.3% Cash, Due 11/20   | 2,575,710 | 2,553,469 | 2,588,048 |
|  | Tranche A Term         |           |           |           |
| Education Management II LLC                                    | Loan                   |           |           |           |
| <i>Healthcare, Education and Childcare</i>                     | 5.5% Cash, Due 7/20    | 200,289   | 201,078   | 50,386    |

See accompanying notes to the financial statements.

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| Portfolio Company/Principal Business  | Investment<br>Interest Rate/Maturity                               | Principal | Cost      | Fair Value |
|---|--|-----------|-----------|------------|
| Education Management II LLC<br><i>Healthcare, Education and Childcare</i>                                   | Tranche B Term<br>Loan<br>2.0% Cash, Due 7/20                      | \$374,420 | \$375,734 | \$18,347   |
| Electric Lightwave Holdings, Inc. (f.k.a.<br>Integra Telecom Holdings, Inc.)<br><i>Telecommunications</i>   | Term B-1 Loan<br>5.3% Cash, Due 8/20                               | 2,392,107 | 2,325,632 | 2,402,872  |
| EnergySolutions, LLC (aka Envirocare<br>of Utah, LLC)<br><i>Ecological</i>                                  | Term Advance<br>6.8% Cash, Due 5/20                                | 918,742   | 920,945   | 927,930    |
| Envigo Laboratories, Inc. (fka BPA<br>Laboratories Inc.)<br><i>Healthcare, Education and Childcare</i>      | Term Loan (First<br>Lien)<br>3.4% Cash, Due 4/20                   | 1,743,896 | 1,649,728 | 1,534,628  |
| Envigo Laboratories, Inc. (fka BPA<br>Laboratories Inc.)<br><i>Healthcare, Education and Childcare</i>      | Term Loan (Second<br>Lien)<br>3.4% Cash, Due 7/17                  | 1,516,318 | 1,493,015 | 1,048,784  |
| Essential Power, LLC<br><i>Utilities</i>  | Term Loan<br>4.8% Cash, Due 8/19                                   | 856,721   | 851,938   | 869,572    |
| Evertec Group, LLC (fka Evertec, LLC)<br><i>Banking, Finance, Insurance &amp; Real<br/>Estate</i>           | Term A Loan<br>2.9% Cash, Due 4/18                                 | 1,380,234 | 1,366,553 | 1,373,767  |
| EWT Holdings III Corp. (fka WTG<br>Holdings III Corp.)<br><i>Ecological</i>                                 | Incremental 2016<br>First Lien<br>Term Loan<br>5.5% Cash, Due 1/21 | 2,274,670 | 2,285,613 | 2,301,693  |
| EWT Holdings III Corp. (fka WTG<br>Holdings III Corp.)<br><i>Ecological</i>                                 | Term Loan (First<br>Lien)<br>4.8% Cash, Due 1/21                   | 970,000   | 972,349   | 978,492    |
| FCA US LLC (fka Chrysler Group LLC)<br><i>Automobile</i>  | Term Loan B<br>3.5% Cash, Due 5/17                                 | 4,172,621 | 4,156,392 | 4,189,562  |
| Federal-Mogul Corporation<br><i>Automobile</i>  | Tranche B Term<br>Loan (2014)<br>4.0% Cash, Due 4/18               | 1,550,593 | 1,529,850 | 1,550,981  |
| Fender Musical Instruments Corporation<br><i>Personal and Non Durable Consumer<br/>Products (Mfg. Only)</i> | Initial Loan<br>5.8% Cash, Due 4/19                                | 1,759,725 | 1,753,723 | 1,737,025  |
| Filtration Group Corporation<br><i>Ecological</i>   | Term Loan (First<br>Lien)<br>4.3% Cash, Due<br>11/20               | 624,502   | 626,008   | 630,160    |
| First Data Corporation<br><i>Banking, Finance, Insurance &amp; Real<br/>Estate</i>                          | 2021C New Dollar<br>Term Loan<br>3.8% Cash, Due 3/21               | 2,095,106 | 2,092,615 | 2,122,018  |
| Gardner Denver, Inc.<br><i>Machinery (Non-Agriculture,<br/>Non-Construction, Non-Electronic)</i>            | Initial Dollar Term<br>Loan<br>4.6% Cash, Due 7/20                 | 2,210,025 | 2,172,541 | 2,191,439  |



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|  |  |           |           |           |
|--|--|-----------|-----------|-----------|
| General Nutrition Centers, Inc.<br><i>Retail Stores</i>  | Amended Tranche B<br>Term Loan<br>3.3% Cash, Due 3/19        | 4,364,001 | 4,365,677 | 4,113,071 |
| Getty Images, Inc.<br><i>Printing and Publishing</i>   | Initial Term Loan<br>4.8% Cash, Due<br>10/19                 | 2,601,451 | 2,591,053 | 2,278,429 |
| Harland Clarke Holdings Corp. (fka<br>Clarke American Corp.)<br><i>Printing and Publishing</i>   | Tranche B-3 Term<br>Loan<br>7.0% Cash, Due 5/18              | 487,985   | 487,985   | 489,815   |
| Harland Clarke Holdings Corp. (fka<br>Clarke American Corp.)<br><i>Printing and Publishing</i>   | Tranche B-5 Term<br>Loan<br>7.0% Cash, Due<br>12/19          | 4,450,523 | 4,451,323 | 4,484,458 |
| HCR Healthcare, LLC<br><i>Healthcare, Education and Childcare</i>  | Initial Term Loan<br>5.0% Cash, Due 4/18                     | 471,250   | 470,402   | 413,647   |
| Hercules Achievement, Inc.(aka Varsity<br>Brands, Inc.)<br><i>Home and Office Furnishings,<br/>Housewares, and Durable Consumer<br/>Products</i> | Initial Term Loan<br>(First Lien)<br>5.0% Cash, Due<br>12/21 | 997,455   | 1,007,140 | 1,013,913 |
| Huntsman International LLC<br><i>Chemicals, Plastics and Rubber</i>  | 2015 Extended Term<br>B Dollar Loan<br>3.7% Cash, Due 4/19   | 1,075,034 | 1,045,099 | 1,081,081 |
| Ineos US Finance LLC<br><i>Chemicals, Plastics and Rubber</i>  | 2020 Dollar Term<br>Loan<br>3.8% Cash, Due<br>12/20          | 3,944,682 | 3,955,292 | 3,969,751 |
| Infor (US), Inc. (fka Lawson Software<br>Inc.)<br><i>Electronics</i>   | Tranche B-5 Term<br>Loan<br>3.8% Cash, Due 6/20              | 2,287,677 | 2,296,269 | 2,294,586 |
| J. Crew Group, Inc.<br><i>Retail Stores</i>  | Initial Loan<br>4.0% Cash, Due 3/21                          | 3,841,375 | 3,843,639 | 2,203,989 |

See accompanying notes to the financial statements.

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| Portfolio Company/Principal Business  | Investment<br>Interest Rate/Maturity   | Principal   | Cost        | Fair Value  |
|---|--|-------------|-------------|-------------|
| JBS USA Lux S.A. (fka JBS USA, LLC)<br><i>Beverage, Food and Tobacco</i>                              | Initial Term Loan<br>3.8% Cash, Due 5/18   | \$4,711,566 | \$4,720,855 | \$4,729,235 |
| KAR Auction Services, Inc.<br><i>Automobile</i>   | Tranche B-2 Term<br>Loan<br>4.2% Cash, Due 3/21                                    | 243,611     | 246,267     | 246,048     |
| Key Safety Systems, Inc.<br><i>Automobile</i>   | Initial Term Loan<br>5.5% Cash, Due 8/21   | 1,283,781   | 1,265,173   | 1,300,150   |
| Kronos Worldwide, Inc.<br><i>Diversified/Conglomerate Service</i>                                     | 2015 Refinancing<br>Term Loan<br>4.0% Cash, Due 2/20                               | 778,000     | 766,847     | 787,725     |
| Las Vegas Sands, LLC<br><i>Hotels, Motels, Inns, and Gaming</i>                                       | Refinancing Term<br>Loan<br>3.0% Cash, Due<br>12/20                                | 3,168,926   | 3,128,432   | 3,189,968   |
| LPL Holdings, Inc.<br><i>Finance</i>  | 2021 Tranche B<br>Term Loan<br>4.3% Cash, Due 3/21                                 | 1,911,195   | 1,903,632   | 1,933,900   |
| MCC Iowa LLC<br><i>Broadcasting and Entertainment</i>   | Tranche J Term<br>Loan<br>3.5% Cash, Due 6/21                                      | 683,429     | 675,784     | 689,836     |
| Mediacom Illinois, LLC (fka Mediacom<br>Communications, LLC)<br><i>Broadcasting and Entertainment</i> | Tranche F Term<br>Loan<br>3.2% Cash, Due 3/18                                      | 5,835,000   | 5,830,528   | 5,860,557   |
| Mitchell International, Inc.<br><i>Electronics</i>  | Initial Term Loan<br>4.5% Cash, Due<br>10/20                                       | 1,979,675   | 1,836,869   | 1,986,069   |
| National CineMedia, LLC<br><i>Leisure, Amusement, Motion Pictures,<br/>Entertainment</i>              | Term Loan (2013)<br>3.5% Cash, Due<br>11/19  | 1,000,000   | 996,689     | 1,009,065   |
| NEP/NCP Holdco, Inc.<br><i>Broadcasting and Entertainment</i>   | Amendment No. 4<br>Incremental<br>Term Loan (First<br>Lien)<br>4.3% Cash, Due 1/20 | 4,211,244   | 4,190,414   | 4,237,564   |
| OCI Beaumont LLC<br><i>Chemicals, Plastics and Rubber</i>   | Term B-3 Loan<br>8.0% Cash, Due 8/19   | 2,393,807   | 2,407,888   | 2,441,684   |
| Onex Carestream Finance LP<br><i>Healthcare, Education and Childcare</i>                              | Term Loan (First<br>Lien 2013)<br>5.0% Cash, Due 6/19                              | 2,290,548   | 2,301,501   | 2,231,372   |
| Otter Products, LLC (OtterBox<br>Holdings, Inc.)<br><i>Consumer goods: Durable</i>                    | Term B Loan<br>5.8% Cash, Due 6/20   | 2,125,900   | 1,914,366   | 2,050,218   |
| Pacific Drilling S.A.<br><i>Oil and Gas</i>   | Term Loan<br>4.5% Cash, Due 6/18   | 2,163,350   | 2,165,248   | 784,214     |
|   |  | 4,862,500   | 4,862,500   | 3,954,841   |

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|   |  |           |           |           |
|---|--|-----------|-----------|-----------|
| Petroleum GEO-Services ASA (PGS Finance, Inc)<br><i>Oil and Gas</i>                                 | Extended Term Loan<br>3.5% Cash, Due 3/21                      |           |           |           |
| QCE, LLC (Quiznos) <sup>(2)</sup><br><i>Personal, Food and Miscellaneous Services</i>               | Existing Term Loan<br>0.0% Cash, Due 6/19                      | 449,499   | 449,486   | 36,522    |
| Quad/Graphics, Inc<br><i>Printing and Publishing</i>  | Term B Loan<br>4.3% Cash, Due 4/21                             | 1,484,772 | 1,383,304 | 1,495,907 |
| Regal Cinemas Corporation<br><i>Leisure, Amusement, Motion Pictures, Entertainment</i>              | Refinancing Term Loan<br>3.3% Cash, Due 4/22<br>Tranche C Term | 958,853   | 965,417   | 967,756   |
| RGIS Services, LLC<br><i>Diversified/Conglomerate Service</i>                                       | Loan<br>5.5% Cash, Due 10/17                                   | 2,559,107 | 2,546,630 | 2,367,174 |
| Select Medical Corporation<br><i>Healthcare, Education and Childcare</i>                            | Series E Tranche B Term Loan<br>6.0% Cash, Due 6/18            | 2,075,986 | 2,069,075 | 2,110,582 |
| Semiconductor Components Industries, LLC (On Semiconductor)<br><i>Electronics</i>                   | Term Loan<br>2.6% Cash, Due 1/18                               | 3,718,750 | 3,695,931 | 3,718,750 |
| Sensata Technologies B.V. (Sensata Technologies Finance Company, LLC)<br><i>Electronics</i>         | Sixth Amendment Term Loan<br>3.0% Cash, Due 10/21              | 534,542   | 531,559   | 538,885   |
| SGS Cayman, L.P.<br><i>Diversified/Conglomerate Service</i>   | Initial Cayman Term Loan<br>6.0% Cash, Due 4/21                | 132,834   | 131,878   | 131,090   |
| Sinclair Television Group, Inc.<br><i>Broadcasting and Entertainment</i>                            | New Tranche B Term Loan<br>3.0% Cash, Due 4/20                 | 66,296    | 66,296    | 66,379    |
| Steinway Musical Instruments, Inc.<br><i>Personal and Non Durable Consumer Products (Mfg. Only)</i> | Loan (First Lien)<br>4.8% Cash, Due 9/19                       | 1,991,985 | 1,981,249 | 1,922,265 |
| Sutherland Global Services Inc.<br><i>Diversified/Conglomerate Service</i>                          | Initial U.S. Term Loan<br>6.0% Cash, Due 4/21                  | 570,647   | 566,540   | 563,157   |
| Toys R US-Delaware, Inc.<br><i>Retail Stores</i>  | Term B-2 Loan<br>5.3% Cash, Due 5/18                           | 1,488,194 | 1,428,809 | 1,406,716 |

See accompanying notes to the financial statements.

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| Portfolio Company/Principal Business  | Investment Interest Rate/Maturity                             | Principal   | Cost        | Fair Value  |
|---|---|-------------|-------------|-------------|
| Transdigm Inc.<br><i>Aerospace and Defense</i>  | Tranche C Term Loan<br>4.0% Cash, Due 2/20                    | \$3,752,368 | \$3,715,669 | \$3,785,782 |
| Tribune Media Company (fka Tribune Company)<br><i>Broadcasting and Entertainment</i>                        | Term B Loan<br>3.8% Cash, Due 12/20                           | 2,078,894   | 2,066,155   | 2,099,943   |
| Tronox Pigments (Netherlands) B. V.<br><i>Chemicals, Plastics and Rubber</i>                                | New Term Loan<br>4.5% Cash, Due 3/20                          | 2,473,836   | 2,467,847   | 2,487,058   |
| United Air Lines, Inc. (fka Continental Airlines, Inc.)<br><i>Personal Transportation</i>                   | Class B Term Loan<br>3.3% Cash, Due 4/19                      | 2,034,432   | 2,036,638   | 2,049,374   |
| Univision Communications Inc.<br><i>Broadcasting and Entertainment</i>                                      | Replacement First-Lien Term Loan (C-4)<br>4.0% Cash, Due 3/20 | 3,204,971   | 3,189,172   | 3,226,716   |
| Valeant Pharmaceuticals International, Inc.<br><i>Healthcare, Education and Childcare</i>                   | Series C-2 Tranche B Term Loan<br>5.3% Cash, Due 12/19        | 1,339,121   | 1,306,042   | 1,339,241   |
| Walter Investment Management Corp.<br><i>Finance</i>  | Tranche B Term Loan<br>4.8% Cash, Due 12/20                   | 2,454,158   | 2,447,189   | 2,349,243   |
| WESCO Distribution, Inc.<br><i>Machinery (Non-Agriculture, Non-Construction, Non-Electronic)</i>            | Tranche B-1 Loan<br>4.0% Cash, Due 12/19                      | 206,786     | 205,914     | 207,497     |
| West Corporation<br><i>Diversified/Conglomerate Service</i>   | Refinanced Term B-14 Loan<br>3.3% Cash, Due 6/21              | 5,472,534   | 5,451,789   | 5,489,663   |
| Windstream Services, LLC (fka Windstream Corporation)<br><i>Telecommunications</i>                          | Tranche B-5 Term Loan<br>3.5% Cash, Due 8/19                  | 5,893,671   | 5,893,671   | 5,908,405   |
| Zekelman Industries, Inc. (fka JMC Steel Group, Inc.)<br><i>Mining, Steel, Iron and Non-Precious Metals</i> | Term Loan<br>6.0% Cash, Due 6/21                              | 1,287,097   | 1,281,369   | 1,301,576   |

|  |             |             |             |
|--|-------------|-------------|-------------|
| <b>Total Investment in Debt Securities</b> | 177,257,703 | 175,174,493 | 170,702,652 |
|--|-------------|-------------|-------------|

## Equity Securities Portfolio

| Portfolio Company/Principal Business   | Equity Investment           | Shares | Cost | Fair Value |
|--|-----------------------------|--------|------|------------|
| Education Management Corporation<br><i>Healthcare, Education and Childcare</i> | Series A-1 Preferred Shares | 2,670  |      | 748        |
| Dex Media, Inc.<br><i>Printing and Publishing</i>                              | Common Stock                | 59,785 |      | 149,462    |
| QCE, LLC (Quiznos)-<br><i>Retail Stores</i>                                    | New Common Stock            | 1,256  |      | 314        |
| <b>Total Investment in Equity Securities</b>                                   |                             |        |      | 150,524    |

## CLO Securities Portfolio

| Portfolio Company                                     | CLO Investment               | Principal | Cost           | Fair Value     |
|---|------------------------------|-----------|----------------|----------------|
| MDPK 2007-4A <sup>(1)</sup><br><i>CLO Rated Notes</i> | Floating 03/2021 D 55817UAF  | 2,000,000 | 2,000,000      | 1,931,600      |
| TRAL 2007-1A <sup>(1)</sup><br><i>CLO Rated Notes</i> | Floating 04/2022 C 89288BAG  | 3,000,000 | 3,000,000      | 2,924,700      |
| TRAL 2007-1A <sup>(1)</sup><br><i>CLO Rated Notes</i> | Floating 04/2022 D 89288AAAI | 1,000,000 | 1,000,000      | 975,500        |
| <b>Total Investment in CLO Rated Notes</b>            |                              | 6,000,000 | 6,000,000      | 5,831,800      |
| <b>Total Investments</b>                              |                              |           | \$ 181,174,493 | \$ 176,684,976 |

(1) Investment in a Collateralized Loan Obligation Fund  
(2) Loan on non-accrual status

See accompanying notes to the financial statements.

TABLE OF CONTENTS**Katonah 2007-I CLO Ltd.****SCHEDULE OF INVESTMENTS  
As of December 31, 2015****Debt Securities Portfolio**

| Portfolio Company/Principal Business   | Investment<br>Interest Rate <sup>(1)</sup> /Maturity              | Principal   | Cost        | Fair Value  |
|--|---|-------------|-------------|-------------|
| AdvancePierre Foods, Inc.<br><i>Beverage, Food and Tobacco</i>                                     | Term Loan (First Lien)<br>5.8% Cash, Due 7/17                     | \$2,469,655 | \$2,484,379 | \$2,465,790 |
| Allison Transmission, Inc.<br><i>Automobile</i>  | Term B-3 Loan<br>3.5% Cash, Due 8/19                              | 4,720,274   | 4,688,227   | 4,698,160   |
| Aramark Corporation<br><i>Diversified/Conglomerate Service</i>                                     | U.S. Term F Loan<br>3.3% Cash, Due 2/21                           | 2,526,481   | 2,443,445   | 2,506,484   |
| Armstrong World Industries, Inc. <sup>(3)</sup><br><i>Buildings and Real Estate</i> <sup>(3)</sup> | Term Loan B<br>3.5% Cash, Due 3/20                                | 972,500     | 972,500     | 967,638     |
| Ascena Retail Group, Inc. (Anntaylor Retail, Inc.)<br><i>Retail Stores</i>                         | Tranche B Term Loan<br>5.3% Cash, Due 8/22<br>Incremental Tranche | 2,000,000   | 1,846,016   | 1,880,000   |
| Asurion, LLC (fka Asurion Corporation)<br><i>Insurance</i>   | B-1<br>Term Loan<br>5.0% Cash, Due 5/19<br>Tranche B Term         | 1,121,067   | 1,095,258   | 1,053,456   |
| Avis Budget Car Rental, LLC<br><i>Personal Transportation</i>                                      | Loan<br>3.0% Cash, Due 3/19<br>Tranche B Term                     | 1,544,939   | 1,534,683   | 1,543,324   |
| Belfor USA Group Inc.<br><i>Ecological</i>   | Loan<br>3.8% Cash, Due 4/19                                       | 1,611,699   | 1,615,203   | 1,601,626   |
| Berry Plastics Corporation<br><i>Containers, Packaging and Glass</i>                               | Term E Loan<br>3.8% Cash, Due 1/21                                | 2,591,612   | 2,507,141   | 2,559,386   |
| Burlington Coat Factory Warehouse Corporation<br><i>Retail Stores</i>                              | Term B-3 Loan<br>4.3% Cash, Due 8/21                              | 2,321,888   | 2,290,743   | 2,298,669   |
| Capital Automotive L.P.<br><i>Finance</i>  | Tranche B-1 Term<br>Loan Facility<br>4.0% Cash, Due 4/19          | 1,267,378   | 1,260,465   | 1,268,170   |
| Capsugel Holdings US, Inc.<br><i>Healthcare, Education and Childcare</i>                           | Initial Term Loan<br>3.5% Cash, Due 8/18                          | 721,164     | 719,601     | 710,123     |
| Cedar Fair, L.P.<br><i>Leisure, Amusement, Motion Pictures,</i>                                    | U.S. Term Facility<br>3.3% Cash, Due 3/20                         | 966,429     | 964,983     | 969,449     |

*Entertainment*

|  |                      |           |           |           |
|--|----------------------|-----------|-----------|-----------|
|  | Dollar Term C-3      |           |           |           |
| Celanese US Holdings LLC                                   | Loan                 |           |           |           |
| <i>Chemicals, Plastics and Rubber</i>                      | 2.5% Cash, Due 10/18 | 1,251,599 | 1,214,068 | 1,254,509 |
| Cequel Communications, LLC                                 | Term Loan            |           |           |           |
| <i>Broadcasting and Entertainment</i>                      | 3.8% Cash, Due 2/19  | 1,879,918 | 1,871,491 | 1,854,070 |
| Charter Communications Operating, LLC (aka CCO Safari LLC) | Term F Loan          |           |           |           |
| <i>Broadcasting and Entertainment</i>                      | 3.0% Cash, Due 1/21  | 1,483,706 | 1,475,779 | 1,457,370 |
| CHS/Community Health Systems, Inc.                         | Incremental 2018     |           |           |           |
| <i>Healthcare, Education and Childcare</i>                 | Term F Loans         |           |           |           |
|  | 3.7% Cash, Due 12/18 | 1,209,226 | 258,686   | 1,195,368 |
| CHS/Community Health Systems, Inc.                         | Incremental 2019     |           |           |           |
| <i>Healthcare &amp; Pharmaceuticals</i>                    | Term G Loan          |           |           |           |
|  | 3.8% Cash, Due 12/19 | 1,062,209 | 1,059,907 | 1,038,145 |
| CHS/Community Health Systems, Inc.                         | Incremental 2021     |           |           |           |
| <i>Healthcare, Education and Childcare</i>                 | Term H Loan          |           |           |           |
|  | 4.0% Cash, Due 1/21  | 2,160,738 | 2,137,064 | 2,131,415 |
| Ciena Corporation  | Term Loan            |           |           |           |
| <i>Electronics</i>   | 3.8% Cash, Due 7/19  | 2,977,387 | 2,992,956 | 2,953,195 |
| Commscope, Inc.  | Tranche 4 Term       |           |           |           |
| <i>Telecommunications</i>                                  | Loan                 |           |           |           |
|  | 3.3% Cash, Due 1/18  | 261,875   | 262,083   | 261,057   |
| Consolidated Communications, Inc.                          | Initial Term Loan    |           |           |           |
| <i>Telecommunications</i>                                  | 4.3% Cash, Due 12/20 | 2,917,802 | 2,898,785 | 2,903,227 |
| Container Store, Inc., The                                 | Term Facility        |           |           |           |
| <i>Retail Stores</i>                                       | 4.3% Cash, Due 4/19  | 1,678,935 | 1,682,649 | 1,553,015 |
| ConvaTec Inc.  | Dollar Term Loan     |           |           |           |
| <i>Healthcare, Education and Childcare</i>                 | 4.3% Cash, Due 6/20  | 1,162,658 | 1,165,259 | 1,145,223 |
| Crown Castle Operating Company <sup>(3)</sup>              | Extended Incremental |           |           |           |
| <i>Buildings and Real Estate<sup>(3)</sup></i>             | Tranche B-2          |           |           |           |
|  | Term Loan            |           |           |           |
|  | 3.0% Cash, Due 1/21  | 2,888,746 | 2,878,350 | 2,881,235 |
| David s Bridal, Inc.                                       | Initial Term Loan    |           |           |           |
| <i>Retail Stores</i>                                       | 5.3% Cash, Due 10/19 | 477,723   | 475,142   | 397,942   |

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| Portfolio Company/Principal Business  | Investment<br>Interest<br>Rate <sup>(1)</sup> /Maturity | Principal   | Cost        | Fair Value  |
|---|---|-------------|-------------|-------------|
| Dealer Computer Services, Inc.<br>(Reynolds & Reynolds)<br><i>Electronics</i>                               | Tranche B Term<br>Loan<br>2.4% Cash, Due 4/16           | \$2,242,828 | \$2,242,828 | \$2,242,827 |
| Delta 2 (Lux) S.a r.l (aka Formula One)<br><i>Leisure, Amusement, Motion Pictures,<br/>Entertainment</i>    | Facility B3 (USD)<br>4.8% Cash, Due 7/21                | 3,421,774   | 3,400,280   | 3,319,121   |
| Delta Air Lines, Inc.<br><i>Personal Transportation</i>   | 2014 Term B-2<br>Loan<br>2.7% Cash, Due 4/16            | 3,402,908   | 3,406,970   | 3,397,583   |
| Dex Media West LLC<br><i>Printing and Publishing</i>  | New Term Loan<br>8.0% Cash, Due<br>12/16                | 695,444     | 692,438     | 379,017     |
| DJO Finance LLC<br><i>Healthcare, Education and Childcare</i>   | Initial Term Loan<br>4.3% Cash, Due 6/20                | 1,955,250   | 1,980,808   | 1,908,813   |
| Drumm Investors LLC (aka Golden<br>Living)<br><i>Healthcare, Education and Childcare</i>                    | Term Loan<br>6.8% Cash, Due 5/18                        | 3,731,318   | 3,718,832   | 3,689,341   |
| Education Management II LLC <sup>(2)</sup><br><i>Healthcare, Education and Childcare</i>                    | Tranche A Term<br>Loan<br>5.5% Cash, Due 7/20           | 200,289     | 201,304     | 50,071      |
| Education Management II LLC <sup>(2)</sup><br><i>Healthcare, Education and Childcare</i>                    | Tranche B Term<br>Loan<br>8.5% Cash, Due 7/20           | 350,666     | 352,357     | 37,872      |
| Envigo Laboratories, Inc. (fka BPA<br>Laboratories Inc.)<br><i>Healthcare, Education and Childcare</i>      | Term Loan (First<br>Lien)<br>2.8% Cash, Due 7/17        | 1,743,896   | 1,663,494   | 1,409,286   |
| Envigo Laboratories, Inc. (fka BPA<br>Laboratories Inc.)<br><i>Healthcare, Education and Childcare</i>      | Term Loan (Second<br>Lien)<br>2.8% Cash, Due 7/17       | 1,516,318   | 1,446,409   | 1,232,009   |
| Essential Power, LLC<br><i>Utilities</i>  | Term Loan<br>4.8% Cash, Due 8/19                        | 932,448     | 925,235     | 921,668     |
| FCA US LLC (fka Chrysler Group LLC)<br><i>Automobile</i>  | Term Loan B<br>3.5% Cash, Due 5/17                      | 3,067,549   | 2,960,527   | 3,061,797   |
| Federal-Mogul Corporation<br><i>Automobile</i>  | Tranche B Term<br>Loan (2014)<br>4.0% Cash, Due 4/18    | 1,566,456   | 1,529,147   | 1,415,191   |
| Fender Musical Instruments Corporation<br><i>Personal and Non Durable Consumer<br/>Products (Mfg. Only)</i> | Initial Loan<br>5.8% Cash, Due 4/19                     | 1,884,150   | 1,874,862   | 1,867,664   |
| First Data Corporation<br><i>Banking, Finance, Insurance &amp; Real<br/>Estate</i>                          | 2018 New Dollar<br>Term Loan<br>3.9% Cash, Due 3/18     | 2,903,500   | 2,900,493   | 2,870,632   |
| First Data Corporation<br><i>Banking, Finance, Insurance &amp; Real</i>                                     | New 2022B Dollar<br>Term Loan                           | 2,546,500   | 2,546,500   | 2,513,714   |



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|  |                      |           |           |           |
|--|----------------------|-----------|-----------|-----------|
| <i>Estate</i>  | 4.2% Cash, Due 7/22  |           |           |           |
| Gardner Denver, Inc.   | Initial Dollar Term  |           |           |           |
| <i>Machinery (Non-Agriculture, Non-Construction, Non-Electronic)</i> | Loan                 | 2,232,868 | 2,184,383 | 2,016,838 |
|  | 4.3% Cash, Due 7/20  |           |           |           |
| General Nutrition Centers, Inc.                                      | Amended Tranche B    |           |           |           |
| <i>Retail Stores</i>   | Term Loan            | 870,762   | 873,222   | 848,997   |
|  | 3.3% Cash, Due 3/19  |           |           |           |
| Getty Images, Inc.   | Initial Term Loan    |           |           |           |
| <i>Printing and Publishing</i>                                       | 4.8% Cash, Due 10/19 | 2,910,000 | 2,894,196 | 1,847,850 |
| Harland Clarke Holdings Corp. (fka Clarke American Corp.)            | Tranche B-2 Term     |           |           |           |
| <i>Printing and Publishing</i>                                       | Loan                 | 2,414,520 | 2,417,333 | 2,342,084 |
|  | 5.9% Cash, Due 6/17  |           |           |           |
| Harland Clarke Holdings Corp. (fka Clarke American Corp.)            | Tranche B-3 Term     |           |           |           |
| <i>Printing and Publishing</i>                                       | Loan                 | 943,396   | 943,396   | 940,472   |
|  | 7.0% Cash, Due 5/18  |           |           |           |
| HCA Inc.   | Tranche B-4 Term     |           |           |           |
| <i>Healthcare, Education and Childcare</i>                           | Loan                 | 2,932,500 | 2,893,337 | 2,932,515 |
|  | 3.4% Cash, Due 5/18  |           |           |           |
| HCR Healthcare, LLC  | Initial Term Loan    |           |           |           |
| <i>Healthcare, Education and Childcare</i>                           | 5.0% Cash, Due 4/18  | 476,250   | 474,710   | 452,142   |
|  | Tranche B-1 Term     |           |           |           |
| Hertz Corporation, The   | Loan                 | 3,894,660 | 3,894,343 | 3,891,252 |
| <i>Personal Transportation</i>                                       | 3.8% Cash, Due 3/18  |           |           |           |
|  | Tranche B-2 Term     |           |           |           |
| Hertz Corporation, The   | Loan                 | 953,050   | 950,930   | 946,198   |
| <i>Personal Transportation</i>                                       | 3.0% Cash, Due 3/18  |           |           |           |
|  | 2015 Extended Term   |           |           |           |
| Huntsman International LLC   | B                    |           |           |           |
| <i>Chemicals, Plastics and Rubber</i>                                | Dollar Loan          | 2,719,781 | 2,610,970 | 2,678,304 |
|  | 3.3% Cash, Due 4/19  |           |           |           |
|  | 2020 Dollar Term     |           |           |           |
| Ineos US Finance LLC   | Loan                 |           |           |           |
| <i>Chemicals, Plastics and Rubber</i>                                | 3.8% Cash, Due 12/20 | 6,376,839 | 6,398,337 | 6,137,707 |
|  | Tranche B-5 Term     |           |           |           |
| Infor (US), Inc. (fka Lawson Software Inc.)                          | Loan                 | 2,352,008 | 2,363,429 | 2,214,321 |
| <i>Electronics</i>   | 3.8% Cash, Due 6/20  |           |           |           |

See accompanying notes to the financial statements.

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| Portfolio Company/Principal Business   | Investment<br>Interest<br>Rate <sup>(1)</sup> /Maturity             | Principal | Cost      | Fair Value |
|--|---|-----------|-----------|------------|
| Integra Telecom Holdings, Inc.<br><i>Telecommunications</i>  | Term B-1 Loan<br>5.3% Cash, Due<br>8/20                             | \$416,454 | \$417,393 | \$404,377  |
| International Architectural Products,<br>Inc. <sup>(2)</sup><br><i>Mining, Steel, Iron and Non-Precious<br/>Metals</i> | Term Loan<br>0.0% Cash, Due<br>5/15                                 | 81,467    | 81,467    | 326        |
| J. Crew Group, Inc.<br><i>Retail Stores</i>  | Initial Loan<br>4.0% Cash, Due<br>3/21                              | 3,880,774 | 3,883,610 | 2,528,324  |
| Jarden Corporation<br><i>Personal and Non Durable Consumer<br/>Products (Mfg. Only)</i>                                | New Tranche B<br>Term Loan<br>3.0% Cash, Due<br>3/18                | 4,769,734 | 4,749,934 | 4,773,216  |
| JBS USA, LLC<br><i>Beverage, Food and Tobacco</i>  | Initial Term Loan<br>3.8% Cash, Due<br>5/18                         | 861,507   | 860,028   | 859,353    |
| JMC Steel Group, Inc.<br><i>Mining, Steel, Iron and Non-Precious<br/>Metals</i>  | Term Loan<br>4.8% Cash, Due<br>4/17                                 | 1,293,564 | 1,291,965 | 1,251,524  |
| Jo-Ann Stores, Inc.<br><i>Retail Stores</i>  | Term B Loan<br>4.0% Cash, Due<br>3/18                               | 941,546   | 943,733   | 885,054    |
| KAR Auction Services, Inc.<br><i>Automobile</i>  | Tranche B-1 Term<br>Loan<br>3.1% Cash, Due<br>3/17                  | 679,145   | 680,354   | 679,430    |
| KAR Auction Services, Inc.<br><i>Automobile</i>  | Tranche B-2 Term<br>Loan<br>3.5% Cash, Due<br>3/21                  | 3,407,047 | 3,453,066 | 3,402,788  |
| Key Safety Systems, Inc.<br><i>Automobile</i>  | Initial Term Loan<br>4.8% Cash, Due<br>8/21                         | 1,364,058 | 1,340,031 | 1,329,956  |
| Kronos Incorporated<br><i>Diversified/Conglomerate Service</i>   | Incremental Term<br>Loan<br>(First Lien)<br>4.5% Cash, Due<br>10/19 | 978,389   | 975,600   | 964,941    |
| Landry's Inc. (fka Landry's Restaurants,<br>Inc.)<br><i>Beverage, Food and Tobacco</i>                                 | B Term Loan<br>4.0% Cash, Due<br>4/18                               | 1,538,848 | 1,548,166 | 1,533,324  |
| Las Vegas Sands, LLC<br><i>Hotels, Motels, Inns, and Gaming</i>  | Term B Loan<br>3.3% Cash, Due                                       | 3,201,595 | 3,172,481 | 3,174,782  |

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|   |   |           |           |           |
|---|---|-----------|-----------|-----------|
|   | 12/20   |           |           |           |
| Live Nation Entertainment, Inc.<br><i>Leisure, Amusement, Motion Pictures, Entertainment</i>          | Term B-1 Loan<br>3.5% Cash, Due<br>8/20   | 472,878   | 471,316   | 472,434   |
| LPL Holdings, Inc.<br><i>Finance</i>  | 2021 Tranche B<br>Term Loan<br>4.3% Cash, Due<br>3/21                                 | 1,930,500 | 1,921,055 | 1,901,543 |
| MCC Iowa LLC<br><i>Broadcasting and Entertainment</i>   | Tranche J Term<br>Loan<br>3.8% Cash, Due<br>6/21                                      | 690,439   | 680,992   | 685,046   |
| Mediacom Illinois, LLC (fka Mediacom<br>Communications, LLC)<br><i>Broadcasting and Entertainment</i> | Tranche F Term<br>Loan<br>2.9% Cash, Due<br>3/18                                      | 5,895,000 | 5,886,840 | 5,801,063 |
| National CineMedia, LLC<br><i>Leisure, Amusement, Motion Pictures, Entertainment</i>                  | Term Loan (2013)<br>3.2% Cash, Due<br>11/19   | 1,000,000 | 995,545   | 996,250   |
| NBTY, INC.<br><i>Personal and Non Durable Consumer Products (Mfg. Only)</i>                           | Term B-2 Loan<br>3.5% Cash, Due<br>10/17  | 3,391,643 | 3,392,700 | 3,351,791 |
| NEP/NCP Holdco, Inc.<br><i>Broadcasting and Entertainment</i>   | Amendment No. 4<br>Incremental<br>Term Loan (First<br>Lien)<br>4.3% Cash, Due<br>1/20 | 2,454,312 | 2,435,744 | 2,313,189 |
| Newsday, LLC<br><i>Printing and Publishing</i>  | Term Loan<br>3.9% Cash, Due<br>10/16  | 3,984,627 | 3,989,720 | 3,989,608 |
| Nielsen Finance LLC (VNU, Inc.)<br><i>Broadcasting and Entertainment</i>                              | Class B-1 Term<br>Loan<br>2.5% Cash, Due<br>5/17                                      | 5,402,525 | 5,407,617 | 5,400,283 |
| NRG Energy, Inc.<br><i>Utilities</i>  | Term Loan (2013)<br>2.8% Cash, Due<br>7/18  | 955,481   | 954,306   | 932,191   |
| OCI Beaumont LLC<br><i>Chemicals, Plastics and Rubber</i>   | Term B-3 Loan<br>6.5% Cash, Due<br>8/19   | 2,486,113 | 2,518,346 | 2,510,974 |
| Omnova Solutions, Inc.<br><i>Chemicals, Plastics and Rubber</i>                                       | Term B-1 Loan<br>4.3% Cash, Due<br>5/18   | 359,276   | 358,928   | 358,827   |
| Onex Carestream Finance LP<br><i>Healthcare, Education and Childcare</i>                              | Term Loan (First<br>Lien 2013)<br>5.0% Cash, Due<br>6/19                              | 2,429,369 | 2,445,779 | 2,200,608 |
| Pacific Drilling S.A.<br><i>Oil and Gas</i>   | Term Loan<br>4.5% Cash, Due<br>6/18   | 2,185,768 | 2,189,041 | 961,738   |

|   |                |           |           |           |
|---|----------------|-----------|-----------|-----------|
| PetCo Animal Supplies, Inc.<br><i>Retail Stores</i> | New Loan       |           |           |           |
|   | 4.0% Cash, Due | 5,328,526 | 5,297,286 | 5,321,359 |
|   | 11/17          |           |           |           |

See accompanying notes to the financial statements.

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| Portfolio Company/Principal Business  | Investment<br>Interest<br>Rate <sup>(1)</sup> /Maturity | Principal   | Cost        | Fair Value  |
|---|---|-------------|-------------|-------------|
| Petroleum GEO-Services ASA (PGS Finance, Inc)<br><i>Oil and Gas</i>                                       | Extended Term<br>Loan<br>3.3% Cash, Due 3/21            | \$4,912,500 | \$4,912,500 | \$3,468,225 |
| PQ Corporation<br><i>Chemicals, Plastics and Rubber</i>   | 2014 Term Loan<br>4.0% Cash, Due 8/17                   | 4,916,982   | 4,915,840   | 4,887,013   |
| QCE, LLC (Quiznos) <sup>(2)</sup><br><i>Personal, Food and Miscellaneous Services</i>                     | Existing Term Loan<br>0.0% Cash, Due 9/20               | 449,499     | 449,486     | 59,932      |
| Quikrete Holdings, Inc. <sup>(3)</sup><br><i>Buildings and Real Estate</i> <sup>(3)</sup>                 | Initial Loan (First Lien)<br>3.0% Cash, Due 9/20        | 2,230,000   | 2,218,850   | 2,208,748   |
| R.H. Donnelley Inc.<br><i>Printing and Publishing</i>   | Loan<br>9.8% Cash, Due 4/22                             | 421,935     | 420,869     | 181,565     |
| Regal Cinemas Corporation<br><i>Leisure, Amusement, Motion Pictures, Entertainment</i>                    | Term Loan<br>3.8% Cash, Due 11/17                       | 963,677     | 969,660     | 962,728     |
| Revlon Consumer Products Corporation<br><i>Personal and Non Durable Consumer Products (Mfg. Only)</i>     | Replacement Term Loan<br>3.3% Cash, Due 12/18           | 4,480,361   | 4,498,987   | 4,476,150   |
| Reynolds Group Holdings Inc.<br><i>Containers, Packaging and Glass</i>                                    | Incremental U.S. Term Loan<br>4.5% Cash, Due 10/17      | 2,058,619   | 2,058,619   | 2,042,109   |
| RGIS Services, LLC<br><i>Diversified/Conglomerate Service</i>   | Tranche C Term Loan<br>5.5% Cash, Due 11/18             | 2,597,871   | 2,569,219   | 1,850,983   |
| RPI Finance Trust<br><i>Healthcare, Education and Childcare</i>   | Term B-3 Term Loan<br>3.3% Cash, Due 6/18               | 2,487,277   | 2,506,353   | 2,483,385   |
| Schaeffler AG (formerly named INA Beteiligungsgesellschaft mit beschränkter Haftung)<br><i>Automobile</i> | Facility B-USD<br>4.3% Cash, Due 5/20                   | 1,015,385   | 1,020,391   | 1,018,685   |
| Select Medical Corporation<br><i>Healthcare, Education and Childcare</i>                                  | Series E Tranche B Term Loan<br>5.0% Cash, Due 1/18     | 2,104,406   | 2,092,431   | 2,091,254   |
| Semiconductor Components Industries, LLC (On Semiconductor)<br><i>Electronics</i>                         | Term Loan<br>2.1% Cash, Due 10/21                       | 4,593,750   | 4,537,373   | 4,455,938   |
| Sensata Technologies B.V. (Sensata Technologies Finance Company, LLC)<br><i>Electronics</i>               | Sixth Amendment Term Loan<br>3.0% Cash, Due 4/20        | 560,135     | 556,355     | 551,851     |

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|   |  |           |           |           |
|---|--|-----------|-----------|-----------|
| Sinclair Television Group, Inc.<br><i>Broadcasting and Entertainment</i>                                | New Tranche B<br>Term Loan<br>3.0% Cash, Due 9/19            | 66,983    | 66,865    | 65,978    |
| Steinway Musical Instruments, Inc.<br><i>Personal and Non Durable Consumer<br/>Products (Mfg. Only)</i> | Loan (First Lien)<br>4.8% Cash, Due 3/19                     | 2,000,000 | 1,985,239 | 1,972,500 |
| Telesat Canada<br><i>Telecommunications</i>   | U.S. Term B-2<br>Loan<br>3.5% Cash, Due<br>12/17             | 2,960,078 | 2,937,884 | 2,920,605 |
| TPF Generation Holdings, LLC<br><i>Utilities</i>  | Term Loan<br>4.8% Cash, Due 2/20                             | 188,393   | 182,268   | 168,611   |
| TransDigm Inc.<br><i>Aerospace and Defense</i>  | Tranche C Term<br>Loan<br>3.8% Cash, Due 3/20                | 3,791,455 | 3,742,603 | 3,708,251 |
| Tronox Pigments (Netherlands) B. V.<br><i>Chemicals, Plastics and Rubber</i>                            | New Term Loan<br>4.5% Cash, Due 2/20                         | 2,499,471 | 2,487,925 | 2,224,005 |
| TWCC Holding Corp.<br><i>Broadcasting and Entertainment</i>   | Term B-1 Loan<br>5.8% Cash, Due 3/20<br>Replacement          | 2,924,754 | 2,905,902 | 2,926,318 |
| Univision Communications Inc.<br><i>Broadcasting and Entertainment</i>                                  | First-Lien<br>Term Loan<br>4.0% Cash, Due<br>12/19           | 3,239,279 | 3,218,251 | 3,176,113 |
| UPC Financing Partnership<br><i>Broadcasting and Entertainment</i>                                      | Facility AH<br>3.3% Cash, Due 6/21                           | 700,000   | 704,142   | 688,517   |
| Valeant Pharmaceuticals International,<br>Inc.<br><i>Healthcare, Education and Childcare</i>            | Series C-2 Tranche<br>B Term Loan<br>3.8% Cash, Due<br>10/19 | 1,389,000 | 1,343,190 | 1,344,205 |
| Vertafore, Inc.<br><i>Electronics</i>   | Term Loan (2013)<br>4.3% Cash, Due<br>11/19                  | 892,097   | 892,097   | 885,964   |
| VFH Parent LLC<br><i>Finance</i>  | Term Loan (2013)<br>5.3% Cash, Due<br>12/20                  | 985,103   | 994,592   | 980,177   |
| Walter Investment Management Corp.<br><i>Finance</i>  | Tranche B Term<br>Loan<br>4.8% Cash, Due<br>12/19            | 2,454,158 | 2,445,426 | 2,124,393 |
| WESCO Distribution, Inc.<br><i>Machinery (Non-Agriculture,<br/>Non-Construction, Non-Electronic)</i>    | Tranche B-1 Loan<br>3.8% Cash, Due 6/18                      | \$249,643 | \$248,233 | \$248,551 |

See accompanying notes to the financial statements.

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| Portfolio Company/Principal Business   | Investment<br>Interest<br>Rate <sup>(1)</sup> /Maturity<br>Term B-10 | Principal   | Cost        | Fair Value  |
|--|--|-------------|-------------|-------------|
| West Corporation<br><i>Diversified/Conglomerate Service</i>  | Loan<br>3.3% Cash, Due<br>7/17                                       | 3,776,796   | 3,756,691   | 3,722,844   |
| WideOpenWest Finance, LLC<br><i>Telecommunications</i>   | Term B-1 Loan<br>2013<br>3.8% Cash, Due<br>8/19                      | 4,724,229   | 4,740,543   | 4,598,234   |
| Windstream Services, LLC (fka<br>Windstream Corporation)<br><i>Telecommunications</i>              | Tranche B-5<br>Term Loan<br>3.5% Cash, Due<br>2/17                   | 5,954,430   | 5,954,430   | 5,801,848   |
| WireCo WorldGroup Inc.<br><i>Machinery (Non-Agriculture,<br/>Non-Construction, Non-Electronic)</i> | Term Loan<br>6.0% Cash, Due<br>2/20                                  | 1,829,576   | 1,825,076   | 1,767,828   |
| Zuffa, LLC<br><i>Leisure, Amusement, Motion Pictures,<br/>Entertainment</i>                        | Initial Term<br>Loan<br>3.8% Cash, Due<br>6/19                       | 2,294,791   | 2,287,980   | 2,242,011   |
| Total Investment in Debt Securities  |  | 246,578,754 | 244,325,246 | 234,403,150 |

**Equity Securities Portfolio**

| Portfolio Company/Principal Business   | Equity Investment              | Shares | Cost | Value <sup>(2)</sup> |
|--|--------------------------------|--------|------|----------------------|
| Education Management Corporation <sup>(2)</sup>                                  | Series A-1 Preferred<br>Shares | 2,670  | \$   | \$ 2,670             |
| QCE, LLC (Quiznos) <sup>(2)</sup>  | New Common<br>Stock            | 1,256  |      | 160                  |
| Total Investment in Equity Securities (100% of net<br>asset value at fair value) |                                |        | \$   | \$ 2,830             |

**CLO Securities Portfolio**

| Portfolio Company                                      | CLO Investment              | Principal   | Cost        | Value     |
|--|-----------------------------|-------------|-------------|-----------|
| APID 2007-5A <sup>(1)</sup><br><i>CLO Rated Notes</i>  | Floating 04/2021 D 03761XA  | \$3,000,000 | \$1,000,000 | \$963,108 |
| HLCNL 2007-2A <sup>(1)</sup><br><i>CLO Rated Notes</i> | Floating 04/2021 D 40537AAA | \$3,000,000 | 2,968,134   | 2,902,077 |
| MDPK 2007-4A <sup>(1)</sup><br><i>CLO Rated Notes</i>  | Floating 03/2021 D 55817UAF | \$2,000,000 | 2,000,000   | 1,869,623 |
| NAVIG 2007-2A <sup>(1)</sup><br><i>CLO Rated Notes</i> | Floating 04/2021 D 63937HAD | \$0,000,000 | 3,000,000   | 2,910,373 |
|  | Floating 04/2022 C 89288BAG | \$0,000,000 | 3,000,000   | 2,778,118 |

TRAL 2007-1A<sup>(1)</sup>

*CLO Rated Notes*

TRAL 2007-1A<sup>(1)</sup>

*CLO Rated Notes*

Total Investment in

CLO Rated Notes

Total Investments

|          |         |   |          |               |               |               |
|----------|---------|---|----------|---------------|---------------|---------------|
| Floating | 04/2022 | D | 89288AAA | 1,000,000     | 1,000,000     | 937,226       |
|          |         |   |          | 13,000,000    | 12,968,134    | 12,360,525    |
|          |         |   |          | \$259,578,754 | \$257,293,380 | \$246,766,505 |

(1)

Investment in a Collateralized Loan Obligation Fund

(2)

Loan on non-accrual status

(3) Buildings and real estate relate to real estate ownership, builders, managers and developers and excludes mortgage debt investments and mortgage lenders or originators.

See accompanying notes to the financial statements.

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## KATONAH 2007-I CLO LTD.

# NOTES TO FINANCIAL STATEMENTS

## 1. ORGANIZATION

Katonah 2007-I CLO LTD. (the Fund) is an exempted company incorporated in November 15, 2006 with limited liability under the laws of the Cayman Islands for the sole purpose of investing in broadly syndicated loans, high-yield bonds and other credit instruments. The Fund is what is commonly known as a collateralized loan obligation fund (CLO Fund).

A CLO Fund generally refers to a special purpose vehicle that owns a portfolio of investments and issues various tranches of debt and subordinated note securities to finance the purchase of those investments. Investments purchased by a CLO Fund are governed by extensive investment guidelines, including limits on exposure to any single industry or issuer and limits on the ratings of the CLO Fund's assets. A CLO Fund has a defined investment period during which it is allowed to make investments or reinvest capital as it becomes available.

A CLO Fund typically issues multiple tranches of debt and subordinated note securities with varying ratings and levels of subordination to finance the purchase of their underlying investments. Interest and principal payments (net of designated CLO Fund expenses) from the CLO Fund are paid to each issued security in accordance with an agreed upon priority of payments, commonly referred to as the waterfall. The most senior notes, generally rated AAA/Aaa, commonly represent the majority of the total liabilities of the CLO Fund. AAA/Aaa notes are issued at a specified spread over LIBOR and normally have the first claim on the earnings on the CLO Fund's investments after payment of certain fees and expenses. Lower subordinated mezzanine tranches of rated notes generally have ratings ranging from AA/Aa to BB/Ba and are usually issued at a specified spread over LIBOR with higher spreads paid on the tranches with lower ratings. Each tranche is typically only entitled to a share of the earnings on the CLO Fund's investments if the required interest and principal payments have been made on the more senior tranches in the waterfall. The most junior tranche can take the form of either subordinated notes or preferred shares. The subordinated notes or preferred shares generally do not have a stated coupon but are entitled to residual cash flows from the CLO Fund's investments after all of the other tranches of notes and certain other fees and expenses are paid.

On January 23, 2008, the Fund sold \$323.9 million of notes or debt securities, consisting of Class A-1L Floating Rate Notes, Class A-2L Floating Rate Notes, Class A-3L Floating Rate Notes, Class B-1L Floating Rate Notes, Class B-2L Floating Rate Notes (Class B-2L Notes) and preferred shares. The notes were issued pursuant to an indenture, dated January 23, 2008 (the Indenture), with U.S. Bank National Association servicing as the trustee thereunder. KCAP Financial, Inc. (KCAP Financial) owns all of the preferred shares of Katonah 2007-I CLO LTD. The Fund's defined investment period ended on April 22, 2014. Following the defined investment period, proceeds from principal payments in the investment portfolio of the Fund are used to pay down its outstanding notes, starting with Class A notes.

Pursuant to a collateral management agreement (the Collateral Management Agreement), Katonah 2007-I Management, L.L.C. (the Manager), which is an indirect wholly-owned portfolio company of KCAP Financial, provides investment management services to the Fund, and makes day-to-day investment decisions concerning the assets of the Fund. The Manager also performs certain administrative services on behalf of the Fund under the Collateral Management Agreement. The Manager is a registered investment adviser under the Investment Advisers

Act of 1940.

## **2. SIGNIFICANT ACCOUNTING POLICIES**

### **Basis of Accounting and Combination**

The financial statements of the Fund have been prepared in accordance with U.S. generally accepted accounting principles ( U.S. GAAP ). In the opinion of the Manager's management, the financial statements of the Fund reflect all adjustments, consisting of normal recurring accruals, which are necessary for the fair presentation of the financial condition and results of operations for the periods presented. Furthermore, the preparation of the financial statements requires management to make significant estimates and assumptions

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**KATONAH 2007-I CLO LTD.**

**NOTES TO FINANCIAL STATEMENTS**

**2. SIGNIFICANT ACCOUNTING POLICIES (continued)**

including the fair value of investments that do not have a readily available market value. Actual results could differ from those estimates, and the differences could be material.

All of the investments held and notes issued by the Fund are presented at fair value in the Fund's Statements of Net Assets.

*Investments of the Fund at Fair Value.* Investment transactions are recorded on the applicable trade date. Realized gains or losses are determined using the specific identification method. Investments held by the Fund are stated at fair value. ASC 820-10, Fair Value Measurements and Disclosures (ASC 820-10), requires among other things, disclosures about assets and liabilities that are measured and reported at fair value.

*Hierarchy of Fair Value Inputs.* The provisions of ASC 820-10 establish a hierarchy that prioritizes inputs to valuation techniques used to measure fair value and require companies to disclose the fair value of their financial instruments according to the fair value hierarchy (i.e., Level 1, 2 and 3 inputs, as defined). The fair value hierarchy gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. Additionally, companies are required to provide additional disclosure regarding instruments in the Level 3 category (which have inputs to the valuation techniques that are unobservable and require significant management judgment), including a reconciliation of the beginning and ending balances separately for each major category of assets and liabilities.

Assets and liabilities measured and reported at fair value are classified and disclosed in one of the following categories:

**Level 1 Inputs:**

Quoted prices (unadjusted) in active markets for identical assets or liabilities at the reporting date.

Level 1 assets may include listed mutual funds, ETFs, equities and certain derivatives.

**Level 2 Inputs:**

Quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities that are not active; quotes from pricing services or brokers, for which the Manager can determine that orderly transactions took place at the quoted price or that the inputs used to arrive at the price were observable; and inputs other than quoted prices that are observable, such as models or other valuation methodologies.

Level 2 assets in this category may include debt securities, bank loans, short-term floating rate notes and asset-backed securities, restricted public securities valued at a discount, as well as over the counter derivatives, including interest and inflation rate swaps and foreign currency exchange contracts that have inputs to the valuations that generally can be corroborated by observable market data.

**Level 3 Inputs:**

Unobservable inputs for the valuation of the asset or liability, which may include non-binding broker quotes. Level 3 assets include investments for which there is little, if any, market activity. These inputs require significant management judgment or estimation.

Level 3 assets in this category may include general and limited partnership interests in private equity funds, funds of private equity funds, real estate funds, hedge funds, and funds of hedge funds, direct private equity investments held within consolidated funds, bank loans, bonds issued by CLO Funds and certain held for sale real estate disposal assets.

Level 3 liabilities included in this category include borrowings of consolidated collateralized loan obligations valued based upon non-binding broker quotes or discounted cash flow model based on a discount margin calculation.

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**KATONAH 2007-I CLO LTD.**

**NOTES TO FINANCIAL STATEMENTS**

**2. SIGNIFICANT ACCOUNTING POLICIES (continued)**

**Significance of Inputs:**

The Manager's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and considers factors specific to the financial instrument.

*Valuation of Portfolio Investments.* Debt and equity securities for which market quotations are readily available are generally valued at such market quotations. Debt and equity securities that are not publicly traded or whose market price is not readily available are valued based on detailed analyses prepared by management, and, in certain circumstances, may utilize third parties with valuation expertise. The Manager follows the provisions of ASC 820-10 with respect to preparing the Fund's financial statements. This standard defines fair value, establishes a framework for measuring fair value, and expands disclosures about assets and liabilities measured at fair value. ASC 820-10 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Subsequent to the adoption of ASC 820-10, the FASB has issued various staff positions clarifying the initial standard as noted below.

*Fair Value Measurements and Disclosures* requires the disclosure of the inputs and valuation techniques used to measure fair value and a discussion of changes in valuation techniques and related inputs, if any, during the period.

The Manager's valuation methodology and procedures for investments held by the Fund are generally as follows:

1. For any asset which is also held by KCAP Financial on the applicable date, the KCAP Financial fair value mark as of such applicable date is used.  
Each portfolio company or investment is cross-referenced to an independent pricing service to determine if a current market quote is available. The nature and quality of such quote is reviewed to determine reliability and relevance of the quote. Factors considered in this determination include whether the quote is from a transaction or is a broker
2. quote, the date and aging of such quote, whether the transaction is arms-length, whether it is of a liquidation or distressed nature and certain other factors judged to be relevant by the Manager's management within the framework of ASC 820-10.
3. If an investment does not have a market quotation on either a broad market exchange or from an independent pricing service, the investment is initially valued by the Manager's investment professionals responsible for the portfolio investment in conjunction with the portfolio management team. Generally, such fair values are determined by reference to public market or private transactions or valuations for comparable companies or assets in the relevant asset class and or industry when such amounts are available. Generally these valuations are derived by multiplying a key performance metric of the investee company or asset (e.g., EBITDA) by the relevant valuation multiple observed for comparable companies or transactions, adjusted by management for differences between the investment and the referenced comparable. If the fair value of such investments cannot be valued by reference to observable valuation measures for comparable companies, then the primary analytical method used to estimate the fair value is a discounted cash flow method and/or cap rate analysis. A sensitivity analysis is applied to the estimated future cash flows using various factors depending on the investment, including assumed growth rates (in

cash flows), capitalization rates (for determining terminal values) and appropriate discount rates to determine a range of reasonable values or to compute projected return on investment.

4. Preliminary valuation conclusions are discussed and documented by the Manager's management.

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## KATONAH 2007-I CLO LTD.

### NOTES TO FINANCIAL STATEMENTS

#### 2. SIGNIFICANT ACCOUNTING POLICIES (continued)

5. Illiquid loans, junior and mezzanine securities and investments in other CLO bonds are fair valued using models developed by the Manager's management with applicable market assumptions.

The Manager's management discusses the valuations and determines in good faith that the fair values of each investment in the portfolio is reasonable based upon any applicable independent pricing service, input of management, and estimates from independent valuation firms (if any).

*Debt Securities.* Most of the Fund's investment portfolio is composed of broadly syndicated debt securities for which an independent pricing service quote is available. To the extent that the investments are exchange traded and are priced or have sufficient price indications from normal course trading at or around the valuation date (financial reporting date), such pricing will determine fair value. Pricing service marks from third party pricing services may be used as an indication of fair value, depending on the volume and reliability of the marks, sufficient and reasonable correlation of bid and ask quotes, and, most importantly, the level of actual trading activity.

*CLO Fund Securities.* The Fund may selectively invest in securities issued by CLO Funds managed by other asset management companies. For bond rated tranches of CLO Funds (those above the junior class) without transactions to support a fair value for the specific CLO Fund and tranche, fair value is based on discounting estimated bond payments at current market yields, which may reflect the adjusted yield on the leveraged loan index for similarly rated tranches, as well as prices for similar tranches for other CLO Funds and also other factors such as the default and recovery rates of underlying assets in the CLO Fund, as may be applicable. Such model assumptions may vary and incorporate adjustments for risk premiums and CLO Fund specific attributes. Such adjustments require judgment and may be material to the calculation of fair value.

*Cash.* Cash is defined as demand deposits. The Fund holds its cash with financial institutions and, at times, cash held in checking accounts may exceed the Federal Deposit Insurance Corporation insured limit.

*Debt at Fair Value.* The Fund has issued rated and unrated bonds to finance its operations. Debt is presented at fair value.

*Interest Income.* Interest income is recorded on the accrual basis on interest-bearing assets. The Fund generally places a loan or security on non-accrual status and ceases recognizing cash interest income on such loan or security when a loan or security becomes 90 days or more past due or if Manager otherwise does not expect the debtor to be able to service its debt obligations.

*Management Fees.* The Fund is externally managed by the Manager pursuant to the Collateral Management Agreement. As compensation for the performance of its obligations under the Collateral Management Agreement, the Manager is entitled to receive from the Fund a senior collateral management fee (the Senior Collateral Management Fee), a subordinated collateral management fee (the Subordinated Collateral Management Fee) and an incentive collateral management fee (the Incentive Collateral Management Fee). The Senior Collateral Management Fee is payable in arrears quarterly (subject to availability of funds and to the satisfaction of payment obligations on the debt obligations of the Fund (the Priority of Payments)) in an amount equal to 0.10% per annum of the aggregate principal

amount of the Fund's investments. The Subordinated Collateral Management Fee is payable in arrears quarterly (subject to availability of funds and to the Priority of Payments) in an amount equal to 0.15% per annum of the aggregate principal amount of the Fund's investments. The Incentive Collateral Management Fee equals 20% of the amount of interest and principal payments remaining available for distribution to the holders of the Fund's preferred shares under the Priority of Payments at which the Incentive Collateral Management Fee may be paid. For the years ended December 31, 2016, 2015 and 2014, there were no Incentive Fees incurred by the Fund.

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**KATONAH 2007-I CLO LTD.**

**NOTES TO FINANCIAL STATEMENTS**

**2. SIGNIFICANT ACCOUNTING POLICIES (continued)**

*Interest Expenses.* The Fund has issued rated and unrated bonds to finance its operations. Interest on debt is calculated by the third party trustee of the Fund. Interest is accrued and generally paid quarterly.

*Trustee Fees.* The Fund has a third party trustee that is the custodian for all investments of the Fund and receives and disburses all cash in accordance to the trustee and custodial agreements. Trustee fees are accrued and paid quarterly by the Fund.

*Income Taxes.* The Fund is not subject to net income taxation in the United States or the Cayman Islands. Accordingly, no provision for income taxes has been made in the accompanying financial statements.

**3. INVESTMENTS**

The investments held by the Fund are primarily invested in senior secured bank loans (typically syndicated by banks), bonds, and equity securities. Bank loan investments, which comprise the majority of the Fund's portfolio, are senior secured corporate loans from a variety of industries, including but not limited to the aerospace and defense, broadcasting, technology, utilities, household products, healthcare, oil and gas, and finance industries. The investments mature at various dates between 2017 and 2022, pay interest at Libor or Prime plus a spread of up to 1.5%, and typically range in credit rating categories from BBB down to unrated. Non-accrual loans represented less than 1% of investments at fair value as of December 31, 2016 and December 31, 2015. The aggregate unpaid principal value of loans past due as of December 31, 2016 and December 31, 2015 was approximately \$449,000 and \$1.1 million, respectively and the difference between fair value and the unpaid principal balance was approximately \$413,000 and \$934,000, respectively. The Fund's investments are valued based on price quotations provided by an independent third-party pricing source which are indicative of traded prices and/or dealer price quotations. In the event that a third-party pricing source is unable to price an investment, other relevant factors, data and information are considered, including: i) information relating to the market for the investment, including price quotations for and trading in the investment and interest in similar investments and the market environment and investor attitudes towards the investment and interests in similar investments; ii) the characteristics of and fundamental analytical data relating to the investment, including the cost, size, current interest rate, period until next interest rate reset, maturity and base lending rate, the terms and conditions of the loan and any related agreements, and the position of the loan in the issuer's debt structure; iii) the nature, adequacy and value of the senior secured corporate loan's collateral, including the CLO's rights, remedies and interests with respect to the collateral; iv) the creditworthiness of the borrower, based on an evaluation of its financial condition, financial statements and information about the business, cash flows, capital structure and future prospects; v) the reputation and financial condition of the agent and any intermediate participants in the senior secured corporate loan; and vi) general economic and market conditions affecting the fair value of the senior secured corporate loan.

The debt issued by the Fund has a stated maturity date of April 23, 2022. The Fund's debt was issued in various tranches with different risk profiles and ratings. The interest rates are variable rates based on Libor plus a pre-defined

spread, which varies from 0.85% for the more senior tranches to 5% for the more subordinated tranches. The debt issued by the Fund is recorded at fair value using an income approach, driven by cash flows expected to be received from the portfolio collateral assets. Fair value is determined using current information, notably market yields and projected cash flows of collateral assets based on forecasted default and recovery rates that a market participant would use in determining the current fair value of the liabilities, taking into account the overall credit quality of the issuers and the Manager's past experience in managing similar securities. Market yields, default rates and recovery rates used in the Manager's estimate of fair value vary based on the nature of the investments in the underlying collateral pools. In periods of rising market yields, default rates and lower debt recovery rates, the fair value, and therefore the carrying value, of the liabilities may be adversely affected. Once the undiscounted cash flows of the collateral assets have been determined, the Manager applies appropriate discount rates that a market participant would use to determine the discounted cash flow valuation of the notes.

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TABLE OF CONTENTS**KATONAH 2007-I CLO LTD.****NOTES TO FINANCIAL STATEMENTS****3. INVESTMENTS (continued)**

The carrying value of investments held and debt issued by the Fund is also their fair value. The following tables present the fair value hierarchy levels of investments held and debt issued by the Fund, which are measured at fair value as of December 31, 2016 and December 31, 2015:

| (\$ in millions)     | Fair Value     | December 31, 2016  |   |  |
|----------------------|----------------|--|---|--|
|                      |                | Quoted Prices<br>in<br>Active<br>Markets<br>for Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Assets:              |                |  |   |  |
| Investments          | \$ 176,684,976 |  |   | \$ 176,684,976                                     |
| Liabilities:         |                |  |   |  |
| CLO Fund Liabilities | \$ 208,812,164 |  |   | \$ 208,812,164                                     |

| (\$ in millions)     | Fair Value     | December 31, 2015  |   |  |
|----------------------|----------------|--|---|--|
|                      |                | Quoted Prices<br>in<br>Active<br>Markets<br>for Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Assets:              |                |  |   |  |
| Investments          | \$ 246,766,505 |  |   | \$ 246,766,505                                     |
| Liabilities:         |                |  |   |  |
| CLO Fund Liabilities | \$ 261,433,473 |  |   | \$ 261,433,473                                     |

The following tables show a reconciliation of the beginning and ending fair value measurements for Level 3 assets using significant unobservable inputs:

For the year  
ended December  
31,  
2016

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|  |               |
|--|---------------|
| Beginning balance  | \$246,766,505 |
| Purchase of investments  | 82,554,227    |
| Proceeds from sale and redemption of investments   | (159,676,298) |
| Net Realized and Unrealized (losses)   | 7,040,542     |
| Ending balance   | \$176,684,976 |
| Changes in unrealized appreciation (depreciation) included in earnings related to investments still held at reporting date | \$3,636,405   |

|  |                                      |
|--|--------------------------------------|
|  | For the year ended December 31, 2015 |
| Beginning balance  | \$273,373,948                        |
| Purchase of investments  | 93,243,381                           |
| Proceeds from sale and redemption of investments   | (113,199,395)                        |
| Net realized and unrealized (losses)   | (6,651,429 )                         |
| Ending balance   | \$246,766,505                        |
| Changes in unrealized appreciation (depreciation) included in earnings related to investments still held at reporting date | \$(5,313,969 )                       |

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TABLE OF CONTENTS**KATONAH 2007-I CLO LTD.****NOTES TO FINANCIAL STATEMENTS****3. INVESTMENTS (continued)**

As of December 31, 2016, the Manager's Level 3 portfolio investments had the following valuation techniques and significant inputs:

| Type                | Fair Value    | Valuation Technique  | Unobservable inputs             | Range of Inputs |
|---------------------|---------------|----------------------|---------------------------------|-----------------|
| Debt Securities     | \$3,787,243   | Income Approach      | Implied Effective Discount Rate | 6.72% 7.89%     |
|                     | 166,915,409   | Market Quote         | Third-Party Bid-Ask Mid         | 4.9% 102.0%     |
| Equity Securities   | 150,524       | Market Quote         | Third-Party Bid-Ask Mid         | 0.25 2.50       |
| CLO Fund Securities | 5,831,800     | Discounted Cash Flow | Discount Rate                   | 3.52% 5.57%     |
|                     | \$176,684,976 |                      |                                 |                 |

As of December 31, 2015, the Manager's Level 3 portfolio investments had the following valuation techniques and significant inputs:

| Type                | Fair Value    | Valuation Technique  | Unobservable inputs     | Range of Inputs |
|---------------------|---------------|----------------------|-------------------------|-----------------|
| Debt Securities     | 234,403,150   | Market Quote         | Third-Party Bid-Ask Mid | 10.8% 101.0%    |
|                     |               |                      |                         |                 |
| Equity Securities   | 2,830         | Market Quote         | Third-Party Bid-Ask Mid | 0.13 1.0        |
| CLO Fund Securities | 12,360,525    | Discounted Cash Flow | Discount Rate           | 3.82% 5.89%     |
|                     | \$246,766,505 |                      |                         |                 |

The following tables show a reconciliation of the beginning and ending fair value measurements for Level 3 liabilities using significant unobservable inputs:

|                         | For the year ended December 31, 2016 |
|-------------------------|--------------------------------------|
| Beginning balance       | \$261,433,473                        |
| Repayments              | (54,179,244 )                        |
| Unrealized depreciation | 1,557,935                            |
| Ending balance          | \$208,812,164                        |
|                         | \$1,557,935                          |

Changes in unrealized appreciation (depreciation) included in earnings related to liabilities still held at reporting date

|   | For the year ended<br>December 31,<br>2015 |
|---|--|
| Beginning balance   | \$290,699,426                              |
| Repayments  | (23,002,449 )                              |
| Unrealized depreciation   | (6,263,504 )                               |
| Ending balance  | \$261,433,473                              |
| Changes in unrealized appreciation included in earnings related to liabilities still held at reporting date | \$(6,263,504 )                             |

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## KATONAH 2007-I CLO LTD.

### NOTES TO FINANCIAL STATEMENTS

#### 3. INVESTMENTS (continued)

Transfers between levels, if any, are recognized at the beginning of the quarter in which the transfers occur. ASC 820-10 specifies a hierarchy of valuation techniques based on whether the inputs to those valuation techniques are observable or unobservable. In accordance with ASC 820-10, these inputs are summarized in the three broad levels listed below.

Level 1 Valuations based on quoted prices in active markets for identical assets or liabilities that the Fund has the ability to access.

Level 2 Valuations based on quoted prices in markets that are not active or for which all significant inputs are observable, either directly or indirectly

Level 3 Valuations based on inputs that are unobservable and significant to the overall fair value measurement  
The Fund's debt is presented at fair value with the difference between principal and fair value recorded as unrealized gain/loss. The par amount of the Fund's debt is approximately \$220 million and \$274 million as of December 31, 2016 and December 31, 2015, respectively.

The Manager has determined that, although the junior tranches have certain characteristics of equity, they should be accounted for and disclosed as debt on the Fund's Statement of Net Assets, as the subordinated and income notes have a stated maturity indicating a date for which they are mandatorily redeemable. The preference shares are also classified as debt, as they are mandatorily redeemable upon liquidation or termination of the Fund.

#### 4. INCOME TAXES

Under the current laws, the Fund is not subject to net income taxation in the United States or the Cayman Islands. Accordingly, no provision for income taxes has been made in the accompanying financial statements.

Pursuant to ASC Topic 740, *Accounting for Uncertainty in Income Taxes*, the Fund adopted the provisions of Financial Accounting Standards Board (FASB) relating to accounting for uncertainty in income taxes which clarifies the accounting for income taxes by prescribing the minimum recognition threshold a tax position must meet before being recognized in the financial statements and applies to all open tax years as of the effective date. As of December 31, 2016 and 2015 there was no impact to the financial statements as a result of the Fund's accounting for uncertainty in income taxes. The Fund does not have any unrecognized tax benefits or liabilities for the years ended December 31, 2016, 2015 and 2014. Also, the Fund recognizes interest and, if applicable, penalties for any uncertain tax positions, as a component of income tax expense. No interest or penalty expense was recorded by the Fund for the years ended December 31, 2016, 2015 and 2014.

TABLE OF CONTENTS**KATONAH 2007-I CLO LTD.****NOTES TO FINANCIAL STATEMENTS****5. DEBT**

On January 23, 2008, the Fund issued \$323.9 million of notes or debt securities, consisting of the Class A-1L Floating Rate Notes, the Class A-2L Floating Rate Notes, the Class A-3L Floating Rate Notes, the Class B-1L Floating Rate Notes, the Class B-2L Floating Rate Notes and the preferred shares. The notes were issued pursuant to the Indenture. The table below sets forth certain information for each outstanding class of debt securities issued pursuant to the Indenture.

| Title of Debt Security         | Principal Amount | Amount Outstanding | Interest Rate | Maturity       | Fair Value    |
|--------------------------------|------------------|--------------------|---------------|----------------|---------------|
| Class A-1L Floating Rate Notes | \$122,686,300    | \$122,686,300      | LIBOR + 0.85% | April 23, 2022 | \$122,673,114 |
| Class A-2L Floating Rate Notes | 26,000,000       | 26,000,000         | LIBOR + 1.50% | April 23, 2022 | 26,062,401    |
| Class A-3L Floating Rate Notes | 18,000,000       | 18,000,000         | LIBOR + 2.00% | April 23, 2022 | 18,059,400    |
| Class B-1L Floating Rate Notes | 11,000,000       | 11,000,000         | LIBOR + 3.00% | April 23, 2022 | 11,025,300    |
| Class B-2L Floating Rate Notes | 10,500,000       | 10,500,000         | LIBOR + 5.00% | April 23, 2022 | 10,538,850    |
| Preferred Shares               | 31,411,736       | 31,411,736         | N/A           | April 23, 2022 | 20,453,099    |
|                                | \$219,598,036    | \$219,598,036      |               |                | \$208,812,164 |

During 2016 and 2015, approximately \$54 million and \$23 million of the Class A-1L Floating Rate Notes was repaid in the normal course of business of the Fund, respectively.

**6. COMMITMENTS AND CONTINGENCIES**

As of December 31, 2016 and 2015 the Fund had no commitments to fund investments.

**7. CAPITALIZATION**

The authorized share capital of the Fund is \$32,250, consisting of 250 ordinary shares of \$1.00 par value, each of which are issued and fully paid, and 32,000,000 preferred shares, 31,411,736 of which are issued and fully paid. The ordinary shares that have been issued are held by Maples Finance Limited, a licensed trust company incorporated in the Cayman Islands, as the trustee pursuant to the terms of a charitable trust. The preferred shares that have been issued by the Fund are owned by KCAP Financial. The preferred shares are classified as debt in the Fund's financial statements, as they are mandatorily redeemable upon liquidation or termination of the Fund.



## **8. SUBSEQUENT EVENTS**

The Fund has evaluated events and transactions occurring subsequent to December 31, 2016 for items that should potentially be recognized or disclosed in these financial statements. Management has determined that there are no material subsequent events that would require adjustment to, or disclosure in, these financial statements.

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**EXHIBIT INDEX**

| Exhibit Number | Description   |
|----------------|---|
| 3.1            | Form of Certificate of Incorporation of the Company. <sup>(1)</sup>   |
| 3.2            | Form of Bylaws of the Company, as amended and restated effective February 29, 2012. <sup>(2)</sup>  |
| 4.1            | Specimen certificate of the Company's common stock, par value \$0.01 per share. <sup>(1)</sup>  |
| 4.2            | Form of Dividend Reinvestment Plan. <sup>(3)</sup>  |
| 4.3            | Form of Base Indenture between the Company and U.S. Bank National Association relating to the 7.375% Senior Notes Due 2019. <sup>(4)</sup>  |
| 4.4            | Form of First Supplemental Indenture between the Company and U.S. Bank National Association relating to the 7.375% Senior Notes Due 2019. <sup>(4)</sup>  |
| 4.5            | Form of Note relating to the 7.375% Senior Notes Due 2019 (included as part of Exhibit 4.4)   |
| 10.1           | Form of the Amended and Restated 2006 Equity Incentive Plan. <sup>(5)*</sup>  |
| 10.2           | Form of Company Non-Qualified Stock Option Certificate. <sup>(3)*</sup>   |
| 10.3           | Form of Custodian Agreement. <sup>(3)</sup>   |
| 10.4           | Form of Overhead Allocation Agreement between the Company and Katonah Debt Advisors, L.L.C. <sup>(3)</sup>  |
| 10.5           | Form of Executive Employment Agreement. <sup>(6)*</sup>   |
| 10.6           | Form of Indemnification Agreement for Officers and Directors of the Company. <sup>(7)</sup>   |
| 10.7           | Amended and Restated Non-Employee Director Plan. <sup>(8)*</sup>  |
| 10.8           | Purchase Agreement, dated June 16, 2013, by and among KCAP Financial, Inc., KCAP Senior Funding I Holdings, LLC, KCAP Senior Funding I, LLC and Guggenheim Securities, LLC. <sup>(9)</sup>            |
| 10.9           | Master Loan Sale Agreement, dated June 18, 2013, by and among KCAP Financial, Inc., KCAP Senior Funding I Holdings, LLC and KCAP Senior Funding I, LLC. <sup>(10)</sup>                               |
| 10.10          | Indenture, dated June 18, 2013, by and between KCAP Senior Funding I, LLC and U.S. Bank National Association. <sup>(11)</sup>   |
| 10.11          | Collateral Management Agreement, dated June 18, 2013, by and between KCAP Senior Funding I, LLC and KCAP Financial, Inc. <sup>(12)</sup>  |
| 10.12          | Collateral Administration Agreement, dated June 18, 2013, by and among KCAP Senior Funding I, LLC and U.S. Bank National Association and U.S. Bank National Association. <sup>(13)</sup>              |
| 10.13          | Upsize Purchase Agreement, dated December 4, 2014, by and among KCAP Financial, Inc., KCAP Senior Funding I Holdings, LLC, KCAP Senior Funding I, LLC and Guggenheim Securities, LLC. <sup>(14)</sup> |
| 10.14          | Subordinated Note Purchase Agreement, dated December 8, 2014, by and between KCAP Senior Funding I, LLC and KCAP Senior Funding I Holdings, LLC. <sup>(15)</sup>                                      |
| 10.15          | First Supplemental Indenture, dated December 8, 2014, by and between KCAP Senior Funding I, LLC and U.S. Bank National Association. <sup>(16)</sup>   |
| 11.1           | Computation of Per Share Earnings (included in the notes to the audited financial statements contained in this report).   |
| 21.1           | List of Subsidiaries. <sup>(17)</sup>   |
| 31.1           | Chief Executive Officer Certification Pursuant to Rule 13a-14 of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.**                         |
| 31.2           | Chief Financial Officer Certification Pursuant to Rule 13a-14 of the Securities Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.**                                  |
| 32.1           |   |

Chief Executive Officer Certification pursuant to Section 1350, Chapter 63 of Title 18, United States Code, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.\*\*

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| Exhibit<br>Number | Description |
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|      |   |
|------|---|
| 32.2 | Chief Financial Officer Certification pursuant to Section 1350, Chapter 63 of Title 18, United States Code, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.** |
|------|---|

- (1) Incorporated by reference to the exhibit included in Pre-Effective Amendment No. 1 on Form N-2, as filed on October 6, 2006 (File No. 333-136714).
- (2) Incorporated by reference to Exhibit 3.1 of the Current Report on Form 8-K, as filed on March 1, 2012 (File No. 814-00735).
- (3) Incorporated by reference to the exhibit included in Pre-Effective Amendment No. 2 on Form N-2, as filed on November 20, 2006 (File No. 333-136714).
- (4) Incorporated by reference to exhibit included in the Registration Statement in Form N-2, as filed on October 3, 2012 (File No. 333-183032).
- (5) Incorporated by reference to Exhibit 10.1 of the Quarterly Report on Form 10-Q, as filed on August 5, 2015 (File No. 814-00735).
- (6) Incorporated by reference to Exhibit 10.1 of the Quarterly Report on Form 10-Q, as filed on May 6, 2015 (File No. 814-00735).
- (7) Incorporated by reference to the exhibit included in Pre-Effective Amendment No. 3 on Form N-2, as filed on November 24, 2006 (File No. 333-136714).
- (8) Incorporated by reference to Exhibit 4.1 included in the Registration Statement on Form S-8, as filed on July 28, 2011 (File No. 333-175838).
- (9) Incorporated by reference to Exhibit 10.1 of Current Report on Form 8-K, as filed on June 19, 2013.
- (10) Incorporated by reference to Exhibit 10.2 of Current Report on Form 8-K, as filed on June 19, 2013.
- (11) Incorporated by reference to Exhibit 10.3 of Current Report on Form 8-K, as filed on June 19, 2013.
- (12) Incorporated by reference to Exhibit 10.4 of Current Report on Form 8-K, as filed on June 19, 2013.
- (13) Incorporated by reference to Exhibit 10.5 of Current Report on Form 8-K, as filed on June 19, 2013.
- (14) Incorporated by reference to Exhibit 10.1 of Current Report on Form 8-K, as filed on December 9, 2014.
- (15) Incorporated by reference to Exhibit 10.2 of Current Report on Form 8-K, as filed on December 9, 2014.
- (16) Incorporated by reference to Exhibit 10.3 of Current Report on Form 8-K, as filed on December 9, 2014.
- (17) Incorporated by reference to Exhibit 21.1 of Annual Report on Form 10-K, as filed on March 9, 2016.

\* Indicates a management contract or compensatory plan, contract or agreement.

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Filed herewith.