

FitchRatings

Research Commentary

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Fitch Rates American Capital Senior Debt 'BBB-'; Outlook Positive

Fitch Ratings-New York-August 3, 2005: Fitch rates American Capital Strategies, Ltd. (ACAS) \$126 million 6.14% debt due in 2010 'BBB-'. The Rating Outlook is Positive. Previously, Fitch rated ACAS on a private basis. Total rated unsecured debt is \$293 million.

ACAS' rating strengths center on the company's position as one of the premier business development companies (BDC) in the U.S. with significant portfolio and management controls. Additionally, ACAS maintains a meaningful corporate infrastructure to support its portfolio companies while maintaining good profitability and a well-capitalized balance sheet. Specific to unsecured debt investors, the company's coverage ratios, as of June 30, 2005, were solid.

Rating concerns consist of ACAS' outsized asset growth since 1998 and expansion into Europe, which will require incremental management oversight. Also, the company is still principally a secured borrower, although this is changing. Management has established a goal of having unsecured debt make up 50% of its total debt. At June 30, 2005, unsecured debt accounted for less than 10% of total debt.

ACAS reported record net income for 2003 and 2004. Based on the company's first-half financial results, ACAS is on track to report another record year in 2005. More important, the company's profitability could improve for the third consecutive year. As recently as 2000, ACAS reported a net loss, due to significant unrealized losses in its investment portfolio. While the company continued to report annual net investment losses for the 2001 through 2003 period, increased operating income as a result of higher loans outstanding resulted in a positive net income. Net income accelerated in 2004 and 2005 as ACAS reported strong operating income, with realized and unrealized gains/losses aggregated, from the investment portfolio. Fitch believes that much of the improvement in the company's investment results was directly related to the work that the Financial

Analysis and Compliance Team (FACT) and Operations team performed during the initial underwriting and improved deal flow.

Fitch believes that ACAS' revenue stream is good quality as it is predominately composed of interest and dividend income from portfolio companies, with a rising component of fee income derived from prepayment fees, investment banking and syndication related fees, as well as operating services provided to portfolio companies. Payment-in-kind (PIK) income has gradually increased and comprised over 16.7% of operating income for the six-month period ending June 30, 2005. However, as a percentage of net income, PIK revenue was only 12% for this period, which is within Fitch's expectations for the current rating. Due to ACAS' low leverage, the company's coverage ratios are very strong.

In terms of credit quality, as a BDC, ACAS is not permitted to take reserves for losses and instead must revalue its portfolio on a quarterly basis and reflect all increases and decreases in appreciation or depreciation in its income statement. This accounting requirement has resulted in wide fluctuations and volatility in reported net income over the past five years. Through the establishment of the FACT and Operations teams beginning in 2000, Fitch believes that ACAS' credit underwriting expertise has sharply improved. This improvement is reflected in the company's investment results, as equity investments originated post-2000 are now beginning to be harvested.

Additionally, loan asset quality has improved since 2003 as reflected in the drop in the percentage of assets graded 1 and 2 from almost 17% at Dec. 31, 2003 to 12% at June 30, 2005. The percentage of assets more than 90 days past due has substantially declined over the past four years from the peak of 6.40% at Dec. 31, 2001 to 0.8% at June 30, 2005. While Fitch recognizes that ACAS' loan asset quality and equity investment results most likely benefited from the general improvement in the domestic economy over the last 24 months, a return to the levels reported in the 1999-2003 period is unlikely, given the highly disciplined nature of the company's credit underwriting process.

Historically, management has funded ACAS through a combination of secured debt and common equity. As part of the company's corporate development, management has revised its funding strategy to include unsecured long-term debt. Management seeks to have a 50/50 mix between secured and unsecured debt and expects to achieve this over the intermediate term. Fitch believes that, in light of ACAS' asset base, this funding mix is acceptable, as the company will still be able to demonstrate asset liquidity in secondary markets while maintaining a high degree of financial flexibility.

ACAS' capitalization and leverage are rating strengths. As a BDC, ACAS is required to keep its financial leverage below 1.00 times (x) while paying out at least 90% of its ordinary earnings as dividends. The combination of these factors is good news/bad news for investors. The low leverage provides investors a margin of safety rarely seen in the commercial finance industry. However, ACAS' inability to retain earnings causes the company to rely on issuing additional equity in order to support growth. Through the implementation of a forward equity program in 2004, ACAS management has sought to remove some of the volatility associated with issuing equity in future periods while improving the efficiency of these transactions.

By virtue of its BDC status and leverage limitation, a significant component of ACAS' loan portfolio is unencumbered. As part of the review process, the company provided Fitch with schedules detailing its unencumbered loan portfolio both by industry and investment rating at March 31, 2005 as well as revenue and interest expense associated with the unencumbered loan portfolio for 12 months ending March 31, 2005. Based on the amount of eligible assets, as defined as unencumbered loans rated 4, 3, or 2, ACAS' unencumbered portfolio provides solid coverage by both asset and revenue measurements. Fitch's approach to this analysis, in terms of revenue recognition, excluded PIK revenue, dividends from equity investments, and free cash flow generated by the currently outstanding collateralized loan obligations.

In April 2005, ACAS announced its plans to expand to Europe, with the opening of a Paris office of its affiliate, European Capital. European Capital intends to invest EUR5 million to EUR125 million per transaction in equity, mezzanine debt and senior debt to fund growth acquisitions and recapitalizations. European Capital is expected to be structured as a portfolio company, thereby limiting ACAS' financial exposure.

American Capital Strategies, Ltd. (ACAS) is a publicly traded buyout and mezzanine fund that provides investment capital in the form of senior and subordinated debt and equity to middle market companies. At June 30, 2005, total assets totaled over \$4.3 billion.

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