

RESEARCH

Research Update:

American Capital Strategies Ltd. Assigned 'BBB' Rating, Outlook Stable

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Rationale

On Dec. 18, 2006, Standard & Poor's Ratings Services assigned its 'BBB' counterparty credit rating on American Capital Strategies Ltd. (NASDAQ: ACAS). The outlook is stable.

The ratings are based on the firm's good to excellent returns on private investments, excellent liquidity management, significant scale relative to competitors and the competitive advantage of its permanent capital base and infrastructure. Offsetting factors include very rapid growth, a high risk portfolio, and the constraints that private investments may place on asset liquidity during adverse markets.

American Capital is a private equity firm that provides debt and equity capital to middle market companies, defined as companies of \$30 million-\$500 million in enterprise value. American Capital focuses on financing buyouts either as the lead equity investor or as a senior debt and/or mezzanine lender. The firm also makes direct investments to support recapitalizations, distressed situations and the growth of middle-size companies. With almost \$8 billion in assets and a permanent capital base, American Capital has been able to develop an infrastructure to survey, select and structure investments in private, middle-market companies. Over the past two years, management has moved to invest in commercial real estate (CMBS) bonds and to establish funds of private assets that the firm will both invest in and manage for third parties. These moves to grow its European business and add fund management (with its more stable fee income) also strengthen our view of the firm's credit worthiness.

Our view of the firm's ability to maintain adequate cash flow during market disruptions or a prolonged downturn is critical to the rating. While low asset liquidity has been a hallmark of the private equity business, American Capital has demonstrated an ability to securitize assets and garners steady cash flow from its fixed income investments. Debt funding is solid and cash flow coverage metrics have been adequate even during periods of economic softness. In addition, management has cultivated excellent access to equity markets. The firm's use of forward equity sales bolsters our view of its ability to maintain funding during a downturn. American Capital's permanent capital base and the breadth of its business are also strengths. Nevertheless, management's decision to grow rapidly limits the rating, especially in the context of a leveraged finance market that has sustained high returns for

longer than has historically been the case. Although we believe American Capital's valuation procedures are strong, these procedures also assume a value consistent with current markets. Thus during a market disruption or recession, the value of the firm's assets would decrease along with enterprise value of its investments. The firm's permanent capital and systematic investing platform have helped American Capital carve out a strong competitive position during a robust market. We remain wary of the firm's rapid growth and the high risk profile of its portfolio.

Outlook

The stable outlook is driven by economic indicators that point toward expanding commercial activity, but the possibility of some weakening private equity markets in the medium term. This outlook imputes continued access to capital markets, some abatement of portfolio growth and the likelihood that earnings will decline in the event of economic softness.

As the firm's rapid growth abates, an upgrade could result from an increase in the proportion of market insensitive revenue from fund management accompanied by stable cash interest coverage. A downgrade could result in the event that a market pullback causes degraded access to capital markets and greater than expected deterioration in interest coverage metrics.

Ratings List

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New Rating; CreditWatch/Outlook Action

American Capital Strategies Ltd.
Counterparty Credit Rating

BBB/Stable/--

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