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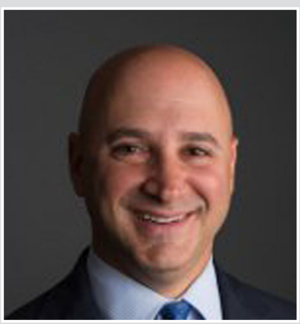
THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Capital Southwest Corporation (NASDAQ:CSWC)

BOWEN S. DIEHL is President and Chief Executive Officer of Capital Southwest Corporation. Mr. Diehl joined Capital Southwest in 2014 and leads the firm's investment activities. He brings almost 20 years of experience in sourcing, structuring and managing investments in a variety of industries. Mr. Diehl came to Capital Southwest from American Capital, Ltd., which he joined in 2001 and was a managing director since 2007. He has closed investments in 15 platform companies and numerous add-on acquisitions, representing over $1.1 billion of invested capital. Mr. Diehl's investments have been in a variety of industries including industrial manufacturing, health care, business services and consumer finance. Mr. Diehl earned a Bachelor of Engineering degree, with majors in environmental/geotechnical engineering and economics, from Vanderbilt University and a Master of Business Administration from the University of Texas at Austin.



MICHAEL SARNER is the Chief Financial Officer at Capital Southwest Corporation and is responsible for initiatives related to the refocus of its BDC activities. Mr. Sarner joined Capital Southwest in the summer of 2015, and brings over 20 years of financial, treasury and BDC experience. Before joining the company, he spent 15 years at American Capital, Ltd., in a variety of financial roles, most recently as Senior Vice President, Treasury. Mr. Sarner received a BBA in business administration/accounting from James Madison University, an MBA in finance from George Washington University's School of Business and Public Management, and is a certified public accountant. Mr. Sarner now lives in Dallas with his wife and three sons.

SECTOR — FINANCIAL SERVICES

TWST: Capital Southwest initiated somewhat of a reorganization in September. Can you tell us about that?

Mr. Diehl: Capital Southwest went public in 1961 with a $15 million offering, which was the last time the firm raised outside capital. It historically invested solely in the equity of small companies and typically held those investments for very long periods of time. There were a couple of industrial investments that had originated back in the 1960s and 1970s, which performed very well over very long hold periods. We had one investment, RectorSeal, marked at $370 million in value with a $53,000 cost basis. However, Capital Southwest owned 100% of the equity in the companies, and the investments grew to represent about 60% of the portfolio.

As a BDC, from both a regulatory and tax perspective, that creates a number of structural challenges that limited our ability to make other investments, and the market recognized these constraints by valuing our stock materially below NAV. When these industrial investments had grown to be large enough to be a public company on their own, we saw an opportunity to restructure the company to better align the industrial businesses within a more appropriate legal structure and to redirect our remaining equity capital in a credit investment strategy more typical of BDCs.

At the end of September, we spun out our industrial business to shareholders in a new publicly traded company called CSW Industrials. Each shareholder of Capital Southwest received one share of CSW Industrials for each share held of Capital Southwest. CSW Industrials trades today on Nasdaq under the ticker CSWI, and continues to grow organically and seek add-on acquisitions.

In parallel with our work over the last year on the spinoff, we have been divesting many of the legacy equity holdings, converting them to cash. We have built a credit investment team to take that cash and redirect it into a yield-oriented credit investment strategy. We've sold most of the assets we're going to sell, and we've invested $50 million or so in new credits, marking significant progress toward building a credit-focused business development company. We operate under an internally managed BDC structure, which we believe is a better structure for shareholder alignment.

TWST: What are the trends currently taking place in the middle market?

Mr. Diehl: I'll separate the middle market into two segments. First is the upper middle market, which includes companies with $50 million of EBITDA and higher. Those deals are typically large syndicated credits where we would typically buy a $5 million to $7 million participation in a $100 million to $200 million first lien or second lien credit facility.

The other market that we are very active in is the lower middle market. This market includes companies with $3 million to $15 million in EBITDA, lending directly to the companies and, in many cases, partnering with private equity firms. In these deals, we are either the sole lender, or we are one of a couple lenders in a club situation.

Those two markets are very different, as you can imagine. Clearly, the larger market is the one that is more efficient in incorporating real-time investor demand into pricing and leverage structures. The metrics in that market are more easily observable, and we have seen the yields and structures in that market become somewhat more investor-friendly over the past few months. It has been a nice opportunity for us to invest in some attractive credits at better yields and prices than we might have seen six months ago. We saw it in particular in the post-Labor Day syndication launches, where almost every second lien credit either priced wide of original guidance or was pulled. We love having significant liquidity during this type of market and expect to continue to see attractive risk-adjusted opportunities, especially if the current credit cycle runs out.

In the lower middle market, real-time pricing and leverage is less efficient because deal structures generally get set at the term-sheet stage, and you often don't have the opportunity to reprice a deal in the 30 to 60 days it may take to go from term sheet to closing. We see the initial signs of improved pricing in the lower middle market. We have tried to push for more pricing on deals, and it feels like we've had some success at the margin.

Overall, the middle market is alive and well, and private equity firms have significant capital to put to work. There are plenty of firms out there lending money, and so from our perspective, there is certainly not any kind of liquidity crisis. Deal flow is generally strong, and we are seeing a nice flow of attractive opportunities. That said, we are still seeing many marginal credits that, frankly, wouldn't have been on the market a year or two ago, which is certainly a sign that there remains a view among many issuers that the market is white hot for financing transactions.

TWST: What makes something a good investment for you? What are you looking for?

Mr. Diehl: We are certainly looking for companies that have a competitive advantage, management teams that have experience and a track record, companies that are relevant in their market and companies that we can understand how they are relevant to their customers in a sustainable way. But on top of that, we are heavily biased toward noncyclical companies and/or companies where we can specifically quantify how they performed in the Great Recession. The one benefit we have, and not just us but anyone doing deals these days, is we have the Great Recession in our rearview mirror. We can all analyze and understand how businesses perform when the wheels come off in the economy, as well as how lenders can exercise rights to protect themselves when things go bad.

So we go back and look at Great Recession performance in every deal we consider and then replicate that performance at certain years of our financial projections, making sure the capital structure and our risk position is appropriate for the business and industry. We look at a private equity sponsor's track record as well as that of the management team, want to see an appropriate amount of equity capital below our debt and a management team with significant equity interest in the success of the portfolio company. We have a stable of sponsor relationships developed over the years at prior firms, and it has been fun to apply the flexible resources of Capital Southwest to those relationships. As far as things we avoid, we avoid significant customer or supplier concentration, as well as binary stroke-of-the-pen risk with government agencies.

Mr. Sarner: Another method we use to assess whether an investment is a good fit for us is understanding its place on the Capital Southwest balance sheet. We make a conscious effort to marry up the left and the right side of our balance sheet, whether that be from a fixed/floating matching of interest rates or maintaining diversity among industries and issuers to ensure optimal financing terms and advance rates from Capital Southwest's lenders. In order to achieve the cheapest cost of capital and the optimal return on equity for each investment, we monitor our diversification requirements and invest with discipline. We feel strongly that, by investing in this manner, we are constructing a portfolio that will perform in all cycles.

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TWST: What is the process of deal generation? How does a deal come to you?

Mr. Diehl: We are actively out in the market sourcing deals from private equity firms, intermediaries, as well as other lenders. We actively cover deal sources across the southern half of the country, Southern California over to Florida, and increasingly in the Midwest. On the larger-market syndicated side, Josh Weinstein, who recently joined us from H.I.G. WhiteHorse, has relationships across the different syndication desks in New York, which has provided a nice flow of first and second lien opportunities. Additionally, at the end of September, we announced the I-45 Senior Loan Fund with Main Street Capital in Houston. That fund will invest approximately $250 million in a granular portfolio of upper-middle-market first lien credits.

TWST: Tell us a little more about I-45, your partnership with Main Street Capital. What was the reasoning behind that partnership?

Mr. Diehl: First of all, the senior loan fund structure is prevalent across the BDC landscape right now. So the fund structure itself is not unique from that perspective. We like the upper-middle-market first lien asset class for a couple of reasons.

First, we have been very careful to construct an allocation of Capital Southwest's capital across different classes of credit investments in a way that balances lower-beta, lower-ROE credits with higher-beta, higher-ROE credits. I-45 is invested in large-market, floating-rate, relatively liquid first lien assets and is levered only 2-to-1, which we think balances nicely with our lower-middle-market assets that are illiquid in nature and often have a fixed interest rate.

Second, we have substantial investable capital on the balance sheet resulting from the divestiture of many of our legacy equity assets. The large-market syndicated first and second lien asset classes are more liquid, so we can make thoughtful credit decisions and ramp capital into those asset classes more quickly than in the lower middle market without taking undue risk. With the market being backed up a bit post-Labor Day, it's been an interesting place to invest.

As we think about I-45, Main Street has been active in the large-market first lien syndicated market for some time, and they have been a very good partner. Capital Southwest and Main Street jointly control the fund, so there is no credit that goes in the fund that we do not both underwrite and approve. So from my perspective, we have created an important partnership with one of the leading investment firms in our market and have put an attractive pool of assets on our book relatively quickly while not outsourcing our credit judgment. We have enjoyed getting to know the Main Street team over the past year and are very pleased with the early progress of our I-45 portfolio.

but are mindful that we may likely be in the late innings of this credit cycle. We aren't in any rush and are truly excited about the opportunity to thoughtfully execute our business plan at a time where we feel opportunity is plentiful.

TWST: Do you have a time frame of when you plan to deploy that cash?

Mr. Diehl: Well, in some sense, it matters when the deals present themselves. We don't want to go out and put money to work just to do it. We are judicious about that. As I mentioned before, one of the reasons the I-45 Senior Loan Fund is important is that it allows us to access an asset class that we believe not only fits our portfolio, but it is also an asset class in which we can identify and make investments with attractive risk-adjusted returns at a more rapid pace than the lower middle market without taking outsized risk.

Mr. Sarner: We see ramping the I-45 Senior Loan Fund in about 12 months. We have recently announced a credit facility with Deutsche Bank that will provide up to two times leverage within the fund and thus provide for a total fund size of up to $250 million. Now that the leverage is in place, we are able to ramp those dollars alongside the equity dollars. Once fully ramped, this fund should produce 11% to 12% returns on our equity investment in the fund. It takes longer to originate lower-middle-market investments, the relationships have a longer sales cycle, and there is more friction to getting those deals done. So we think that our lower-middle-market strategy will take two-plus years to fully deploy.

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TWST: You mentioned the changes in the portfolio. Is it where you would like it to be?

Mr. Diehl: Right now, we are still building out the portfolio. We are making decisions today regarding what our portfolio construction will look like with the end game in mind. Specifically, we are planning an asset mix that we believe will provide our shareholders with the most reliable, most sustainable market dividend with a steadily growing net asset value per share. We currently have approximately $276 million of investable equity capital with no debt on our balance sheet. So as we invest that equity capital in debt investments, we are building out a collateral base that we believe will allow us to effectively lever the balance sheet.

Today, our portfolio includes about $50 million of credit investments, about $50 million of legacy equity assets, and have made excellent progress toward ramping the I-45 fund. We have a plan to take our earning assets under management from $276 million today to over $650 million, including prudent leverage securing different portions of our investment strategy. As far as progress in transitioning the portfolio, we've sold almost all of the legacy equity assets we identified for divestiture and are executing our growth plan for the remaining legacy assets. We are excited about the credits that we've been putting on our books, and we continue to see some really interesting opportunities.

So overall, I am very happy with the progress thus far, but it is $50 million on the way to $600 million-plus. With $183 million of cash and no leverage on the balance sheet, we have a lot of work to do

We plan to seek leverage on our SBIC license during calendar 2016, and if successful, this leverage should allow us to produce a levered return on our SBIC assets in the high teens. Lastly, our direct middle-market business, outside the SBIC, including last out senior unitranche and broadly syndicated first and second lien assets, will likely take up to 18 months to fully deploy. We plan on utilizing these assets as collateral for an on-balance-sheet financing, which we expect to close during the first half of 2016. So overall we plan to fully deploy our initial post-spin equity capital within two to three years across all three of our investment platforms.

TWST: Tell us about your backgrounds.

Mr. Diehl: I joined Capital Southwest in March of 2014 after spending over 12 years at American Capital as a senior deal professional in the Dallas office. Before that, I was an investment banker in New York and Houston. American Capital invested in both debt and equity on both a control and noncontrol basis. Most recently at American Capital, I was one of the co-heads of the Sponsor Finance Group, which is their lending business.

Mr. Sarner: I joined Capital Southwest in July of this year after spending the previous 15 years working at American Capital, the last 10 of which I was the Treasurer. Prior to that, I worked in several finance companies and have an audit background in public accounting.

Mr. Diehl: We were blessed to be able to convince Michael to move his family from Virginia down here to Dallas. Michael spent over 15 years at American Capital, initially as the first finance-department employee during its startup phase to the last 10 years as Treasurer, managing a very complicated balance sheet. In addition to running debt capital markets at American Capital, he also ran all capital planning, treasury operations, BDC and RIC compliance as well as serviced all debt capital. So as you can imagine, for a BDC like Capital Southwest transforming into an active middle-market lender, that skill set is critical. Additionally, his extensive knowledge and experience managing internal systems and controls, compliance and tax planning is critically important for Capital Southwest.

TWST: Tell us about the rest of your team.

Mr. Diehl: On the deal side, I was able to recruit a senior deal professional from American Capital, Doug Kelley. Doug and I worked together at American Capital for over 10 years. Doug is an extremely bright, very astute credit investor. He has a strong track record of originating investment opportunities, structuring and closing deals, as well as managing a credit portfolio. He and I worked together through the Great Recession. We saw investments perform well, and we saw some that did not, and are able to take that experience and knowledge of the reasons for the outperformance or underperformance and apply that experience to investing in today's market.

Bill Ashbaugh, a managing director on the team, has been with Capital Southwest since 2001. Bill has strong knowledge of the legacy portfolio, and is very well-known and liked in the Southwest market. Bill has proven to be an effective originator of lower-middle-market credit opportunities.

We recruited Josh Weinstein to join Capital Southwest as a principal. Josh is an experienced credit investor, most recently spending eight years at H.I.G. WhiteHorse, a very active credit platform here in Dallas, which includes a publicly traded BDC. He has deep experience in both underwriting and structuring opportunities on the large-market syndicated side, both second lien and first lien, as well as underwriting and closing transactions in the middle market for their BDC. In addition, we have four other investment professionals, including two associates that we hired over the past year from large leverage finance firms.

Mr. Sarner: The finance and accounting team has come together very well too. I was able to convince Chris Rehberger, my former right-hand man at American Capital, to move his family to Dallas and join Capital Southwest as our Treasurer. We have a strong Controller; Jessie Porter, who came over from the Big Four, has been with Capital Southwest for the past four years maintaining a deep knowledge of legacy Capital Southwest. Rounding out the finance team are our two accountants, one with a long history with Capital Southwest and one recently hired with extensive public accounting experience.

Overall, we have set this team up not only to originate and close deals but, equally as important, to service and manage the portfolio. As we all know, sometimes the easy part is putting the money out; the hard part is getting it back.

TWST: What do you see as the most important strengths of Capital Southwest?

Mr. Diehl: I'm going to take that question from two different perspectives. One is a perspective of our shareholders. Our shareholders can buy any BDC stock, but they want to own ours. Why would they want to own ours versus the other 50 BDCs that are out there? First and foremost, one of our advantages is the internally managed model, which we believe is truly the most effective model to align management's interest with that of our shareholders.

All of our eggs are in the Capital Southwest basket. We don't have an external management contract that pays us in large part as a function of the BDC's assets under management or for managing other pools of capital. We are successful only if we increase CSWC shareholder dividends and net asset value per share, rather than merely increasing our asset base. In terms of the other internally managed BDC comps, you're generally talking about Main Street Capital and Triangle Capital, both of which are extremely respected and have extensive track records of success.

With respect to the market, Capital Southwest is a relatively small organization, but we have advantages. We believe that our size gives us an advantage in terms of being nimble. Michael and I not only sit on the investment committee, but we are also very active in deal flow so that our entire team knows where the firm stands at any given time on every deal. Our deal teams can make decisions quickly and speak for the firm, and that matters to our partners in the market. Lastly, while we invest and have relationships nationwide, we also think our presence in the Southwest is a true advantage in terms of economic performance and job creation, one which we definitely plan on capitalizing on.

Mr. Sarner: Another point I would make, in terms of this management team, Bowen and I were both with American Capital through a meteoric rise, a restructuring and a reorganization. We have seen things go well, and we've seen things go not so well. So we both have those experiences to draw from. I believe we are both better managers and leaders for having persevered through those times and gained perspective from the journey. Today, we have this unique opportunity to build a business from the ground floor using those experiences and lessons.

Mr. Diehl: The senior executives here have all worked together for a long time, and we are the beneficiaries of having lived through the turmoil of the Great Recession. Now, we have an opportunity to essentially rebuild Capital Southwest from scratch, and we are all pretty excited about that.

TWST: Thank you. (LMR)

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