

PROSPECT CAPITAL CORP
Form N-2/A
October 11, 2011

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As filed with the Securities and Exchange Commission on October 7, 2011

Registration No. 333-176637

U.S. SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM N-2

✓ REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933

✓ PRE-EFFECTIVE AMENDMENT NO. 1

o POST-EFFECTIVE AMENDMENT NO.

PROSPECT CAPITAL CORPORATION

(Exact Name of Registrant as Specified in Charter)

10 East 40th Street, 44th Floor
New York, NY 10016

(Address of Principal Executive Offices)

Registrant's Telephone Number, including Area Code: (212) 448-0702

John F. Barry III

Brian H. Oswald

c/o Prospect Capital Management LLC

10 East 40th Street, 44th Floor

New York, NY 10016

(212) 448-0702

(Name and Address of Agent for Service)

Copies of information to:

Richard T. Prins

Skadden Arps Slate Meagher & Flom LLP

4 Times Square

New York, NY 10036

(212) 735-3000

Approximate Date of Proposed Public Offering: As soon as practicable after the effective date of this Registration Statement.

If any securities being registered on this form will be offered on a delayed or continuous basis in reliance on Rule 415 under the Securities Act of 1933, other than securities offered in connection with a distribution reinvestment plan, check the following box. ✓

It is proposed that this filing will become effective (check appropriate box):

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- o when declared effective pursuant to section 8(c).
If appropriate, check the following box:
- o This post-effective amendment designates a new effective date for a previously filed post-effective amendment registration statement.
- o This form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act and the Securities Act registration statement number of the earlier effective registration statement for the same offering is .

CALCULATION OF REGISTRATION FEE UNDER THE SECURITIES ACT OF 1933

| Title of Securities Being Registered | Amount Being Registered | Proposed Maximum Offering Price Per Unit | Proposed Maximum Aggregate Offering Price(1) | Amount of Registration Fee |
|--|-------------------------|--|--|----------------------------|
| Common Stock, \$.001 par value per share(2) | | | | |
| Preferred Stock, \$.001 par value per share(2) | | | | |
| Debt Securities(3) | | | | |
| Warrants(4) | | | | |
| Units(5) | | | | |
| Total | \$750,000,000 | | \$750,000,000(6) | \$63,301(7) |

- (1) Estimated solely for the purpose of calculating the registration fee. Pursuant to Rule 457(o) of the rules and regulations under the Securities Act of 1933 (the "Securities Act"), which permits the registration fee to be calculated on the basis of the maximum offering price of all the securities listed, the table does not specify by each class information as to the amount to be registered, proposed maximum offering price per unit or proposed maximum aggregate offering price. Pursuant to Rule 415(a)(6) under the Securities Act, this registration statement covers a total of \$530,675,000 of unsold securities that had previously been registered under the registrant's registration statement on Form N-2, initially filed with the Securities and Exchange Commission (the "SEC") on November 19, 2010 (No. 333-170724) (the "Prior Registration Statement") and that are being carried forward to this registration statement. The Prior Registration Statement initially registered securities for a maximum aggregate offering price of \$750,000,000 and of that amount the registrant has previously sold common stock for an aggregate offering price of \$219,325,000, leaving a balance of unsold securities with an aggregate offering price of \$530,675,000. In connection with the registration of securities on the Prior Registration Statement, the registrant paid a registration fee of \$37,837 covering such unsold securities and which registration fee is being carried forward to this registration statement and will continue to be applied to such unsold securities pursuant to Rule 415(a)(6). Pursuant to Rule 415(a)(6), the offering of the unsold securities registered under the Prior Registration Statement will be deemed terminated as of the date of effectiveness of this registration statement. If the registrant sells any of such unsold securities pursuant to the Prior Registration Statement after the date of the initial filing, and prior to the date of effectiveness, of this registration statement, the registrant will file a pre-effective amendment to this registration statement which will reduce the number of such unsold securities included on this registration statement.
- (2) Subject to Note 6 below, there is being registered hereunder an indeterminate principal amount of common stock or preferred stock as may be sold, from time to time separately or as units in combination with other securities registered hereunder.
- (3) Subject to Note 6 below, there is being registered hereunder an indeterminate principal amount of debt securities as may be sold, from time to time separately or as units in combination with other securities registered hereunder. If any debt securities are issued at an original issue discount, then the offering price shall be in such greater principal amount as shall result in an aggregate price to investors not to exceed \$750,000,000.
- (4) Subject to Note 6 below, there is being registered hereunder an indeterminate principal amount of warrants as may be sold, from time to time separately or as units in combination with other securities registered hereunder, representing rights to purchase common stock, preferred stock or debt securities.
- (5) Subject to Note 6 below, there is being registered hereunder an indeterminate number of units. Each unit may consist of a combination of any one or more securities being registered hereunder and may also include securities being issued by third parties, including the U.S. Treasury.
- (6) In no event will the aggregate offering price of all securities issued from time to time pursuant to this registration statement exceed \$750,000,000.

(7)

Previously paid.

THE REGISTRANT HEREBY AMENDS THIS REGISTRATION STATEMENT ON SUCH DATE OR DATES AS MAY BE NECESSARY TO DELAY ITS EFFECTIVE DATE UNTIL THE REGISTRANT SHALL FILE A FURTHER AMENDMENT WHICH SPECIFICALLY STATES THAT THE REGISTRATION STATEMENT SHALL THEREAFTER BECOME EFFECTIVE IN ACCORDANCE WITH SECTION 8(A) OF THE SECURITIES ACT OF 1933 OR UNTIL THE REGISTRATION STATEMENT SHALL BECOME EFFECTIVE ON SUCH DATES AS THE COMMISSION, ACTING PURSUANT TO SAID SECTION 8(A), MAY DETERMINE.

The information in this preliminary prospectus is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission has been declared effective. This preliminary prospectus is not an offer to sell nor does it seek an offer to buy these securities in any jurisdiction where the offer or sale is not permitted.

SUBJECT TO COMPLETION, DATED OCTOBER 7, 2011

\$750,000,000

PROSPECT CAPITAL CORPORATION

**Common Stock
Preferred Stock
Debt Securities
Warrants
Units**

We may offer, from time to time, in one or more offerings or series, together or separately, up to \$750,000,000 of our common stock, preferred stock, debt securities, warrants representing rights to purchase shares of common stock, preferred stock or debt securities, or units comprised of any combination of the foregoing, collectively, the Securities, to provide us with additional capital. Securities may be offered at prices and on terms to be disclosed in one or more supplements to this prospectus. You should read this prospectus and the applicable prospectus supplement carefully before you invest in our Securities.

We may offer shares of common stock, or warrants, options or rights to acquire shares of common stock, at a discount to net asset value per share in certain circumstances. Sales of common stock at prices below net asset value per share dilute the interests of existing stockholders, have the effect of reducing our net asset value per share and may reduce our market price per share. At our 2010 annual meeting, held on December 10, 2010, our stockholders approved our ability to sell or otherwise issue an unlimited number of shares of our common stock at any level of discount from net asset value per share for a period of twelve months, expiring on December 10, 2011. We are currently seeking stockholder approval at our 2011 annual meeting, to be held on December 8, 2011, to continue for an additional year our ability to issue shares of common stock below net asset value, subject to the condition that the maximum number of shares salable below net asset value pursuant to this authority in any particular offering that could result in such dilution is limited to 25% of our then outstanding common stock immediately prior to each such offering.

Our Securities may be offered directly to one or more purchasers, or through agents designated from time to time by us, or to or through underwriters or dealers. The prospectus supplement relating to the offering will identify any agents or underwriters involved in the sale of our Securities, and will disclose any applicable purchase price, fee, commission or discount arrangement between us and our agents or underwriters or among our underwriters or the basis upon which such amount may be calculated. See "Plan of Distribution." We may not sell any of our Securities through agents, underwriters or dealers without delivery of the prospectus and a prospectus supplement describing the method and terms of the offering of such Securities. Our common stock is traded on The NASDAQ Global Select Market under the symbol "PSEC." As of October 6, 2011, the last reported sales price for our common stock was \$8.71.

Prospect Capital Corporation, or the Company, is a company that lends to and invests in middle market privately-held companies. Prospect Capital Corporation, a Maryland corporation, has been organized as a closed-end investment company since April 13, 2004 and has filed an election to be treated as a business development company under the Investment Company Act of 1940, as amended, or the 1940 Act, and is a non-diversified investment company within the meaning of the 1940 Act.

Prospect Capital Management LLC, our investment adviser, manages our investments and Prospect Administration LLC, our administrator, provides the administrative services necessary for us to operate.

Investing in our Securities involves a heightened risk of total loss of investment and is subject to risks.

Before buying any Securities, you should read the discussion of the material risks of investing in our Securities in "Risk Factors" beginning on page 10 of this prospectus.

This prospectus contains important information about us that you should know before investing in our Securities. Please read it before making an investment decision and keep it for future reference. We file annual, quarterly and current reports, proxy statements and other information about us with the Securities and Exchange Commission, or the SEC. You may make inquiries or obtain this information free of charge by writing to Prospect Capital Corporation at 10 East 40th Street, 44th Floor, New York, NY 10016, or by calling 212-448-0702. Our Internet address is <http://www.prospectstreet.com>. Information contained on our website is not incorporated by reference into this prospectus and you should not consider information contained on our website to be a part of this prospectus. You may also obtain information about us from our website and the SEC's website (<http://www.sec.gov>).

The SEC has not approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

This prospectus may not be used to consummate sales of securities unless accompanied by a prospectus supplement.

The date of this Prospectus is _____, 2011

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ABOUT THIS PROSPECTUS

This prospectus is part of a registration statement that we have filed with the SEC, using the "shelf" registration process. Under the shelf registration process, we may offer, from time to time on a delayed basis, up to \$750,000,000 of our common stock, preferred stock, debt securities or warrants representing rights to purchase shares of our common stock, preferred stock or debt securities, or units comprised of any combination of the foregoing, on the terms to be determined at the time of the offering. The Securities may be offered at prices and on terms described in one or more supplements to this prospectus. This prospectus provides you with a general description of the Securities that we may offer. Each time we use this prospectus to offer Securities, we will provide a prospectus supplement that will contain specific information about the terms of that offering. The prospectus supplement may also add, update or change information contained in this prospectus. Please carefully read this prospectus and any prospectus supplement together with any exhibits and the additional information described under the heading "Available Information" and the section under the heading "Risk Factors" before you make an investment decision.

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PROSPECTUS SUMMARY

The following summary contains basic information about this offering. It does not contain all the information that may be important to an investor. For a more complete understanding of this offering, we encourage you to read this entire document and the documents to which we have referred.

Information contained or incorporated by reference in this prospectus may contain "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995, which are statements about the future that may be identified by the use of forward-looking terminology such as "may," "will," "expect," "intend," "plans," "anticipate," "estimate" or "continue" or the negative thereof or other variations thereon or comparable terminology. These forward-looking statements do not meet the safe harbor for forward-looking statements pursuant to Section 27A of the Securities Act of 1933, as amended, or the Securities Act. The matters described in "Risk Factors" and certain other factors noted throughout this prospectus and in any exhibits to the registration statement of which this prospectus is a part, constitute cautionary statements identifying important factors with respect to any such forward-looking statements, including certain risks and uncertainties, that could cause actual results to differ materially from those in such forward-looking statements. The Company reminds all investors that no forward-looking statement can be relied upon as an accurate or even mostly accurate forecast because humans cannot forecast the future.

The terms "we," "us," "our," "Prospect," and "Company" refer to Prospect Capital Corporation; "Prospect Capital Management" or the "Investment Adviser" refers to Prospect Capital Management LLC, our investment adviser; and "Prospect Administration" or the "Administrator" refers to Prospect Administration LLC, our administrator.

The Company

We are a financial services company that lends to and invests in middle market privately-held companies.

We were originally organized under the name "Prospect Street Energy Corporation" and we changed our name to "Prospect Energy Corporation" in June 2004. We changed our name again to "Prospect Capital Corporation" in May 2007 and at the same time terminated our policy of investing at least 80% of our net assets in energy companies. From our inception to the fiscal year ended June 30, 2007, we invested primarily in industries related to the industrial/energy economy. Since then, we have widened our strategy to focus on other sectors of the economy and continue to broaden our portfolio holdings.

We have been organized as a closed-end investment company since April 13, 2004 and have filed an election to be treated as a business development company under the 1940 Act. We are a non-diversified company within the meaning of the 1940 Act. Our headquarters are located at 10 East 40th Street, 44th Floor, New York, NY 10016, and our telephone number is (212) 448-0702.

The Investment Adviser

Prospect Capital Management, an affiliate of the Company, manages our investment activities. Prospect Capital Management is an investment adviser that has been registered under the Investment Advisers Act of 1940, or the Advisers Act, since March 31, 2004. Under an investment advisory and management agreement between us and Prospect Capital Management, or the Investment Advisory Agreement, we have agreed to pay Prospect Capital Management investment advisory fees, which will consist of an annual base management fee based on our gross assets, which we define as total assets without deduction for any liabilities, as well as a two-part incentive fee based on our performance.

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The Offering

We may offer, from time to time, in one or more offerings or series, together or separately, up to \$750,000,000 of our Securities, which we expect to use initially to maintain balance sheet liquidity, involving repayment of debt under our credit facility, investment in high quality short-term debt instruments or a combination thereof, and thereafter to make long-term investments in accordance with our investment objectives.

Our Securities may be offered directly to one or more purchasers, through agents designated from time to time by us, or to or through underwriters or dealers. The prospectus supplement relating to a particular offering will disclose the terms of that offering, including the name or names of any agents or underwriters involved in the sale of our Securities by us, the purchase price, and any fee, commission or discount arrangement between us and our agents or underwriters or among our underwriters, or the basis upon which such amount may be calculated. See "Plan of Distribution." We may not sell any of our Securities through agents, underwriters or dealers without delivery of a prospectus supplement describing the method and terms of the offering of our Securities.

We may sell our common stock, or warrants, options or rights to acquire our common stock, at a price below the current net asset value of our common stock upon approval of our directors, including a majority of our independent directors, in certain circumstances. At our 2010 annual meeting, held on December 10, 2010, our stockholders approved our ability to sell or otherwise issue an unlimited number of shares of our common stock at any level of discount from net asset value per share for a period of twelve months, expiring on December 10, 2011. We are currently seeking stockholder approval at our 2011 annual meeting, to be held on December 8, 2011, to continue for an additional year our ability to issue shares of common stock below net asset value, subject to the condition that the maximum number of shares salable below net asset value pursuant to this authority in any particular offering that could result in such dilution is limited to 25% of our then outstanding common stock immediately prior to each such offering. Similarly, our stockholders approved our ability to issue warrants, options or rights to acquire our common stock at our 2008 annual meeting of stockholders for an unlimited time period and in accordance with the 1940 Act which provides that the conversion or exercise price of such warrants, options or rights may be less than net asset value per share at the date such securities are issued or at the date such securities are converted into or exercised for shares of our common stock. See "Sales of Common Stock Below Net Asset Value" in this prospectus and in the prospectus supplement, if applicable. Sales of common stock at prices below net asset value per share dilute the interests of existing stockholders, have the effect of reducing our net asset value per share and may reduce our market price per share. We have no current intention of engaging in a rights offering, although we reserve the right to do so in the future.

Set forth below is additional information regarding the offering of our Securities:

Use of proceeds

Unless otherwise specified in a prospectus supplement, we intend to use the net proceeds from selling Securities pursuant to this prospectus initially to maintain balance sheet liquidity, involving repayment of debt under our credit facility, investments in high quality short-term debt instruments or a combination thereof, and thereafter to make long-term investments in accordance with our investment objective. See "Use of Proceeds."

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Distributions

In June 2010, our Board of Directors approved a change in dividend policy from quarterly distributions to monthly distributions. Since that time, we have paid monthly distributions to the holders of our common stock and generally intend to continue to do so. The amount of the monthly distributions is determined by our Board of Directors and is based on our estimate of our investment company taxable income and net short-term capital gains. Certain amounts of the monthly distributions may from time to time be paid out of our capital rather than from earnings for the month as a result of our deliberate planning or accounting reclassifications. Distributions in excess of our current or accumulated earnings or profits constitute a return of capital and will reduce the stockholder's adjusted tax basis in such stockholder's common stock. After the adjusted basis is reduced to zero, these distributions will constitute capital gains to such stockholders. Certain additional amounts may be deemed as distributed to stockholders for income tax purposes. Other types of Securities will likely pay distributions in accordance with their terms. See "Price Range of Common Stock," "Distributions" and "Material U.S. Federal Income Tax Considerations."

Taxation

We have qualified and elected to be treated for U.S. Federal income tax purposes as a regulated investment company, or a RIC, under Subchapter M of the Internal Revenue Code of 1986, or the Code. As a RIC, we generally do not have to pay corporate-level U.S. Federal income taxes on any ordinary income or capital gains that we distribute to our stockholders as dividends. To maintain our qualification as a RIC and obtain RIC tax treatment, we must maintain specified source-of-income and asset diversification requirements and distribute annually at least 90% of our ordinary income and realized net short-term capital gains in excess of realized net long-term capital losses, if any. See "Distributions" and "Material U.S. Federal Income Tax Considerations."

Dividend reinvestment plan

We have a dividend reinvestment plan for our stockholders. This is an "opt out" dividend reinvestment plan. As a result, when we declare a dividend, the dividends are automatically reinvested in additional shares of our common stock, unless a stockholder specifically "opts out" of the dividend reinvestment plan so as to receive cash dividends. Stockholders who receive distributions in the form of stock are subject to the same U.S. Federal, state and local tax consequences as stockholders who elect to receive their distributions in cash. See "Dividend Reinvestment Plan."

The NASDAQ Global Select Market

Symbol

PSEC

Anti-takeover provisions

Our charter and bylaws, as well as certain statutory and regulatory requirements, 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. See "Description Of Our Capital Stock."

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Management arrangements

Prospect Capital Management serves as our investment adviser. Prospect Administration serves as our administrator. For a description of Prospect Capital Management, Prospect Administration and our contractual arrangements with these companies, see "Business Management Services Investment Advisory Agreement," and "Business Management Services Administration Agreement."

Risk factors

Investment in our Securities involves certain risks relating to our structure and investment objective that should be considered by prospective purchasers of our Securities. We have a limited operating history upon which you can evaluate our business. In addition, as a business development company, our portfolio primarily includes securities issued by privately-held companies. These investments generally involve a high degree of business and financial risk, and are less liquid than public securities. We are required to mark the carrying value of our investments to fair value on a quarterly basis, and economic events, market conditions and events affecting individual portfolio companies can result in quarter-to-quarter mark-downs and mark-ups of the value of individual investments that collectively can materially affect our net asset value, or NAV. Also, our determinations of fair value of privately-held securities may differ materially from the values that would exist if there was a ready market for these investments. A large number of entities compete for the same kind of investment opportunities as we do. Moreover, our business requires a substantial amount of capital to operate and to grow and we seek additional capital from external sources. In addition, the failure to qualify as a RIC eligible for pass-through tax treatment under the Code on income distributed to stockholders could have a materially adverse effect on the total return, if any, obtainable from an investment in our Securities. See "Risk Factors" and the other information included in this prospectus for a discussion of factors you should carefully consider before deciding to invest in our Securities.

Plan of distribution

We may offer, from time to time, up to \$750,000,000 of our common stock, preferred stock, debt securities or warrants representing rights to purchase shares of our common stock, preferred stock or debt securities, or units comprised of any combination of the foregoing, on the terms to be determined at the time of the offering. Securities may be offered at prices and on terms described in one or more supplements to this prospectus directly to one or more purchasers, through agents designated from time to time by us, or to or through underwriters or dealers. The supplement to this prospectus relating to the offering will identify any agents or underwriters involved in the sale of our Securities, and will set forth any applicable purchase price, fee and commission or discount arrangement or the basis upon which such amount may be calculated. We may not sell Securities pursuant to this prospectus without delivering a prospectus supplement describing the method and terms of the offering of such Securities. For more information, see "Plan of Distribution."

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Fees and Expenses

The following tables are intended to assist you in understanding the costs and expenses that an investor in this offering will bear directly or indirectly. We caution you that some of the percentages indicated in the table below are estimates and may vary. In these tables, we assume that we have borrowed \$400 million under our credit facility, which is the maximum amount available under the credit facility. We do not intend to issue preferred stock during the year. Except where the context suggests otherwise, whenever this prospectus contains a reference to fees or expenses paid by "you" or "us" or that "we" will pay fees or expenses, the Company will pay such fees and expenses out of our net assets and, consequently, you will indirectly bear such fees or expenses as an investor in the Company. However, you will not be required to deliver any money or otherwise bear personal liability or responsibility for such fees or expenses.

| | |
|--|--------|
| Stockholder transaction expenses: | |
| Sales load (as a percentage of offering price)(1) | 5.00% |
| Offering expenses borne by us (as a percentage of offering price)(2) | 0.50% |
| Dividend reinvestment plan expenses(3) | None |
| Total stockholder transaction expenses (as a percentage of offering price)(4) | 5.50% |
| Annual expenses (as a percentage of net assets attributable to common stock)(4): | |
| Management fees(5) | 3.35% |
| Incentive fees payable under Investment Advisory Agreement (20% of realized capital gains and 20% of pre-incentive fee net investment income)(6) | 2.11% |
| Total advisory fees | 5.46% |
| Interest payments on the credit facility | 1.53% |
| Interest payments on the 2010 Notes(7) | 0.84% |
| Interest payments on the 2011 Notes(8) | 0.85% |
| Total interest expense | 3.22% |
| Acquired Fund Fees and Expenses(9) | 0.01% |
| Other expenses(10) | 1.52% |
| Total annual expenses(6)(10) | 10.21% |

Example

The following table demonstrates the projected dollar amount of cumulative expenses we would pay out of net assets and that you would indirectly bear over various periods with respect to a hypothetical investment in our common stock. In calculating the following expense amounts, we have assumed we would have borrowed all \$400 million available under our line of credit, that our annual operating expenses would remain at the levels set forth in the table above and that we would pay the costs shown in the table above.

| | 1 Year | 3 Years | 5 Years | 10 Years |
|---|-----------|-----------|-----------|-----------|
| You would pay the following expenses on a \$1,000 investment, assuming a 5% annual return | \$ 131.54 | \$ 277.56 | \$ 414.68 | \$ 721.98 |

While the example assumes, as required by the SEC, a 5% annual return, our performance will vary and may result in a return greater or less than 5%. The income incentive fee under our Investment Advisory Agreement with Prospect Capital Management is unlikely to be material assuming a 5% annual return and is not included in the example. If we achieve sufficient returns on our

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investments, including through the realization of capital gains, to trigger an incentive fee of a material amount, our distributions to our common stockholders and our expenses would likely be higher. In addition, while the example assumes reinvestment of all dividends and other distributions at NAV, participants in our dividend reinvestment plan will receive a number of shares of our common stock determined by dividing the total dollar amount of the distribution payable to a participant by the market price per share of our common stock at the close of trading on the valuation date for the distribution. See "Dividend Reinvestment Plan" for additional information regarding our dividend reinvestment plan.

This example and the expenses in the table above should not be considered a representation of our future expenses. Actual expenses (including the cost of debt, if any, and other expenses) may be greater or less than those shown.

- (1) In the event that the Securities to which this prospectus relates are sold to or through underwriters, a corresponding prospectus supplement will disclose the estimated applicable sales load.
- (2) The related prospectus supplement will disclose the estimated amount of offering expenses, the offering price and the estimated offering expenses borne by us as a percentage of the offering price.
- (3) The expenses of the dividend reinvestment plan are included in "other expenses."
- (4) The related prospectus supplement will disclose the offering price and the total stockholder transaction expenses as a percentage of the offering price.
- (5) Our base management fee is 2% of our gross assets (which include any amount borrowed, i.e., total assets without deduction for any liabilities). Although no plans are in place to borrow the full amount under our line of credit, assuming that we borrowed \$400 million, the 2% management fee of gross assets equals approximately 3.35% of net assets. See "Business Management Services Investment Advisory Agreement" and footnote 6 below.
- (6) Based on the incentive fee paid during our fiscal year ended June 30, 2011, all of which consisted of an income incentive fee. For a more detailed discussion of the calculation of the two-part incentive fee, see "Management Services Investment Advisory Agreement" in this prospectus.
- (7) On December 21, 2010, the Company issued \$150 million in aggregate principal amount of 6.25% Convertible Senior Notes due 2015, which we refer to as the 2010 Notes. See "Business General" and "Risk Factors Risks Related to our Business" for more detail on the 2010 Notes.
- (8) On February 18, 2011, the Company issued \$172.5 million in aggregate principal amount of 5.5% Convertible Senior Notes due 2016, which we refer to as the 2011 Notes. See "Business General" and "Risk Factors Risks Related to our Business" for more detail on the 2011 Notes. The 2011 Notes and the 2010 Notes are referred to collectively as the Notes.
- (9) The Company's stockholders indirectly bear the expenses of underlying investment companies in which the Company invests. This amount includes the fees and expenses of investment companies in which the Company is invested in as of June 30, 2011. When applicable, fees and expenses are based on historic fees and expenses for the investment companies and for those investment companies with little or no operating history, fees and expenses are based on expected fees and expenses stated in the investment companies' prospectus or other similar communication without giving effect to any performance. Future fees and expenses for certain investment companies may be substantially higher or lower because certain fees and expenses are based on the performance of the investment companies, which may fluctuate over time. The amount of the Company's

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average net assets used in calculating this percentage was based on net assets of approximately \$1.1 billion as of June 30, 2011.

- (10) "Other expenses" are based on estimated amounts for the current fiscal year. The amount shown above represents annualized expenses during our three months ended June 30, 2011 representing all of our estimated recurring operating expenses (except fees and expenses reported in other items of this table) that are deducted from our operating income and reflected as expenses in our Statement of Operations. The estimate of our overhead expenses, including payments under an administration agreement with Prospect Administration, or the Administration Agreement, based on our projected allocable portion of overhead and other expenses incurred by Prospect Administration in performing its obligations under the Administration Agreement. "Other expenses" does not include non-recurring expenses. See "Business Management Services Administration Agreement."

Table of Contents**SELECTED CONDENSED FINANCIAL DATA**

You should read the condensed consolidated financial information below with the Consolidated Financial Statements and notes thereto included in this prospectus. Financial information below for the years ended June 30, 2011, 2010, 2009, 2008 and 2007 has been derived from the financial statements that were audited by our independent registered public accounting firm. Certain reclassifications have been made to the prior period financial information to conform to the current period presentation. See "Management's Discussion and Analysis of Financial Condition and Results of Operations" starting on page 33 for more information.

| | For the Year/Period Ended June 30, | | | | |
|--|------------------------------------|-------------------|-------------------|-------------------|-------------------|
| | 2011 | 2010 | 2009 | 2008 | 2007 |
| (in thousands except data relating to shares, per share and number of portfolio companies) | | | | | |
| Performance Data: | | | | | |
| Interest income | \$ 134,454 | \$ 86,518 | \$ 62,926 | \$ 59,033 | \$ 30,084 |
| Dividend income | 15,092 | 15,366 | 22,793 | 12,033 | 6,153 |
| Other income | 19,930 | 12,675 | 14,762 | 8,336 | 4,444 |
| Total investment income | 169,476 | 114,559 | 100,481 | 79,402 | 40,681 |
| Interest and credit facility expenses | (17,598) | (8,382) | (6,161) | (6,318) | (1,903) |
| Investment advisory expense | (46,051) | (30,727) | (26,705) | (20,199) | (11,226) |
| Other expenses | (11,606) | (8,260) | (8,452) | (7,772) | (4,421) |
| Total expenses | (75,255) | (47,369) | (41,318) | (34,289) | (17,550) |
| Net investment income | 94,221 | 67,190 | 59,163 | 45,113 | 23,131 |
| Realized and unrealized gains (losses) | 24,017 | (47,565) | (24,059) | (17,522) | (6,403) |
| Net increase in net assets from operations | \$ 118,238 | \$ 19,625 | \$ 35,104 | \$ 27,591 | \$ 16,728 |
| Per Share Data: | | | | | |
| Net increase in net assets from operations(1) | \$ 1.38 | \$ 0.33 | \$ 1.11 | \$ 1.17 | \$ 1.06 |
| Distributions declared per share | \$ (1.21) | \$ (1.33) | \$ (1.62) | \$ (1.59) | \$ (1.54) |
| Average weighted shares outstanding for the period | 85,978,757 | 59,429,222 | 31,559,905 | 23,626,642 | 15,724,095 |
| Assets and Liabilities Data: | | | | | |
| Investments | \$ 1,463,010 | \$ 748,483 | \$ 547,168 | \$ 497,530 | \$ 328,222 |
| Other assets | 86,307 | 84,212 | 119,857 | 44,248 | 48,280 |
| Total assets | 1,549,317 | 832,695 | 667,025 | 541,778 | 376,502 |
| Amount drawn on credit facility | 84,200 | 100,300 | 124,800 | 91,167 | |
| 2010 Notes | 150,000 | | | | |
| 2011 Notes | 172,500 | | | | |
| Amount owed to related parties | 7,918 | 9,300 | 6,713 | 6,641 | 4,838 |
| Other liabilities | 20,342 | 11,671 | 2,916 | 14,347 | 71,616 |
| Total liabilities | 434,960 | 121,271 | 134,429 | 112,155 | 76,454 |
| Net assets | \$ 1,114,357 | \$ 711,424 | \$ 532,596 | \$ 429,623 | \$ 300,048 |
| Investment Activity Data: | | | | | |
| No. of portfolio companies at period end | 72 | 58 | 30 | 29(2) | 24(2) |

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| | | | | | | | | | | |
|--|----|---------|----|------------|----|--------|----|---------|----|---------|
| Acquisitions | \$ | 953,337 | \$ | 364,788(3) | \$ | 98,305 | \$ | 311,947 | \$ | 167,255 |
| Sales, repayments, and other disposals | \$ | 285,562 | \$ | 136,221 | \$ | 27,007 | \$ | 127,212 | \$ | 38,407 |
| Weighted-Average Yield at end of period(4) | | 12.8% | | 14.2% | | 13.7% | | 15.5% | | 17.1% |

- (1) Per share data is based on average weighted shares for the period
- (2) Includes a net profits interest in Charlevoix Energy Trading LLC ("Charlevoix"), remaining after loan was paid.
- (3) Includes \$207,126 of acquired portfolio investments from Patriot Acquisition.
- (4) Includes dividends from certain equity investments.

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RISK FACTORS

Investing in our Securities involves a high degree of risk. You should carefully consider the risks described below, together with all of the other information included in this prospectus, before you decide whether to make an investment in our Securities. The risks set forth below are not the only risks we face. If any of the adverse events or conditions described below occur, our business, financial condition and results of operations could be materially adversely affected. In such case, our NAV, and the trading price of our common stock could decline, or the value of our preferred stock, debt securities, warrants, and units, if any are outstanding, may decline, and you may lose all or part of your investment.

Risks Relating To Our Business

We may suffer credit losses.

Investment in small and middle-market companies is highly speculative and involves a high degree of risk of credit loss. These risks are likely to increase during volatile economic periods, such as the US and many other economies have recently been experiencing. See "Risks Related to Our Investments."

Our financial condition and results of operations will depend on our ability to manage our future growth effectively.

Prospect Capital Management has been registered as an investment adviser since March 31, 2004, and we have been organized as a closed-end investment company since April 13, 2004. Our ability to achieve our investment objective depends on our ability to grow, which depends, in turn, on our Investment Adviser's ability to continue to identify, analyze, invest in and monitor companies that meet our investment criteria. Accomplishing this result on a cost-effective basis is largely a function of our Investment Adviser's structuring of investments, its ability to provide competent, attentive and efficient services to us and our access to financing on acceptable terms. As we continue to grow, Prospect Capital Management will need to continue to hire, train, supervise and manage new employees. Failure to manage our future growth effectively could have a materially adverse effect on our business, financial condition and results of operations.

We are dependent upon Prospect Capital Management's key management personnel for our future success.

We depend on the diligence, skill and network of business contacts of the senior management of our Investment Adviser. We also depend, to a significant extent, on our Investment Adviser's access to the investment professionals and the information and deal flow generated by these investment professionals in the course of their investment and portfolio management activities. The senior management team of the Investment Adviser evaluates, negotiates, structures, closes, monitors and services our investments. Our success depends to a significant extent on the continued service of the senior management team, particularly John F. Barry III and M. Grier Eliasek. The departure of any of the senior management team could have a materially adverse effect on our ability to achieve our investment objective. In addition, we can offer no assurance that Prospect Capital Management will remain our investment adviser or that we will continue to have access to its investment professionals or its information and deal flow.

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 in target companies. We compete with other business development companies, public and private funds, commercial and investment banks and commercial financing companies. Additionally, because competition for investment opportunities generally has increased among alternative investment vehicles, such as hedge funds, those entities have begun to invest in areas they have not traditionally invested in,

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including investments in middle-market companies. As a result of these new entrants, competition for investment opportunities at middle-market companies has intensified, a trend we expect to continue.

Many of our existing and potential competitors are substantially larger and have considerably greater financial, technical and marketing resources than we do. For example, some competitors may have a lower cost of funds and access to funding sources that are not available to us. 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 and establish more or fuller relationships with borrowers and sponsors than us. Furthermore, many of our competitors are not subject to the regulatory restrictions that the 1940 Act imposes on us as a business development company. We cannot assure you that the competitive pressures we face will not have a materially adverse effect on our business, financial condition and results of operations. Also, as a result of existing and increasing competition and our competitors ability to provide a total package solution, we may not be able to take advantage of attractive investment opportunities from time to time, and we can offer no assurance that we will be able to identify and make investments that are consistent with our investment objective.

We do not seek to compete primarily based on the interest rates that we offer, and we believe that some of our competitors make loans with interest rates that are comparable to or lower than the rates we offer. We may lose investment opportunities if we do not match our competitors' pricing, terms and structure. If we match our competitors' pricing, terms and structure, we may experience decreased net interest income and increased risk of credit loss.

Most of our portfolio investments are recorded at fair value as determined in good faith by our Board of Directors and, as a result, there is uncertainty as to the value of our portfolio investments.

A large percentage of our portfolio investments consist of securities of privately held companies. Hence, market quotations are generally not readily available for determining the fair values of such investments. The determination of fair value, and thus the amount of unrealized losses we may incur in any year, is to a degree subjective, and the Investment Adviser has a conflict of interest in making the determination. We value these securities quarterly at fair value as determined in good faith by our Board of Directors based on input from our Investment Adviser, a third party independent valuation firm and our audit committee. Our Board of Directors utilizes the services of an independent valuation firm to aid it in determining the fair value of any securities. The types of factors that may be considered in determining the fair values of 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, current market interest rates and other relevant factors. Because such valuations, and particularly valuations of private securities and private companies, are inherently uncertain, the valuations may fluctuate significantly over short periods of time due to changes in current market conditions. The determinations of fair value by our Board of Directors may differ materially from the values that would have been used if an active market and market quotations existed for these investments. Our net asset value could be adversely affected if the determinations regarding the fair value of our investments were materially higher than the values that we ultimately realize upon the disposal of such securities.

In addition, decreases in the market values or fair values of our investments are recorded as unrealized depreciation. Unprecedented declines in prices and liquidity in the corporate debt markets experienced during the recent financial crises resulted in significant net unrealized depreciation in our portfolio in the past. The effect of all of these factors on our portfolio reduced our NAV by increasing net unrealized depreciation in our portfolio. Depending on market conditions, we could incur substantial realized losses and may continue to suffer additional unrealized losses in future periods, which could have a material adverse impact on our business, financial condition and results of operations.

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Senior securities, including debt, expose us to additional risks, including the typical risks associated with leverage and could adversely affect our business, financial condition and results of operations.

We currently use our revolving credit facility to leverage our portfolio and we expect in the future to borrow from and issue senior debt securities to banks and other lenders and may securitize certain of our portfolio investments. We also have the Notes outstanding, which are a form of leverage and are senior in payment to our common stock.

With certain limited exceptions, as a business development company, or BDC, we are only allowed to borrow amounts such that our asset coverage, as defined in the 1940 Act, is at least 200% after such borrowing. The amount of leverage that we employ will depend on our Investment Adviser's and our Board of Directors' assessment of market conditions and other factors at the time of any proposed borrowing. There is no assurance that a leveraging strategy will be successful. Leverage involves risks and special considerations for stockholders, including the following, any of which could adversely affect our business, financial condition and result of operations:

A likelihood of greater volatility in the net asset value and market price of our common stock;

Diminished operating flexibility as a result of asset coverage or investment portfolio composition requirements required by lenders or investors that are more stringent than those imposed by the 1940 Act;

The possibility that investments will have to be liquidated at less than full value or at inopportune times to comply with debt covenants or to pay interest or dividends on the leverage;

Increased operating expenses due to the cost of leverage, including issuance and servicing costs;

Convertible or exchangeable securities issued in the future may have rights, preferences and privileges more favorable than those of our common stock;

Subordination to lenders' superior claims on our assets as a result of which lenders will be able to receive proceeds available in the case of our liquidation before any proceeds will be distributed to our stockholders;

Making it more difficult for us to meet our payment and other obligations under the Notes and our other outstanding debt;

The occurrence of an event of default if we fail to comply with the financial and/or other restrictive covenants contained in our debt agreements, including the credit agreement and each indenture governing the Notes, which event of default could result in all or some of our debt becoming immediately due and payable;

Reduced availability of our cash flow to fund investments, acquisitions and other general corporate purposes, and limiting our ability to obtain additional financing for these purposes;

The risk of increased sensitivity to interest rate increases on our indebtedness with variable interest rates, including borrowings under our amended senior credit facility; and

Reduced flexibility in planning for, or reacting to, and increasing our vulnerability to, changes in our business, the industry in which we operate and the general economy.

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For example, the amount we may borrow under our revolving credit facility is determined, in part, by the fair value of our investments. If the fair value of our investments declines, we may be forced to sell investments at a loss to maintain compliance with our borrowing limits. Other debt facilities we may enter into in the future may contain similar provisions. Any such forced sales would reduce our NAV and also make it difficult for the net asset value to recover. Our Investment Adviser and our Board of Directors in their best judgment nevertheless may determine to use leverage if they expect that the benefits to our stockholders of maintaining the leveraged position will outweigh the risks.

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In addition, our ability to meet our payment and other obligations of the Notes and our credit facility depends on our ability to generate significant cash flow in the future. This, to some extent, is subject to general economic, financial, competitive, legislative and regulatory factors as well as other factors that are beyond our control. We cannot assure you that our business will generate cash flow from operations, or that future borrowings will be available to us under our existing credit facility or otherwise, in an amount sufficient to enable us to meet our payment obligations under the Notes and our other debt and to fund other liquidity needs. If we are not able to generate sufficient cash flow to service our debt obligations, we may need to refinance or restructure our debt, including the Notes, sell assets, reduce or delay capital investments, or seek to raise additional capital. If we are unable to implement one or more of these alternatives, we may not be able to meet our payment obligations under the Notes and our other debt.

Illustration. The following table illustrates the effect of leverage on returns from an investment in our common stock assuming various annual returns, net of interest expense. The calculations in the table below are hypothetical and actual returns may be higher or lower than those appearing below. The calculation assumes (i) \$1.5 billion in total assets, (ii) an average cost of funds of 5.88%, (iii) \$400 million in debt outstanding and (iv) \$1.1 billion of stockholders' equity.

| | | | | | |
|--|-----------------|----------------|----------------|--------------|---------------|
| Assumed Return on Our Portfolio (net of expenses) | (10)% | (5)% | 0% | 5% | 10% |
| Corresponding Return to Stockholder | (15.77)% | (8.96)% | (2.14)% | 4.68% | 11.50% |

The assumed portfolio return is required by regulation of the SEC and is not a prediction of, and does not represent, our projected or actual performance. Actual returns may be greater or less than those appearing in the table.

The Notes present other risks to holders of our common stock, including the possibility that the Notes could discourage an acquisition of the Company by a third party and accounting uncertainty.

Certain provisions of the Notes could make it more difficult or more expensive for a third party to acquire us. Upon the occurrence of certain transactions constituting a fundamental change, holders of the Notes will have the right, at their option, to require us to repurchase all of their Notes or any portion of the principal amount of such Notes in integral multiples of \$1,000. We may also be required to increase the conversion rate or provide for conversion into the acquirer's capital stock in the event of certain fundamental changes. These provisions could discourage an acquisition of us by a third party.

The accounting for convertible debt securities is subject to frequent scrutiny by the accounting regulatory bodies and is subject to change. We cannot predict if or when any such change could be made and any such change could have an adverse impact on our reported or future financial results. Any such impacts could adversely affect the market price of our common stock.

We fund a portion of our investments with borrowed money, which magnifies the potential for gain or loss on amounts invested and may increase the risk of investing in us.

Borrowings and other types of financing, also known as leverage, magnify the potential for gain or loss on amounts invested and, therefore, increase the risks associated with investing in our securities. Our lenders have fixed dollar claims on our assets that are superior to the claims of our common stockholders or any preferred stockholders. If the value of our assets increases, then leveraging would cause the net asset value to increase more sharply than it would have had we not leveraged. Conversely, if the value of our assets decreases, leveraging would cause net asset value to decline more sharply than it otherwise would have had we not leveraged. Similarly, any increase in our income in excess of consolidated interest payable on the borrowed funds would cause our net income to increase more than it would without the leverage, while any decrease in our income would cause net income to decline more sharply than it would have had we not borrowed. Such a decline could negatively affect

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our ability to make common stock dividend payments. Leverage is generally considered a speculative investment technique.

We may in the future determine to fund a portion of our investments with preferred stock, which would magnify the potential for gain or loss and the risks of investing in us in the same way as our borrowings.

Preferred stock, which is another form of leverage, has the same risks to our common stockholders as borrowings because the dividends on any preferred stock we issue must be cumulative. Payment of such dividends and repayment of the liquidation preference of such preferred stock must take preference over any dividends or other payments to our common stockholders, and preferred stockholders are not subject to any of our expenses or losses and are not entitled to participate in any income or appreciation in excess of their stated preference.

In addition to regulatory restrictions that restrict our ability to raise capital, our credit facility contains various covenants which, if not complied with, could accelerate repayment under the facility, thereby materially and adversely affecting our liquidity, financial condition and results of operations.

The agreement governing our credit facility requires us to comply with certain financial and operational covenants. These covenants include:

restrictions on the level of indebtedness that we are permitted to incur in relation to the value of our assets;

restrictions on our ability to incur liens; and

maintenance of a minimum level of stockholders' equity.

As of June 30, 2011, we were in compliance with these covenants. However, our continued compliance with these covenants depends on many factors, some of which are beyond our control. Accordingly, there are no assurances that we will continue to comply with the covenants in our credit facility. Failure to comply with these covenants would result in a default under this facility which, if we were unable to obtain a waiver from the lenders thereunder, could result in an acceleration of repayments under the facility and thereby have a material adverse impact on our business, financial condition and results of operations.

Failure to extend our existing credit facility, the revolving period of which is currently scheduled to expire on June 13, 2012, could have a material adverse effect on our results of operations and financial position and our ability to pay expenses and make distributions.

The revolving period for our credit facility with a syndicate of lenders is currently scheduled to terminate on June 13, 2012. If the credit facility is not renewed or extended by the participant banks by June 13, 2012, we will not be able to make further borrowings under the facility after such date and the outstanding principal balance on that date will be due and payable on June 13, 2013. At June 30, 2011 we had outstanding borrowings of \$84.2 million under our credit facility. Interest on borrowings under the credit facility is one-month LIBOR plus 325 basis points, subject to a minimum LIBOR floor of 100 basis points. Additionally, the lenders charge a fee on the unused portion of the credit facility equal to either 75 basis points if at least half of the credit facility is used or 100 basis points otherwise. If we are unable to extend our facility or find a new source of borrowing on acceptable terms, we will be required to pay down the amounts outstanding under the facility during the one-year term-out period through one or more of the following: (1) principal collections on our securities pledged under the facility, (2) at our option, interest collections on our securities pledged under the facility and cash collections on our securities not pledged under the facility, or (3) possible liquidation of some or all of our loans and other assets, any of which could have a material adverse effect on our results of operations and financial position and may force us to decrease or stop paying certain expenses and

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making distributions until the facility is repaid. In addition, our stock price could decline significantly, we would be restricted in our ability to acquire new investments and, in connection with our year-end audit, our independent registered accounting firm could raise an issue as to our ability to continue as a going concern.

Changes in interest rates may affect our cost of capital and net investment income.

A significant portion of the debt investments we make bears interest at fixed rates and the value of these investments could be negatively affected by increases in market interest rates. In addition, as the interest rate on our revolving credit facility is at a variable rate based on an index, an increase in interest rates would make it more expensive to use debt to finance our investments. As a result, a significant increase in market interest rates could both reduce the value of our portfolio investments and increase our cost of capital, which would reduce our net investment income.

We need to raise additional capital to grow because we must distribute most of our income.

We need additional capital to fund growth in our investments. A reduction in the availability of new capital could limit our ability to grow. We must distribute at least 90% of our ordinary income and realized net short-term capital gains in excess of realized net long-term capital losses, if any, to our shareholders to maintain our RIC status. As a result, such earnings are not available to fund investment originations. We have sought additional capital by borrowing from financial institutions and may issue debt securities or additional equity securities. If we fail to obtain funds from such sources or from other sources to fund our investments, we could be limited in our ability to grow, which may have an adverse effect on the value of our common stock. In addition, as a business development company, we are generally required to maintain a ratio of total assets to total borrowings and other senior securities of at least 200%, which may restrict our ability to borrow in certain circumstances.

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

We generally make investments in private companies. Substantially all of these securities are subject to legal and other restrictions on resale or are otherwise less liquid than publicly traded securities. The illiquidity of our investments may make it difficult for us to sell such investments if the need arises. 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 have previously recorded our investments. In addition, we may face other restrictions on our ability to liquidate an investment in a portfolio company to the extent that we or our Investment Adviser has material non-public information regarding such portfolio company.

We may experience fluctuations in our quarterly results.

We could experience fluctuations in our quarterly operating results due to a number of factors, including the interest or dividend rates payable on the debt or equity securities we hold, the default rate on debt securities, the level of our expenses, variations in and the timing of the recognition of realized and unrealized gains or losses, the degree to which we encounter competition in our markets, the seasonality of the energy industry, weather patterns, changes in energy prices 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.

Our most recent NAV was calculated as of June 30, 2011 and our NAV when calculated as of September 30, 2011 may be higher or lower.

Our most recently estimated NAV per share is \$10.04 on an as adjusted basis solely to give effect to distributions with record dates of July 29, 2011, August 31, 2011 and September 30, 2011, our

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issuance of common stock on July 22, 2011, August 26, 2011 and September 23, 2011 in connection with our dividend reinvestment plan, and our issuance of 1,500,000 shares of common stock on July 18, 2011 in connection with the option granted with the June 21, 2011 offering of 10,000,000 shares which were delivered June 24, 2011, versus \$10.36 determined by us as of June 30, 2011. NAV per share as of September 30, 2011, may be higher or lower than \$10.04 based on potential changes in valuations and earnings for the quarter then ended. Our Board of Directors has not yet determined the fair value of portfolio investments at any date subsequent to June 30, 2011. Our Board of Directors determines the fair value of our portfolio investments on a quarterly basis in connection with the preparation of quarterly financial statements and based on input from an independent valuation firm, our Investment Adviser and the audit committee of our Board of Directors.

Potential conflicts of interest could impact our investment returns.

Our executive officers and directors, and the executive officers of our Investment Adviser, Prospect Capital Management, may serve as officers, directors or principals of entities that operate in the same or related lines of business as we do or of investment funds managed by our affiliates. Accordingly, they may have obligations to investors in those entities, the fulfillment of which might not be in our best interests or those of our stockholders. Nevertheless, it is possible that new investment opportunities that meet our investment objective may come to the attention of one of these entities in connection with another investment advisory client or program, and, if so, such opportunity might not be offered, or otherwise made available, to us. However, as an investment adviser, Prospect Capital Management has a fiduciary obligation to act in the best interests of its clients, including us. To that end, if Prospect Capital Management or its affiliates manage any additional investment vehicles or client accounts in the future, Prospect Capital Management will endeavor to allocate investment opportunities in a fair and equitable manner over time so as not to discriminate unfairly against any client. If Prospect Capital Management chooses to establish another investment fund in the future, when the investment professionals of Prospect Capital Management identify an investment, they will have to choose which investment fund should make the investment.

In the course of our investing activities, under the Investment Advisory Agreement we pay base management and incentive fees to Prospect Capital Management, and reimburse Prospect Capital Management for certain expenses it incurs. As a result of the Investment Advisory Agreement, there may be times when the senior management team of Prospect Capital Management has interests that differ from those of our stockholders, giving rise to a conflict.

Prospect Capital Management receives a quarterly income incentive fee based, in part, on our pre-incentive fee net investment income, if any, for the immediately preceding calendar quarter. This income incentive fee is subject to a fixed quarterly hurdle rate before providing an income incentive fee return to the Investment Adviser. This fixed hurdle rate was determined when then current interest rates were relatively low on a historical basis. Thus, if interest rates rise, it would become easier for our investment income to exceed the hurdle rate and, as a result, more likely that our Investment Adviser will receive an income incentive fee than if interest rates on our investments remained constant or decreased. Subject to the receipt of any requisite stockholder approval under the 1940 Act, our Board of Directors may adjust the hurdle rate by amending the Investment Advisory Agreement.

The income incentive fee payable by us is computed and paid on income that may include interest that has been accrued but not yet received in cash. If a portfolio company defaults on a loan that has a deferred interest feature, it is possible that interest accrued under such loan that has previously been included in the calculation of the income incentive fee will become uncollectible. If this happens, our Investment Adviser is not required to reimburse us for any such income incentive fee payments. If we do not have sufficient liquid assets to pay this incentive fee or distributions to stockholders on such accrued income, we may be required to liquidate assets in order to do so. This fee structure could give rise to a conflict of interest for our Investment Adviser to the extent that it may encourage the

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Investment Adviser to favor debt financings that provide for deferred interest, rather than current cash payments of interest.

We have entered into a royalty-free license agreement with Prospect Capital Management. Under this agreement, Prospect Capital Management agrees to grant us a non-exclusive license to use the name "Prospect Capital." Under the license agreement, we have the right to use the "Prospect Capital" name for so long as Prospect Capital Management or one of its affiliates remains our Investment Adviser. In addition, we rent office space from Prospect Administration, an affiliate of Prospect Capital Management, and pay Prospect Administration our allocable portion of overhead and other expenses incurred by Prospect Administration in performing its obligations as Administrator under the Administration Agreement, including rent and our allocable portion of the costs of our chief financial officer and chief compliance officer and their respective staffs. This may create conflicts of interest that our Board of Directors monitors.

Our incentive fee could induce Prospect Capital Management to make speculative investments.

The incentive fee payable by us to Prospect Capital Management may create an incentive for our Investment Adviser to make investments on our behalf that are more speculative or involve more risk than would be the case in the absence of such compensation arrangement. The way in which the incentive fee payable is determined (calculated as a percentage of the return on invested capital) may encourage the Investment Adviser to use leverage to increase the return on our investments. Increased use of leverage and this increased risk of replacement of that leverage at maturity, would increase the likelihood of default, which would disfavor holders of our common stock. Similarly, because the Investment Adviser will receive an incentive fee based, in part, upon net capital gains realized on our investments, the Investment Adviser may invest more than would otherwise be appropriate in companies whose securities are likely to yield capital gains, as compared to income producing securities. Such a practice could result in our investing in more speculative securities than would otherwise be the case, which could result in higher investment losses, particularly during economic downturns.

The incentive fee payable by us to Prospect Capital Management could create an incentive for our Investment Adviser to invest on our behalf in instruments, such as zero coupon bonds, that have a deferred interest feature. Under these investments, we would accrue interest income over the life of the investment but would not receive payments in cash on the investment until the end of the term. Our net investment income used to calculate the income incentive fee, however, includes accrued interest. For example, accrued interest, if any, on our investments in zero coupon bonds will be included in the calculation of our incentive fee, even though we will not receive any cash interest payments in respect of payment on the bond until its maturity date. Thus, a portion of this incentive fee would be based on income that we may not have yet received in cash in the event of default may never receive.

We may be obligated to pay our investment adviser incentive compensation even if we incur a loss.

Our investment adviser is entitled to incentive compensation for each fiscal quarter based, in part, on our pre-incentive fee net investment income if any, for the immediately preceeding calendar quarter above a performance threshold for that quarter. Accordingly, since the performance threshold is based on a percentage of our net asset value, decreases in our net asset value make it easier to achieve the performance threshold. Our pre-incentive fee net investment income for incentive compensation purposes excludes realized and unrealized capital losses or depreciation that we may incur in the fiscal quarter, even if such capital losses or depreciation result in a net loss on our statement of operations for that quarter. Thus, we may be required to pay Prospect Capital Management incentive compensation for a fiscal quarter even if there is a decline in the value of our portfolio or we incur a net loss for that quarter.

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Changes in laws or regulations governing our operations may adversely affect our business.

We and our portfolio companies are subject to regulation by laws at the local, state and U.S. Federal levels. These laws and regulations, as well as their interpretation, may be changed from time to time. Accordingly, changes in these laws or regulations could have a material adverse effect on our business. For additional information regarding the regulations we are subject to, see "Regulation."

Foreign and domestic political risk may adversely affect our business.

We are exposed to political risk to the extent that Prospect Capital Management, on its behalf and subject to its investment guidelines, transacts in securities in the U.S. and foreign markets. The governments in any of these jurisdictions could impose restrictions, regulations or other measures, which may have a material adverse impact on our strategy.

Capital markets have recently been in a period of disruption and instability. These market conditions have materially and adversely affected debt and equity capital markets in the United States and abroad, which have had, and may in the future have, a negative impact on our business and operations.

The U.S. and foreign capital markets have recently been in a period of disruption as evidenced by a lack of 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 certain major financial institutions. Despite actions of the United States 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 these conditions appear to be improving, they could continue for a prolonged period of time or worsen in the future. In addition, while these conditions persist, we and other companies in the financial services sector may have to access, if available, alternative markets for debt and equity capital in order to grow. Equity capital may be difficult to raise 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. At our annual meeting of stockholders held on December 10, 2010, subject to certain determinations required to be made by our Board of Directors, our stockholders approved our ability to sell or otherwise issue shares of our common stock at a price below its then current net asset value per share for a twelve month period expiring on the anniversary of the date of stockholder approval. We are currently seeking stockholder approval at our 2011 annual meeting, to be held on December 8, 2011, to continue for an additional year our ability to issue shares of common stock below net asset value, subject to the condition that the maximum number of shares salable below net asset value pursuant to this authority in any particular offering that could result in such dilution is limited to 25% of our then outstanding common stock immediately prior to each such offering. In addition, our ability to incur indebtedness or issue other senior securities (including by issuing preferred stock) is limited by applicable regulations such that our asset coverage, as defined in the 1940 Act, must equal at least 200% immediately after each time we incur indebtedness or issue other senior securities. The debt capital that will be available, if at all, may be at a higher cost and on less favorable terms and conditions in the future. Any inability to raise capital could have a negative effect on our business, financial condition and results of operations.

Moreover, recent market conditions have made, and may in the future make, it difficult to extend the maturity of or refinance our existing indebtedness and any failure to do so could have a material adverse effect on our business. The illiquidity of our investments may make it difficult for us to sell such investments if required. As a result, we may realize significantly less than the value at which we have recorded our investments.

Given the recent extreme volatility and dislocation in the capital markets, many BDCs have faced, and may in the future face, a challenging environment in which to raise capital. Recent significant

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changes in the capital markets affecting our ability to raise capital have affected the pace of our investment activity. In addition, significant changes in the capital markets, including the recent extreme volatility and disruption, has had, and may in the future have, a negative effect on the valuations of our investments and on the potential for liquidity events involving our investments. An inability to raise capital, and any required sale of our investments for liquidity purposes, could have a material adverse impact on our business, financial condition or results of operations.

Risks Relating To Our Operation As A Business Development Company

A failure on our part to maintain our status as a business development company would significantly reduce our operating flexibility.

If we do not continue to qualify as a business development company, we might be regulated as a registered closed-end investment company under the 1940 Act; our failure to qualify as a BDC would make us subject to additional regulatory requirements, which may significantly decrease our operating flexibility by limiting our ability to employ leverage and issue common stock.

If we fail to qualify as a RIC, we will have to pay corporate-level taxes on our income, and our income available for distribution would be reduced.

To maintain our qualification for federal income tax purposes as a RIC under Subchapter M of the Code, and obtain RIC tax treatment, we must meet certain source of income, asset diversification and annual distribution requirements.

The source of income requirement is satisfied if we derive at least 90% of our annual gross income from interest, dividends, payments with respect to certain securities loans, gains from the sale or other disposition of securities or options thereon or foreign currencies, or other income derived with respect to our business of investing in such securities or currencies, and net income from interests in "qualified publicly traded partnerships," as defined in the Code.

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

To maintain our qualification as a RIC, we must also meet certain asset diversification requirements at the end of each calendar quarter. Failure to meet these tests 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 are in private companies, any such dispositions could be made at disadvantageous prices and may result in substantial losses.

If we fail to qualify as a RIC for any reason or become subject to corporate income tax, the resulting corporate taxes would substantially reduce our net assets, the amount of income available for distribution, and the actual amount of our distributions. Such a failure would have a materially adverse effect on us and our stockholders. For additional information regarding asset coverage ratio and RIC requirements, see "Regulation Senior Securities" and "Material U.S. Federal Income Tax Considerations".

We may have difficulty paying our required distributions if we recognize income before or without receiving cash representing such income.

For U.S. federal income tax purposes, we include in income certain amounts that we have not yet received in cash, such as original issue discount or payment-in-kind interest, which represents contractual interest added to the loan balance and due at the end of the loan term. Such original issue

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discount, which could be significant relative to our overall investment activities, or increases in loan balances as a result of payment-in-kind arrangements, are included in our taxable income before we receive any corresponding cash payments. We also may be required to include in taxable income certain other amounts that we do not receive in cash. While we focus primarily on investments that will generate a current cash return, our investment portfolio currently includes, and we may continue to invest in, securities that do not pay some or all of their return in periodic current cash distributions.

The income incentive fee payable by us is computed and paid on income that may include interest that has been accrued but not yet received in cash. If a portfolio company defaults on a loan that is structured to provide accrued interest, it is possible that accrued interest previously used in the calculation of the income incentive fee will become uncollectible.

Since in some cases we may recognize taxable income before or without receiving cash representing such income, we may have difficulty distributing at least 90% of our ordinary income and realized net short-term capital gains in excess of realized net long-term capital losses, if any, as required to maintain RIC tax treatment. Accordingly, we may have to sell some of our investments at times we would not consider advantageous, raise additional debt or equity capital or reduce new investment originations to meet these distribution requirements. If we are not able to obtain cash from other sources, we may fail to qualify for RIC treatment and thus become subject to corporate-level income tax. See "Regulation Senior Securities" and "Material U.S. Federal Income Tax Considerations".

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

We have incurred indebtedness under our revolving credit facility and through the issuance of the Notes and, in the future, may issue preferred stock and/or borrow additional money from banks or other financial institutions, which we refer to collectively as "senior securities," up to the maximum amount permitted by the 1940 Act. Under the provisions of the 1940 Act, we are permitted, as a BDC, to incur indebtedness or issue senior securities only in amounts such that our asset coverage, as defined in the 1940 Act, equals at least 200% after each issuance of senior securities. If the value of our assets declines, we may be unable to satisfy this test, which would prohibit us from paying dividends and could prohibit us from qualifying as a RIC. If we cannot satisfy this test, we may be required to sell a portion of our investments or sell additional shares of common stock at a time when such sales may be disadvantageous in order to repay a portion of our indebtedness. In addition, issuance of additional common stock could dilute the percentage ownership of our current stockholders in us.

As a BDC regulated under provisions of the 1940 Act, we are not generally able to issue and sell our common stock at a price below the current net asset value per share. If our common stock trades at a discount to net asset value, this restriction could adversely affect our ability to raise capital. We may, however, sell our common stock, or warrants, options or rights to acquire our common stock, at a price below the current net asset value of our common stock in certain circumstances, including if (i)(1) the holders of a majority of our shares (or, if less, at least 67% of a quorum consisting of a majority of our shares) and a similar majority of the holders of our shares who are not affiliated persons of us approve the sale of our common stock at a price that is less than the current net asset value, and (2) a majority of our Directors who have no financial interest in the transaction and a majority of our independent Directors (a) determine that such sale is in our and our stockholders' best interests and (b) in consultation with any underwriter or underwriters of the offering, make a good faith determination as of a time either immediately prior to the first solicitation by us or on our behalf of firm commitments to purchase such shares, or immediately prior to the issuance of such shares, that the price at which such shares are to be sold is not less than a price which closely approximates the market value of such shares, less any distributing commission or discount or if (ii) a majority of the number of the beneficial holders of our common stock entitled to vote at our annual meeting, without regard to whether a majority of such shares are voted in favor of the proposal, approve the sale of our

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common stock at a price that is less than the current net asset value per share. At our 2010 annual meeting of stockholders held on December 10, 2010, we obtained the first method of approval from our shareholders to sell an unlimited number of shares of common stock at any discount to net asset value per share for a period of twelve months, expiring on December 10, 2011. We are currently seeking stockholder approval at our 2011 annual meeting, to be held on December 8, 2011, to continue for an additional year our ability to issue shares of common stock below net asset value, subject to the condition that the maximum number of shares salable below net asset value pursuant to this authority in any particular offering that could result in such dilution is limited to 25% of our then outstanding common stock immediately prior to each such offering. We will not sell shares of common stock under a prospectus supplement to the registration statement (the "current registration statement") if the cumulative dilution to our NAV per share from offerings under the current registration statement exceeds 15%. See "If we sell common stock at a discount to our net asset value per share, stockholders who do not participate in such sale will experience immediate dilution in an amount that may be material" discussed below.

To generate cash for funding new investments, we pledged a substantial portion of our portfolio investments under our revolving credit facility. These assets are not available to secure other sources of funding or for securitization. Our ability to obtain additional secured or unsecured financing on attractive terms in the future is uncertain.

Alternatively, we may securitize our future loans to generate cash for funding new investments. See " Securitization of our assets subjects us to various risks."

Securitization of our assets subjects us to various risks.

We may securitize assets to generate cash for funding new investments. We refer to the term securitize to describe a form of leverage under which a company (sometimes referred to as an "originator" or "sponsor") transfers income producing assets to a single-purpose, bankruptcy-remote subsidiary (also referred to as a "special purpose entity" or SPE), which is established solely for the purpose of holding such assets and entering into a structured finance transaction. The SPE then issues notes secured by such assets. The special purpose entity may issue the notes in the capital markets either publicly or privately to a variety of investors, including banks, non-bank financial institutions and other investors. There may be a single class of notes or multiple classes of notes, the most senior of which carries less credit risk and the most junior of which may carry substantially the same credit risk as the equity of the SPE.

An important aspect of most debt securitization transactions is that the sale and/or contribution of assets into the SPE be considered a true sale and/or contribution for accounting purposes and that a reviewing court would not consolidate the SPE with the operations of the originator in the event of the originator's bankruptcy based on equitable principles. Viewed as a whole, a debt securitization seeks to lower risk to the note purchasers by isolating the assets collateralizing the securitization in an SPE that is not subject to the credit and bankruptcy risks of the originator. As a result of this perceived reduction of risk, debt securitization transactions frequently achieve lower overall leverage costs for originators as compared to traditional secured lending transactions.

In accordance with the above description, to securitize loans, we may create a wholly owned subsidiary and contribute a pool of our assets to such subsidiary. The SPE may be funded with, among other things, whole loans or interests from other pools and such loans may or may not be rated. The SPE would then sell its notes to purchasers who we would expect to be willing to accept a lower interest rate and the absence of any recourse against us to invest in a pool of income producing assets to which none of our creditors would have access. We would retain all or a portion of the equity in the SPE. An inability to successfully securitize portions of our portfolio or otherwise leverage our portfolio through secured and unsecured borrowings could limit our ability to grow our business and fully execute our business strategy, and could decrease our earnings, if any. However, the successful

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securitization of portions of our portfolio exposes us to a risk of loss for the equity we retain in the SPE and might expose us to greater risk on our remaining portfolio because the assets we retain may tend to be those that are riskier and more likely to generate losses. A successful securitization may also impose financial and operating covenants that restrict our business activities and may include 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 under Subchapter M of the Code. The 1940 Act may also impose restrictions on the structure of any securitizations.

Interests we hold in the SPE, if any, will be subordinated to the other interests issued by the SPE. As such, we will only receive cash distributions on such interests if the SPE has made all cash interest and other required payments on all other interests it has issued. In addition, our subordinated interests will likely be unsecured and rank behind all of the secured creditors, known or unknown, of the SPE, including the holders of the senior interests it has issued. Consequently, to the extent that the value of the SPE's portfolio of assets has been reduced as a result of conditions in the credit markets, or as a result of defaults, the value of the subordinated interests we retain would be reduced. Securitization imposes on us the same risks as borrowing except that our risk in a securitization is limited to the amount of subordinated interests we retain, whereas in a borrowing or debt issuance by us directly we would be at risk for the entire amount of the borrowing or debt issuance.

Generally, we would expect the SPE not to be consolidated with us and in that event our only interest will be the value of our retained subordinated interest and the income allocated to us, which may be more or less than the cash we receive from the SPE, and none of the SPE's liabilities will be reflected as our liabilities. If the assets of the SPE are not consolidated with our assets and liabilities, then our interest in the SPE may be deemed not to be a qualifying asset for purposes of determining whether 70% of our assets are qualifying assets and the leverage incurred by such SPE may or may not be treated as borrowings by us for purposes of the requirement that we not issue senior securities in an amount in excess of our net assets.

We may also engage in transactions utilizing SPEs and securitization techniques where the assets sold or contributed to the SPE remain on our balance sheet for accounting purposes. If, for example, we sell the assets to the SPE with recourse or provide a guarantee or other credit support to the SPE, its assets will remain on our balance sheet. Consolidation would also generally result if we, in consultation with the SEC, determine that consolidation would result in a more accurate reflection of our assets, liabilities and results of operations. In these structures, the risks will be essentially the same as in other securitization transactions but the assets will remain our assets for purposes of the limitations described above on investing in assets that are not qualifying assets and the leverage incurred by the SPE will be treated as borrowings incurred by us for purposes of our limitation on the issuance of senior securities.

Our Investment Adviser may have conflicts of interest with respect to potential securitizations in as much as securitizations that are not consolidated may reduce our assets for purposes of determining its investment advisory fee although in some circumstances our investment adviser may be paid certain fees for managing the assets of the SPE so as to reduce or eliminate any potential bias against securitizations.

Our ability to invest in public companies may be limited in certain circumstances.

As a BDC, we must not acquire any assets other than "qualifying assets" specified in the 1940 Act unless, at the time the acquisition is made, at least 70% of our total assets are qualifying assets (with certain limited exceptions). Subject to certain exceptions for follow-on investments and distressed companies, an investment in an issuer that has outstanding securities listed on a national securities exchange may be treated as qualifying assets only if such issuer has a market capitalization that is less than \$250 million at the time of such investment.

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Price declines and illiquidity in the corporate debt markets have adversely affected, and may in the future adversely affect, the fair value of our portfolio investments, reducing our net asset value through increased net unrealized depreciation.

As a BDC, we are required to carry our investments at market value or, if no market value is ascertainable, at fair value as determined in good faith by or under the direction of our Board of Directors. As part of the valuation process, the types of factors that we may take into account in determining the fair value of our investments include, as relevant and among other factors: available current market data, including relevant and applicable market trading and transaction comparables, applicable market yields and multiples, security covenants, call protection provisions, information rights, the nature and realizable value of any collateral, the portfolio company's ability to make payments, its earnings and discounted cash flows, the markets in which the portfolio company does business, comparisons of financial ratios of peer companies that are public, merger and acquisition comparables, our principal market (as the reporting entity) and enterprise values. Decreases in the market values or fair values of our investments are recorded as unrealized depreciation. Unprecedented declines in prices and liquidity in the corporate debt markets resulted in significant net unrealized depreciation in our portfolio in the past. The effect of all of these factors on our portfolio has reduced our net asset value by increasing net unrealized depreciation in our portfolio. Depending on market conditions, we could incur substantial realized losses and may suffer additional unrealized losses in future periods, which could have a material adverse impact on our business, financial condition and results of operations.

Our common stock may trade at a discount to our net asset value per share.

Common stock of BDCs, like that of closed-end investment companies, frequently trades at a discount to current net asset value, which could adversely affect the ability to raise capital. In the past, our common stock has traded at a discount to our net asset value. The risk that our common stock may continue to trade at a discount to our net asset value is separate and distinct from the risk that our net asset value per share may decline.

If we sell common stock at a discount to our net asset value per share, stockholders who do not participate in such sale will experience immediate dilution in an amount that may be material.

At our 2010 annual meeting of stockholders held on December 10, 2010, our stockholders approved our ability to sell an unlimited number of shares of our common stock at any level of discount from net asset value per share during the 12 month period following the December 10, 2010 approval in accordance with the exception described above in " Regulations governing our operation as a business development company affect our ability to raise, and the way in which we raise, additional capital." We are currently seeking stockholder approval at our 2011 annual meeting, to be held on December 8, 2011, to continue for an additional year our ability to issue shares of common stock below net asset value, subject to the condition that the maximum number of shares salable below net asset value pursuant to this authority in any particular offering that could result in such dilution is limited to 25% of our then outstanding common stock immediately prior to each such offering. The issuance or sale by us of shares of our common stock at a discount to net asset value poses a risk of dilution to our stockholders. In particular, stockholders who do not purchase additional shares at or below the discounted price in proportion to their current ownership will experience an immediate decrease in net asset value per share (as well as in the aggregate net asset value of their shares if they do not participate at all). These stockholders will also experience a disproportionately greater decrease in their participation in our earnings and assets and their voting power than the increase we experience in our assets, potential earning power and voting interests from such issuance or sale. In addition, such sales may adversely affect the price at which our common stock trades. For additional information and hypothetical examples of these risks, see "Sales of Common Stock Below Net Asset Value" and the prospectus supplement pursuant to which such sale is made. We have sold shares of our common stock

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at prices below net asset value per share and may continue to do so to the future. For additional information, see "Recent Sales of Common Stock Below Net Asset Value" in the prospectus supplement pursuant to which such sale is made, if applicable.

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

We are prohibited under the 1940 Act from knowingly participating in certain transactions with our affiliates without the prior approval of our independent directors. 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 security or other property from or to such affiliate, absent the prior approval of our independent directors. The 1940 Act also prohibits "joint" transactions with an affiliate, which could include investments in the same portfolio company (whether at the same or different times), without prior approval of our independent directors. We are prohibited from buying or selling any security or other property from or to our Investment Adviser and its affiliates and persons with whom we are in a control relationship, or entering into joint transactions with any such person, absent the prior approval of the SEC.

Risks Relating To Our Investments

We may not realize gains or income from our investments.

We seek to generate both current income and capital appreciation. However, the securities we invest in may not appreciate and, in fact, may decline in value, and the issuers of debt securities we invest in may default on interest and/or principal payments. Accordingly, we may not be able to realize gains from our investments, and any gains that we do realize may not be sufficient to offset any losses we experience. See "Business Our Investment Objective and Policies."

Our investments in prospective portfolio companies may be risky and we could lose all or part of our investment.

Some of our portfolio companies have relatively short or no operating histories. These companies are and will be subject to all of the business risk and uncertainties associated with any new business enterprise, including the risk that these companies may not reach their investment objective and the value of our investment in them may decline substantially or fall to zero.

In addition, investment in the middle market companies that we are targeting involves a number of other significant risks, including:

these companies may have limited financial resources and may be unable to meet their obligations under their securities that we hold, which may be accompanied by a deterioration in the value of their securities or of any collateral with respect to any securities and a reduction in the likelihood of our realizing on any guarantees we may have obtained in connection with our investment;

they may have 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;

because many of these companies are privately held companies, public information is generally not available about these companies. As a result, we will depend on the ability of our Investment Adviser to obtain adequate information to evaluate these companies in making investment decisions. If our Investment Adviser is unable to uncover all material information about these companies, it may not make a fully informed investment decision, and we may lose money on our investments;

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they are more likely to depend on the 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 materially adverse impact on our portfolio company and, in turn, on us;

they may have less predictable operating results, may from time to time be parties to litigation, may be engaged in changing businesses with products subject to a risk of obsolescence and may require substantial additional capital to support their operations, finance expansion or maintain their competitive position;

they may have difficulty accessing the capital markets to meet future capital needs;

increased taxes, regulatory expense or the costs of changes to the way they conduct business due to the effects of climate change may adversely affect their business, financial structure or prospects.

In addition, our executive officers, directors and our Investment Adviser could, in the ordinary course of business, be named as defendants in litigation arising from proposed investments or from our investments in the portfolio companies.

Economic recessions or downturns could impair our portfolio companies and harm our operating results.

The U.S. and foreign financial markets have been experiencing a high level of volatility, disruption and distress, which was exacerbated by the failure of several major financial institutions in the last few months of 2008. Despite actions of the United States 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 these conditions appear to be improving, they could continue for a prolonged period of time or worsen in the future both in the U.S. and globally. Our portfolio companies will generally be affected by the conditions and overall strength of the national, regional and local economies, including interest rate fluctuations, changes in the capital markets and changes in the prices of their primary commodities and products. These factors also impact the amount of residential, industrial and commercial growth in the energy industry. Additionally, these factors could adversely impact the customer base and customer collections of our portfolio companies.

Many of our portfolio companies may be susceptible to economic slowdowns or recessions and may be unable to repay our loans or meet other obligations during these periods. Therefore, our non-performing assets are likely to increase, and the value of our portfolio is likely to decrease, during these periods. Adverse economic conditions also may decrease the value of collateral securing some of our loans and the value of our equity investments. Economic slowdowns or recessions could lead to financial losses in our portfolio and a decrease in revenues, net income and assets. 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 prevent us from increasing investments and harm our operating results.

A portfolio company's failure to satisfy financial or operating covenants imposed by us or other lenders could lead to defaults and, potentially, termination of its loans and foreclosure on its secured assets, which could trigger cross-defaults under other agreements and jeopardize a portfolio company's ability to meet its obligations under the debt or equity securities that we hold. We may incur expenses to the extent necessary to seek recovery upon default or to negotiate new terms, which may include the waiver of certain financial covenants, with a defaulting portfolio company. In addition, if one of our portfolio companies were to go bankrupt, even though we may have structured our interest as senior debt or preferred equity, depending on the facts and circumstances, including the extent to which we actually provided managerial assistance to that portfolio company, a bankruptcy court might

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re-characterize our debt or equity holding and subordinate all or a portion of our claim to those of other creditors.

Our portfolio contains a limited number of portfolio companies, which subjects us to a greater risk of significant loss if any of these companies defaults on its obligations under any of its debt securities.

A consequence of the limited number of investments in our portfolio is that the aggregate returns we realize may be significantly adversely affected if one or more of our significant portfolio company investments perform poorly or if we need to write down the value of any one significant investment. Beyond our income tax diversification requirements, we do not have fixed guidelines for diversification, and our portfolio could contain relatively few portfolio companies.

Our failure to make follow-on investments in our portfolio companies could impair the value of our portfolio.

Following an initial investment in a portfolio company, we may make additional investments in that portfolio company as "follow-on" investments, in order to: (1) increase or maintain in whole or in part our equity ownership percentage; (2) exercise warrants, options or convertible securities that were acquired in the original or subsequent financing or (3) attempt to preserve or enhance the value of our investment.

We may elect not to make follow-on investments, may be constrained in our ability to employ available funds, or otherwise may lack sufficient funds to make those investments. We have the discretion to make any follow-on investments, subject to the availability of capital resources. The failure to make follow-on investments may, in some circumstances, jeopardize the continued viability of a portfolio company and our initial investment, or may result in a missed opportunity for us to increase our participation in a successful operation. Even if we have sufficient capital to make a desired follow-on investment, we may elect not to make a follow-on investment because we may not want to increase our concentration of risk, because we prefer other opportunities, or because we are inhibited by compliance with BDC requirements or the desire to maintain our tax status.

We may be unable to invest the net proceeds raised from offerings 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 in interest-bearing deposits or other short-term instruments or use the net proceeds from such offerings to reduce then-outstanding obligations under our credit facility. 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.

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

We make investments in private companies. A portion of these investments may be subject to legal and other restrictions on resale, transfer, pledge or other disposition or will otherwise be less liquid than publicly traded securities. The illiquidity of our investments may make it difficult for us to sell such investments if the need arises. 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 have previously recorded our investments. In addition, we face other restrictions on our ability to liquidate an investment in a business entity to the extent that we or our Investment Adviser has or could be deemed to have material non-public information regarding such business entity.

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 Adviser's investment

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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 and other rules that govern public companies. If we are unable to uncover all material information about these companies, we may not make a fully informed investment decision, and we may lose money on our investment.

We may not be in a position to control a portfolio investment when we are a debt or minority equity investor and its management may make decisions that could decrease the value of our investment.

We make both debt and minority equity investments in portfolio companies. As a result, we are subject to the risk that a portfolio company may make business decisions with which we disagree, and the management of such company, as representatives of the holders of their common equity, 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.

Our portfolio companies may incur debt or issue equity securities that rank equally with, or senior to, our investments in such companies.

We may invest in mezzanine debt and dividend-paying equity securities issued by our portfolio companies. Our portfolio companies usually have, or may be permitted to incur, other debt, or issue other equity securities, that rank equally with, or senior to, the securities in which we invest. By their terms, such instruments may provide that the holders are entitled to receive payment of dividends, interest or principal on or before the dates on which we are entitled to receive payments in respect of the securities in which we invest. Also, in the event of insolvency, liquidation, dissolution, reorganization or bankruptcy of a portfolio company, holders of securities 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 the senior security holders, the portfolio company may not have any remaining assets to use for repaying its obligation to us. In the case of securities ranking equally with securities in which we invest, we would have to share on an equal basis any distributions with other security holders in the event of an insolvency, liquidation, dissolution, reorganization or bankruptcy of the relevant portfolio company.

We may not be able to fully realize the value of the collateral securing our debt investments.

Although a substantial amount of our debt investments are protected by holding security interests in the assets of the portfolio companies, we may not be able to fully realize the value of the collateral securing our investments due to one or more of the following factors:

our debt investments may be made in the form of mezzanine loans, therefore our liens on the collateral, if any, may be subordinated to those of the senior secured debt of the portfolio companies, if any. As a result, we may not be able to control remedies with respect to the collateral;

the collateral may not be valuable enough to satisfy all of the obligations under our secured loan, particularly after giving effect to the repayment of secured debt of the portfolio company that ranks senior to our loan;

bankruptcy laws may limit our ability to realize value from the collateral and may delay the realization process;

our rights in the collateral may be adversely affected by the failure to perfect security interests in the collateral;

the need to obtain regulatory and contractual consents could impair or impede how effectively the collateral would be liquidated and could affect the value received; and

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some or all of the collateral may be illiquid and may have no readily ascertainable market value. The liquidity and value of the collateral could be impaired as a result of changing economic conditions, competition, and other factors, including the availability of suitable buyers.

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

Our investment strategy contemplates potential investments in securities of foreign companies including those located in emerging market countries. 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. Such risks are more pronounced in emerging market countries.

Although currently most of our investments are, and we expect that most of our investments will be, U.S. dollar-denominated, investments that are denominated in a foreign currency will be subject to the risk that the value of a particular currency will change in relation to one or more other currencies. 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.

We may expose ourselves to risks if we engage in hedging transactions.

We may employ hedging techniques to minimize certain investment risks, such as fluctuations in interest and currency exchange rates, but we can offer no assurance that such strategies will be effective. If we engage in hedging transactions, we may expose ourselves to risks associated with such transactions. We may utilize instruments such as forward contracts, currency options and interest rate swaps, caps, collars and floors to seek to hedge against fluctuations in the relative values of our portfolio positions from changes in currency exchange rates and market interest rates. Hedging against a decline in the values of our portfolio positions does not eliminate the possibility of fluctuations in the values of such positions or prevent losses if the values of such positions decline. However, such hedging can establish other positions designed to gain from those same developments, thereby offsetting the decline in the value of such portfolio positions. Such hedging transactions may also limit the opportunity for gain if the values of the portfolio positions should increase. Moreover, it may not be possible to hedge against an exchange rate or interest rate fluctuation that is so generally anticipated that we are not able to enter into a hedging transaction at an acceptable price.

The success of our hedging transactions depends on our ability to correctly predict movements, currencies and interest rates. Therefore, while we may enter into such transactions to seek to reduce currency exchange rate and interest rate risks, unanticipated changes in currency exchange rates or interest rates may result in poorer overall investment performance than if we had not engaged in any such hedging transactions. The degree of correlation between price movements of the instruments used in a hedging strategy and price movements in the portfolio positions being hedged may vary. Moreover, for a variety of reasons, we may not seek to establish a perfect correlation between such hedging instruments and the portfolio holdings being hedged. Any such imperfect correlation may prevent us from achieving the intended hedge and expose us to risk of loss. In addition, it may not be possible to hedge fully or perfectly against currency fluctuations affecting the value of securities denominated in non-U.S. currencies. The Company has no current intention of engaging in any of the hedging transaction described above, although it reserves the right to do so in the future.

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Our Board of Directors may change our operating policies and strategies without prior notice or stockholder approval, the effects of which may be adverse to us and could impair the value of our stockholders' investment.

Our Board of Directors has the authority to modify or waive our current operating policies and our strategies without prior notice and without stockholder approval. We cannot predict the effect any changes to our current operating policies and strategies would have on our business, financial condition, and value of our common stock. However, the effects might be adverse, which could negatively impact our ability to pay dividends and cause stockholders to lose all or part of their investment.

Risks Relating To Our Securities

Investing in our securities may involve a high degree of risk and is highly speculative.

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

The market price of our securities may fluctuate significantly.

The market price and liquidity of the market for our securities 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:

significant volatility in the market price and trading volume of securities of business development companies or other companies in the energy industry, which are not necessarily related to the operating performance of these companies;

changes in regulatory policies or tax guidelines, particularly with respect to RICs or business development companies;

loss of RIC qualification;

changes in earnings or variations in operating results;

changes in the value of our portfolio of investments;

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

departure of one or more of Prospect Capital Management's key personnel;

operating performance of companies comparable to us;

changes in prevailing interest rates;

litigation matters;

general economic trends and other external factors; and

loss of a major funding source.

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In the past, following periods of volatility in the market price of a company's securities, securities class action litigation has, from time to time, been brought against that company.

If our stock price fluctuates significantly, we may be the target of securities litigation in the future. Securities litigation could result in substantial costs and divert management's attention and resources from our business.

Sales of substantial amounts of our securities in the public market may have an adverse effect on the market price of our securities.

Sales of substantial amounts of our securities or the availability of such securities for sale could adversely affect the prevailing market price for our securities. If this occurs and continues it could impair our ability to raise additional capital through the sale of securities should we desire to do so.

There is a risk that you may not receive distributions or that our distributions may not grow over time.

We have made and intend to continue to make distributions on a quarterly basis to our stockholders out of assets legally available for distribution. We cannot assure you that we will achieve investment results or maintain a tax status that will allow or require any specified level of cash distributions or year-to-year increases in cash distributions. In addition, due to the asset coverage test applicable to us as a business development company, we may be limited in our ability to make distributions.

Provisions of the Maryland General Corporation Law and of our charter and bylaws could deter takeover attempts and have an adverse impact on the price of our common stock.

Our charter and bylaws and the Maryland General Corporation Law contain provisions that may have the effect of delaying, deferring or preventing a transaction or a change in control that might involve a premium price for our stockholders or otherwise be in their best interest. These provisions may prevent stockholders from being able to sell shares of our common stock at a premium over the current of prevailing market prices.

Our charter provides for the classification of our Board of Directors into three classes of directors, serving staggered three-year terms, which may render a change of control or removal of our incumbent management more difficult. Furthermore, any and all vacancies on our Board of Directors will be filled generally only by the affirmative vote of a majority of the remaining directors in office, even if the remaining directors do not constitute a quorum, and any director elected to fill a vacancy will serve for the remainder of the full term until a successor is elected and qualifies.

Our Board of Directors is authorized to create and issue new series of shares, to classify or reclassify any unissued shares of stock into one or more classes or series, including preferred stock and, without stockholder approval, to amend our charter to increase or decrease the number of shares of common stock that we have authority to issue, which could have the effect of diluting a stockholder's ownership interest. Prior to the issuance of shares of common stock of each class or series, including any reclassified series, our Board of Directors is required by our governing documents to set the terms, preferences, conversion or other rights, voting powers, restrictions, limitations as to dividends or other distributions, qualifications and terms or conditions of redemption for each class or series of shares of stock.

Our charter and bylaws also provide that our Board of Directors has the exclusive power to adopt, alter or repeal any provision of our bylaws, and to make new bylaws. The Maryland General

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Corporation Law also contains certain provisions that may limit the ability of a third party to acquire control of us, such as:

The Maryland Business Combination Act, which, subject to certain limitations, prohibits certain business combinations between us and an "interested stockholder" (defined generally as any person who beneficially owns 10% or more of the voting power of the common stock or an affiliate thereof) for five years after the most recent date on which the stockholder becomes an interested stockholder and, thereafter, imposes special minimum price provisions and special stockholder voting requirements on these combinations; and

The Maryland Control Share Acquisition Act, which provides that "control shares" of a Maryland corporation (defined as shares of common stock which, when aggregated with other shares of common stock controlled by the stockholder, entitles the stockholder to exercise one of three increasing ranges of voting power in electing directors, as described more fully below) acquired in a "control share acquisition" (defined as the direct or indirect acquisition of ownership or control of "control shares") have no voting rights except to the extent approved by stockholders by the affirmative vote of at least two-thirds of all the votes entitled to be cast on the matter, excluding all interested shares of common stock.

The provisions of the Maryland Business Combination Act will not apply, however, if our Board of Directors adopts a resolution that any business combination between us and any other person will be exempt from the provisions of the Maryland Business Combination Act. Our Board of Directors has adopted a resolution that any business combination between us and any other person is exempted from the provisions of the Business Combination Act, *provided* that the business combination is first approved by the Board of Directors, including a majority of the directors who are not interested persons as defined in the 1940 Act. There can be no assurance that this resolution will not be altered or repealed in whole or in part at any time. If the resolution is altered or repealed, the provisions of the Maryland Business Combination Act may discourage others from trying to acquire control of us.

As permitted by Maryland law, our bylaws contain a provision exempting from the Maryland Control Share Acquisition Act any and all acquisitions by any person of our common stock. Although our bylaws include such a provision, such a provision may also be amended or eliminated by our Board of Directors at any time in the future, provided that we will notify the Division of Investment Management at the SEC prior to amending or eliminating this provision. It is the view of the staff of the SEC that opting into the Maryland Control Share Acquisition Act would be acting in a manner inconsistent with section 18(i) of the 1940 Act.

We may in the future choose to pay dividends in our own stock, in which case our stockholders may be required to pay tax in excess of the cash they receive.

We may distribute taxable dividends that are payable in part in our stock. Under IRS Revenue Procedure 2010-12, up to 90% of any such taxable dividend could be payable in our stock for dividends paid on or before December 31, 2012 with respect to any taxable year ending on or before December 31, 2011. The IRS has also issued private letter rulings on cash/stock dividends paid by regulated investment companies and real estate investment trusts if certain requirements are satisfied. Taxable stockholders receiving such dividends would be required to include the full amount of the dividend as ordinary income (or as long-term capital gain to the extent such distribution is properly designated as a capital gain dividend) to the extent of our current and accumulated earnings and profits for United States federal income tax purposes. As a result, a U.S. stockholder may be required to pay tax with respect to such dividends in excess of any cash received. If a U.S. stockholder sells the stock it receives as a dividend in order to pay this tax, it may be subject to transaction fees (e.g. broker fees or transfer agent fees) and the sales proceeds may be less than the amount included in income with respect to the dividend, depending on the market price of our stock at the time of the sale.

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Furthermore, with respect to non-U.S. stockholders, we may be required to withhold U.S. tax with respect to such dividends, including in respect of all or a portion of such dividend that is payable in stock. In addition, if a significant number of our stockholders determine to sell shares of our stock in order to pay taxes owed on dividends, it may put downward pressure on the trading price of our stock. It is unclear whether and to what extent we will be able to pay dividends in cash and our stock (whether pursuant to Revenue Procedure 2010-12, a private letter ruling, or otherwise).

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**MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

(All figures in this section are in thousands except share, per share and other data)

The following discussion should be read in conjunction with our consolidated financial statements and related notes and other financial information appearing elsewhere in this offering memorandum or incorporated by reference into this offering memorandum. In addition to historical information, the following discussion and other parts of this offering memorandum 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 "Risk Factors" and "Forward-Looking Statements" appearing elsewhere herein.

Note on Forward Looking Statements

Some of the statements in this section of the offering memorandum constitute forward-looking statements, which relate to future events or our future performance or financial condition. The forward-looking statements contained herein involve risks and uncertainties, including statements as to:

our future operating results;

our business prospects and the prospects of our portfolio companies;

the impact of investments that we expect to make;

our contractual arrangements and 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 ability of our portfolio companies to achieve their objectives;

our expected financings and investments;

the adequacy of our cash resources and working capital; and

the timing of cash flows, if any, from the operations of our portfolio companies.

We generally use words such as "anticipates", "believes", "expects", "intends" and similar expressions to identify forward-looking statements. Our actual results could differ materially from those projected in the forward-looking statements for any reason, including the factors set forth in "Risk Factors" and elsewhere in this offering memorandum. These forward-looking statements do not meet the safe harbor for forward-looking statements pursuant to Section 27A of the Securities Act.

We have based the forward-looking statements included in herein on information available to us on the date of this document, and we assume no obligation to update any such forward-looking statements. Although we undertake no obligation to revise or update any forward-looking statements, whether as a result of new information, future events or otherwise, you are advised to consult any additional disclosures that we may make directly to you or through reports that we in the future may file with the SEC, including any annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K.

Overview

We are a financial services company that primarily lends to and invests in middle market privately-held companies. We are a closed-end investment company that has filed an election to be treated as a business development company under the Investment Company Act of 1940, or the 1940 Act. We invest primarily in senior and subordinated debt and equity of companies in need of capital for

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acquisitions, divestitures, growth, development and recapitalization. We work with the management teams or financial sponsors to seek investments with historical cash flows, asset collateral or contracted pro-forma cash flows.

We seek to be a long-term investor with our portfolio companies. From our July 27, 2004 inception to the fiscal year ended June 30, 2007, we invested primarily in industries related to the industrial/energy economy. Since then, we have widened our strategy to focus in other sectors of the economy and continue to reduce our exposure to the energy industry, and our holdings in the energy and energy related industries now represent less than 20% of our investment portfolio.

The aggregate value of our portfolio investments was \$1,463,010 and \$748,483 as of June 30, 2011 and June 30, 2010, respectively. During the fiscal year ended June 30, 2011, our net cost of investments increased by \$706,975, or 97.0%, as a result of twenty-eight new investments, twelve follow-on investments and revolver advances of \$943,703, accrued of payment-in-kind interest of \$9,634 and accretion of purchase discount of \$23,035, while we received full repayment on fourteen investments, sold three investments and received several partial prepayments and revolver repayments totaling of \$269,397.

Compared to the end of the fiscal year ended June 30, 2010, our net assets increased by \$402,933 or 56.6% during the year ended June 30, 2011, from \$711,424 to \$1,114,357. This increase resulted from the issuance of new shares of our common stock (less offering costs) in the amount of \$379,929, dividend reinvestments of \$10,934, and another \$118,238 from operations. These increases, in turn, were offset by \$106,167 in dividend distributions to our stockholders. The \$118,238 increase in net assets resulting from operations is net of the following: net investment income of \$94,221, net realized gain on investments of \$16,465, and an increase in net assets due to changes in net unrealized appreciation of investments of \$7,552.

Market Opportunity

We believe that current market conditions present attractive opportunities for us to invest in middle-market companies; specifically:

We believe that the dislocation in the credit markets that began in 2007 resulted in reduced competition, a widening of interest spreads, increased fees and generally more conservative capital structures and deal terms. These previous market conditions may continue to create favorable opportunities to invest at attractive risk-adjusted returns.

We believe that many senior lenders have, in recent years, de-emphasized their service and product offerings to middle-market businesses in favor of lending to large corporate clients and managing capital markets transactions. In addition, commercial and investment banks are limited in their ability to underwrite and syndicate bank loans and high yield securities for middle-market issuers as they seek to build capital and reduce leverage, resulting in opportunities for alternative funding sources and therefore higher new-issue market opportunities.

We believe there is a large pool of un-invested private equity capital for middle-market businesses. We expect private equity firms will seek to leverage their investments by combining equity capital with senior secured loans and mezzanine debt from other sources.

A high volume of senior secured and high yield debt was originated in the calendar years 2004 through 2007 and will come due in the near term and, accordingly, we believe that new financing opportunities will increase as many companies seek to refinance this indebtedness.

To capitalize on these opportunities, expansion of the capital base has been and may continue to be necessary. We have demonstrated our continuing access to capital markets in several equity and debt transactions during the year ended June 30, 2011, From July 1, 2010 to December 15, 2010, we raised

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\$181,946 of equity capital through our at the market program. On December 21, 2010 and February 18, 2011, we issued \$150,000 and \$172,500, respectively, of senior convertible notes. On April 7, 2011, we completed a public stock offering for 9,000,000 shares of our common stock raising \$102,600 of gross proceeds. On June 24, 2011, we completed a public stock offering for 10,000,000 shares of our common stock at \$10.15 per share, raising \$101,500 of gross proceeds. On July 18, 2011, the underwriter exercised its option to purchase an additional 1,500,000 shares of our common stock.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of income and expenses during the reported period. Changes in the economic environment, financial markets and any other parameters used in determining these estimates could cause actual results to differ.

Fourth Quarter Highlights

Investment Transactions

On April 18, 2011, we made a \$13,000 secured debt investment to support the acquisition of New Meatco Provisions, LLC ("Meatco"), a leading food distributor, by Annex Capital Management. The second lien note bears interest in cash at the greater of 12.0% or Libor plus 9.0% and interest in kind of 4.0% and has a final maturity on April 18, 2016.

On April 18, 2011, Unitek Acquisition, Inc. ("Unitek") repaid the \$11,500 loan receivable to us.

On April 26, 2011, we made a senior secured follow-on investment of \$11,000 in ICON Health & Fitness, Inc ("ICON"). The first lien note bears interest in cash at 11.875% and has a final maturity on October 15, 2016.

On May 2, 2011, we sold our membership interests in Fischbein, LLC ("Fischbein") realizing a gain of \$9,893 on the sale and received a repayment of the loan that was outstanding. We subsequently made a \$3,334 senior secured second-lien term loan and invested \$875 in the common equity of Fischbein with the new ownership group. The second lien note bears interest in cash at 12.0% and interest in kind of 2.0% and has a final maturity on October 31, 2016.

On May 3, 2011, we made a debt investment of \$25,000 to support the acquisition of Byrider Systems Acquisition Corp. ("Byrider"), a leading used car sales and finance business, by Altamont Capital Partners. The second lien note bears interest in cash at 12.0% and interest in kind of 2.0% and has a final maturity on November 3, 2016.

On May 6, 2011, we made a \$34,450 investment in NMMB Holdings, Inc. ("NMMB"), an advertising media buying business, of which \$31,750 was funded at closing. \$24,250 is structured as senior secured debt, \$2,800 as subordinated debt and \$4,400 as controlling equity. The loans bear interest in cash at 14.0% and 15.0%, respectively, and have a final maturity on May 6, 2016. The \$3,000 revolver, of which \$300 was drawn at closing, bears interest in cash at the greater of 10.50% or Libor plus 8.50% and has a final maturity on May 6, 2016.

On May 6, 2011, we provided \$15,000 in secured second-lien acquisition financing for Mood Media Corporation ("Mood Media"), a company in the in-store media industry. The second lien note bears interest in cash at the greater of 10.25% or Libor plus 8.75% and has a final maturity on November 6, 2018.

On May 6, 2011, we provided \$15,000 in secured second-lien financing for the recapitalization of Potters Holdings II, L.P. ("Potters"), a leading company in the engineered glass materials industry. The second lien note bears interest in cash at the greater of 10.25% or Libor plus 8.50% and has a final maturity on November 6, 2017.

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On May 25, 2011, we provided \$24,000 in secured first-lien financing to Targus Group International, Inc. ("Targus"), the leading global supplier of notebook carrying cases and accessories. The first lien note bears interest in cash at the greater of 11.0% or Libor plus 9.50% and has a final maturity on May 25, 2016.

On May 31, 2011, we provided \$35,000 in secured second-lien financing to Springs Window Fashions, LLC ("Springs Window"), a leading designer and manufacturer of high-quality window treatments. The second lien note bears interest in cash at the greater of 11.25% or Libor plus 9.25% and has a final maturity on November 30, 2017.

On May 31, 2011, Label Corp Holdings Inc ("Label Corp") repaid the \$5,749 loan receivable to us.

On June 3, 2011, Prince Mineral Company, Inc. ("Prince") repaid the \$23,540 loan receivable to us and we recognized \$10,463 of accelerated purchase discount accretion.

On June 16, 2011, we made a senior secured debt investment of \$26,500 to support the acquisition of ST Products, LLC ("STP"), a leading North American producer of precision redrawn, small diameter, thin wall copper, and specialty alloy tubes. The first lien note bears interest in cash at the greater of 12.0% or Libor plus 9.00% and has a final maturity date on June 16, 2016.

On June 21, 2011, we provided \$25,000 in secured second lien financing for the recapitalization of U.S. HealthWorks Holding Company, Inc. ("U.S.H."), a leading company in the occupational medical services industry. The second lien note bears interest in cash at the greater of 10.50% or Libor plus 9.00% and has a final maturity on June 15, 2017.

On June 30, 2011, we made a senior secured debt investment of \$82,500 in CRT MIDCO, LLC ("CRT"), a market-leading specialty media buying business, of which \$75,000 was funded at closing. The first lien notes bear interest in cash at the greater of 10.50% or Libor plus 7.50% and have a final maturity on June 30, 2017. The revolver, which was undrawn at closing of \$7,500, bears interest in cash at the greater of 10.50% or Libor plus 7.50% and has a final maturity on June 30, 2012.

On June 30, 2011 we provided \$5,000 in secured second lien financing for the acquisition of Pre-Paid Legal Services, Inc. ("Pre-Paid Legal"), a top company in the professional services subscription market. The second lien notes bear interest in cash at the greater of 11.00% or Libor plus 9.50% and has a final maturity on December 31, 2016.

Equity Issuance

On April 7, 2011, we completed a public stock offering for 9,000,000 shares of our common stock raising \$102,600 of gross proceeds and \$102,164 of net proceeds.

On June 24, 2011, we completed a public stock offering for 10,000,000 shares of our common stock at \$10.15 per share, raising \$101,500 of gross proceeds and \$100,173 of net proceeds. On July 18, 2011, the underwriter exercised its option to purchase an additional 1,500,000 shares of our common stock, raising an additional \$15,225 of gross proceeds and \$15,060 of net proceeds.

On April 29, 2011, May 31, 2011 and June 24, 2011, we issued 76,377, 78,689 and 92,813 shares of our common stock in connection with the dividend reinvestment plan, respectively.

Dividend

On May 9, 2011, we announced the declaration of monthly dividends in the following amounts and with the following dates:

\$0.101225 per share for May 2011 to holders of record on May 31, 2011 with a payment date of June 24, 2011;

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\$0.101250 per share for June 2011 to holders of record on June 30, 2011 with a payment date of July 22, 2011;

\$0.101275 per share for July 2011 to holders of record on July 29, 2011 with a payment date of August 26, 2011;

\$0.101300 per share for August 2011 to holders of record on August 31, 2011 with a payment date of September 23, 2011.

Credit Facility

On April 21, 2011, we announced an increase in commitments to our credit facility of \$40,000. The commitments to the credit facility stood at \$325,000 at June 30, 2011.

Patriot Acquisition

On December 2, 2009, we acquired the outstanding shares of Patriot Capital Funding, Inc. ("Patriot") common stock for \$201,083. Under the terms of the merger agreement, Patriot common shareholders received 0.363992 shares of our common stock for each share of Patriot common stock, resulting in 8,444,068 shares of common stock being issued by us. In connection with the transaction, we repaid all the outstanding borrowings of Patriot, in compliance with the merger agreement.

On December 2, 2009, Patriot made a final dividend equal to its undistributed net ordinary income and capital gains of \$0.38 per share. In accordance with a recent IRS revenue procedure, the dividend was paid 10% in cash and 90% in newly issued shares of Patriot's common stock. The exchange ratio was adjusted to give effect to the final income distribution. The merger has been accounted for as an acquisition of Patriot by Prospect Capital Corporation ("Prospect") in accordance with acquisition method of accounting as detailed in Accounting Standards Codification ("ASC" or "Codification") 805, *Business Combinations* ("ASC 805"). The fair value of the consideration paid was allocated to the assets acquired and liabilities assumed based on their fair values as the date of acquisition. As described in more detail in ASC 805, goodwill, if any, would have been recognized as of the acquisition date, if the consideration transferred exceeded the fair value of identifiable net assets acquired. As of the acquisition date, the fair value of the identifiable net assets acquired exceeded the fair value of the consideration transferred, and we recognized the excess as a gain. A preliminary gain of \$5,714 was recorded by Prospect in the quarter ended December 31, 2009 related to the acquisition of Patriot, which was revised in the fourth quarter of the fiscal year ended June 30, 2010, to \$7,708, when we settled severance accruals related to certain members of Patriot's top management, and finalized during the first quarter of the fiscal year ended June 30, 2011, to \$8,632, when we settled the remaining severance accruals related to the last two members of Patriot's top management. Under ASC 805, the adjustments to our preliminary estimates were reflected in the three months ended December 31, 2009 (See Note 14 to our consolidated financial statements.). The acquisition of Patriot was negotiated in July 2009 with the purchase agreement being signed on August 3, 2009. Between July 2009 and December 2, 2009, our valuation of certain of the investments acquired from Patriot increased due to market improvement, which resulted in the recognition of the gain at closing.

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The purchase price has been allocated to the assets acquired and the liabilities assumed based on their estimated fair values as summarized in the following table:

| | |
|---|--------------|
| Cash (to repay Patriot debt) | \$ 107,313 |
| Cash (to fund purchase of restricted stock from former Patriot employees) | 970 |
| Common stock issued(1) | 92,800 |
| Total purchase price | 201,083 |
| Assets acquired: | |
| Investments(2) | 207,126 |
| Cash and cash equivalents | 1,697 |
| Other assets | 3,859 |
| Assets acquired | 212,682 |
| Other liabilities assumed | (2,967) |
| Net assets acquired | 209,715 |
| Gain on Patriot acquisition(3) | \$ 8,632 |

-
- (1) The value of the shares of common stock exchanged with the Patriot common shareholders was based upon the closing price of our common stock on December 2, 2009, the price immediately prior to the closing of the transaction.
- (2) The fair value of Patriot's investments was determined by the Board of Directors in conjunction with an independent valuation agent. This valuation resulted in a purchase price which was \$98,150 below the amortized cost of such investments. For those assets which are performing, Prospect will record the accretion to par value in interest income over the remaining term of the investment.
- (3) The gain has been determined after the final payments of certain liabilities were settled.

During the year ended June 30, 2011, we recognized \$22,084 of interest income due to purchase discount accretion from the assets acquired from Patriot. Included in the \$22,084 is \$4,912 of normal accretion, \$12,035 of accelerated accretion resulting from the repayment of Impact Products, LLC ("Impact Products"), Label Corp and Prince and \$4,968 of accelerated accretion resulting from the recapitalization of our debt investments in Arrowhead General Insurance Agency, Inc. ("Arrowhead"), The Copernicus Group, Inc. ("Copernicus"), Fischbein and Northwestern Management Services, LLC ("Northwestern"). The restructured loans for Arrowhead, Copernicus, Fischbein and Northwestern were issued at market terms comparable to other industry transactions. In accordance with ASC 320-20-35 the cost basis of the new loan was recorded at par value, which precipitated the acceleration of original purchase discount from the loan repayment which was recognized as interest income.

During the period from the acquisition of Patriot on December 2, 2009 to June 30, 2010, we recognized \$18,795 of interest income due to purchase discount accretion from the assets acquired from Patriot. Included in this amount \$4,579 of normal accretion and \$14,216 of accelerated accretion resulting from the early repayments of four loans, three revolving lines of credit, sale of one investment position and restructuring of our loans to Aircraft Fasteners International, LLC ("AFI"), EXL Acquisition Corp. ("EXL"), LHC Holdings Corp. ("LHC"), Prince, ROM Acquisition Corporation ("ROM"). The revised terms were more favorable than the original terms and increased the present value of the future cash flows. In accordance with ASC 320-20-35 the cost basis of the new loans were recorded at par value, which precipitated the acceleration of original purchase discount from the loan repayment which was recognized as interest income.

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Investment Holdings

As of June 30, 2011, we continue to pursue our investment strategy. In May 2007, we changed our name to "Prospect Capital Corporation" and the terminated of our policy to invest at least 80% of our net assets in energy companies. Since that time, we have reduced our exposure to the energy industry, and our holdings in the energy and energy related industries now represent less than 20% of our investment portfolio.

At June 30 2011, approximately \$1,463,010 or 131.3% of our net assets are invested in 72 long-term portfolio investments and 5.4% of our net assets invested in money market funds.

During the year ended June 30, 2011, we originated \$953,337 of new investments. Our origination efforts recently have focused primarily on secured lending and reducing the risk in the portfolio, including a higher percentage of first lien loans than in prior periods, though we also continue to close selected junior debt and equity investments. In addition to targeting investments senior in corporate capital structures with our new originations, we have also increased our origination business mix of third party private equity sponsor owned companies, which tend to have more third party equity capital supporting our debt investments than non sponsor transactions. Our portfolio's annualized current yield decreased from 14.2% as of June 30, 2010 to 12.8% as of June 30, 2011 across all long-term debt and certain equity investments. We expect Prospect's current asset yield may decline modestly over the next few quarters as we increase the size of the portfolio while reducing credit risk. Monetization of other equity positions that we hold is not included in this yield calculation. In many of our portfolio companies, we hold equity positions, ranging from minority interests to majority stakes, which we expect over time to contribute to our investment returns. Some of these equity positions include features such as contractual minimum internal rates of returns, preferred distributions, flip structures and other features expected to generate additional investment returns, as well as contractual protections and preferences over junior equity, in addition to the yield and security offered by our cash flow and collateral debt protections.

We classify our investments by level of control. As defined in the 1940 Act, control investments are those where there is the ability or power to exercise a controlling influence over the management or policies of a company. Control is generally deemed to exist when a company or individual possesses or has the right to acquire within 60 days or less, a beneficial ownership of 25% or more of the voting securities of an investee company. Affiliated investments and affiliated companies are defined by a lesser degree of influence and are deemed to exist through the possession outright or via the right to acquire within 60 days or less, beneficial ownership of 5% or more of the outstanding voting securities of another person.

As of June 30, 2011, we own controlling interests in AIRMALL USA, Inc. ("AIRMALL"), Ajax Rolled Ring & Machine, Inc. ("Ajax"), AWCNC, LLC, Borga, Inc. ("Borga"), C&J Cladding LLC, Change Clean Energy Holdings, Inc. ("CCEHI"), Freedom Marine Services LLC ("Freedom Marine"), Gas Solutions Holdings, Inc. ("GSHI"), Integrated Contract Services, Inc. ("ICS"), Iron Horse Coiled Tubing, Inc. ("Iron Horse"), Manx Energy, Inc. ("Manx"), NMMB, NRG Manufacturing, Inc. ("NRG"), Nupla Corporation ("Nupla"), R-V Industries, Inc. ("R-V") and Yatesville Coal Holdings, Inc. ("Yatesville"). We also own an affiliated interest in BNN Holdings Corp. f/k/a Biotronic NeuroNetwork ("Biotronic"), Boxercraft Incorporated ("Boxercraft"), Smart, LLC, and Sport Helmets Holdings, LLC ("Sport Helmets").

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The following is a summary of our investment portfolio by level of control at June 30, 2011 and June 30, 2010, respectively:

| Level of Control | June 30, 2011 | | | | June 30, 2010 | | | |
|---------------------------|---------------------|----------------------|---------------------|----------------------|-------------------|----------------------|-------------------|----------------------|
| | Cost | Percent of Portfolio | Fair Value | Percent of Portfolio | Cost | Percent of Portfolio | Fair Value | Percent of Portfolio |
| Control | \$ 262,301 | 18.0% | \$ 310,072 | 20.4% | \$ 185,720 | 23.3% | \$ 195,958 | 24.0% |
| Affiliate | 56,833 | 3.9% | 72,337 | 4.7% | 65,082 | 8.2% | 73,740 | 9.0% |
| Non-control/Non-affiliate | 16,600 | 74.1% | 1,080,601 | 71.0% | 477,957 | 59.9% | 478,785 | 58.6% |
| Money Market Funds | 59,903 | 4.0% | 59,903 | 3.9% | 68,871 | 8.6% | 68,871 | 8.4% |
| Total Portfolio | \$ 1,495,637 | 100.0% | \$ 1,522,913 | 100.0% | \$ 797,630 | 100.0% | \$ 817,354 | 100.0% |

The following is our investment portfolio presented by type of investment at June 30, 2011 and June 30, 2010, respectively:

| Type of Investment | June 30, 2011 | | | | June 30, 2010 | | | |
|------------------------------|---------------------|----------------------|---------------------|----------------------|-------------------|----------------------|-------------------|----------------------|
| | Cost | Percent of Portfolio | Fair Value | Percent of Portfolio | Cost | Percent of Portfolio | Fair Value | Percent of Portfolio |
| Money Market Funds | \$ 59,903 | 4.0% | \$ 59,903 | 3.9% | \$ 68,871 | 8.6% | \$ 68,871 | 8.4% |
| Revolving Line of Credit | 7,144 | 0.5% | 7,278 | 0.5% | 4,754 | 0.6% | 5,017 | 0.6% |
| Senior Secured Debt | 822,582 | 55.0% | 789,981 | 51.9% | 313,755 | 39.4% | 287,470 | 35.2% |
| Subordinated Secured Debt | 491,188 | 32.9% | 448,675 | 29.5% | 333,453 | 41.8% | 313,511 | 38.4% |
| Subordinated Unsecured Debt | 54,687 | 3.7% | 55,336 | 3.6% | 30,209 | 3.8% | 30,895 | 3.8% |
| Preferred Stock | 31,979 | 2.1% | 25,454 | 1.7% | 16,969 | 2.1% | 5,872 | 0.7% |
| Common Stock | 19,865 | 1.3% | 116,076 | 7.6% | 20,243 | 2.5% | 77,131 | 9.4% |
| Membership Interests | 6,128 | 0.4% | 15,392 | 1.0% | 6,964 | 0.9% | 17,730 | 2.2% |
| Overriding Royalty Interests | | % | 2,168 | 0.1% | | % | 2,768 | 0.3% |
| Net Profit Interests | | % | | % | | % | 1,020 | 0.1% |
| Warrants | 2,161 | 0.1% | 2,650 | 0.2% | 2,412 | 0.3% | 7,069 | 0.9% |
| Total Portfolio | \$ 1,495,637 | 100.0% | \$ 1,522,913 | 100.0% | \$ 797,630 | 100.0% | \$ 817,354 | 100.0% |

The following is our investment portfolio presented by geographic location of the investment at June 30, 2011 and June 30, 2010, respectively:

| Geographic Location | June 30, 2011 | | | | June 30, 2010 | | | |
|---------------------|---------------|----------------------|------------|----------------------|---------------|----------------------|------------|----------------------|
| | Cost | Percent of Portfolio | Fair Value | Percent of Portfolio | Cost | Percent of Portfolio | Fair Value | Percent of Portfolio |
| Canada | \$ 74,239 | 5.0% | \$ 75,207 | 4.9% | \$ 21,002 | 2.6% | \$ 12,054 | 1.5% |
| Ireland | 14,908 | 1.0% | 15,000 | 1.0% | 14,903 | 1.9% | 15,000 | 1.8% |
| Netherlands | | % | | % | 1,397 | 0.2% | 1,233 | 0.2% |
| Midwest US | (49.4) | | | | | | | |

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| | | | | | | | | | | | | | | | | |
|----------------------------------|----|------|----|-------|----|-------|----|--------|----|--------|----|-------|----|-----|----|-------|
| Balance, February 28, 2015 | \$ | 45.0 | \$ | 442.2 | \$ | 632.2 | \$ | (99.8) | \$ | (78.7) | \$ | 940.9 | \$ | 0.9 | \$ | 941.8 |
|----------------------------------|----|------|----|-------|----|-------|----|--------|----|--------|----|-------|----|-----|----|-------|

The accompanying Notes to Condensed Consolidated Financial

Statements are an integral part of these statements.

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AAR CORP. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

February 28, 2015

(Unaudited)

(Dollars in millions, except per share amounts)

Note 1 Basis of Presentation

AAR CORP. and its subsidiaries are referred to herein collectively as AAR, Company, we, us, and our, unless the context indicates otherwise. The accompanying Condensed Consolidated Financial Statements include the accounts of AAR and its subsidiaries after elimination of intercompany accounts and transactions.

We have prepared these statements without audit, pursuant to the rules and regulations of the United States Securities and Exchange Commission (SEC). The Condensed Consolidated Balance Sheet as of May 31, 2014 has been derived from audited financial statements. To prepare the financial statements in conformity with U.S. generally accepted accounting principles (GAAP), management has made a number of estimates and assumptions relating to the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities. Actual results could differ from those estimates. Certain information and note disclosures, normally included in comprehensive financial statements prepared in accordance with GAAP, have been condensed or omitted pursuant to such rules and regulations of the SEC. These Condensed Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements and notes thereto included in our latest annual report on Form 10-K.

In the opinion of management, the condensed consolidated financial statements reflect all adjustments (which consist only of normal recurring adjustments) necessary to present fairly the condensed consolidated financial position of AAR CORP. and its subsidiaries as of February 28, 2015, the Condensed Consolidated Statements of Operations and the Condensed Consolidated Statements of Comprehensive Income for the three- and nine-month periods ended February 28, 2015 and 2014, the Condensed Consolidated Statements of Cash Flows for the nine-month periods ended February 28, 2015 and 2014, and the Condensed Consolidated Statement of Changes in Equity for the nine-month period ended February 28, 2015. The results of operations for such interim periods are not necessarily indicative of the results for the full year.

Note 2 Discontinued Operations

On March 26, 2015, we completed the sale of our Telair Cargo Group to TransDigm, Inc. for \$725 million, subject to certain post-closing adjustments, including a working capital adjustment. The Telair Cargo Group was comprised of Telair International, Telair US, and Nordisk Aviation Products. Cash received at closing was \$705 million with the remaining consideration of \$20 million placed in escrow and payable based on the occurrence of certain post-closing events related to a cargo system development program. In addition, incremental contingent consideration of up to \$15 million related to the same cargo system development program could increase total proceeds to \$740 million. We expect to report a pre-tax gain on the sale (net of transaction expenses and fees) of approximately \$200 million in the fourth quarter of fiscal 2015.

We have also announced our intention to sell our Precision Systems Manufacturing business comprised of our metal and composite machined and fabricated parts manufacturing operations. During the three months ended February 28, 2015, we recognized an impairment charge of \$46.4 million to reduce the carrying value of Precision Systems Manufacturing business's net assets to their expected value at the time of sale.

The Telair Cargo Group and Precision Systems Manufacturing, which were both previously reported in our Technology Products segment, are reported as discontinued operations in the Condensed Consolidated Statements of Operations for all periods presented. Interest expense allocated to discontinued operations was \$2.8 million and \$3.3 million during the three months ended February 28, 2015 and 2014, respectively, and \$8.4 million and \$10.0 million during the nine months ended February 28, 2015 and 2014, respectively. No amounts for general corporate overhead were allocated to discontinued operations. The assets and liabilities of these businesses have been reclassified to Assets of discontinued operations and Liabilities of discontinued operations on the Condensed Consolidated Balance Sheets.

Sales for our discontinued operations were \$91.8 million and \$74.6 million during the three months ended February 28, 2015 and 2014, respectively, and \$252.6 million and \$241.1 million during the nine months ended February 28, 2015 and 2014, respectively.

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AAR CORP. and Subsidiaries

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(Unaudited)

(Dollars in millions, except per share amounts)

The assets and liabilities held for sale related to discontinued operations on the Consolidated Balance Sheet as of February 28, 2015 are as follows:

| | | |
|--|----|--------|
| Accounts receivable, net | \$ | 73.2 |
| Inventory | | 109.1 |
| Property, plant and equipment, net | | 41.8 |
| Goodwill | | 119.6 |
| Intangible assets, net | | 98.9 |
| Capitalized program development costs | | 114.9 |
| Other assets | | 18.2 |
| Total assets | | 575.7 |
| Less: Reserve for assets held for sale | | (46.4) |
| | \$ | 529.3 |
| Accounts payable | \$ | 23.1 |
| Accrued liabilities | | 34.2 |
| | \$ | 57.3 |

Unless otherwise noted, amounts and disclosures throughout these Notes to Condensed Consolidated Financial Statements relate to our continuing operations.

Note 3 Revenue Recognition

Sales and related cost of sales for product sales are recognized upon shipment of the product to the customer. Our standard terms and conditions provide that title passes to the customer when the product is shipped to the customer. Sales of certain defense products are recognized upon customer acceptance, which includes transfer of title. Under the majority of our expeditionary airlift services contracts, we are paid and record as revenue a fixed daily amount per aircraft for each day an aircraft is available to perform airlift services. In addition, we are paid and record as revenue an amount which is based on number of hours flown. Sales from services and the related cost of services are generally recognized when customer-owned material is shipped back to the customer. We have adopted this accounting policy because at the time the customer-owned material is shipped back to the customer, all services related to that material are complete as our service agreements generally do not require us to provide services at customer sites. Furthermore, serviced units are typically shipped to the customer immediately upon completion of the related services. Sales and related cost of sales for certain long-term manufacturing contracts, certain large airframe maintenance contracts, and performance-based logistics programs are recognized by the percentage of completion method, either based on the relationship of costs incurred to date to the estimated total costs or the units of delivery method. Lease revenues are recognized as earned. Income from monthly or quarterly rental payments is recorded in the pertinent period according to the lease agreement. However, for leases that provide variable rents, we

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recognize lease income on a straight-line basis. In addition to a monthly lease rate, some engine leases require an additional rental amount based on the number of hours the engine is used in a particular month. Lease income associated with these contingent rentals is recorded in the period in which actual usage is reported to us by the lessee, which is normally the month following the actual usage.

Certain supply chain management programs we provide to our customers contain multiple elements or deliverables, such as program and warehouse management, parts distribution, and maintenance and repair services. We recognize revenue for each element or deliverable that can be identified as a separate unit of accounting at the time of delivery based upon the relative fair value of the products and services.

Included in accounts receivable as of February 28, 2015 and May 31, 2014, are \$21.1 million and \$19.7 million, respectively, of unbilled accounts receivable related to the KC10 supply agreement. These unbilled accounts receivable relate to costs we have incurred on parts that were requested and accepted by our customer to support the program. These costs have not been billed by us because the customer has not issued the final paperwork necessary to allow for billing.

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In addition to the unbilled accounts receivable, included in *Other* non-current assets on the Condensed Consolidated Balance Sheet as of February 28, 2015 and May 31, 2014, are \$8.1 million and \$9.9 million, respectively, of costs in excess of amounts billed for the flight-hour portion of the same KC10 supply agreement. These amounts represent the difference between the amount of revenue recognized by us driven by costs incurred under the flight hour portion of the program, compared to what was billed.

New Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board issued Accounting Standards Update (ASU) No. 2014-09, *Revenue from Contracts with Customers*, which provides guidance for revenue recognition. This ASU affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of non-financial assets. This ASU will supersede the revenue recognition requirements in ASC 605, Revenue Recognition, and most industry-specific guidance. This ASU will also supersede certain cost guidance included in Subtopic 605-35, Revenue Recognition-Construction-Type and Production-Type Contracts. This new standard will be effective for us beginning June 1, 2017. We are currently evaluating the impact of the adoption of this new standard on our consolidated financial statements.

Note 4 Accounting for Stock-Based Compensation

Restricted Stock

In July 2014, as part of our annual long-term stock incentive compensation, we granted 192,250 shares of performance-based restricted stock and 95,956 shares of time-based restricted stock to eligible employees. The grant date fair value per share for both grants was \$26.08. In June 2014, we also granted 45,000 shares of time-based restricted stock to members of the Board of Directors with a grant date fair value per share of \$24.50. In the three-months ended February, 28, 2015, we granted 3,000 shares of time-based restricted stock with a grant date fair value of \$25.36. No other restricted stock was granted in fiscal 2015. Expense charged to operations for restricted stock was \$1.6 million and \$1.2 million during the three months ended February 28, 2015 and 2014, respectively, and \$4.3 million and \$3.7 million during the nine months ended February 28, 2015 and 2014, respectively.

Stock Options

The total intrinsic value of stock options exercised during the nine-month periods ended February 28, 2015 and 2014 was \$1.5 million and \$3.8 million, respectively. Expense charged to operations for stock options was \$0.8 million and \$1.0 million during the three months ended February 28, 2015 and 2014, respectively, and \$2.2 million and \$2.6 million during the nine months ended February 28, 2015 and 2014, respectively.

Note 5 Inventory

The summary of inventories is as follows:

| | February 28, 2015 | May 31, 2014 |
|--|------------------------------|-------------------------|
| Raw materials and parts | \$ 41.7 | \$ 114.1 |
| Work-in-process | 19.4 | 57.5 |
| Aircraft and engine parts, components and finished goods | 359.6 | 297.3 |
| Aircraft held for sale and related support parts | 30.3 | 26.4 |
| | \$ 451.0 | \$ 495.3 |

We classify certain aircraft from our expeditionary airlift business as assets held for sale at the time management commits to a plan to sell the aircraft, changes to the planned sale are not likely, the aircraft are actively marketed and available for immediate sale, and the sale is expected to be completed within one year. Upon designation of an aircraft as held for sale, we record the aircraft's value at the lower of its carrying value or its estimated fair value, less estimated costs to sell. Assets held for sale are not depreciated.

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Aircraft may be classified as assets held for sale for more than one year as we continue to actively market the aircraft at reasonable prices. Certain aircraft types we currently have available for sale are specifically designed for particular functions which limits the marketability of those assets. At February 28, 2015, we had 12 aircraft held for sale comprised of eight fixed-wing and four rotary-wing aircraft. At May 31, 2014, we had nine aircraft held for sale comprised of five fixed-wing and four rotary-wing aircraft. During the three-month period ended February 28, 2015, we recognized an impairment charge of \$4.7 million reflecting the decrease in fair value for five fixed-wing aircraft held for sale and related rotatable assets.

Note 6 Supplemental Cash Flow Information

| | Nine Months Ended | | | |
|-----------------------------|-------------------|------|------|------|
| | February 28, | | 2014 | |
| | 2015 | | 2014 | |
| Interest paid | \$ | 32.1 | \$ | 30.9 |
| Income taxes paid | | 11.7 | | 9.2 |
| Income tax refunds received | | 12.1 | | 6.6 |

Note 7 Financing Arrangements

A summary of the carrying amount of our debt is as follows:

| | February 28, 2015 | May 31, 2014 |
|--|----------------------|-----------------|
| Revolving credit facility expiring April 24, 2018 with interest payable monthly | \$ 185.0 | \$ 130.0 |
| Secured credit facility (secured by aircraft and related engines and components) due April 23, 2015 with floating interest rate, payable monthly | 23.0 | 29.9 |
| Note payable due March 9, 2017 with floating interest rate, payable semi-annually on June 1 and December 1 | 20.0 | 30.0 |
| Notes payable due January 15, 2022 with interest at 7.25% payable semi-annually on January 15 and July 15 | 332.0 | 332.6 |
| Convertible notes payable due March 1, 2016 with interest at 2.25% payable semi-annually on March 1 and September 1 | 47.3 | 45.7 |

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| | | | | |
|----------------------------|----|--------|----|--------|
| Other(1) | | 36.0 | | 65.8 |
| Total debt | | 643.3 | | 634.0 |
| Current maturities of debt | | (43.9) | | (69.7) |
| Long-term debt | \$ | 599.4 | \$ | 564.3 |

(1) Included in Other is a mortgage loan (secured by Wood Dale, Illinois facility) due August 1, 2015 of \$11.0 million and \$11.0 million, 1.75% convertible notes due February 1, 2015 of \$0 and \$29.8 million, and an industrial revenue bond (secured by property, plant, and equipment) due August 1, 2018 of \$25.0 million and \$25.0 million at February 28, 2015 and May 31, 2014, respectively.

At February 28, 2015, the carrying value of our 7.25% bonds and 2.25% convertible notes was \$379.4 million and the estimated fair value was approximately \$407.6 million. These debt issuances are classified as Level 2 in the fair value hierarchy. This classification is defined as a fair value determined using market-based inputs other than quoted prices that are observable for the liability, either directly or indirectly.

At February 28, 2015, our remaining variable rate and fixed rate debt had a fair value that approximates the carrying value of \$264.0 million. These debt instruments are classified as Level 3 in the fair value hierarchy, which is defined as a fair value determined based upon one or more significant unobservable inputs.

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We are subject to a number of covenants under our financing arrangements, including at February 28, 2015 restrictions that relate to the payment of cash dividends, maintenance of minimum net working capital and tangible net worth levels, fixed charge coverage ratio, sales of assets, additional financing, purchase of our shares and other matters. We are in compliance with all financial and other covenants under our financing arrangements.

Convertible Notes

During the three-month period ended November 30, 2014, we repurchased all of the outstanding 1.75% convertible notes due February 1, 2015 with total face value of \$30.0 million for \$31.1 million cash including \$1.1 million of accrued interest.

As of February 28, 2015 and May 31, 2014, the long-term debt and equity component (recorded in capital surplus, net of income tax benefit) for our 2.25% convertible notes consisted of the following:

| | February 28, 2015 | May 31, 2014 |
|------------------------------|----------------------|-----------------|
| Long-term debt: | | |
| Principal amount | \$ 49.8 | \$ 49.8 |
| Unamortized discount | (2.5) | (4.1) |
| Net carrying amount | \$ 47.3 | \$ 45.7 |
| Equity component, net of tax | \$ 20.6 | \$ 20.6 |

The unamortized discount on the liability component of long-term debt is being amortized using the effective interest method based on an effective rate of 7.41% for our 2.25% convertible notes. The if converted value for our 2.25% convertible notes does not exceed its principal amount.

The interest expense associated with all convertible notes was as follows:

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| | Three Months Ended February 28, | | | | Nine Months Ended February 28, | | | |
|---|------------------------------------|-----|------|-----|-----------------------------------|-----|------|-----|
| | 2015 | | 2014 | | 2015 | | 2014 | |
| Coupon interest | \$ | 0.3 | \$ | 0.8 | \$ | 1.2 | \$ | 2.5 |
| Amortization of deferred financing fees | | | | 0.1 | | 0.1 | | 0.3 |
| Amortization of discount | | 0.4 | | 1.5 | | 1.7 | | 4.4 |
| Interest expense related to convertible notes | \$ | 0.7 | \$ | 2.4 | \$ | 3.0 | \$ | 7.2 |

Credit Facility Amendment

On March 24, 2015, we entered into an amendment (the Amendment) to our credit agreement dated April 12, 2011, as amended, with various financial institutions, as lenders and Bank of America, N.A., as administrative agent for the lenders (the Credit Agreement).

Under the terms of the Credit Agreement as in effect prior to the Amendment, the aggregate revolving credit commitment amount under the Credit Agreement was \$475 million. The Amendment increases the above-referenced \$475 million to \$500 million. Under certain circumstances, the Company also could request an increase to the revolving commitment by an aggregate amount of up to \$250 million, not to exceed \$750 million in total.

The Amendment also extends the maturity of the Credit Agreement by approximately two years to March 24, 2020. The Amendment also deleted the minimum fixed charge coverage ratio and added a minimum interest coverage ratio. Except as specifically amended and modified by the Amendment, the terms and conditions of the Credit Agreement remain in effect.

Redemption of 7.25% Senior Notes

We have sent out a notice of redemption for our \$325 million 7.25% Senior Notes. The redemption price for the Senior Notes will include an approximately \$45 million make-whole premium and we will record a pre-tax charge for this amount in the fourth quarter of fiscal 2015.

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Note 8 Derivative Instruments and Hedging Activities

We are exposed to interest rate risk associated with fluctuations in interest rates on our variable rate debt. We utilize two derivative financial instruments to manage our variable interest rate exposure over a medium- to long-term period. We have a floating-to-fixed interest rate swap and an interest rate cap agreement, each hedging \$50.0 million of notional principal interest under our Credit Agreement.

We do not hold or issue derivative instruments for trading purposes and are not a party to any instruments with leverage or prepayment features. In connection with derivative financial instruments, there exists the risk of the possible inability of counterparties to meet the terms of their contracts. We mitigate this risk by performing financial reviews before the contract is entered into, as well as on-going periodic evaluations. We do not expect any significant losses from counterparty defaults.

We classify the derivatives as assets or liabilities on the balance sheet. Accounting for the change in fair value of the derivatives is a function of whether the instrument qualifies for, and has been designated as, a hedging relationship, and the type of hedging relationship. As of February 28, 2015, all of our derivative instruments were classified as cash flow hedges. The fair value of the interest rate swap and interest rate cap agreements represents the difference in the present values of cash flows calculated at the contracted interest rates and at current market interest rates at the end of the reporting period.

We record the fair value of assets and liabilities in accordance with the hierarchy established by ASC 820, *Fair Value Measurement*. The fair value of our interest rate derivatives is classified as Level 2, which refers to fair values estimated using significant other observable inputs including quoted prices for similar assets or liabilities in active markets and quoted prices for identical or similar assets or liabilities in markets that are not active. The following table summarizes the classification and fair values of our interest rate derivative instruments reported in the Condensed Consolidated Balance Sheets at February 28, 2015 and May 31, 2014.

| Derivatives designated as hedging instruments | Balance Sheet Classification | February 28, 2015 | May 31, 2014 |
|--|------------------------------|----------------------|-----------------|
| Interest rate cap | Long-term assets | \$ 0.1 | \$ 0.1 |
| Interest rate swap | Long-term liabilities | (2.3) | (2.8) |

We include gains and losses on the derivative instruments in other comprehensive income. We recognize the gains and losses on our derivative instruments as an adjustment to interest expense in the period the hedged interest payment affects earnings. The impact of the interest rate swap and interest cap agreement on the Condensed Consolidated Statement of Comprehensive Income for the three-month periods ended February 28, 2015 and 2014 was an unrealized gain of \$0.4 million and \$0.3 million, respectively. The impact of the interest rate swap and interest cap agreement on the Condensed Consolidated Statements of Operations for the nine-month periods ended February 28, 2015 and 2014 was an unrealized gain of \$0.0 million and \$0.6 million, respectively. The unrealized gains and losses were recorded in accumulated other comprehensive income (loss).

In connection with the Amendment of our Credit Agreement, we settled our floating-to-fixed interest rate swap and interest rate cap agreements for approximately \$2.6 million.

Note 9 Earnings per Share

The computation of basic earnings per share is based on the weighted average number of common shares outstanding during each period. The computation of diluted earnings per share is based on the weighted average number of common shares outstanding during the period plus, when their effect is dilutive, incremental shares

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consisting of shares subject to stock options, shares issuable upon vesting of restricted stock awards, and shares to be issued upon conversion of convertible debt.

We used the if converted method in calculating the diluted earnings per share effect of the assumed conversion of our contingently convertible debt because the principal can be settled in stock, cash, or a combination thereof. Under the if converted method, the after-tax effect of interest expense related to the convertible securities is added back to net income, and the convertible debt is assumed to have been converted into common shares at the beginning of the period.

In accordance with ASC 260-10-45, *Share-Based Payment Arrangements and Participating Securities and the Two-Class Method*, our unvested time-based restricted stock awards are deemed participating securities since these shares are entitled to participate in dividends declared on shares of common stock. During periods of net income, the calculation of earnings per share for common stock excludes income attributable to unvested restricted stock awards from the numerator and excludes the dilutive impact of those shares from the denominator. During periods of net loss, no effect is given to the participating securities because they do not share in the losses of the Company.

The following table provides a reconciliation of the computations of basic and diluted earnings per share information for the three- and nine-month periods ended February 28, 2015 and 2014.

| | Three Months Ended February 28, | | | | Nine Months Ended February 28, | | | |
|--|------------------------------------|--------|------|-------|-----------------------------------|--------|------|-------|
| | 2015 | | 2014 | | 2015 | | 2014 | |
| Income from continuing operations | \$ | 1.9 | \$ | 16.9 | \$ | 27.6 | \$ | 52.3 |
| Less income attributable to participating shares | | (0.1) | | (0.4) | | (0.6) | | (1.2) |
| Income from continuing operations attributable to common shareholders | | 1.8 | | 16.5 | | 27.0 | | 51.1 |
| Income (Loss) from discontinued operations attributable to common shareholders | | (36.4) | | 1.0 | | (32.5) | | 3.5 |
| Net income (loss) attributable to common shareholders | \$ | (34.6) | \$ | 17.5 | \$ | (5.5) | \$ | 54.6 |
| Weighted average common shares outstanding basic | | 38.7 | | 38.6 | | 38.7 | | 38.6 |
| Additional shares from the assumed exercise of stock options | | 0.5 | | 0.5 | | 0.5 | | 0.5 |

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| | | | | | | | | |
|--|----|--------|----|------|----|--------|----|------|
| Weighted average common shares outstanding diluted | | 39.2 | | 39.1 | | 39.2 | | 39.1 |
| Earnings per share basic: | | | | | | | | |
| Earnings from continuing operations | \$ | 0.05 | \$ | 0.43 | \$ | 0.70 | \$ | 1.32 |
| Earnings (Loss) from discontinued operations | | (0.94) | | 0.02 | | (0.84) | | 0.09 |
| Earnings (Loss) per share basic | \$ | (0.89) | \$ | 0.45 | \$ | (0.14) | \$ | 1.41 |
| Earnings per share diluted: | | | | | | | | |
| Earnings from continuing operations | \$ | 0.05 | \$ | 0.43 | \$ | 0.69 | \$ | 1.31 |
| Earnings (Loss) from discontinued operations | | (0.94) | | 0.02 | | (0.84) | | 0.09 |
| Earnings (Loss) per share diluted | \$ | (0.89) | \$ | 0.45 | \$ | (0.15) | \$ | 1.40 |

At February 28, 2015 and 2014, respectively, stock options to purchase 169,163 shares and 170,000 shares of common stock were outstanding, but were not included in the computation of diluted earnings per share because the exercise price of each of these options was greater than the average market price of the common shares during the interim periods then ended.

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AAR CORP. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

February 28, 2015

(Unaudited)

(Dollars in millions, except per share amounts)

Note 10 Accumulated Other Comprehensive Loss

Changes in our accumulated other comprehensive loss (AOCL) by component for the three- and nine-month periods ended February 28, 2015 and 2014 were as follows:

| | | | | | | | | |
|--------------------------------|----|--------|----|--------|----|-------|----|--------|
| Balance at December 1, 2014 | \$ | (15.1) | \$ | (35.3) | \$ | (2.4) | \$ | (52.8) |
| Amounts reclassified from AOCL | | | | (0.2) | | | | (0.2) |
| Balance at February 28, 2015 | \$ | (41.2) | \$ | (35.5) | \$ | (2.0) | \$ | (78.7) |
| Balance at December 1, 2013 | \$ | 6.4 | \$ | (33.3) | \$ | (3.0) | \$ | (29.9) |
| Amounts reclassified from AOCL | | | | 0.2 | | | | 0.2 |
| Balance at February 28, 2014 | \$ | 10.6 | \$ | (33.1) | \$ | (2.7) | \$ | (25.2) |

| | | | | | | | | |
|--------------------------------|----|--------|----|--------|----|-------|----|--------|
| Balance at June 1, 2014 | \$ | 8.7 | \$ | (35.4) | \$ | (2.6) | \$ | (29.3) |
| Amounts reclassified from AOCL | | | | (0.1) | | | | (0.1) |
| Balance at February 28, 2015 | \$ | (41.2) | \$ | (35.5) | \$ | (2.0) | \$ | (78.7) |
| Balance at June 1, 2013 | \$ | (5.4) | \$ | (33.8) | \$ | (3.3) | \$ | (42.5) |
| Amounts reclassified from AOCL | | | | 0.7 | | | | 0.7 |
| Balance at February 28, 2014 | \$ | 10.6 | \$ | (33.1) | \$ | (2.7) | \$ | (25.2) |

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AAR CORP. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

February 28, 2015

(Unaudited)

(Dollars in millions, except per share amounts)

Note 11 Business Segment Information

As discussed in Note 2 Discontinued Operations, we began reporting our Telair Cargo Group and Precision Systems Manufacturing businesses as discontinued operations effective in the third quarter of fiscal 2015. Prior to the decision to sell these two businesses, we reported our activities in the following two business segments: *Aviation Services* comprised of our supply chain, maintenance, repair and overhaul (MRO) and airlift activities and *Technology Products* comprised of our Telair Cargo Group, Precision Systems Manufacturing, and mobility businesses.

As a result of the divestitures of the Telair Cargo Group and Precision Systems Manufacturing, we have revised our reportable segments to align to our new organizational structure. We will report our results in two new segments: *Aviation Services* comprised of supply chain and MRO activities and *Expeditionary Services* comprised of airlift and mobility activities. This new presentation reflects the way our chief operating decision making officer (Chief Executive Officer) now evaluates performance and our internal organizational and management structure.

The Aviation Services segment consists of businesses that provide spares and maintenance support for aircraft operated by our commercial and government/defense customers. Sales in the Aviation Services segment are derived from the sale and lease of a wide variety of new, overhauled and repaired engine and airframe parts and components to the commercial aviation and government and defense markets. We provide customized inventory supply chain management, performance based logistics programs, aircraft component repair management services, and aircraft modifications. The segment also includes repair, maintenance and overhaul of aircraft, landing gear and components. Cost of sales consists principally of the cost of product, direct labor and overhead.

The Expeditionary Services segment consists of businesses that provide products and services supporting the movement of equipment and personnel by the U.S. DoD, foreign governments and non-governmental organizations. Sales in the Expeditionary Services segment are derived from the delivery of airlift services to mostly government and defense customers and the design and manufacture of pallets, shelters, and containers used to support the U.S. military's requirements for a mobile and agile force. We also provide system integration services for specialized command and control systems. Cost of sales consists principally of aircraft maintenance costs, depreciation, the cost of material to manufacture products, direct labor and overhead.

Segment results have been reclassified for all periods presented to reflect our new segment presentation.

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The accounting policies for the segments are the same as those described in Note 1 of Notes to Consolidated Financial Statements included in our annual report on Form 10-K for the year ended May 31, 2014. Our Chief Executive Officer evaluates performance based on the reportable segments and utilizes gross profit as a primary profitability measure. Gross profit is calculated by subtracting cost of sales from sales. The assets and certain expenses related to corporate activities are not allocated to the segments. Our reportable segments are aligned principally around differences in products and services.

Selected financial information for each segment is as follows:

| | Three Months Ended February 28, | | Nine Months Ended February 28, | |
|------------------------|------------------------------------|----------|-----------------------------------|------------|
| | 2015 | 2014 | 2015 | 2014 |
| Sales: | | | | |
| Aviation Services | \$ 318.4 | \$ 289.7 | \$ 955.9 | \$ 923.5 |
| Expeditionary Services | 61.7 | 110.1 | 222.6 | 365.0 |
| | \$ 380.1 | \$ 399.8 | \$ 1,178.5 | \$ 1,288.5 |

| | Three Months Ended February 28, | | Nine Months Ended February 28, | |
|------------------------|------------------------------------|---------|-----------------------------------|----------|
| | 2015 | 2014 | 2015 | 2014 |
| Gross profit: | | | | |
| Aviation Services | \$ 50.7 | \$ 38.3 | \$ 152.8 | \$ 125.5 |
| Expeditionary Services | (0.6) | 27.9 | 26.9 | 89.9 |
| | \$ 50.1 | \$ 66.2 | \$ 179.7 | \$ 215.4 |

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AAR CORP. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

February 28, 2015

(Unaudited)

(Dollars in millions, except per share amounts)

The following table reconciles segment gross profit to income from continuing operations before provision for income taxes:

| | Three Months Ended February 28, | | | | Nine Months Ended February 28, | | | |
|--|------------------------------------|--------|------|--------|-----------------------------------|---------|------|---------|
| | 2015 | | 2014 | | 2015 | | 2014 | |
| Segment gross profit | \$ | 50.1 | \$ | 66.2 | \$ | 179.7 | \$ | 215.4 |
| Selling, general and administrative | | (41.7) | | (37.7) | | (120.3) | | (120.3) |
| Earnings from joint ventures | | 0.6 | | 0.6 | | 1.8 | | 2.5 |
| Interest expense | | (6.4) | | (7.1) | | (19.4) | | (21.9) |
| Interest income | | | | 0.3 | | 0.2 | | 0.9 |
| Income before provision for income taxes | \$ | 2.6 | \$ | 22.3 | \$ | 42.0 | \$ | 76.6 |

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Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations (Dollars in millions)

General Overview

We began reporting our Telair Cargo Group and Precision Systems Manufacturing businesses as discontinued operations during the third quarter of fiscal 2015. Prior to the decision to divest these two businesses, we reported our activities in the following two business segments: *Aviation Services* comprised of supply chain, maintenance, repair and overhaul (MRO) and airlift activities *Technology Products* comprised of Telair Cargo Group, Precision Systems Manufacturing, and mobility businesses.

As a result of the divestitures of the Telair Cargo Group and Precision Systems Manufacturing, we have revised our reportable segments to align to our new organizational structure. We will report our results in two new segments: *Aviation Services*, comprised of supply chain and MRO activities and *Expeditionary Services*, comprised of airlift and mobility activities. This new presentation reflects the way our chief operating decision making officer (Chief Executive Officer) now evaluates performance and our internal organizational and management structure.

The Aviation Services segment consists of businesses that provide spares and maintenance support for aircraft operated by our commercial and government/defense customers. Sales in the Aviation Services segment are derived from the sale and lease of a wide variety of new, overhauled and repaired engine and airframe parts and components to the commercial aviation and government and defense markets. We provide customized inventory supply chain management, performance based logistics programs, aircraft component repair management services, and aircraft modifications. The segment also includes repair, maintenance and overhaul of aircraft, landing gear and components. Cost of sales consists principally of the cost of product, direct labor and overhead.

The Expeditionary Services segment consists of businesses that provide products and services supporting the movement of equipment and personnel by the U.S. DoD, foreign governments and non-governmental organizations. Sales in the Expeditionary Services segment are derived from the delivery of airlift services to mostly government and defense customers and the design and manufacture of pallets, shelters, and containers used to support the U.S. military's requirements for a mobile and agile force. We also provide system integration services for specialized command and control systems. Cost of sales consists principally of aircraft maintenance costs, depreciation, the cost of material to manufacture products, direct labor and overhead.

The accounting policies for the segments are the same as those described in Note 1 of Notes to Consolidated Financial Statements included in our annual report on Form 10-K for the year ended May 31, 2014. Our Chief Executive Officer evaluates performance based on the reportable segments and utilizes gross profit as a primary profitability measure. Gross profit is calculated by subtracting cost of sales from sales. The assets and certain expenses related to corporate activities are not allocated to the segments. Our reportable segments are aligned principally around differences in products and services.

Consolidated sales for the first nine months of fiscal 2015 decreased \$110.0 million or 8.5% compared to the prior year period. Sales to government and defense customers decreased \$151.4 million or 25.4% compared to the prior year driven primarily by lower demand by the U.S. Department of Defense (DoD) for expeditionary airlift services in Afghanistan. Sales to government and defense customers in our expeditionary airlift services business decreased \$122.8 million which reflects the reduction in U.S. troops in Afghanistan slightly offset by new contract awards in Africa. The prior year results also were enhanced by the delivery of three aircraft to government customers in fiscal 2014, as

compared to no deliveries in fiscal 2015, which contributed \$37.7 million of the decrease in sales.

The DoD's reduced role in Afghanistan as a result of the troop drawn-down has had a significant impact on our expeditionary airlift fleet operations in Afghanistan. At the beginning of fiscal 2014, we had 40 aircraft in revenue service compared to 19 aircraft in revenue service as of February 28, 2015. We believe that the pipeline of opportunities in the airlift services market will enable us to return our idled aircraft to revenue service in the near future.

During the first nine months of fiscal 2015, sales to commercial customers increased \$41.4 million or 6.0% compared to the prior year driven primarily by higher supply chain volumes. This increase was partially offset by a significant engineering services program that ended in the second quarter of fiscal 2014 which represented \$14.6 million of sales in the prior period. We also experienced a decrease in sales of \$15.4 million related to lower volumes in our maintenance, repair and overhaul services businesses.

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Sales and gross profit (loss) for our two business segments for the three- and nine months ended February 28, 2015 and 2014 were as follows:

| | Three Months Ended February 28, | | | Nine Months Ended February 28, | | |
|------------------------|---------------------------------|----------|-------------|--------------------------------|----------|-------------|
| | 2015 | 2014 | % Change | 2015 | 2014 | % Change |
| Sales: | | | | | | |
| Aviation Services | | | | | | |
| Commercial | \$ 238.9 | \$ 227.0 | 5.2% | \$ 719.1 | \$ 685.8 | 4.9% |
| Defense | 79.5 | 62.7 | 26.8% | 236.8 | 237.7 | (0.4)% |
| | \$ 318.4 | \$ 289.7 | 9.9% | \$ 955.9 | \$ 923.5 | 3.5% |
| Expeditionary Services | | | | | | |
| Commercial | \$ 6.6 | \$ 1.4 | 371% | \$ 15.1 | \$ 7.0 | 116% |
| Defense | 55.1 | 108.7 | (49.3)% | 207.5 | 358.0 | (42.0)% |
| | \$ 61.7 | \$ 110.1 | (44.0)% | \$ 222.6 | \$ 365.0 | (39.0)% |

| | Three Months Ended February 28, | | | Nine Months Ended February 28, | | |
|-----------------------------|---------------------------------|---------|-------------|--------------------------------|----------|-------------|
| | 2015 | 2014 | % Change | 2015 | 2014 | % Change |
| Gross Profit (Loss): | | | | | | |
| Aviation Services | | | | | | |
| Commercial | \$ 38.2 | \$ 29.6 | 29.1% | \$ 115.1 | \$ 100.7 | 14.3% |
| Defense | 12.5 | 8.7 | 43.7% | 37.7 | 24.8 | 52.0% |
| | \$ 50.7 | \$ 38.3 | 32.4% | \$ 152.8 | \$ 125.5 | 21.8% |
| Expeditionary Services | | | | | | |
| Commercial | \$ 0.3 | \$ 0.1 | 200% | \$ 1.2 | \$ 0.2 | 500% |
| Defense | (0.9) | 27.8 | (103)% | 25.7 | 89.7 | (71.3)% |
| | \$ (0.6) | \$ 27.9 | (102)% | \$ 26.9 | \$ 89.9 | (70.1)% |

Three-Month Period Ended February 28, 2015*Aviation Services Segment*

For the three-month period ended February 28, 2015, sales in the Aviation Services segment increased \$28.7 million or 9.9% from the prior year period. The increase in sales was due to an \$11.9 million or 5.2% increase in sales to commercial customers attributable to higher supply chain volumes principally from new contract wins announced in the second half of fiscal 2014.

Sales in this segment to government and defense customers increased \$16.8 million or 26.8% over the prior year primarily attributable to stronger volumes in our defense logistics business principally due to new contract wins. We are also providing design, outfitting and integration services to a government customer for their new military MRO facility which contributed \$2.5 million in sales during the three-month period ended February 28, 2015.

Gross profit for the third quarter ended February 28, 2015 in the Aviation Services segment increased \$12.4 million or 32.4%. Gross profit on sales to commercial customers increased \$8.6 million or 29.1% over the prior year with the gross profit margin increasing to 16.0% compared to 13.0% in the prior year. The increase in gross profit on sales to commercial customers is primarily attributable to growth in our supply chain businesses which contributed \$6.7 million of the increased gross profit.

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Gross profit in this segment on sales to government and defense customers increased \$3.8 million or 43.7% from the prior year with stronger volumes in our defense logistics business contributing an additional \$2.5 million during the three-months ended February 28, 2014 over the prior period. The increase in our gross profit margin from 13.9% to 15.7% was primarily attributable to the support services for a government customer's new MRO facility.

Expeditionary Services Segment

For the three-month period ended February 28, 2015, sales in the Expeditionary Services segment decreased \$48.4 million or 44.0% from the prior year period. The decrease in sales was due to a \$43.5 million decrease in sales from our expeditionary airlift services business from the reduction in our aircraft positions in Afghanistan. Lower demand for mobility products represented the remainder of the decrease in sales in the expeditionary services segment as the DoD reduced its purchases of these products due to the reduced troop activity.

Gross profit for the third quarter ended February 28, 2015 in the Expeditionary Services segment decreased \$28.5 million or 102.2% to a loss of \$0.6 million. The reduction in aircraft positions comprised the majority of the decrease in gross profit. We also recognized an impairment charge of \$4.7 million related to five aircraft available for sale and their related inventory and rotatable assets. The lower sales volumes at our mobility products also contributed \$3.3 million to the gross profit decrease.

Selling, General and Administrative Expenses

Selling, general and administrative expenses increased \$4.0 million in the third quarter ended February 28, 2015 from the prior year period reflecting severance costs of \$1.4 million and incremental investments in business development activities principally in our Aviation Services segment.

Operating Income and Taxes

Operating income decreased \$20.1 million or 69.1% from the prior year primarily due to the impact of lower sales in our Expeditionary Services segment and higher selling, general and administrative expenses.

Our effective income tax rate for continuing operations was 26.9% for the quarter ended February 28, 2015 compared to 24.2% in the prior year period. These effective tax rates reflect the allocation of income tax expense across our continuing and discontinued operations. During the three-month period ended February 28, 2014, we recognized a \$2.7 million reduction in income tax expense related to tax provision to federal income tax return filing differences.

Discontinued Operations

Income (Loss) from discontinued operations decreased from income of \$1.1 million for the three-month period ended February 28, 2014 to a loss of \$36.3 million in the current period. The decrease is primarily attributable to a pre-tax impairment charge of \$46.4 million to reduce the carrying value of the Precision Systems Manufacturing's net assets to their expected value at the time of sale.

Nine-Month Period Ended February 28, 2015

Aviation Services Segment

For the nine-month period ended February 28, 2015, sales in the Aviation Services segment increased \$32.4 million or 3.5% from the prior year period due to a \$33.3 million or 4.9% increase in sales to commercial customers. The increase in sales to commercial customers was primarily attributable to higher supply chain volumes due principally to new contract wins announced in the second half of fiscal 2014 partially offset by a significant engineering services program that ended in the second quarter of fiscal 2014 with sales of \$14.6 million in the nine-months ended February 28, 2014. We have also experienced lower volumes in our maintenance, repair and overhaul facilities with sales decreased \$15.4 million from the prior period.

Sales in this segment to government and defense customers decreased \$0.9 million or 0.4% over the prior year primarily due to the delivery of three aircraft to government customers in fiscal 2014 representing sales of

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\$37.7 million with no deliveries in the first nine months of fiscal 2015. This decrease was largely offset by higher supply chain volumes in our defense logistics business.

Gross profit in the Aviation Services segment increased \$27.3 million or 21.8%. Gross profit on sales to commercial customers increased \$14.4 million or 14.3% over the prior year with the gross profit margin increasing to 16.0% compared to 14.7% in the prior year. The increase in gross profit on sales to commercial customers is primarily attributable to higher supply chain activity providing an additional \$21.6 million of gross profit in the current nine-month period. This increase was partially offset by a slight decline in gross profit margins in our maintenance, repair and overhaul businesses due to reduced volumes.

Gross profit in this segment on sales to government and defense customers increased \$12.9 million or 52.0% from the prior year with stronger volumes in our defense logistics business contributing the majority of the increase. Gross profit margin increased from 10.4% to 15.9% primarily due to these increased volumes.

Expeditionary Services Segment

For the nine-month period ended February 28, 2015, sales in the Expeditionary Services segment decreased \$142.4 million or 39.0% from the prior year period. The decrease in sales was due to a \$124.2 million decrease in sales from our expeditionary airlift services business from the reduction in our aircraft positions in Afghanistan. Lower demand for mobility products represented the remainder of the decrease in sales in the Expeditionary Services segment.

Gross profit in the Expeditionary Services segment decreased \$63.0 million or 70.1% for the nine-month period ended February 28, 2015. The reduction in aircraft positions comprised the majority of the decrease in gross profit. We also recognized an impairment charge of \$4.7 million related to five aircraft available for sale and their related inventory and rotatable assets. The lower sales volumes at our mobility products business also contributed \$9.0 million to the gross profit decrease.

Selling, General and Administrative Expenses and Earnings from Aircraft Joint Ventures

Selling, general and administrative expenses were flat at \$120.3 million for the nine-months ended February 28, 2015. This reflects the realization of benefits from the cost control measures implemented by the Company during fiscal 2014 offset by severance costs of \$1.4 million and incremental investments in business development activities incurred during the three-month period ended February 28, 2015.

Earnings from aircraft joint ventures decreased \$0.7 million reflecting lower lease revenue from our joint ventures.

Operating Income and Taxes

Operating income decreased \$36.4 million or 37.3% from the prior year primarily due to the impact of lower sales in our Expeditionary Services segment.

Our effective income tax rate for continuing operations was 34.3% for the nine-month period ended February 28, 2015 compared to 31.7% in the prior year period. These effective tax rates reflect the allocation of income tax expense across our continuing and discontinued operations. During the nine-month period ended February 28, 2014, we recognized a \$2.7 million reduction in income tax expense related to tax provision to federal income tax return filing differences.

Discontinued Operations

Income (Loss) from discontinued operations decreased from income of \$3.7 million for the nine-month period ended February 28, 2014 to a loss of \$32.3 million in the current period. The decrease is primarily attributable to a pre-tax impairment charge of \$46.4 million to reduce the carrying value of the Precision Systems Manufacturing business's net assets to their expected value at the time of sale.

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Liquidity, Capital Resources and Financial Position

Our operating activities are funded and commitments met principally through the generation of cash from operations. Periodically, we may raise capital through the issuance of common stock or debt in the public and private markets. In addition to these cash sources, our current capital resources include an unsecured credit facility, as well as a separate secured credit facility. We continually evaluate various financing arrangements, including the issuance of common stock or debt, which would allow us to improve our liquidity position and finance future growth on commercially reasonable terms. Our continuing ability to borrow from our lenders and issue debt and equity securities to the public and private markets in the future may be negatively affected by a number of factors, including the overall health of the credit markets, general economic conditions, airline industry conditions, geo-political events, and our operating performance. Our ability to generate cash from operations is influenced primarily by our operating performance and changes in working capital. Under our universal shelf registration statement filed with the Securities and Exchange Commission that became effective May 4, 2012 and expires on May 4, 2015, we registered an indeterminate number of principal amount or shares of common stock, shares of preferred stock, debt securities, warrants, stock purchase contracts and stock purchase units which may be sold from time to time, subject to market conditions.

At February 28, 2015, our liquidity and capital resources included cash of \$67.0 million and working capital of \$1,104.1 million.

On March 24, 2015, we entered into an amendment (the Amendment) to our credit agreement dated April 12, 2011, as amended, with various financial institutions, as lenders and Bank of America, N.A., as administrative agent for the lenders (the Credit Agreement). Under the terms of the Credit Agreement as in effect prior to the Amendment, the aggregate revolving credit commitment amount under the Credit Agreement was \$475 million. The Amendment increased the aggregate revolving credit commitment from \$475 million to \$500 million and provided that the Company, under certain circumstances, may request an increase to the revolving credit commitment by an aggregate amount of up to \$250 million, not to exceed \$750 million in total.

The Amendment also extended the maturity of the Credit Agreement by approximately two years to March 24, 2020. The Amendment also deleted the minimum fixed charge coverage ratio and added a minimum interest coverage ratio. Except as specifically amended and modified by the Amendment, the terms and conditions of the Credit Agreement remain in effect.

Borrowings under the Credit Agreement in effect prior to the Amendment bore interest at the offered Eurodollar Rate plus 125 to 225 basis points based on certain financial measurements if a Eurodollar Rate loan, or at the offered fluctuating Base Rate plus 25 to 125 basis points based on certain financial measurements if a Base Rate loan. The Amendment generally reduced the interest rate on borrowings by 25 basis points. Borrowings under the Credit Agreement subsequent to the Amendment bear interest at the offered Eurodollar Rate plus 100 to 200 basis points based on certain financial measurements if a Eurodollar Rate loan, or at the offered fluctuating Base Rate plus 0 to 100 basis points based on certain financial measurements if a Base Rate loan.

Borrowings outstanding under the Credit Agreement at February 28, 2015 were \$185.0 million and there were approximately \$15.0 million of outstanding letters of credit, which reduced the availability of this facility to \$275.0 million. There are no other terms or covenants limiting the availability of this facility. We also had \$5.1 million available under a foreign line of credit at February 28, 2015.

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In addition to our unsecured Credit Agreement, we have a \$40.0 million secured term credit facility with The Huntington National Bank (the Huntington Loan Agreement). Borrowings under the Huntington Loan Agreement are secured by aircraft and related engines and components owned by us. The Huntington Loan Agreement expires on April 23, 2015. Borrowings bear interest at LIBOR plus 175 basis points. As of February 28, 2015, \$23.0 million was outstanding under this agreement.

We are in compliance with all financial and other covenants under each of our financing arrangements.

On March 26, 2015, we completed the sale of our Telair Cargo Group to TransDigm, Inc. for \$725 million which will generate net cash proceeds, after cash taxes and expenses, of approximately \$600 million. We have sent out a notice of redemption for our \$325 million 7.25% Senior Notes. The redemption price for the Senior Notes will include an approximately \$45 million make-whole premium

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and we will record a pre-tax charge for this amount in the fourth quarter of fiscal 2015. On March 16, 2015, we also announced a new Board authorization to purchase up to \$250 million of our common stock.

Cash Flows from Operating Activities

During the nine-month period ended February 28, 2015, our cash flow from operations was \$9.0 million primarily as a result of net income attributable to AAR and noncontrolling interest, depreciation, amortization, impairment charges and an increase in accounts payable resulting from the volume growth within our supply chain businesses. These positive impacts were partially offset by increases in accounts receivable and inventory as well as additional investments in equipment on or available for long-term lease. These increases were primarily driven by sales growth within our supply chain businesses which experienced sales growth of 17.0% during the nine-month period due to new contract wins. The Company expects continued strength from its Aviation Services segment as a result of these investments and new contract wins.

During the nine-month period ended February 28, 2015, cash flow from operations decreased \$67.7 million from the nine-month period ended February 28, 2014 primarily due to increased accounts receivable and inventory related to the new supply chain contract wins announced in the second half of fiscal 2014.

Cash Flows from Investing Activities

During the nine-month period ended February 28, 2015, our investing activities used \$23.9 million of cash principally due to property, plant and equipment expenditures.

During the nine-month period ended February 28, 2015, cash flows used in investing activities decreased \$12.6 million over the nine-month period ended February 28, 2014 due to the acquisition of the cargo system assets of PFW Aerospace GmbH for \$16.1 million in the nine-month period ended February 28, 2014.

Cash Flows from Financing Activities

During the nine-month period ended February 28, 2015, our financing activities used \$3.3 million of cash primarily due to reduction in borrowings, which consist primarily of the retirement of the 1.75% convertible notes for \$30.0 million, and the payment of dividends, partially offset by additional borrowings on our revolving credit facility.

During the nine-month period ended February 28, 2015, cash flows used in financing activities increased \$1.3 million over the nine-month period ended February 28, 2014 primarily from fewer stock option exercises.

Critical Accounting Policies and Significant Estimates

We make a number of significant estimates, assumptions and judgments in the preparation of our financial statements. See *Management's Discussion and Analysis of Financial Condition and Results of Operations* in our 2014 Form 10-K for a discussion of our critical accounting policies. There have been no significant changes to the application of our critical accounting policies during the third quarter of fiscal 2015.

Forward-Looking Statements

This report contains certain forward-looking statements as that term is defined in the Private Securities Litigation Reform Act of 1995. These forward-looking statements are based on beliefs of our management, as well as assumptions and estimates based on information available to us as of the dates such assumptions and estimates are made, and are subject to certain risks and uncertainties that could cause actual results to differ materially from historical results or those anticipated, depending on a variety of factors, including those factors set forth under Part I, Item 1A in our Annual Report on Form 10-K for the year ended May 31, 2014 and in our Quarterly Report on Form 10-Q for the quarterly period ended August 31, 2014. Should one or more of those risks or uncertainties materialize adversely, or should underlying assumptions or estimates prove incorrect, actual results may vary materially from those described. Those events and uncertainties are difficult or impossible to predict accurately and many are beyond our control. We assume no obligation to update any forward-looking statements to reflect events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events.

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Item 3 Quantitative and Qualitative Disclosures About Market Risk

Our exposure to market risk includes fluctuating interest rates under our credit agreements and changes in foreign exchange rates.

Foreign Currency Risk. Revenues and expenses of our foreign operations are translated at average exchange rates during the period, and balance sheet accounts are translated at period-end exchange rates. Balance sheet translation adjustments are excluded from the results of operations and are recorded in stockholders' equity as a component of accumulated other comprehensive loss.

On March 26, 2015, we sold our Telair Cargo Group which comprised the majority of our foreign operations and as a result, a hypothetical 10 percent devaluation of foreign currencies against the U.S. dollar would not have had a material impact on our financial position or continuing operations.

Interest Rate Risk. We are exposed to the risk that our earnings and cash flows could be adversely impacted by fluctuations in interest rates. We manage interest costs by using a mix of fixed- and floating-rate debt. As of February 28, 2015, we utilized two derivative financial instruments to manage our variable interest rate exposure over a medium- to long-term period which included a floating-to-fixed interest rate swap and an interest rate cap agreement. In connection with the Amendment of our Credit Agreement, we settled our floating-to-fixed interest rate swap and interest rate cap agreements in the fourth quarter of fiscal 2015 for approximately \$2.6 million.

Item 4 Controls and Procedures

As required by Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, we conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures as of February 28, 2015. This evaluation was carried out under the supervision and with participation of our Chief Executive Officer and Chief Financial Officer. There are inherent limitations to the effectiveness of any system of disclosure controls and procedures. Therefore, effective disclosure controls and procedures can only provide reasonable assurance of achieving their control objectives. Based upon our evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective as of February 28, 2015, ensuring that information required to be disclosed in the reports that are filed under the Securities Exchange Act of 1934 is recorded, processed, summarized, and reported in a timely manner.

There were no changes in our internal control over financial reporting during the third quarter ended February 28, 2015 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II OTHER INFORMATION

Item 1A Risk Factors

There have been no material changes to our risk factors as set forth in our Annual Report on Form 10-K for the year ended May 31, 2014 and our Quarterly Report on Form 10-Q for the quarter ended August 31, 2014.

Item 6 Exhibits

The exhibits to this report are listed on the Exhibit Index included elsewhere herein. Management contracts and compensatory arrangements, if any, have been marked with an asterisk (*) on the Exhibit Index.

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SIGNATURE

Pursuant to the requirements 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.

AAR CORP.
(Registrant)

Date: March 31, 2015

/s/ JOHN C. FORTSON
John C. Fortson
Vice President, Chief Financial Officer and Treasurer
(Principal Financial Officer and officer duly
authorized to sign on behalf of registrant)

/s/ MICHAEL J. SHARP
Michael J. Sharp
Vice President, Controller and Chief Accounting Officer
(Principal Accounting Officer)

Table of ContentsEXHIBIT INDEX

| Exhibit No. | Description | Exhibits |
|--------------------|---|--|
| 31. | Rule 13a-14(a)/15(d)-14(a) Certifications | 31.1 Section 302 Certification dated March 31, 2015 of David P. Storch, Chairman and Chief Executive Officer of Registrant (filed herewith). 31.2 Section 302 Certification dated March 31, 2015 of John C. Fortson, Vice President, Chief Financial Officer and Treasurer of Registrant (filed herewith). |
| 32. | Section 1350 Certifications | 32.1 Section 906 Certification dated March 31, 2015 of David P. Storch, Chairman and Chief Executive Officer of Registrant (filed herewith). 32.2 Section 906 Certification dated March 31, 2015 of John C. Fortson, Vice President, Chief Financial Officer and Treasurer of Registrant (filed herewith). |
| 101. | Interactive Data File | 101 The following materials from the Registrant's Quarterly Report on Form 10-Q for the quarter ended February 28, 2015, formatted in XBRL (eXtensible Business Reporting Language): (i) Condensed Consolidated Balance Sheets at February 28, 2015 and May 31, 2014, (ii) Condensed Consolidated Statements of Operations for the three and nine months ended February 28, 2015 and 2014, (iii) Condensed Consolidated Statements of Comprehensive Income for the three and nine months ended February 28, 2015 and 2014, (iv) Condensed Consolidated Statements of Cash Flows for the nine months ended February 28, 2015 and 2014, (v) Condensed Consolidated Statement of Changes in Equity for the nine months ended February 28, 2015 and (vi) Notes to Condensed Consolidated Financial Statements.** |

** Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files on Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.