

BABSON CAPITAL PARTICIPATION INVESTORS  
Form N-CSRS  
September 05, 2012

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM N-CSR

CERTIFIED SHAREHOLDER REPORT OF REGISTERED MANAGEMENT  
INVESTMENT COMPANIES

Investment Company Act file number 811-5531

Babson Capital Participation Investors

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(Exact name of registrant as specified in charter)

1500 Main Street, P.O. Box 15189, Springfield, MA 01115-5189

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(Address of principal executive offices) (Zip code)

Christopher A. DeFrancis, Vice President and Secretary  
1500 Main Street, Suite 2800, P.O. Box 15189, Springfield, MA 01115-5189

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(Name and address of agent for service)

Registrant's telephone number, including area code: 413-226-1000

Date of fiscal year end: 12/31

Date of reporting period: 06/30/12

Form N-CSR is to be used by management investment companies to file reports with the Commission not later than 10 days after the transmission to stockholders of any report that is required to be transmitted to stockholders under Rule 30e-1 under the Investment Company Act of 1940 (17 CFR 270.30e-1). The Commission may use the information provided on Form N-CSR in its regulatory, disclosure review, inspection and policymaking roles.

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A registrant is required to disclose the information specified by Form N-CSR, and the Commission will make this information public. A registrant is not required to respond to the collection of information contained in Form N-CSR unless the Form displays a currently valid Office of Management and Budget ("OMB") control number. Please direct comments concerning the accuracy of the information collection burden estimate and any suggestions for reducing the burden to Secretary, Securities and Exchange Commission, 110 F Street NE, Washington, DC 20549. The OMB has reviewed this collection of information under the clearance requirements of 44 U.S.C. ss. 3507.

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ITEM 1. REPORT TO STOCKHOLDERS.

Attached hereto is the semi-annual shareholder report transmitted to shareholders pursuant to Rule 30e-1 of the Investment Company Act of 1940, as amended.



#### Adviser

Babson Capital Management LLC  
1500 Main Street, P.O. Box 15189  
Springfield, Massachusetts 01115-5189

#### Transfer Agent & Registrar

DST Systems, Inc.  
P.O. Box 219086  
Kansas City, MO 64121-9086  
1-800-647-7374

#### Independent Registered Public Accounting Firm

KPMG LLP  
Boston, Massachusetts 02110

#### Internet Website

[www.babsoncapital.com/mpv](http://www.babsoncapital.com/mpv)

#### Counsel to the Trust

Ropes & Gray LLP  
Boston, Massachusetts 02110

Babson Capital Participation Investors  
c/o Babson Capital Management LLC  
1500 Main Street, Suite 2200  
Springfield, Massachusetts 01115  
(413) 226-1516

#### Custodian

State Street Bank and Trust Company  
Boston, Massachusetts 02116

#### Investment Objective and Policy

Babson Capital Participation Investors (the "Trust") is a closed-end management investment company, first offered to the public in 1988, whose shares are traded on the New York Stock Exchange under the trading symbol "MPV". The Trust's share price can be found in the financial section of most newspapers under either the New York Stock Exchange listings or Closed- End Fund Listings.

The Trust's investment objective is to maximize total return by providing a high level of current income, the potential for growth of income, and capital appreciation. The Trust's principal investments are privately placed, below-investment grade, long-term debt obligations purchased directly from their issuers, which tend to be smaller companies. At least half of these investments normally include equity features such as common stock, warrants, conversion rights, or other equity features that provide the Trust with the opportunity to realize capital gains. The Trust will also invest in publicly traded debt securities (including high yield securities), again with an emphasis on those with equity features, and in convertible preferred

#### Form N-Q

The Trust files its complete schedule of portfolio holdings with the U.S. Securities and Exchange Commission ("SEC") for the first and third quarters of each fiscal year on Form N-Q. This information is available (i) on the SEC's website at <http://www.sec.gov>; and (ii) at the SEC's Public Reference Room in Washington, DC (which information on their operation may be obtained by calling 1-800-SEC-0330). A complete schedule of portfolio holdings as of each quarter-end is available upon request by calling, toll-free, 866-399-1516.

#### Proxy Voting Policies & Procedures; Proxy Voting Record

The Trustees of the Trust have delegated proxy voting responsibilities relating to the voting of securities held by the Trust to Babson Capital. A description of Babson Capital's proxy voting policies and procedures is available (1) without charge, upon request, by calling, toll-free 866-399-1516; (2) on the Trust's website: <http://www.babsoncapital.com/mpv>; and (3) on the SEC's website at <http://www.sec.gov>. Information regarding how the Trust voted proxies relating to portfolio securities during the most recent 12-month period ended June 30 is available (1) on the Trust's website: <http://www.babsoncapital.com/mpv>; and (2) on the SEC's website at <http://www.sec.gov>.

stocks and, subject to certain limitations, readily marketable equity securities. Below-investment grade or high yield securities have predominantly speculative characteristics with respect to the capacity of the issuer to pay interest and repay principal. In addition, the Trust may temporarily invest in high quality, readily marketable securities.

Babson Capital Management LLC (“Babson Capital”) manages the Trust on a total return basis. The Trust distributes substantially all of its net income to shareholders each year. Accordingly, the Trust pays dividends to shareholders in January, May, August, and November. All registered shareholders are automatically enrolled in the Dividend Reinvestment and Cash Purchase Plan unless cash distributions are requested.

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Babson Capital Participation Investors

TO OUR SHAREHOLDERS

July 31, 2012

We are pleased to present the June 30, 2012 Quarterly Report of Babson Capital Participation Investors (the "Trust").

The Board of Trustees declared a quarterly dividend of 27 cents per share, payable on August 10, 2012 to shareholders of record on July 30, 2012. The Trust paid a 27 cent per share dividend for the preceding quarter. The Trust earned 25 cents per share of net investment income for the second quarter of 2012, compared to 27 cents per share in the previous quarter.

During the second quarter, the net assets of the Trust increased to \$124,331,897 or \$12.25 per share compared to \$123,221,791 or \$12.16 per share on March 31, 2012. This translates into a 3.0% total return for the quarter, based on the change in the Trust's net assets assuming the reinvestment of all dividends. Longer term, the Trust returned 8.1%, 13.4%, 8.0%, and 13.0% for the 1-, 3-, 5-, and 10-year time periods, respectively, based on the change in the Trust's net assets assuming the reinvestment of all dividends.

The Trust's share price decreased 3.7% during the quarter, from \$14.96 per share as of March 31, 2012 to \$14.40 per share as of June 30, 2012. The Trust's market price of \$14.40 per share equates to a 17.6% premium over the June 30, 2012 net asset value per share of \$12.25. The Trust's average quarter-end premium for the 3, 5 and 10-year periods was 15.6%, 8.7% and 10.1%, respectively. U.S. equity markets, as approximated by the Russell 2000 Index, decreased 3.5% for the quarter. U.S. fixed income markets, as approximated by the Barclays Capital U.S. Corporate High Yield Index, increased 1.8% for the quarter.

The Trust closed two new private placement investments during the second quarter. The two new investments were in Baby Jogger Holdings LLC and DPL Holding Corporation. A brief description of these investments can be found in the Consolidated Schedule of Investments. The total amount invested by the Trust in these two transactions was \$2,218,431.

U.S. middle market buyout activity continued at a sluggish pace during the second quarter of 2012. While there is a shortage of quality deal flow, there is plenty of equity capital and senior and mezzanine debt looking to be invested. The result is that attractive companies are being aggressively pursued by buyers and lenders alike, pushing both purchase price multiples and leverage levels up. As we head into the third quarter of 2012, most market participants expect deal flow to improve over the remainder of the year, due to the abundant supply of debt and equity capital, and the proposed changes in capital-gains tax rates due to be enacted in 2013. Our deal flow did pick up late in the second quarter and has remained strong early in the third quarter. We have a number of deals under review and anticipate that our new investment activity in the third and fourth quarters will increase from the second quarter. We continue to be cautious, though, in light of the more aggressive leverage multiples and mezzanine pricing we are seeing in the market. We intend to maintain the same discipline and investment philosophy, based on taking prudent levels of risk and getting paid appropriately for the risks taken, that has served us well for so many years.

We continue to be pleased with the operating performance of most of our portfolio companies. Realization activity for the Trust also remains strong. We had two companies sold for nice gains in the second quarter, OakRiver Technology, Inc. and Xaloy Superior Holdings, Inc. The Xaloy realization is particularly noteworthy. Due to the company's weak performance, at year-end 2009 we valued our subordinated notes at 50% of par, and our equity investment at zero. Due to the efforts of the private equity sponsor and Xaloy's management team, and a recovery in the economy, the company's performance improved dramatically. When the company was sold in June, our

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subordinated notes were repaid in full and we received over three times the cost of our equity investment. We have a healthy backlog of companies in the process of being sold and we expect 2012 to be a good year for realizations. Refinancing activities, in which the Trust's subordinated note holdings are fully or partially prepaid, continues at a high level, as companies seek to take advantage of lower interest rates and credit availability. We had four full prepayments and one partial prepayment during the second quarter. As mentioned in prior reports, strong realization and refinancing activity is a double-edged sword, as the resulting loss of income-producing investments could adversely impact the Trust's ability to sustain its dividend level. We have been fortunate that our new investment activity in recent periods has been strong and has had a positive impact on net investment income. We will need to maintain a robust level of new investment activity in the face of expected high levels of realization and refinancing activity.

Thank you for your continued interest in and support of Babson Capital Participation Investors.

Sincerely,

Michael L. Klofas  
President

Portfolio Composition as of 6/30/12 \*

\* Based on market value of total investments (including cash)

Cautionary Notice: Certain statements contained in this report may be "forward looking" statements. Investors are cautioned not to place undue reliance on forward-looking statements, which speak only as of the date on which they are made and which reflect management's current estimates, projections, expectations or beliefs, and which are subject to risks and uncertainties that may cause actual results to differ materially. These statements are subject to change at any time based upon economic, market or other conditions and may not be relied upon as investment advice or an indication of the Trust's trading intent. References to specific securities are not recommendations of such securities, and may not be representative of the Trust's current or future investments. We undertake no obligation to publicly update forward looking statements, whether as a result of new information, future events, or otherwise.

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CONSOLIDATED STATEMENT OF ASSETS AND LIABILITIES

Babson Capital Participation Investors

June 30, 2012

(Unaudited)

Assets:

Investments

(See Consolidated Schedule of Investments)

Corporate restricted securities at fair value

(Cost - \$109,754,652)

\$97,492,801

Corporate restricted securities at market value

(Cost - \$5,479,508)

5,485,927

Corporate public securities at market value

(Cost - \$18,994,754)

20,140,688

Short-term securities at amortized cost

13,170,654

Total investments (Cost - \$147,399,568)

136,290,070

Cash

4,482,070

Interest receivable

1,168,568

Receivable for investments sold

304,626

Other assets

35,726

Total assets

142,281,060

Liabilities:

Note payable

15,000,000

Payable for investments purchased

2,050,703

Deferred tax liability

350,547

Investment advisory fee payable

279,747

Interest payable

27,267

Accrued expenses

240,899

Total liabilities

17,949,163

Total net assets

124,331,897

Net Assets:

Common shares, par value \$.01 per share

\$ 101,521

Additional paid-in capital

94,619,851

Retained net realized gain on investments, prior years

33,183,269

Undistributed net investment income

3,819,433

Accumulated net realized gain on investments

4,067,868

Net unrealized depreciation of investments

(11,460,045 )

Total net assets

124,331,897

Common shares issued and outstanding (14,785,750 authorized)

10,152,113

Net asset value per share

12.25

See Notes to Consolidated Financial Statements

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CONSOLIDATED STATEMENT OF OPERATIONS

For the six months ended June 30, 2012

(Unaudited)

Investment Income:	
Interest	\$6,155,433
Dividends	336,841
Other	87,167
Total investment income expenses:	6,579,441
Expenses:	
Investment advisory fees	556,996
Interest	306,750
Trustees' fees and expenses	220,000
Professional fees	138,100
Reports to shareholders	30,000
Custodian fees	18,000
Other	13,293
Total expenses	1,283,139
Investment income - net	5,296,302
Net realized and unrealized gain/loss on investments:	
Net realized gain on investments before taxes	2,185,012
Income tax expense	(174 )
Net realized gain on investments after taxes	2,184,838
Net change in unrealized depreciation of investments before taxes	(1,457,569)
Net change in deferred income tax expense	151,581
Net change in unrealized depreciation of investments after taxes	(1,305,988)
Net gain on investments	878,850
Net increase in net assets resulting from operations	\$6,175,152

See Notes to Consolidated Financial Statements

## CONSOLIDATED STATEMENT OF CASH FLOWS

Babson Capital Participation Investors

For the six months ended June 30, 2012

(Unaudited)

Net decrease in cash:

Cash flows from operating activities:

Purchases/Proceeds/Maturities from short-term portfolio securities, net	\$(5,146,136 )
Purchases of portfolio securities	(14,042,005)
Proceeds from disposition of portfolio securities	20,943,086
Interest, dividends and other income received	5,244,021
Interest expense paid	(310,158 )
Operating expenses paid	(929,351 )
Income taxes paid	(174 )

Net cash provided by operating activities	5,759,283
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Cash flows from financing activities:

Cash dividends paid from net investment income	(6,983,571 )
Receipts for shares issued on reinvestment of dividends	573,658
Net cash used for financing activities	(6,409,913 )

Net decrease in cash	(650,630 )
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Cash - beginning of year	5,132,700
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Cash - end of period	\$4,482,070
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Reconciliation of net increase in net assets to net cash provided by operating activities:

Net increase in net assets resulting from operations	\$6,175,152
Increase in investments	(2,247,108 )
Decrease in interest receivable	
Increase in receivable for investments sold	109,579
Decrease in other assets	
Increase in payable for investments purchased	83,534
Decrease in deferred tax liability	
Increase in investment advisory fee payable	
Decrease in interest payable	(3,408 )
Increase in accrued expenses	38,010

Total adjustments to net assets from operations	(415,869 )
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Net cash provided by operating activities	\$5,759,283
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See Notes to Consolidated Financial Statements



## CONSOLIDATED STATEMENTS OF CHANGES IN NET ASSETS

	For the six months ended 6/30/2012 (Unaudited)	For the year ended 12/31/2011
Increase in net assets:		
Operations:		
Investment income - net	\$5,296,302	\$11,526,972
Net realized gain on investments after taxes	2,184,838	627,341
Net change in unrealized depreciation of investments after taxes	(1,305,988 )	166,242
Net increase in net assets resulting from operations	6,175,152	12,320,555
Increase from common shares issued on reinvestment of dividends		
Common shares issued (2012 - 40,227; 2011 - 61,615)	573,658	871,579
Dividends to shareholders from:		
Net investment income (2012 - \$0.27 per share; 2011 - \$1.23 per share)	(2,736,579 )	(12,387,295 )
Net realized gains (2012 - \$0.00 per share; 2011 - \$0.00 per share)	-	(25,408 )
Total increase in net assets	4,012,231	779,431
Net assets, beginning of year	120,319,666	119,540,235
Net assets, end of period/year (including undistributed net investment income of \$3,819,433 and \$1,259,710, respectively)	\$124,331,897	120,319,666

See Notes to Consolidated Financial Statements

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## CONSOLIDATED SELECTED FINANCIAL HIGHLIGHTS

Babson Capital Participation Investors

Selected data for each share of beneficial interest outstanding:

	For the six months ended 06/30/2012 (Unaudited)	For the years ended December 31,				
	2011	2010	2009	2008	2007	
Net asset value:						
Beginning of year	\$ 11.90	\$ 11.89	\$ 10.91	\$ 11.10	\$ 12.84	\$ 12.90
Net investment income (a)	0.52	1.14	1.02	0.94	1.08	1.23
Net realized and unrealized gain (loss) on investments	0.09	0.08	0.95	(0.13 )	(1.82 )	(0.05 )
Total from investment operations	0.61	1.22	1.97	(0.81 )	0.74	1.18
Dividends from net investment income to common shareholders	(0.27 )	(1.23 )	(1.00 )	(1.00 )	(1.00 )	(1.23 )
Dividends from net realized gain on investments to common shareholders	-	(0.00 )(b)	-	-	-	(0.02 )
Increase from dividends reinvested	0.01	0.02	0.01	0.00	0.00	0.01
Total dividends	(0.26 )	(1.21 )	(0.99 )	(1.00 )	(1.00 )	(1.24 )
Net asset value: End of period/year	\$ 12.25	\$ 11.90	\$ 11.89	\$ 10.91	\$ 11.10	\$ 12.84
Per share market value: End of period/year	\$ 14.40	\$ 15.85	\$ 13.88	\$ 12.20		