

Stellus Capital Investment Corp  
Form 10-K  
March 06, 2018

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

**FORM 10-K**

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934

**For the fiscal year ended December 31, 2017**

**OR**

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934

**COMMISSION FILE NUMBER: 1-35730**

**STELLUS CAPITAL INVESTMENT CORPORATION**

**(Exact name of registrant as specified in its charter)**

Maryland  
(State of Incorporation)

46-0937320  
(I.R.S. Employer Identification Number)

4400 Post Oak Parkway, Suite 2200  
Houston, TX  
(Address of principal executive offices)

77027  
(Zip Code)

**Registrant's telephone number, including area code:  
(713) 292-5400**

**Securities registered pursuant to Section 12(b) of the  
Act:**

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, par value \$0.001 per share	New York Stock Exchange
5.75% Notes Due 2022	New York Stock Exchange

**Securities registered pursuant to Section 12(g) of the  
Act:  
None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the Registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements

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incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definition of large accelerated filer, accelerated filer, smaller reporting company and emerging growth company in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

Emerging growth company

(Do not check if a smaller reporting company)

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes  No

The aggregate market value of the Registrant's common stock held by non-affiliates of the Registrant as of June 30, 2017 was: \$209,528,850.

There were 15,953,811 shares of the Registrant's common stock outstanding as of March 5, 2018.

## Documents Incorporated by Reference

Portions of the registrant's definitive Proxy Statement relating to the registrant's 2018 Annual Meeting of Stockholders, to be filed with the Securities and Exchange Commission within 120 days following the end of the Company's fiscal year, are incorporated by reference in Part III of this Annual Report on Form 10-K as indicated herein.

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**FORM 10-K FOR THE FISCAL YEAR  
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## PART I

### Item 1. Business

*Except as otherwise indicated, the terms we, us, our, and the Company refer to Stellus Capital Investment Corporation; and Stellus Capital Management refers to our investment adviser and administrator, Stellus Capital Management, LLC.*

#### General

We are an externally managed, closed-end, non-diversified management investment company that has elected to be regulated as a business development company, or BDC, under the Investment Company Act of 1940, or the 1940 Act. We originate and invest primarily in private middle-market companies (typically those with \$5 million to \$50 million of EBITDA (earnings before interest, taxes, depreciation and amortization)) through first lien, second lien, unitranche and mezzanine debt financing, with corresponding equity co-investments. Unitranche debt is typically structured as first lien loans with certain risk characteristics of mezzanine debt. Mezzanine debt includes senior unsecured and subordinated loans.

Our investment activities are managed by our investment adviser, Stellus Capital Management, an investment advisory firm led by Robert T. Ladd and its other senior investment professionals. We source investments primarily through the extensive network of relationships that the senior investment professionals of Stellus Capital Management have developed with financial sponsor firms, financial institutions, middle-market companies, management teams and other professional intermediaries. The companies in which we invest are typically highly leveraged, and, in most cases, our investments in such companies will not be rated by national rating agencies. If such investments were rated, we believe that they would likely receive a rating which is often referred to as junk.

Our investment objective is to maximize the total return to our stockholders in the form of current income and capital appreciation. We seek to achieve our investment objective by:

- accessing the extensive origination channels that have been developed and established by the Stellus Capital Management investment professionals that include long-standing relationships with private equity firms, commercial banks, investment banks and other financial services firms;
- investing in what we believe to be companies with strong business fundamentals, generally within our core middle-market company focus;
- focusing on a variety of industry sectors, including business services, energy, general industrial, government services, healthcare, software and specialty finance;
- focusing primarily on directly originated transactions;
- applying the disciplined underwriting standards that the Stellus Capital Management investment professionals have developed over their extensive investing careers; and
- capitalizing upon the experience and resources of the Stellus Capital Management investment team to monitor our investments.

In addition, we received exemptive relief from the SEC to co-invest with investment funds managed by Stellus Capital Management where doing so is consistent with our investment strategy as well as applicable law (including the terms and conditions of the exemptive order issued by the SEC). Under the terms of the relief permitting us to co-invest with other funds managed by Stellus Capital Management, a required majority (as defined in Section 57(o) of the 1940 Act) of our independent directors must make certain conclusions in connection with a co-investment transaction,

including that (1) the terms of the proposed transaction, including the consideration to be paid, are reasonable and fair to us and our stockholders and do not involve overreaching of us or our stockholders on the part of any person concerned and (2) the transaction is consistent with the interests of our stockholders and is consistent with our investment objectives and strategies. We intend to co-invest, subject to the conditions included in the exemptive order we received from the SEC, with private credit funds managed by Stellus Capital Management that have an investment strategy that is identical to our investment strategy. We believe that such co-investments may afford us additional investment opportunities and an ability to achieve greater diversification.

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As a BDC, we are required to comply with regulatory requirements, including limitations on our use of debt. We are permitted to, and expect to continue to, finance our investments through borrowings. However, as a BDC, we are only generally allowed to borrow amounts such that our asset coverage, as defined in the 1940 Act, equals at least 200% after such borrowing. The amount of leverage that we employ will depend on our assessment of market conditions and other factors at the time of any proposed borrowing, such as the maturity, covenant package and rate structure of the proposed borrowings, our ability to raise funds through the issuance of our securities and the risks of such borrowings within the context of our investment outlook. Ultimately, we only intend to use leverage if the expected returns from borrowing to make investments will exceed the cost of such borrowings.

We have elected and qualified to be treated for federal income tax purposes as a regulated investment company, or RIC, under Subchapter M of the Internal Revenue Code, or the Code. As a RIC, we generally will not have to pay corporate-level federal income taxes on any net ordinary income or capital gains that we distribute to our stockholders as dividends if we meet certain source-of-income, distribution and asset diversification requirements.

Our principal executive office is currently located at 4400 Post Oak Parkway, Suite 2200, Houston, TX 77027, and our telephone number is (713) 292-5400. We maintain a website on the Internet at [www.stelluscapital.com](http://www.stelluscapital.com) (under the Public Investors section). Information contained on our website is not incorporated by reference into this annual report on Form 10-K and you should not consider information contained on our website to be part of this annual report on Form 10-K.

## **SBIC License**

Our wholly owned subsidiary holds a license to operate as a small business investment company, or SBIC. Our wholly owned SBIC subsidiary's SBIC license allows it to obtain leverage by issuing SBA-guaranteed debentures up to a maximum of \$150 million under current SBIC regulations, subject to required capitalization of the SBIC subsidiary and other requirements. The principal amount of SBA-guaranteed debentures is not required to be paid prior to maturity but may be prepaid at any time without penalty. We believe that the SBA-guaranteed debentures are an attractive source of debt capital.

We have received exemptive relief from the SEC to permit us to exclude the debt of our SBIC subsidiary guaranteed by the SBA from the definition of senior securities in the 200% asset coverage ratio we are required to maintain under the 1940 Act. This relief allows us increased flexibility under the 200% asset coverage test by allowing us to borrow up to \$135 million more than we would otherwise be able to borrow absent the receipt of this exemptive relief, based on our regulatory capital of \$67.5 million at December 31, 2017.

## **Portfolio Composition**

Our investments generally range in size from \$5 million to \$30 million, and we may also selectively invest in larger positions. We generally expect that the size of our positions will increase in proportion to the size of our capital base.

Pending such investments, we may reduce our outstanding indebtedness or invest in cash, cash equivalents, U.S. government securities and other high-quality debt investments with a maturity of one year or less. In the future, we may adjust opportunistically the percentage of our assets held in various types of loans, our principal loan sources and the industries to which we have greatest exposure, based on market conditions, the credit cycle, available financing and our desired risk/return profile.





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The following table provides a summary of our portfolio investments as of December 31, 2017:

	As of December 31, 2017 (\$ in millions)
Number of investments	48
Fair value <sup>(a)</sup>	\$ 371.8
Cost	\$ 368.5
% of portfolio at fair value first lien debt	37.9 %
% of portfolio at fair value second lien debt	48.0 %
% of portfolio at fair value mezzanine debt	7.4 %
% of portfolio at fair value equity	6.7 %
Weighted-average annual yield <sup>(b)</sup>	10.8 %

As of December 31, 2017, \$300.3 million of our debt investments at fair value were at floating interest rates, which represented approximately 87% of our total portfolio of debt investments at fair value. As of December 31, 2017, (a) \$46.5 million of our debt investments at fair value were at fixed interest rates, which represented approximately 13% of our total portfolio of debt investments at fair value.

The weighted average yield on all of our debt investments as of December 31, 2017, was approximately 10.8%, of which approximately 10.2% was current cash interest. The weighted average yield of our debt investments on accrual is not the same as a return on investment for our stockholders but, rather, relates to a portion of our investment portfolio and is calculated before the payment of all of our and our subsidiaries' fees and expenses. (b) The weighted average yield was computed using the effective interest rates for all of our debt investments, which represents the interest rate on our debt investment restated as an interest rate payable annually in arrears and is computed including cash and payment in kind, or PIK interest, as well as accretion of original issue discount. There can be no assurance that the weighted average yield will remain at their current level.

(c) Includes unitranche investments, which account for 13.2% of our investment portfolio at fair value.

### **Stellus Capital Management**

Stellus Capital Management manages our investment activities and is responsible for analyzing investment opportunities, conducting research and performing due diligence on potential investments, negotiating and structuring our investments, originating prospective investments and monitoring our investments and portfolio companies on an ongoing basis.

The senior investment professionals of Stellus Capital Management have an average of over 28 years of investing, corporate finance, restructuring, consulting and accounting experience and have worked together at several companies. The Stellus Capital Management investment professionals have a wide range of experience in middle-market investing, including originating, structuring and managing loans and debt securities through market cycles. The Stellus Capital Management investment professionals continue to provide investment sub-advisory services to the D. E. Shaw & Co., L.P. and its associated investment funds (the D.E. Shaw group) with respect to an approximately \$134 million investment portfolio (as of December 31, 2017) in middle-market companies pursuant to sub-advisory arrangements.

In addition to serving as our investment adviser and the sub-advisor to the D. E. Shaw group as noted above, Stellus Capital Management currently manages a private credit fund that has an investment strategy that is identical to our

investment strategy and energy private equity funds. We received exemptive relief from the SEC to co-invest with investment funds managed by Stellus Capital Management (other than the D. E. Shaw group funds) where doing so is consistent with our investment strategy as well as applicable law (including the terms and conditions of the exemptive order issued by the SEC). We believe that such co-investments may afford us additional investment opportunities and an ability to achieve greater diversification. We will not co-invest with the energy private equity funds, as the energy private equity funds focus on predominantly equity-related investments, and we focus on predominantly credit-related investments.

Stellus Capital Management is headquartered in Houston, Texas, and also maintains offices in Washington, D.C. and Charlotte, North Carolina.

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## Market Opportunity

We originate and invest primarily in private middle-market companies through first lien, second lien, unitranche and mezzanine debt financing, with corresponding equity co-investment. We believe the environment for investing in middle-market companies is attractive for several reasons, including:

***Robust Demand for Debt Capital.*** We believe that private equity firms have significant committed but uncalled capital, a large portion of which is still available for investment in the United States. We expect the large amount of uninvested capital commitments will drive buyout activity over the next several years, which should, in turn, create lending opportunities for us. In addition to increased buyout activity, a high volume of senior secured and high yield debt was originated in the calendar years 2011 through 2013 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.

***Reduced Availability of Capital for Middle-Market Companies.*** We believe there are fewer providers of, and less capital available for financing to middle-market companies, as compared to the time period prior to the economic downturn that began in December 2007. We believe that, as a result of that downturn, many financing providers have chosen to focus on large, liquid corporate loans and managing capital markets transactions rather than lending to middle-market businesses. In addition, we believe regulatory changes, including the adoption of the Dodd-Frank Act and the introduction of the international capital and liquidity requirements under the Basel III Accords, or Basel III, have caused banks to curtail their lending to middle-market-companies. As a result, we believe that less competition will facilitate higher quality deal flow and allow for greater selectivity throughout the investment process.

***Attractive Deal Pricing and Structures.*** We believe that the pricing of middle-market debt investments is higher, and the terms of such investments are more conservative, compared to larger liquid, public debt financings, due to the more limited universe of lenders as well as the highly negotiated nature of these financings. These transactions tend to offer stronger covenant packages, higher interest rates, lower leverage levels and better call protection compared to larger financings. In addition, middle-market loans typically offer other investor protections such as default penalties, lien protection, change of control provisions and information rights for lenders.

***Specialized Lending Requirements.*** Lending to middle-market companies requires in-depth diligence, credit expertise, restructuring experience and active portfolio management. We believe that several factors render many U.S. financial institutions ill-suited to lend to middle-market companies. For example, based on the experience of Stellus Capital Management's investment professionals, lending to middle-market companies in the United States (a) is generally more labor intensive than lending to larger companies due to the smaller size of each investment and the fragmented nature of the information available with respect to such companies, (b) requires specialized due diligence and underwriting capabilities, and (c) may also require more extensive ongoing monitoring by the lender. We believe that, through Stellus Capital Management, we have the experience and expertise to meet these specialized lending requirements.

## Competitive Strengths

We believe that the following competitive strengths will allow us to achieve positive returns for our investors:

***Experienced Investment Team.*** Through our investment adviser, Stellus Capital Management, we have access to the experience and expertise of the Stellus Capital Management investment professionals, including its senior investment professionals who have an average of over 28 years of investing, corporate finance, restructuring, consulting and accounting experience and have worked together at several companies. The Stellus Capital Management investment

professionals have a wide range of experience in middle-market investing, including originating, structuring and managing loans and debt securities through market cycles. We believe the members of Stellus Capital Management's investment professionals are proven and experienced, with extensive capabilities in leveraged credit investing, having participated in these markets for the predominant portion of their careers. We believe that the experience and demonstrated ability of the Stellus Capital Management investment professionals to complete transactions enhances the quantity and quality of investment opportunities available to us.

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***Established, Rigorous Investment and Monitoring Process.*** The Stellus Capital Management investment professionals have developed an extensive review and credit analysis process. Each investment that is reviewed by Stellus Capital Management is brought through a structured, multi-stage approval process. In addition, Stellus Capital Management takes an active approach in monitoring all investments, including reviews of financial performance on at least a quarterly basis and regular discussions with management. Stellus Capital Management's investment and monitoring process and the depth and experience of its investment professionals should allow it to conduct the type of due diligence and monitoring that enables it to identify and evaluate risks and opportunities.

***Demonstrated Ability to Structure Investments Creatively.*** Stellus Capital Management has the expertise and ability to structure investments across all levels of a company's capital structure. Furthermore, we believe that current market conditions will allow us to structure attractively priced debt investments and may allow us to incorporate other return-enhancing mechanisms such as commitment fees, original issue discounts, early redemption premiums, payment-in-kind, or PIK, interest or some form of equity securities.

***Resources of Stellus Capital Management Platform.*** We have access to the resources and capabilities of Stellus Capital Management, which has 16 investment professionals, including Robert T. Ladd, Dean D. Angelo, Joshua T. Davis and Todd A. Overbergen, who are supported by six managing directors, two principals, two vice presidents and three analysts. These individuals have developed long-term relationships with middle-market companies, management teams, financial sponsors, lending institutions and deal intermediaries by providing flexible financing throughout the capital structure. We believe that these relationships provide us with a competitive advantage in identifying investment opportunities in our target market. We also expect to benefit from Stellus Capital Management's due diligence, credit analysis, origination and transaction execution experience and capabilities, including the support provided with respect to those functions by Mr. Huskinson, who serves as our chief financial officer and chief compliance officer, and his staff of eight finance and operations professionals.

## **Investment Strategy**

The Stellus Capital Management investment professionals employ an opportunistic and flexible investing approach, combined with strong risk management processes, which we believe will yield a highly diversified portfolio across companies, industries, and investment types. We seek direct origination opportunities of first lien, second lien, unitranche and mezzanine debt financing, with corresponding equity co-investments, in middle-market companies. We believe that businesses in this size range often have limited access to public financial markets, and will benefit from Stellus Capital Management's reliable lending partnership. Many financing providers have chosen to focus on large corporate clients and managing capital markets transactions rather than lending to middle-market businesses. Further, many financial institutions and traditional lenders are faced with constrained balance sheets and are requiring existing borrowers to reduce leverage.

With an average of over 28 years of investing, corporate finance, restructuring, consulting and accounting experience, the senior investment professionals of Stellus Capital Management has demonstrated investment expertise throughout the balance sheet and in a variety of situations, including financial sponsor buyouts, growth capital, debt refinancings, balance sheet recapitalizations, rescue financings, distressed opportunities, and acquisition financings. Our investment philosophy emphasizes capital preservation through superior credit selection and risk mitigation. We expect our portfolio to provide downside protection through conservative cash flow and asset coverage requirements, priority in the capital structure and information requirements. We also anticipate benefiting from equity participation through warrants and other equity instruments structured as part of our investments. This flexible approach enables Stellus Capital Management to respond to market conditions and offer customized lending solutions.

Stellus Capital Management invests across a wide range of industries with deep expertise in select verticals including, but not limited to, business services, retail, general industrial, government services, healthcare, software and specialty finance. Our typical transactions include providing financing for leveraged buyouts, acquisitions, recapitalizations, growth opportunities, rescue financings, distressed or turnaround situations and bridge loans. We seek to maintain a diversified portfolio of investments as a method to manage risk and capitalize on specific sector trends. In addition, we intend to co-invest with private credit funds

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managed by Stellus Capital Management that have an identical investment strategy as us and where doing so is consistent with conditions of the exemptive order issued by the SEC.

Our objective is to act as the lead or largest investor in transactions, generally investing between \$5 million and \$30 million per transaction. We expect the average investment holding period to be between two and four years, depending upon portfolio company objectives and conditions in the capital markets.

We focus on middle-market companies with between \$5 million and \$50 million of EBITDA in a variety of industry sectors with positive long-term dynamics and dependable cash flows. We seek businesses with management teams with demonstrated track records and economic incentives in strong franchises and sustainable competitive advantages with dependable and predictable cash flows.

We employ leverage prudently and within the limitations of the applicable laws and regulations for BDCs. Any decision on our part to use leverage will depend upon our assessment of the attractiveness of available investment opportunities in relation to the costs and perceived risks of such leverage.

## **Transaction Sourcing**

As access to investment opportunities is highly relationship-driven, the senior investment team and other investment professionals of Stellus Capital Management spend considerable time developing and maintaining contacts with key deal sources, including private equity firms, investment banks and senior lenders. The senior investment team and other investment professionals of Stellus Capital Management have been actively investing in the middle-market for the past decade and have focused on extensive calling and marketing efforts via speaking engagements, sponsorships, industry events and referrals to broaden their relationship network. Existing relationships are constantly cultivated through transactional work and other personal contacts.

In addition to financial sponsors, Stellus Capital Management has developed a network of other deal sources, including:

- management teams and entrepreneurs;
- portfolio companies of private equity firms;
- other investment firms that have similar strategies to Stellus Capital Management and are seeking co-investors;
- placement agents and investment banks representing financial sponsors and issuers;
- corporate operating advisers and other financial advisers; and
- consultants, attorneys and other service providers to middle-market companies and financial sponsors.

We believe that Stellus Capital Management's broad network of deal origination contacts will afford us with a continuous source of investment opportunities.

These origination relationships provide access not only to potential investment opportunities but also to market intelligence on trends across the credit markets. Since inception, Stellus Capital Management has completed financing transactions with more than 130 equity sponsors and completed multiple financing transactions with 29 of those equity sponsors.

We believe that, over the past decade, the senior investment team and other investment professionals of Stellus Capital Management have built a reputation as a thoughtful and disciplined provider of capital to middle-market companies and a preferred financing source for private equity sponsors and management teams. We believe these factors give Stellus Capital Management a competitive advantage in sourcing investment opportunities, which are put to use for



our benefit.

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## **Investment Structuring**

Stellus Capital Management believes that each investment has unique characteristics that must be considered, understood and analyzed. Stellus Capital Management structures investment terms based on the business, the credit profile, the outlook for the industry in which a potential portfolio company operates, the competitive landscape, the products or services which the company sells and the management team and ownership of the company, among other factors. Stellus Capital Management relies upon the analysis conducted and information gathered through the investment process to evaluate the appropriate structure for our investments.

We invest primarily in the debt securities of middle-market companies. Our investments typically carry a high level of cash pay interest and may incorporate other return-enhancing mechanisms such as commitment fees, original issue discounts, early redemption premiums, PIK interest and some form of equity participation, including preferred stock, common stock, warrants and other forms of equity participation. We expect that a typical debt investment in which we invest will have a term at origination of between five and seven years. We expect to hold most of our investments to maturity or repayment, but we may sell some of our investments earlier if a liquidity event occurs, such as a sale, recapitalization or worsening of the credit quality of the portfolio company.

Stellus Capital Management negotiates covenants in connection with debt investments that provide protection for us but allow appropriate flexibility for the portfolio company. Such covenants may include affirmative and negative covenants, default penalties, lien protection and change of control provisions. Stellus Capital Management requires comprehensive information rights including access to management, financial statements and budgets and, in some cases, membership on the board of directors or board of directors observation rights. Additionally, Stellus Capital Management generally requires financial covenants and terms that restrict an issuer's use of leverage and limitations on asset sales and capital expenditures.

### **Secured Debt**

Secured debt, including first lien, second lien and unitranche financing, has liens on the assets of the borrower that serve as collateral in support of the repayment of such loans.

*First Lien Debt.* First lien debt is structured with first-priority liens on the assets of the borrower that serve as collateral in support of the repayment of such loans. First lien loans may provide for moderate loan amortization in the early years of the loan, with the majority of the amortization deferred until loan maturity.

*Second Lien Debt.* Second lien debt is structured as junior, secured loans, with second priority liens on an issuer's assets. These loans typically provide for moderate loan amortization in the initial years of the loan, with the majority of the amortization deferred until loan maturity.

*Unitranche Debt.* Unitranche debt typically is structured as first lien loans with certain risk characteristics of second lien debt. Unitranche debt typically provides for moderate loan amortization in the initial years of the debt, with the majority of the principal payment deferred until loan maturity. Since unitranche debt generally allows the borrower to make a large lump sum payment of principal at the end of the loan term, there is a risk of loss if the borrower is unable to pay the lump sum or refinance the amount owed at maturity. In some cases, we will be the sole lender, or we together with our affiliates will be the sole lender, of unitranche debt, which can provide us with more influence interacting with a borrower in terms of monitoring and, if necessary, remediation in the event of underperformance.

## **Mezzanine Debt**

Mezzanine debt, including senior unsecured and subordinated loans, is not be secured by any collateral and is effectively subordinated to the borrower's secured indebtedness (to the extent of the collateral securing such indebtedness), including pursuant to one or more intercreditor agreements that we enter into with holders of a borrower's senior debt.

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*Senior Unsecured Loans.* Senior unsecured loans are structured as loans that rank senior in right of payment to any of the borrower's unsecured indebtedness that is contractually subordinated to such loans. These loans generally provide for fixed interest rates and amortize evenly over the term of the loan. Senior unsecured loans are generally less volatile than subordinated loans due to their priority over subordinated loans.

*Subordinated Loans.* Subordinated loans are structured as unsecured, subordinated loans that provide for relatively high, fixed interest rates that provide us with significant current interest income. These loans typically have interest-only payments (often representing a combination of cash pay and PIK interest) in the early years, with amortization of principal deferred to maturity. Subordinated loans generally allow the borrower to make a large lump sum payment of principal at the end of the loan term, and there is a risk of loss if the borrower is unable to pay the lump sum or refinance the amount owed at maturity. Subordinated loans are generally more volatile than secured loans and senior unsecured loans and may involve a greater risk of loss of principal as compared to other types of loans. Subordinated loans often include a PIK feature, which effectively operates as negative amortization of loan principal, thereby increasing credit risk exposure over the life of the loan.

## **Equity Securities**

In connection with some of our debt investments, we may also invest in preferred or common stock or receive nominally priced warrants or options to buy an equity interest in the portfolio company. As a result, as a portfolio company appreciates in value, we may achieve additional investment return from this equity interest. We may structure such equity investments and warrants to include provisions protecting our rights as a minority-interest holder, as well as a put, or right to sell such securities back to the issuer, upon the occurrence of specified events. In many cases, we may also seek to obtain registration rights in connection with these equity interests, which may include demand and piggyback registration rights.

## **Investment Process**

Through the resources of Stellus Capital Management, we have access to significant research resources, experienced investment professionals, internal information systems and a credit analysis framework and investment process. Stellus Capital Management has designed a highly involved and interactive investment management process, which is the core of its culture and the basis for what we believe is a strong track record of investment returns. The investment process seeks to select only those investments which it believes have the most attractive risk/reward characteristics. The process involves several levels of review and is coordinated in an effort to identify risks in potential investments.

Stellus Capital Management applies its expertise to screen our investment opportunities as described below. This rigorous process, combined with our broad origination capabilities, has allowed the Stellus Capital Management team to be prudent in selecting opportunities in which to make an investment.

All potential investment opportunities undergo an initial informal review by Stellus Capital Management's investment professionals. Each potential investment opportunity that an investment professional determines merits consideration is presented and evaluated at a weekly meeting in which Stellus Capital Management's investment professionals discuss the merits and risks of a potential investment opportunity as well as the due diligence process and the pricing and structure. If Stellus Capital Management's investment professionals believe an investment opportunity merits further review, the deal team prepares and presents to the investment committee for initial review a prescreen memorandum that generally describes the potential transaction and includes a description of the risks, due diligence process and proposed structure and pricing for the proposed investment opportunity.

Prior to making an investment, Stellus Capital Management conducts rigorous diligence on each investment opportunity. In connection with its due diligence on a potential investment opportunity, Stellus Capital Management utilizes its internal diligence resources which include its internally developed credit analytical framework, subscriptions to third party research resources, discussions with industry experts, internal information sharing systems and the analytical expertise of its investment professionals. Stellus Capital Management typically reviews the company's historical financials; industry drivers and outlook,

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competitive threats, customer concentration, asset coverage, projected financials and credit metrics; management background checks; and, if applicable, the track record and funding capabilities of the private equity sponsor.

Upon review of the prescreen memorandum, if the investment committee determines to proceed with the review of an investment opportunity, the deal team continues its diligence and deal structuring plans, and prepares a credit approval memorandum for review by the investment committee. The credit approval memorandum, updates the prescreen memorandum with more deal specific detail, including an update to the diligence process and any changes in the structure and pricing of the proposed investment. Upon unanimous approval by the investment committee of the proposed investment as presented in the credit approval memorandum, Stellus Capital Management's Chief Investment Officer reviews any amendments before finalizing and closing negotiations with the prospective portfolio company.

### **Investment Committee**

Each new investment opportunity is unanimously approved by Stellus Capital Management's investment committee. Follow-on investments in existing portfolio companies require the investment committee's approval beyond that obtained when the initial investment in the company was made. The purpose of Stellus Capital Management's investment committee is to evaluate and approve all of our investments, subject at all times to the oversight and approval of our board of directors. The investment committee process is intended to bring the diverse experience and perspectives of the committee's members to the analysis and consideration of each investment. The investment committee consists of Messrs. Ladd, D'Angelo, Davis, Overbergen and Huskinson. The investment committee serves to provide investment consistency and adherence to our core investment philosophy and policies. The investment committee also determines appropriate investment sizing and suggests ongoing monitoring requirements.

In addition to reviewing investments, investment committee meetings serve as a forum to discuss credit views and outlooks. Potential transactions and deal flow are reviewed on a regular basis. Members of the investment team are encouraged to share information and views on credits with the investment committee early in their analysis. We believe this process improves the quality of the analysis and assists the deal team members to work more efficiently.

Each transaction is presented to the investment committee in a formal written report. All of our new investments require unanimous approval by the investment committee. Each member of the investment committee performs a similar role for other accounts managed by Stellus Capital Management. In certain instances, including in connection with co-investments under our exemptive order, approval by our board of directors may also be required prior to the making of an investment.

### **Monitoring Investments**

In most cases, we do not have board influence over portfolio companies. In some instances, Stellus Capital Management's investment professionals may obtain board representation or observation rights in conjunction with our investments. Stellus Capital Management takes an active approach in monitoring all investments, including reviews of financial performance on at least a quarterly basis and regular discussions with management. The monitoring process begins with structuring terms and conditions, which require the timely delivery and access to critical financial and business information on portfolio companies.

Specifically, Stellus Capital Management's monitoring system consists of the following activities:

*Regular Investment Committee Updates.* Key portfolio company developments are discussed each week as part of the standard investment committee meeting agenda.

## Edgar Filing: Stellus Capital Investment Corp - Form 10-K

*Written Reports.* The deal teams provide periodic written updates as appropriate for key events that impact portfolio company performance or valuation. In addition, deal teams provide written updates following each portfolio company board meeting.

*Quarterly Full Portfolio Review.* Stellus Capital Management's Chief Investment Officer and our Chief Compliance Officer perform a quarterly comprehensive review of every portfolio company with the deal teams. This process includes a written performance and valuation update, and credit-specific discussion on

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each of our portfolio companies. In addition, pursuant to our valuation policy, quarterly valuations are reviewed by our independent third party valuation firm.

As part of the monitoring process, Stellus Capital Management also tracks developments in the broader marketplace. Stellus Capital Management's investment professionals have a wealth of information on the competitive landscape, industry trends, relative valuation metrics, and analyses that assist in the execution of our investment strategy. In addition, Stellus Capital Management's extensive communications with brokers and dealers allows its investment professionals to monitor market and industry trends that could affect portfolio investments. Stellus Capital Management may provide ongoing strategic, financial and operational guidance to some portfolio companies either directly or by recommending its investment professionals or other experienced representatives to participate on the board of directors. Stellus Capital Management maintains an extensive network of strategic and operational advisers to call upon for industry expertise or to supplement existing management teams.

### **Asset Quality**

In addition to various risk management and monitoring tools, Stellus Capital Management uses an investment ranking system to characterize and monitor the credit profile and expected level of returns on each investment in our portfolio.

This investment ranking system uses a five-level numeric scale. The following is a description of the conditions associated with each investment category:

Investment Category 1 is used for investments that are performing above expectations, and whose risks remain favorable compared to the expected risk at the time of the original investment.

Investment Category 2 is used for investments that are performing within expectations and whose risks remain neutral compared to the expected risk at the time of the original investment. All new loans are initially rated 2.

Investment Category 3 is used for investments that are performing below expectations and that require closer monitoring, but where no loss of return or principal is expected. Portfolio companies with a rating of 3 may be out of compliance with financial covenants.

Investment Category 4 is used for investments that are performing substantially below expectations and whose risks have increased substantially since the original investment. These investments are often in work out. Investments with a rating of 4 are those for which some loss of contractual return but no loss of principal is expected.

Investment Category 5 is used for investments that are performing substantially below expectations and whose risks have increased substantially since the original investment. These investments are almost always in work out. Investments with a rating of 5 are those for which some loss of return and principal is expected.

In the event that Stellus Capital Management determines that an investment is underperforming, or circumstances suggest that the risk associated with a particular investment has significantly increased, Stellus Capital Management will increase its monitoring intensity and prepare regular updates for the investment committee, summarizing current operating results and material impending events and suggesting recommended actions. While the investment ranking system identifies the relative risk for each investment, the ranking alone does not dictate the scope and/or frequency of any monitoring that is performed. The frequency of Stellus Capital Management's monitoring of an investment is determined by a number of factors, including, but not limited to, the trends in the financial performance of the portfolio company, the investment structure and the type of collateral securing the investment.



## **Determination of Net Asset Value and Portfolio Valuation Process**

The net asset value per share of our outstanding shares of common stock is determined quarterly by dividing the value of total assets minus liabilities by the total number of shares outstanding.

In calculating the value of our total assets, investment transactions will be recorded on the trade date. Realized gains or losses will be computed using the specific identification method. Investments for which market quotations are readily available are valued at such market quotations. Debt and equity securities that are not publicly traded or whose market price is not readily available are valued at fair value as determined in

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good faith by our board of directors based on the input of our management and audit committee. In addition, our board of directors retains one or more independent valuation firms to review at least twice annually, the valuation of each portfolio investment for which a market quotation is not readily available. We also have adopted Accounting Standards Board Accounting Standards Codification 820, *Fair Value Measurements and Disclosures*, or ASC 820. This accounting statement requires us to assume that the portfolio investment is assumed to be sold in the principal market to market participants, or in the absence of a principal market, the most advantageous market, which may be a hypothetical market. Market participants are defined as buyers and sellers in the principal or most advantageous market that are independent, knowledgeable, and willing and able to transact. In accordance with ASC 820, the market in which we can exit portfolio investments with the greatest volume and level activity is considered our principal market.

A readily available market value is not expected to exist for most of the investments in our portfolio, and we value these portfolio investments at fair value as determined in good faith by our board of directors under our valuation policy and process. The types of factors that our board of directors may take into account in determining the fair value of our investments generally include, as appropriate, comparisons of financial ratios portfolio company to peer companies that are public, the nature and realizable value of any collateral, the portfolio company's ability to make payments and its earnings and discounted cash flow, the markets in which the portfolio company does business, and other relevant factors.

When an external event such as a purchase transaction, public offering or subsequent equity sale occurs, we consider the pricing indicated by the external event to corroborate our valuation. Due to the inherent uncertainty of determining the fair value of investments that do not have a readily available market value, the fair value of the investments may differ materially from the values that would have been used had a readily available market value existed for such investments. In addition, changes in the market environment and other events that may occur over the life of the investments may cause the gains or losses ultimately realized on these investments to be different from the valuations currently assigned.

With respect to investments for which market quotations are not readily available, our board of directors undertakes a multi-step valuation process each quarter, as described below:

our quarterly valuation process begins with each portfolio company or investment being initially valued by the investment professionals of Stellus Capital Management responsible for the portfolio investment;  
preliminary valuation conclusions are then documented and discussed with our senior investment professionals and Stellus Capital Management;  
at least twice annually, the valuation for each portfolio investment is reviewed by an independent valuation firm;  
the audit committee of our board of directors then reviews these preliminary valuations and makes a recommendation to our board of directors; and  
the audit committee of our board of directors then reviews these preliminary valuations;  
the board of directors then discusses the valuations and determines the fair value of each investment in our portfolio in good faith, based on the input of Stellus Capital Management, the independent valuation firm and the audit committee.

In following these approaches, the types of factors that are taken into account in fair value pricing our investments include, as relevant, but are not limited to:

available current market data, including relevant and applicable market trading and transaction comparables;  
applicable market yields and multiples;  
security covenants;  
call protection provisions;



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information rights;  
the nature and realizable value of any collateral;  
the portfolio company's ability to make payments, its earnings and discounted cash flows and the markets in which it does business;  
comparisons of financial ratios of peer companies that are public;  
comparable merger and acquisition transactions; and  
the principal market and enterprise values.

### **Realization of Investments**

The potential exit scenarios of a portfolio company play an important role in evaluating investment decisions. As such, Stellus Capital Management formulates specific exit strategies at the time of investment. Our debt-orientation provides for increased potential exit opportunities, including (a) the sale of investments in the private markets, (b) the refinancing of investments held, often due to maturity or recapitalizations, and (c) other liquidity events including the sale or merger of the portfolio company. Since we seek to maintain a debt orientation in our investments, we expect to receive interest income over the course of the investment period, resulting in a return on invested capital well in advance of final exit.

### **Derivatives**

We may utilize hedging techniques such as interest rate swaps to mitigate potential interest rate risk on our indebtedness. Such interest rate swaps would principally be used to protect us against higher costs on our indebtedness resulting from increases in both short-term and long-term interest rates. We also may use various hedging and other risk management strategies to seek to manage various risks, including changes in currency exchange rates and market interest rates. Such hedging strategies would be utilized to seek to protect the value of our portfolio investments, for example, against possible adverse changes in the market value of securities held in our portfolio.

### **Managerial Assistance**

As a BDC, we offer, and must provide upon request, managerial assistance to our portfolio companies. This assistance could involve monitoring the operations of our portfolio companies, participating in board and management meetings, consulting with and advising officers of portfolio companies and providing other organizational and financial guidance. Stellus Capital Management or an affiliate of Stellus Capital Management provides such managerial assistance on our behalf to portfolio companies that request this assistance. We may receive fees for these services and will reimburse Stellus Capital Management or an affiliate of Stellus Capital Management for its allocated costs in providing such assistance, subject to the review by our board of directors, including our independent directors.

### **Competition**

Our primary competitors in providing financing to middle-market companies include public and private funds, other BDCs, commercial and investment banks, commercial financing companies and, to the extent they provide an alternative form of financing, private equity and hedge funds. Many of our competitors are substantially larger and have considerably greater financial, technical and marketing resources than we do. For example, we believe some competitors may have 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 relationships than us. Furthermore, many of our competitors are not subject to the regulatory restrictions that the 1940 Act imposes on us as a BDC or to the distribution and other requirements we must satisfy to maintain our qualification as a RIC.

We use the expertise of the investment professionals of Stellus Capital Management to which we have access to assess investment risks and determine appropriate pricing for our investments in portfolio companies. In addition, we believe that the relationships of the investment professionals of Stellus Capital Management enable us to learn about, and compete effectively for, financing opportunities with attractive middle-market companies in the industries in which we invest.

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### **Employees**

We do not have any direct employees, and our day-to-day investment operations are managed by Stellus Capital Management. We have a chief executive officer and president and a chief financial officer and chief compliance officer. To the extent necessary, we may hire additional personnel going forward. Our officers are employees of Stellus Capital Management and our allocable portion of the cost of our chief financial officer and chief compliance officer and his staff is paid by us pursuant to the administration agreement that we have entered into with Stellus Capital Management.

### **Management Agreements**

Stellus Capital Management serves as our investment adviser and is registered as an investment adviser under the Investment Advisers Act of 1940, as amended, or the Advisers Act. In addition, Stellus Capital Management serves as our administrator.

### **Investment Advisory Agreement**

Subject to the overall supervision of our board of directors and in accordance with the 1940 Act, Stellus Capital Management manages our day-to-day operations and provides investment advisory services to us. Under the terms of the investment advisory agreement, Stellus Capital Management:

determines the composition of our portfolio, the nature and timing of the changes to our portfolio and the manner of implementing such changes;

identifies, evaluates and negotiates the structure of the investments we make;

executes, closes, services and monitors the investments we make;

determines the securities and other assets that we purchase, retain or sell;

performs due diligence on prospective portfolio companies; and

provides us with such other investment advisory, research and related services as we may, from time to time, reasonably require for the investment of our funds.

Pursuant to the investment advisory agreement, we have agreed to pay Stellus Capital Management a fee for investment advisory and management services consisting of two components – a base management fee and an incentive fee. The cost of both the base management fee and the incentive fee are borne by our stockholders.

### **Management Fee**

The base management fee is calculated at an annual rate of 1.75% of our gross assets, including assets purchased with borrowed funds or other forms of leverage (including preferred stock, public and private debt issuances, derivative instruments, repurchase agreements and other similar instruments or arrangements) and excluding cash and cash equivalents. For services rendered under the investment advisory agreement, the base management fee is payable quarterly in arrears. The base management fee is calculated based on the average value of our gross assets, excluding cash and cash equivalents, at the end of the two most recently completed calendar quarters. Base management fees for any partial month or quarter are appropriately pro-rated.

## Incentive Fee

We pay Stellus Capital Management an incentive fee. Incentive fees are calculated as below and payable quarterly in arrears. The incentive fee, which provides Stellus Capital Management with a share of the income that it generates for us, has two components, ordinary income and capital gains, calculated as follows:

The ordinary income component is calculated and payable quarterly in arrears based on our pre-incentive fee net investment income for the immediately preceding calendar quarter, subject to a total return requirement, and deferral of non-cash amounts, and is 20.0% of the amount, if any, by which our pre-incentive fee net investment income, expressed as a rate of return on the value of our net assets attributable to our common stock, for the immediately preceding calendar quarter, exceeds a 2.0% (which is 8.0% annualized) hurdle rate and a catch-up provision measured as of the end of each calendar quarter.

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Under this provision, in any calendar quarter, Stellus Capital Management receives no incentive fee until our pre-incentive fee net investment income equals the hurdle rate of 2.0%, but then receives, as a catch-up, 100% of our pre-incentive fee net investment income with respect to that portion of such pre-incentive fee net investment income, if any, that exceeds the hurdle rate but is less than 2.5%.

The effect of the catch-up provision is that, subject to the total return provision discussed below, if pre-incentive fee net investment income exceeds 2.5% in any calendar quarter, Stellus Capital Management receives 20.0% of our pre-incentive fee net investment income as if a hurdle rate did not apply. For this purpose, pre-incentive fee net investment income means interest income, dividend income and any other income (including any other fees, such as commitment, origination, structuring, diligence, managerial assistance and consulting fees or other fees that we receive from portfolio companies) accrued during the calendar quarter, minus our operating expenses for the quarter (including the base management fee, expenses payable under the administration agreement (as described below), and any interest expense and any distributions paid on any issued and outstanding preferred stock, but excluding the incentive fee). Pre-incentive fee net investment income includes, in the case of investments with a deferred interest feature (such as original issue discount, debt instruments with PIK interest and zero coupon securities), accrued income that we have not yet received in cash. The foregoing incentive fee is subject to a total return requirement, which provides that no incentive fee in respect of the Company's pre-incentive fee net investment income will be payable except to the extent 20.0% of the cumulative net increase in net assets resulting from operations over the then current and 11 preceding quarters exceeds the cumulative incentive fees accrued and/or paid for the 11 preceding quarters. In other words, any ordinary income incentive fee that is payable in a calendar quarter will be limited to the lesser of (i) 20.0% of the amount by which our pre-incentive fee net investment income for such calendar quarter exceeds the 2.0% hurdle, subject to the catch-up provision, and (ii) (x) 20.0% of the cumulative net increase in net assets resulting from operations for the then current and 11 preceding calendar quarters *minus* (y) the cumulative incentive fees accrued and/or paid for the 11 preceding calendar quarters.

For the foregoing purpose, the cumulative net increase in net assets resulting from operations is the amount, if positive, of the sum of pre-incentive fee net investment income, realized gains and losses and unrealized appreciation and depreciation of the Company for the then current and 11 preceding calendar quarters. In addition, the portion of such incentive fee that is attributable to deferred interest (such as PIK interest or OID) will be paid to Stellus Capital Management, without any interest thereon, only if and to the extent we actually receive such interest in cash, and any accrual thereof will be reversed if and to the extent such interest is reversed in connection with any write-off or similar treatment of the investment giving rise to any deferred interest accrual. Any reversal of such amounts would reduce net income for the quarter by the net amount of the reversal (after taking into account the reversal of incentive fees payable) and would result in a reduction and possible elimination of the incentive fees for such quarter. There is no accumulation of amounts on the hurdle rate from quarter to quarter, and accordingly there is no clawback of amounts previously paid if subsequent quarters are below the quarterly hurdle, and there is no delay of payment if prior quarters are below the quarterly hurdle. Stellus Capital Management has agreed to permanently waive any interest accrued on the portion of the incentive fee attributable to deferred interest (such as PIK interest or OID).

Pre-incentive fee net investment income does not include any realized capital gains, realized capital losses or unrealized capital appreciation or depreciation. Because of the structure of the incentive fee, it is possible that we may pay an incentive fee in a quarter where we incur a loss, subject to the total return requirement. For example, if we receive pre-incentive fee net investment income in excess of the quarterly minimum hurdle rate, we will pay the applicable incentive fee even if we have incurred a loss in that quarter due to realized and unrealized capital losses. Our net investment income used to calculate this component of the incentive fee is also included in the amount of our gross assets used to calculate the 1.75% base management fee. These calculations are appropriately prorated for any period of less than three months and adjusted for any share issuances or repurchases during the current quarter.





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The following is a graphical representation of the calculation of the income-related portion of the incentive fee:

**Quarterly Incentive Fee Based on Net Investment  
Income  
Pre-Incentive Fee Net Investment Income  
(expressed as a percentage of the value of net assets)**

**Percentage of Pre-incentive Fee Net Investment  
Income  
Allocated to Income-Related Portion of Incentive Fee**

The capital gains component of the incentive fee is determined and payable in arrears as of the end of each calendar year (or upon termination of the investment advisory agreement, as of the termination date), is equal to 20.0% of our cumulative aggregate realized capital gains from inception through the end of that calendar year, computed net of our aggregate cumulative realized capital losses and our aggregate cumulative unrealized capital depreciation through the end of such year, less the aggregate amount of any previously paid capital gains incentive fees. If such amount is negative, then no capital gains incentive fee will be payable for such year. Additionally, if the investment advisory agreement is terminated as of a date that is not a calendar year end, the termination date will be treated as though it were a calendar year end for purposes of calculating and paying the capital gains incentive fee.

**Examples of Quarterly Incentive Fee Calculation**

**Example 1: Income Related Portion of Incentive Fee before Total  
Return Requirement Calculation:**

**Alternative 1**

**Assumptions**

Investment income (including interest, dividends, fees, etc.) = 1.25%  
Hurdle rate<sup>(1)</sup> = 2.0%  
Management fee<sup>(2)</sup> = 0.4375%  
Other expenses (legal, accounting, custodian, transfer agent, etc.) = 0.2%  
Pre-incentive fee net investment income  
(investment income (management fee + other expenses)) = 0.6125%

Pre-incentive fee net investment income does not exceed hurdle rate, therefore there is no income-related incentive fee.

## Alternative 2

### Assumptions

Investment income (including interest, dividends, fees, etc.) = 2.9%

Hurdle rate<sup>(1)</sup> = 2.0%

Management fee<sup>(2)</sup> = 0.4375%

Other expenses (legal, accounting, custodian, transfer agent, etc.) = 0.2%

Pre-incentive fee net investment income

(investment income (management fee + other expenses)) = 2.2625%

Incentive fee = 100% × Pre-incentive fee net investment income (subject to catch-up<sup>(3)</sup>)  
= 100% × (2.2625% - 2.0%)  
= 0.2625%

Pre-incentive fee net investment income exceeds the hurdle rate, but does not fully satisfy the catch-up provision, therefore the income related portion of the incentive fee is 0.2625%.

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**Alternative 3**

**Assumptions**

Investment income (including interest, dividends, fees, etc.) = 3.5%  
 Hurdle rate<sup>(1)</sup> = 2.0%  
 Management fee<sup>(2)</sup> = 0.4375%  
 Other expenses (legal, accounting, custodian, transfer agent, etc.) = 0.2%  
 Pre-incentive fee net investment income  
 (investment income (management fee + other expenses)) = 2.8625%  
 Incentive fee = 100% × Pre-incentive fee net investment income (subject to catch-up<sup>(3)</sup>)  
 Incentive fee = 100% × catch-up + (20.0% × (Pre-Incentive Fee Net Investment Income 2.5%))

	= 2.5% 2.0%
	= 0.5%
	= (100% × 0.5%) + (20.0% × (2.8625% 2.5%))
	= 0.5% + (20.0% × 0.3625%)
Incentive fee	= 0.5% + 0.0725%
	= 0.5725%

Pre-incentive fee net investment income exceeds the hurdle rate, and fully satisfies the catch-up provision, therefore the income related portion of the incentive fee is 0.5725%.

(1) Represents 8.0% annualized hurdle rate.

(2) Represents 1.75% annualized base management fee.

The catch-up provision is intended to provide Stellus Capital Management with an incentive fee of 20.0% on all (3)pre-incentive fee net investment income as if a hurdle rate did not apply when our net investment income exceeds 2.5% in any fiscal quarter.

**Example 2: Income Portion of Incentive Fee with Total Return Requirement Calculation:**

**Alternative 1:**

**Assumptions**

Investment income (including interest, dividends, fees, etc.) = 3.5%  
 Hurdle rate<sup>(1)</sup> = 2.0%  
 Management fee<sup>(2)</sup> = 0.4375%  
 Other expenses (legal, accounting, custodian, transfer agent, etc.) = 0.2%  
 Pre-incentive fee net investment income  
 (investment income (management fee + other expenses)) = 2.8625%  
 Cumulative incentive compensation accrued and/or paid for preceding 11 calendar quarters = \$9,000,000  
 20.0% of cumulative net increase in net assets resulting from operations over current and preceding  
 11 calendar quarters = \$8,000,000

Although our pre-incentive fee net investment income exceeds the hurdle rate of 2.0% (as shown in Alternative 3 of Example 1 above), no incentive fee is payable because 20.0% of the cumulative net increase in net assets resulting from operations over the then current and 11 preceding calendar quarters did not exceed the cumulative income and capital gains incentive fees accrued and/or paid for the preceding 11 calendar quarters.

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**Alternative 2:**

**Assumptions**

Investment income (including interest, dividends, fees, etc.) = 3.5%  
Hurdle rate<sup>(1)</sup> = 2.0%  
Management fee<sup>(2)</sup> = 0.4375%  
Other expenses (legal, accounting, custodian, transfer agent, etc.) = 0.2%  
Pre-incentive fee net investment income  
(investment income (management fee + other expenses) = 2.8625%  
Cumulative incentive compensation accrued and/or paid for preceding 11 calendar quarters = \$9,000,000  
20.0% of cumulative net increase in net assets resulting from operations over current and preceding  
11 calendar quarters = \$10,000,000

Because our pre-incentive fee net investment income exceeds the hurdle rate of 2.0% and because 20.0% of the cumulative net increase in net assets resulting from operations over the then current and 11 preceding calendar quarters exceeds the cumulative income and capital gains incentive fees accrued and/or paid for the preceding 11 calendar quarters, an incentive fee would be payable, as shown in Alternative 3 of Example 1 above.

(1) Represents 8.0% annualized hurdle rate.

(2) Represents 1.75% annualized base management fee.

**Example 3: Capital Gains Portion of Incentive Fee(\*):**

**Alternative 1:**

**Assumptions**

Year 1: \$2.0 million investment made in Company A ( Investment A ), and \$3.0 million investment made in Company B ( Investment B )

Year 2: Investment A sold for \$5.0 million and fair market value ( FMV ) of Investment B determined to be \$3.5 million

Year 3: FMV of Investment B determined to be \$2.0 million

Year 4: Investment B sold for \$3.25 million

The capital gains portion of the incentive fee would be:

Year 1: None

Year 2: Capital gains incentive fee of \$0.6 million ( \$3.0 million realized capital gains on sale of Investment A multiplied by 20.0% )

Year 3: None \$0.4 million (20.0% multiplied by (\$3.0 million cumulative capital gains less \$1.0 million cumulative capital depreciation)) less \$0.6 million (previous capital gains fee paid in Year 2)

Year 4: Capital gains incentive fee of \$50,000 \$0.65 million (\$3.25 million cumulative realized capital gains multiplied by 20.0%) less \$0.6 million (capital gains incentive fee taken in Year 2)

## **Alternative 2**

### **Assumptions**

Year 1: \$2.0 million investment made in Company A ( Investment A ), \$5.25 million investment made in Company B ( Investment B ) and \$4.5 million investment made in Company C ( Investment C )

Year 2: Investment A sold for \$4.5 million, FMV of Investment B determined to be \$4.75 million and FMV of Investment C determined to be \$4.5 million

Year 3: FMV of Investment B determined to be \$5.0 million and Investment C sold for \$5.5 million

Year 4: FMV of Investment B determined to be \$6.0 million

Year 5: Investment B sold for \$4.0 million

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The capital gains incentive fee, if any, would be:

Year 1: None

Year 2: \$0.4 million capital gains incentive fee 20.0% multiplied by \$2.0 million (\$2.5 million realized capital gains on Investment A less \$0.5 million unrealized capital depreciation on Investment B)

Year 3: \$0.25 million capital gains incentive fee<sup>(1)</sup> \$0.65 million (20.0% multiplied by \$3.25 million (\$3.5 million cumulative realized capital gains less \$0.25 million unrealized capital depreciation)) less \$0.4 million capital gains incentive fee received in Year 2

Year 4: \$0.05 million capital gains incentive fee \$0.7 million (\$3.50 million cumulative realized capital gains multiplied by 20.0%) less \$0.65 million cumulative capital gains incentive fee paid in Year 2 and Year 3

Year 5: None \$0.45 million (20.0% multiplied by \$2.25 million (cumulative realized capital gains of \$3.5 million less realized capital losses of \$1.25 million)) less \$0.7 million cumulative capital gains incentive fee paid in Year 2, Year 3 and Year 4<sup>(2)</sup>

The hypothetical amounts of returns shown are based on a percentage of our total net assets and assume no leverage.

\*There is no guarantee that positive returns will be realized and actual returns may vary from those shown in this example.

As illustrated in Year 3 of Alternative 1 above, if a portfolio company were to be wound up on a date other than its (1) fiscal year end of any year, it may have paid aggregate capital gains incentive fees that are more than the amount of such fees that would be payable if such portfolio company had been wound up on its fiscal year end of such year.

As noted above, it is possible that the cumulative aggregate capital gains fee received by Stellus Capital (2) Management (\$0.70 million) is effectively greater than \$0.45 million (20.0% of cumulative aggregate realized capital gains less net realized capital losses or net unrealized depreciation (\$2.25 million)).

### **Payment of Our Expenses**

All investment professionals of Stellus Capital Management, when and to the extent engaged in providing investment advisory and management services to us, and the compensation and routine overhead expenses of personnel allocable to these services to us, are provided and paid for by Stellus Capital Management and not by us. We bear all other out-of-pocket costs and expenses of our operations and transactions, including, without limitation, those relating to:

organization and offering;

calculating our net asset value (including the cost and expenses of any independent valuation firm);

fees and expenses payable to third parties, including agents, consultants or other advisors, in monitoring financial and legal affairs for us and in monitoring our investments and performing due diligence on our prospective portfolio companies or otherwise relating to, or associated with, evaluating and making investments;

interest payable on debt, if any, incurred to finance our investments and expenses related to unsuccessful portfolio acquisition efforts;

offerings of our common stock and other securities;

base management and incentive fees;

administration fees and expenses, if any, payable under the administration agreement (including our allocable portion of Stellus Capital Management's overhead in performing its obligations under the administration agreement, including rent and the allocable portion of the cost of our chief compliance officer and chief financial officer and his staff);



transfer agent, dividend agent and custodial fees and expenses;  
U.S. federal and state registration fees;

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all costs of registration and listing our shares on any securities exchange;  
U.S. federal, state and local taxes;  
independent directors' fees and expenses;  
costs of preparing and filing reports or other documents required by the SEC or other regulators;  
costs of any reports, proxy statements or other notices to stockholders, including printing costs;  
costs and fees associated with any fidelity bond, directors and officers/errors and omissions liability insurance, and any other insurance premiums;  
direct costs and expenses of administration, including printing, mailing, long distance telephone, copying, secretarial and other staff, independent auditors and outside legal costs;  
proxy voting expenses; and  
all other expenses incurred by us or Stellus Capital Management in connection with administering our business.

### **Duration and Termination**

Unless terminated earlier as described below, the investment advisory agreement will continue in effect from year to year if approved annually by our board of directors or by the affirmative vote of the holders of a majority of our outstanding voting securities, and, in either case, if also approved by a majority of our directors who are not interested persons. The investment advisory agreement automatically terminates in the event of its assignment, as defined in the 1940 Act, by Stellus Capital Management and may be terminated by either party without penalty upon 60 days' written notice to the other. The holders of a majority of our outstanding voting securities may also terminate the investment advisory agreement without penalty upon 60 days' written notice. See Item 1A. Risk Factors Risks Relating to our Business and Structure. We are dependent upon key personnel of Stellus Capital Management for our future success. If Stellus Capital Management were to lose any of its key personnel, our ability to achieve our investment objective could be significantly harmed.

### **Indemnification**

The investment advisory agreement provides that Stellus Capital Management and its officers, managers, partners, agents, employees, controlling persons and members, and any other person or entity affiliated with it, are entitled to indemnification from us for any damages, liabilities, costs and expenses (including reasonable attorneys' fees and amounts reasonably paid in settlement) arising from the rendering of Stellus Capital Management's services under the investment advisory agreement or otherwise as our investment adviser. Our obligation to provide indemnification under the investment advisory agreement, however, is limited by the 1940 Act and Investment Company Act Release No. 11330, which, among other things, prohibit us from indemnifying any director, officer or other individual from any liability resulting directly from the willful misconduct, bad faith, gross negligence in the performance of duties or reckless disregard of applicable obligations and duties of the directors, officers or other individuals and require us to set forth reasonable and fair means for determining whether indemnification shall be made.

### **Board Approval of the Investment Advisory Agreement**

Our board of directors, including a majority of our independent directors, approved the investment advisory agreement at its first meeting, held on September 24, 2012, and approved the annual continuation of the investment advisory agreement on January 11, 2018. In its consideration of the investment advisory agreement, the board of directors focused on information it had received relating to, among other things: (a) the nature, quality and extent of the advisory and other services to be provided to us by our investment adviser; (b) comparative data with respect to advisory fees or similar expenses paid by other BDCs with similar investment objectives; (c) our projected operating expenses and expense ratio compared to BDCs with similar investment objectives; (d) any existing and potential sources of indirect income to our investment adviser from its relationships with us and the profitability of those

relationships; (e) information about the services to be performed and the personnel performing such services under the investment advisory

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agreement; (f) the organizational capability and financial condition of our investment adviser; and (g) various other factors. The board of directors did not rank or otherwise assign relative weights to the specific factors it considered in connection with its evaluation of the Investment Advisory Agreement, nor did it undertake to make any specific determination as to whether any particular factor, or any aspect of any particular factor, was favorable or unfavorable to the ultimate decision made by our board of directors. Rather, the board of directors based its approval of the Investment Advisory Agreement on the totality of information presented to it. In considering the factors discussed above, individual directors may have given different weights to different factors.

Based on the information reviewed and the discussions, the board of directors, including a majority of the non-interested directors, concluded that the investment management fee rates and terms are reasonable in relation to the services to be provided and approved the investment advisory agreement as being in the best interests of our stockholders.

### **Administration Agreement**

Under the administration agreement, Stellus Capital Management furnishes us with office facilities and equipment and will provide us with clerical, bookkeeping, recordkeeping and other administrative services at such facilities. Stellus Capital Management also performs, or oversees the performance of, our required administrative services, which include being responsible for the financial and other records that we are required to maintain and preparing reports to our stockholders and reports and other materials filed with the SEC. In addition, Stellus Capital Management assists us in determining and publishing our net asset value, oversees the preparation and filing of our tax returns and the printing and dissemination of reports and other materials to our stockholders, and generally oversees the payment of our expenses and the performance of administrative and professional services rendered to us by others. Under the administration agreement, Stellus Capital Management also provides managerial assistance on our behalf to those portfolio companies that have accepted our offer to provide such assistance.

Payments under the administration agreement are equal to an amount based upon our allocable portion (subject to the review of our board of directors) of Stellus Capital Management's overhead in performing its obligations under the administration agreement, including rent, the fees and expenses associated with performing compliance functions and our allocable portion of the cost of our chief financial officer and chief compliance officer and his staff. In addition, if requested to provide significant managerial assistance to our portfolio companies, Stellus Capital Management will be paid an additional amount based on the services provided, which shall not exceed the amount we receive from such portfolio companies for providing this assistance. The administration agreement has an initial term of two years and may be renewed with the approval of our board of directors. The administration agreement may be terminated by either party without penalty upon 60 days' written notice to the other party. To the extent that Stellus Capital Management outsources any of its functions, we will pay the fees associated with such functions on a direct basis without any incremental profit to Stellus Capital Management. Stockholder approval is not required to amend the administration agreement.

### **Indemnification**

The administration agreement provides that Stellus Capital Management, its affiliates and their respective, officers, managers, partners, agents, employees, controlling persons and members, and any other person or entity affiliated with it, are entitled to indemnification from us for any damages, liabilities, costs and expenses (including reasonable attorneys' fees and amounts reasonably paid in settlement) arising from the rendering of Stellus Capital Management's services under the administration agreement or otherwise as our administrator. Our obligation to provide indemnification under the administration agreement, however, is limited by the 1940 Act and Investment Company

Act Release No. 11330, which, among other things, prohibit us from indemnifying any director, officer or other individual from any liability resulting directly from the willful misconduct, bad faith, gross negligence in the performance of duties or reckless disregard of applicable obligations and duties of the directors, officers or other individuals and require us to set forth reasonable and fair means for determining whether indemnification shall be made.

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### **License Agreement**

We have entered into a license agreement with Stellus Capital Management under which Stellus Capital Management has agreed to grant us a non-exclusive, royalty-free license to use the name Stellus Capital. Under this agreement, we have a right to use the Stellus Capital name for so long as Stellus Capital Management or one of its affiliates remains our investment adviser. Other than with respect to this limited license, we have no legal right to the Stellus Capital name. This license agreement will remain in effect for so long as the investment advisory agreement with Stellus Capital Management is in effect.

### **Exchange Act Reports**

We maintain a website at [www.stelluscapital.com](http://www.stelluscapital.com). The information on our website is not incorporated by reference in this annual report on Form 10-K.

We make available on or through our website certain reports and amendments to those reports that we file with or furnish to the SEC in accordance with the Securities Exchange Act of 1934, or the Exchange Act. These include our annual reports on Form 10-K, our quarterly reports on Form 10-Q and our current reports on Form 8-K. We make this information available on our website free of charge as soon as reasonably practicable after we electronically file the information with, or furnish it to, the SEC.

### **Regulation as a Business Development Company**

We are a BDC under the 1940 Act that has elected to be treated as a RIC under the Code. The 1940 Act contains prohibitions and restrictions relating to transactions between BDCs and their affiliates (including any investment advisers), principal underwriters and affiliates of those affiliates or underwriters and requires that a majority of the directors be persons other than interested persons, as that term is defined in the 1940 Act. In addition, the 1940 Act provides that we may not change the nature of our business so as to cease to be, or to withdraw our election as, a BDC unless approved by a majority of our outstanding voting securities.

We may invest up to 100% of our assets in securities acquired directly from issuers in privately negotiated transactions. With respect to such securities, we may, for the purpose of public resale, be deemed an underwriter as that term is defined in the Securities Act. Our intention is to not write (sell) or buy put or call options to manage risks associated with the publicly traded securities of our portfolio companies, except that we may enter into hedging transactions to manage the risks associated with interest rate fluctuations. However, we may purchase or otherwise receive warrants to purchase the common stock of our portfolio companies in connection with acquisition financing or other investments. Similarly, in connection with an acquisition, we may acquire rights to require the issuers of acquired securities or their affiliates to repurchase them under certain circumstances. We also do not intend to acquire securities issued by any investment company that exceed the limits imposed by the 1940 Act. Under these limits, we generally cannot acquire more than 3% of the voting stock of any registered investment company, invest more than 5% of the value of our total assets in the securities of one investment company or invest more than 10% of the value of our total assets in the securities of more than one investment company. With regard to that portion of our portfolio invested in securities issued by investment companies, it should be noted that such investments might subject our stockholders to additional expenses. None of these policies is fundamental and may be changed without stockholder approval upon 60 days prior written notice to stockholders.

## Qualifying Assets

Under the 1940 Act, a BDC may not acquire any asset other than assets of the type listed in section 55(a) of the 1940 Act, which are referred to as qualifying assets, unless, at the time the acquisition is made, qualifying assets represent at least 70% of the company's total assets. The principal categories of qualifying assets relevant to our business are the following:

- Securities purchased in transactions not involving any public offering from the issuer of such securities, which issuer (subject to certain limited exceptions) is an eligible portfolio company, or from any person who is, or has been during the preceding 13 months, an affiliated person of an eligible portfolio company, or from any other person, subject to such rules as may be prescribed by the SEC. Under the 1940 Act and the rules thereunder, eligible portfolio companies include (1) private domestic operating companies, (2) public domestic operating companies whose securities

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are not listed on a national securities exchange (e.g., the New York Stock Exchange), and (3) public domestic operating companies having a market capitalization of less than \$250 million. Public domestic operating companies whose securities are quoted on the over-the-counter bulletin board or through Pink Sheets LLC are not listed on a national securities exchange and therefore are eligible portfolio companies.

(2) Securities of any eligible portfolio company which we control.

Securities purchased in a private transaction from a U.S. issuer that is not an investment company or from an affiliated person of the issuer, or in transactions incident to such a private transaction, if the issuer is in bankruptcy (3) and subject to reorganization or if the issuer, immediately prior to the purchase of its securities, was unable to meet its obligations as they came due without material assistance other than conventional lending or financing arrangements.

(4) Securities of an eligible portfolio company purchased from any person in a private transaction if there is no ready market for such securities and we already own 60% of the outstanding equity of the eligible portfolio company.

(5) Securities received in exchange for or distributed on or with respect to securities described above, or pursuant to the exercise of warrants or rights relating to such securities.

(6) Cash, cash equivalents, U.S. government securities or high-quality debt securities that mature in one year or less from the date of investment.

The regulations defining qualifying assets may change over time. We may adjust our investment focus as needed to comply with and/or take advantage of any regulatory, legislative, administrative or judicial actions in this area.

## **Managerial Assistance to Portfolio Companies**

In order to count portfolio securities as qualifying assets for the purpose of the 70% test, a BDC must either control the issuer of the securities or must offer to make available to the issuer of the securities significant managerial assistance. However, when the BDC purchases securities in conjunction with one or more other persons acting together and one of the other persons in the group may make available such managerial assistance. Making available managerial assistance means any arrangement whereby the BDC, through its directors, officers, employees or agents, offers to provide, and, if accepted, does so provide, significant guidance and counsel concerning the management, operations or business objectives and policies of a portfolio company. With respect to an SBIC, making available managerial assistance means the making of loans to a portfolio company. Stellus Capital Management will provide such managerial assistance on our behalf to portfolio companies that request this assistance.

## **Temporary Investments**

Pending investment in other types of qualifying assets, as described above, our investments may consist of cash, cash equivalents, U.S. government securities, repurchase agreements and high-quality debt investments that mature in one year or less from the date of investment, which we refer to, collectively, as temporary investments, so that 70% of our assets are qualifying assets or temporary investments. Typically, we will invest in U.S. Treasury bills or in repurchase agreements, so long as the agreements are fully collateralized by cash or securities issued by the U.S. government or its agencies. A repurchase agreement involves the purchase by an investor, such as us, of a specified security and the simultaneous agreement by the seller to repurchase it at an agreed-upon future date and at a price that is greater than the purchase price by an amount that reflects an agreed-upon interest rate. There is no percentage restriction on the proportion of our assets that may be invested in such repurchase agreements. However, if more than 25% of our total assets constitute repurchase agreements from a single counterparty, we would not meet the diversification tests in order to maintain our qualification as a RIC for U.S. federal income tax purposes. Accordingly, we do not intend to enter into repurchase agreements with a single counterparty in excess of this limit. Stellus Capital Management will monitor the creditworthiness of the counterparties with which we enter into repurchase agreement transactions.





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### **Warrants and Options**

Under the 1940 Act, a BDC is subject to restrictions on the amount of warrants, options, restricted stock or rights to purchase shares of capital stock that it may have outstanding at any time. Under the 1940 Act, we may generally only offer warrants provided that (i) the warrants expire by their terms within ten years, (ii) the exercise or conversion price is not less than the current market value at the date of issuance, (iii) our stockholders authorize the proposal to issue such warrants, and our board of directors approves such issuance on the basis that the issuance is in the best interests of us and our stockholders and (iv) if the warrants are accompanied by other securities, the warrants are not separately transferable unless no class of such warrants and the securities accompanying them has been publicly distributed. The 1940 Act also provides that the amount of our voting securities that would result from the exercise of all outstanding warrants, as well as options and rights, at the time of issuance may not exceed 25% of our outstanding voting securities. In particular, the amount of capital stock that would result from the conversion or exercise of all outstanding warrants, options or rights to purchase capital stock cannot exceed 25% of the BDC's total outstanding shares of capital stock.

### **Senior Securities**

We are permitted, under specified conditions, to issue multiple classes of indebtedness and one class of stock senior to our common stock if our asset coverage, as defined in the 1940 Act, is at least equal to 200% immediately after each such issuance. We may also borrow amounts up to 5% of the value of our total assets for temporary or emergency purposes without regard to asset coverage. For a discussion of the risks associated with leverage, see Item 1A. Risk Factors Risks Relating to our Business and Structure Regulations governing our operation as a BDC affect our ability to, and the way in which we, raise additional capital. As a BDC, the necessity of raising additional capital may expose us to risks, including the typical risks associated with leverage.

### **Common Stock**

We are not generally able to issue and sell our common stock at a price below net asset value per share. We may, however, sell our common stock at a price below the current net asset value of the common stock if our board of directors determines that such sale is in our best interests and that of our stockholders, and our stockholders approve such sale. In any such case, the price at which our securities are to be issued and sold may not be less than a price which, in the determination of our board of directors, closely approximates the market value of such securities (less any distributing commission or discount). We would need approval from our stockholders to issue shares below the then current net asset value per share any time after the expiration of the current approval. We may also make rights offerings to our stockholders at prices per share less than the net asset value per share, subject to applicable requirements of the 1940 Act.

### **Codes of Ethics**

We and Stellus Capital Management have each adopted a code of ethics pursuant to Rule 17j-1 under the 1940 Act that establishes procedures for personal investments and restricts certain personal securities transactions. Personnel subject to each such code may invest in securities for their personal investment accounts, including securities that may be purchased or held by us, so long as such investments are made in accordance with such code's requirements. You may read and copy our code of ethics at the SEC's Public Reference Room in Washington, D.C. You may obtain information on the operation of the Public Reference Room by calling the SEC at (202) 551-8090. In addition, each code of ethics is available on the EDGAR Database on the SEC's website at [www.sec.gov](http://www.sec.gov). You may also obtain copies of each code of ethics, after paying a duplicating fee, by electronic request at the following e-mail address:

*publicinfo@sec.gov*, or by writing the SEC's Public Reference Section, 100 F Street, N.E., Washington, D.C. 20549.

## **Proxy Voting Policies and Procedures**

We have delegated our proxy voting responsibility to Stellus Capital Management. The proxy voting policies and procedures of Stellus Capital Management are set out below. The guidelines will be reviewed periodically by Stellus Capital Management and our directors who are not interested persons, and, accordingly, are subject to change.

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*Introduction.* As an investment adviser registered under the Advisers Act, Stellus Capital Management has a fiduciary duty to act solely in our best interests. As part of this duty, Stellus Capital Management recognizes that it must vote our securities in a timely manner free of conflicts of interest and in our best interests.

Stellus Capital Management's policies and procedures for voting proxies for its investment advisory clients are intended to comply with Section 206 of, and Rule 206(4)-6 under, the Advisers Act.

*Proxy Policies.* Stellus Capital Management votes proxies relating to our portfolio securities in what it perceives to be the best interest of our stockholders. Stellus Capital Management reviews on a case-by-case basis each proposal submitted to a stockholder vote to determine its effect on the portfolio securities we hold. In most cases Stellus Capital Management will vote in favor of proposals that Stellus Capital Management believes are likely to increase the value of the portfolio securities we hold. Although Stellus Capital Management will generally vote against proposals that may have a negative effect on our portfolio securities, Stellus Capital Management may vote for such a proposal if there exist compelling long-term reasons to do so.

Stellus Capital Management has established a proxy voting committee and adopted proxy voting guidelines and related procedures. The proxy voting committee establishes proxy voting guidelines and procedures, oversees the internal proxy voting process, and reviews proxy voting issues. To ensure that Stellus Capital Management's vote is not the product of a conflict of interest, Stellus Capital Management requires that anyone involved in the decision-making process disclose to our Chief Compliance Officer any potential conflict that he or she is aware of and any contact that he or she has had with any interested party regarding a proxy vote. Where conflicts of interest may be present, Stellus Capital Management will disclose such conflicts to us, including our independent directors and may request guidance from us on how to vote such proxies.

*Proxy Voting Records.* You may obtain information about how Stellus Capital Management voted proxies by making a written request for proxy voting information to: Stellus Capital Investment Corporation, Attention: Investor Relations, 4400 Post Oak Parkway, Suite 2200, Houston, TX 77027, or by calling us collect at (713) 292-5414. The SEC also maintains a website at [www.sec.gov](http://www.sec.gov) that contains this information.

## **Privacy Principles**

We are committed to maintaining the privacy of our stockholders and to safeguarding their nonpublic personal information. The following information is provided to help you understand what personal information we collect, how we protect that information and why, in certain cases, we may share information with select other parties.

Generally, we do not receive any nonpublic personal information relating to our stockholders, although certain nonpublic personal information of our stockholders may become available to us. We do not disclose any nonpublic personal information about our stockholders or former stockholders to anyone, except as permitted by law or as is necessary in order to service stockholder accounts (for example, to a transfer agent or third-party administrator).

We restrict access to nonpublic personal information about our stockholders to employees of Stellus Capital Management and its affiliates with a legitimate business need for the information. We intend to maintain physical, electronic and procedural safeguards designed to protect the nonpublic personal information of our stockholders.

## Other

We are required to provide and maintain a bond issued by a reputable fidelity insurance company to protect us against larceny and embezzlement. Furthermore, as a BDC, we are prohibited from protecting any director or officer against any liability to us or our stockholders arising from willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of such person's office.

We and Stellus Capital Management are each required to adopt and implement written policies and procedures reasonably designed to prevent violation of relevant federal securities laws, review these policies

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and procedures annually for their adequacy and the effectiveness of their implementation, and designate a chief compliance officer to be responsible for administering the policies and procedures.

In general, BDCs are prohibited under the 1940 Act from knowingly participating in certain transactions with our affiliates without the prior approval of our board of directors who are not interested persons and, in some cases, prior approval by the SEC. The SEC has interpreted the BDC prohibition on transactions with affiliates to prohibit all joint transactions between entities that share a common investment adviser. The staff of the SEC has granted no-action relief permitting purchases of a single class of privately placed securities provided that the adviser negotiates no term other than price and certain other conditions are met. In addition, we received exemptive relief from the SEC to co-invest with investment funds managed by Stellus Capital Management (other than the D. E. Shaw group funds, as defined below) where doing so is consistent with our investment strategy as well as applicable law (including the terms and conditions of the exemptive order issued by the SEC). Under the terms of the relief permitting us to co-invest with other funds managed by Stellus Capital Management, a required majority (as defined in Section 57(o) of the 1940 Act) of our independent directors must make certain conclusions in connection with a co-investment transaction, including (1) the terms of the proposed transaction, including the consideration to be paid, are reasonable and fair to us and our stockholders and do not involve overreaching of us or our stockholders on the part of any person concerned and (2) the transaction is consistent with the interests of our stockholders and is consistent with our investment objectives and strategies. We intend to co-invest, subject to the conditions included in the exemptive order we received from the SEC, with a private credit fund managed by Stellus Capital Management that has an investment strategy that is identical to our investment strategy. We believe that such co-investments may afford us additional investment opportunities and an ability to achieve greater diversification.

## **Sarbanes-Oxley Act of 2002**

The Sarbanes-Oxley Act of 2002 imposes a wide variety of regulatory requirements on publicly held companies and their insiders. Many of these requirements affect us. For example:

pursuant to Rule 13a-14 under the Exchange Act, our principal executive officer and principal financial officer must certify the accuracy of the financial statements contained in our periodic reports;

pursuant to Item 307 under Regulation S-K, our periodic reports must disclose our conclusions about the effectiveness of our disclosure controls and procedures;

pursuant to Rule 13a-15 under the Exchange Act, our management must prepare an annual report regarding its assessment of our internal control over financial reporting; and

pursuant to Item 308 of Regulation S-K and Rule 13a-15 under the Exchange Act, our periodic reports must disclose whether there were significant changes in our internal controls over financial reporting or in other factors that could significantly affect these controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

## **Taxation as a Regulated Investment Company**

As a BDC, we have elected and qualified to be treated as a RIC under Subchapter M of 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 continue to maintain our qualification as a RIC, we must, among other things, meet certain source-of-income and asset diversification requirements (as described below). In addition, to maintain our RIC treatment we must distribute to our stockholders, for each taxable year, at least 90% of our investment company taxable income, which is generally our ordinary income plus the excess of our realized net short-term capital gains over our realized net long-term capital losses (the Annual Distribution Requirement).

For any taxable year in which we:

qualify as a RIC; and  
satisfy the Annual Distribution Requirement;

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We will not be subject to U.S. federal income tax on the portion of our income we distribute to stockholders. We will be subject to U.S. federal income tax at the regular corporate rates on any income or capital gains not distributed (or deemed distributed) to our stockholders.

We will be subject to a 4% nondeductible U.S. federal excise tax on our undistributed income unless we distribute in a timely manner an amount at least equal to the sum of (a) 98% of our net ordinary income for each calendar year, (b) 98.2% of our capital gain net income for the one-year period ending December 31 (c) any income realized, but not distributed, in the preceding year and on which we paid no U.S. federal income tax, or the Excise Tax Avoidance Requirement. For this purpose, however, any net ordinary income or capital gain net income retained by us that is subject to corporate income tax for the tax year ending in that calendar year will be considered to have been distributed by year end (or earlier if estimated taxes are paid). In order to qualify as a RIC for U.S. federal income tax purposes, we must, among other things:

continue to qualify as a BDC under the 1940 Act at all times during each year;  
derive in each taxable year at least 90% of our gross income from dividends, interest, payments with respect to certain securities loans, gains from the sale of stock or other securities, or other income derived with respect to our business of investing in such stock or securities, and net income derived from interests in qualified publicly traded partnerships (which generally are partnerships that are traded on an established securities market or tradable on a secondary market, other than partnerships that derive 90% of their income from interest, dividends and other permitted RIC income), or the 90% Income Test; and

diversify our holdings so that at the end of each quarter of the taxable year:  
at least 50% of the value of our assets consists of cash, cash equivalents, U.S. government securities, securities of other RICs, and other securities if such other securities of any one issuer do not represent more than 5% of the value of our assets or more than 10% of the outstanding voting securities of the issuer; and  
no more than 25% of the value of our assets is invested in the securities, other than U.S. government securities or securities of other RICs, of one issuer or of two or more issuers that are controlled, as determined under applicable tax rules, by us and that are engaged in the same or similar or related trades or businesses or in the securities of one or more qualified publicly traded partnerships, or the Diversification Tests.

We may invest in partnerships, including qualified publicly traded partnerships, which may result in our being subject to state, local or foreign income, franchise or withholding tax liabilities.

We may be required to recognize taxable income in circumstances in which we do not receive cash. For example, if we hold debt obligations that are treated under applicable tax rules as having original issue discount (such as debt instruments with PIK interest or, in certain cases, with increasing interest rates or issued with warrants), we must include in income each year a portion of the original issue discount that accrues over the life of the obligation, regardless of whether cash representing such income is received by us in the same taxable year. Because any original issue discount accrued will be included in our investment company taxable income for the year of accrual, we may be required to make a distribution to our stockholders in order to satisfy the Annual Distribution Requirement, even though we will not have received any corresponding cash amount. If we are not able to obtain sufficient cash from other sources to satisfy the Annual Distribution Requirement, we may fail to maintain our tax treatment as a RIC and become subject to corporate-level U.S. federal income taxes on all of our taxable income without the benefit of the dividends-paid deduction.

Although we do not presently expect to do so, we are authorized to borrow funds and to sell assets in order to satisfy (i) the Annual Distribution Requirements and to otherwise eliminate our liability for U.S. federal income and excise taxes and/or (ii) the Diversification Tests. However, under the 1940 Act, we are not permitted in certain circumstances to make distributions to our stockholders while our debt obligations and other senior securities are outstanding unless certain asset coverage tests are met. See Item 1A. Regulation as a Business Development Company Senior Securities.



Moreover, our ability to dispose of

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assets to meet the Annual Distribution Requirement, the Excise Tax Avoidance Requirement or the Diversification Test may be limited by (a) the illiquid nature of our portfolio and/or (b) other requirements relating to our qualifications as a RIC, including the Diversification Tests. If we dispose of assets in order to meet the Annual Distribution Requirement, the Excise Tax Avoidance Requirement or the Diversification Tests, we may make such dispositions at times that, from an investment standpoint, are not advantageous.

In addition, we have formed and operate a SBIC subsidiary, and are partially dependent on the SBIC subsidiary for cash distributions to enable us to meet the RIC distribution requirements. The SBIC subsidiary may be limited by the Small Business Investment Act of 1958, and SBA regulations governing SBICs, from making certain distributions to us that may be necessary to maintain our tax treatment as a RIC. We may have to request a waiver of the SBA's restrictions for the SBIC subsidiary to make certain distributions to maintain our RIC tax treatment. We cannot assure you that the SBA will grant such waiver. If the SBIC subsidiary is unable to obtain a waiver, compliance with the SBA regulations may cause us to fail to maintain our tax treatment as a RIC, which would result in us becoming subject to corporate-level federal income tax.

Certain of our investment practices may be subject to special and complex U.S. federal income tax provisions that may, among other things, (a) treat dividends that would otherwise constitute qualified dividend income as non-qualified dividend income, (b) treat dividends that would otherwise be eligible for the corporate dividends received deduction as ineligible for such treatment, (c) disallow, suspend or otherwise limit the allowance of certain losses or deductions, (d) convert lower-taxed long term capital gain into higher-taxed short-term capital gain or ordinary income, (e) convert an ordinary loss or a deduction into a capital loss (the deductibility of which is more limited), (f) cause us to recognize income or gain without a corresponding receipt of cash, (g) adversely affect the time as to when a purchase or sale of stock or securities is deemed to occur, (h) adversely alter the characterization of certain complex financial transactions and (i) produce income that will not be qualifying income for purposes of the 90% Income Test. We intend to monitor our transactions and may make certain tax elections to mitigate the effect of these provisions and prevent our disqualification as a RIC.

Gain or loss realized by us from warrants acquired by us as well as any loss attributable to the lapse of such warrants generally will be treated as capital gain or loss. Such capital gain or loss generally will be long term or short term, depending on how long we held a particular warrant. Some of the income and fees that we may recognize will not satisfy the 90% Income Test. In order to ensure that such income and fees do not disqualify us as a RIC for a failure to satisfy the 90% Income Test, we may hold assets that generate such income and provide services that generate such fees indirectly through one or more entities treated as corporations for U.S. federal income tax purposes. Such corporations will be required to pay U.S. federal corporate income tax on their earnings, which ultimately will reduce our return on such income and fees.

If we are unable to qualify for tax treatment as a RIC, and if certain remedial provisions are not available, we would be subject to tax on all of our taxable income at regular corporate rates. We would not be able to deduct distributions to stockholders, nor would they be required to be made. Subject to certain limitations under the Code, corporate stockholders would be eligible to claim a dividends received deduction with respect to such distributions, non-corporate stockholders would be able to treat such dividend income as qualified dividend income, which is subject to reduced rates of U.S. federal income tax. Distributions in excess of our current and accumulated earnings and profits would be treated first as a return of capital to the extent of the stockholder's tax basis, and any remaining distributions would be treated as a capital gain. If we fail to qualify as a RIC for a period greater than two taxable years, to requalify as a RIC in a subsequent year we may be subject to regular corporate tax on any net built-in gains with respect to certain of our assets (i.e., the excess of the aggregate gains, including items of income, over aggregate losses that would have been realized with respect to such assets if we had been liquidated) that we elect to recognize on requalification or when recognized over the next five years.



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## **Our Status as an Emerging Growth Company**

We ceased to qualify as an emerging growth company beginning January 1, 2017.

## **The New York Stock Exchange Corporate Governance Regulations**

The New York Stock Exchange has adopted corporate governance regulations that listed companies must comply with. We are in compliance with such corporate governance listing standards applicable to BDCs.

## **Regulation as a Small Business Investment Company**

Our wholly-owned subsidiary's SBIC license allows it to obtain leverage by issuing SBA-guaranteed debentures, subject to customary procedures. SBA-guaranteed debentures are non-recourse, interest only debentures with interest payable semi-annually and have a ten-year maturity. The principal amount of SBA-guaranteed debentures is not required to be paid prior to maturity but may be prepaid at any time without penalty. The interest rate of SBA-guaranteed debentures is fixed at the time of issuance at a market-driven spread over U.S. Treasury Notes with ten-year maturities.

SBICs are designed to stimulate the flow of private equity capital to eligible small businesses. Under SBA regulations, SBICs may make loans to eligible small businesses and invest in the equity securities of small businesses. Under present SBA regulations, eligible small businesses include businesses that have a tangible net worth not exceeding \$19.5 million and have average annual fully taxed net income not exceeding \$6.5 million for the two most recent fiscal years. In addition, an SBIC must devote 25% of its investment activity to smaller enterprises as defined by the SBA. A smaller enterprise is one that has a net worth not exceeding \$6 million and has average annual fully taxed net income not exceeding \$2 million for the two most recent fiscal years. SBA regulations also provide alternative size standard criteria to determine eligibility, which depend on the industry in which the business is engaged and are based on such factors as the number of employees and gross sales. According to SBA regulations, SBICs may make long-term loans to small businesses, invest in the equity securities of such businesses and provide them with consulting and advisory services.

SBA regulations currently limit the amount that an SBIC subsidiary may borrow to a maximum of \$150 million when it has at least \$75 million in regulatory capital. In December 2015, the 2016 omnibus spending bill approved by Congress and signed into law by the President increased the amount of SBA-guaranteed debentures that affiliated SBIC funds can have outstanding from \$225 million to \$350 million. This legislation may allow us to issue additional SBA-guaranteed debentures above the \$350 million threshold subject to SBA approval. As of December 31, 2017, our SBIC subsidiary had \$67.5 million in regulatory capital and \$90.0 million in SBA-guaranteed debentures outstanding, which approximated their fair value.

We have received exemptive relief from the SEC to permit us to exclude the debt of our SBIC subsidiaries guaranteed by the SBA from the definition of senior securities in the 200% asset coverage test under the 1940 Act. This allows us increased flexibility under the 200% asset coverage test by permitting us to borrow up to \$135 million more than we would otherwise be able to absent the receipt of this exemptive relief, based on our regulatory capital of \$67.5 million at December 31, 2017.

The SBA restricts the ability of SBICs to repurchase their capital stock. SBA regulations also include restrictions on a change of control or transfer of an SBIC and require that SBICs invest idle funds in accordance with SBA regulations. In addition, our SBIC subsidiary may also be limited in its ability to make distributions to us if it does not have sufficient capital, in accordance with SBA regulations.

Our SBIC subsidiary is subject to regulation and oversight by the SBA, including requirements with respect to maintaining certain minimum financial ratios and other covenants. Receipt of an SBIC license does not assure that our SBIC subsidiary will receive SBA guaranteed debenture funding, which is dependent upon our SBIC subsidiary continuing to be in compliance with SBA regulations and policies. The SBA, as a creditor, will have a superior claim to our SBIC subsidiary's assets over our stockholders in the event we liquidate our SBIC subsidiary or the SBA exercises its remedies under the SBA-guaranteed debentures issued by our SBIC subsidiary upon an event of default.

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**Item 1A. Risk Factors**

**RISK FACTORS**

*Investing in our securities involves a number of significant risks. Before you invest in our securities, you should be aware of various risks, including those described below. You should carefully consider these risk factors, together with all of the other information included in this annual report on Form 10-K, before you decide whether to make an investment in our securities. The risks set out below are the principal risks with respect to an investment in our securities generally and with respect to a BDC with investment objectives, investment policies, capital structures or trading markets similar to ours. However, they may not be the only risks we face. Additional risks and uncertainties not presently known to us or not presently deemed material by us may also impair our operations and performance. If any of the following events occur, our business, financial condition, results of operations and cash flows could be materially and adversely affected. In such case, our net asset value and the trading price of our securities could decline, and you may lose all or part of your investment.*

**Risks Relating to our Business and Structure**

**We are dependent upon key personnel of Stellus Capital Management for our future success. If Stellus Capital Management were to lose any of its key personnel, our ability to achieve our investment objective could be significantly harmed.**

We depend on the diligence, skill and network of business contacts of the investment professionals of Stellus Capital Management to achieve our investment objective. Stellus Capital Management's team of investment professionals evaluates, negotiates, structures, closes and monitors our investments in accordance with the terms of our investment advisory agreement. We can offer no assurance, however, that Stellus Capital Management's investment professionals will continue to provide investment advice to us.

Stellus Capital Management's investment committee, which provides oversight over our investment activities, is provided to us by Stellus Capital Management under the investment advisory agreement. Stellus Capital Management's investment committee consists of five members, including Messrs. Ladd, D'Angelo and Davis, each a member of our board of directors, Mr. Huskinson, our chief financial officer and chief compliance officer and the chief financial officer of Stellus Capital Management and Mr. Overbergen, an investment professional of Stellus Capital Management. The loss of any member of Stellus Capital Management's investment committee limit our ability to achieve our investment objective and operate our business. This could have a material adverse effect on our financial condition, results of operations and cash flows.

**Our business model depends to a significant extent upon strong referral relationships. Any inability of Stellus Capital Management to maintain or develop these relationships, or the failure of these relationships to generate investment opportunities, could adversely affect our business.**

We depend upon Stellus Capital Management to maintain its relationships with private equity sponsors, placement agents, investment banks, management groups and other financial institutions, and we rely to a significant extent upon

these relationships to provide us with potential investment opportunities. If Stellus Capital Management fails to maintain such relationships, or to develop new relationships with other sources of investment opportunities, we will not be able to grow our investment portfolio. In addition, individuals with whom Stellus Capital Management has relationships are not obligated to provide us with investment opportunities, and we can offer no assurance that these relationships will generate investment opportunities for us in the future.

**Our financial condition, results of operations and cash flows will depend on our ability to manage our business effectively.**

Our ability to achieve our investment objective will depend on our ability to manage our business and to grow our investments and earnings. This will depend, in turn, on Stellus Capital Management's ability to identify, invest in and monitor portfolio companies that meet our investment criteria. The achievement of our investment objective on a cost-effective basis will depend upon Stellus Capital Management's execution of our

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investment process, its ability to provide competent, attentive and efficient services to us and, to a lesser extent, our access to financing on acceptable terms. Stellus Capital Management's investment professionals will have substantial responsibilities in connection with the management of other investment funds, accounts and investment vehicles. The personnel of Stellus Capital Management may be called upon to provide managerial assistance to our portfolio companies. These activities may distract them from sourcing new investment opportunities for us or slow our rate of investment. Any failure to manage our business and our future growth effectively could have a material adverse effect on our business, financial condition, results of operations and cash flows.

**There are significant potential conflicts of interest that could negatively affect our investment returns.**

The members of Stellus Capital Management's investment committee serve, or may serve, as officers, directors, members, or principals of entities that operate in the same or a related line of business as we do, or of investment funds, accounts, or investment vehicles managed by Stellus Capital Management. Similarly, Stellus Capital Management may have other clients with similar, different or competing investment objectives. In serving in these multiple capacities, they may have obligations to other clients or investors in those entities, the fulfillment of which may not be in the best interests of us or our stockholders. For example, Stellus Capital Management currently manages private credit funds that have an investment strategy that is identical to our investment strategy, and with which we intend to co-invest. Stellus Capital Management also provides sub-advisory services to the D. E. Shaw group with respect to a private investment fund and a strategy of a private multi-strategy investment fund to which the D. E. Shaw group serves as investment adviser that have an investment strategy similar to our investment strategy.

In addition, there may be times when Stellus Capital Management, members of its investment committee or its other investment professionals have interests that differ from those of our stockholders, giving rise to a conflict of interest. In particular, a private investment fund for which Stellus Capital Management provides investment advisory services hold minority equity interests in certain of the portfolio companies in which we hold debt investments. As a result, Stellus Capital Management, members of its investment committee or its other investment professionals may face conflicts of interest in connection with making business decisions for these portfolio companies to the extent that such decisions affect the debt and equity holders in these portfolio companies differently. In addition, Stellus Capital Management may face conflicts of interests in connection with making investment or other decisions, including granting loan waivers or concessions, on our behalf with respect to these portfolio companies given that they also provide investment advisory services to a private investment funds that holds the equity interests in these portfolio companies. Although our investment adviser will endeavor to handle these investment and other decisions in a fair and equitable manner, we and the holders of the shares of our common stock could be adversely affected by these decisions. Moreover, given the subjective nature of the investment and other decisions made by our investment adviser on our behalf, we are unable to monitor these potential conflicts of interest between us and our investment adviser; however, our board of directors, including the independent directors, reviews conflicts of interest in connection with its review of the performance of our investment adviser.

**The senior investment professionals and other investment team members of Stellus Capital Management may, from time to time, possess material non-public information, limiting our investment discretion.**

The senior investment professionals and other investment team members of Stellus Capital Management, including members of Stellus Capital Management's investment committee, may serve as directors of, or in a similar capacity with, portfolio companies in which we invest, the securities of which are purchased or sold on our behalf. In the event



that material nonpublic information is obtained with respect to such companies, or we become subject to trading restrictions under the internal trading policies of those companies or as a result of applicable law or regulations, we could be prohibited for a period of time from purchasing or selling the securities of such companies, and this prohibition may have an adverse effect on us.

**The management fee structure we have with Stellus Capital Management may create incentives that are not fully aligned with the interests of our stockholders.**

In the course of our investing activities, we pay management and incentive fees to Stellus Capital Management. We have entered into an investment advisory agreement with Stellus Capital Management that provides for a management fee based on the value of our gross assets. Because this fee is based on the value

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of our gross assets, Stellus Capital Management will benefit when we incur debt or use leverage. This fee structure may encourage Stellus Capital Management to cause us to borrow money to finance additional investments. Under certain circumstances, the use of borrowed money may increase the likelihood of default, which would disfavor our stockholders. As a result of this arrangement, Stellus Capital Management may from time to time have interests that differ from those of our stockholders, giving rise to a conflict.

Our board of directors is charged with protecting our interests by monitoring how Stellus Capital Management addresses these and other conflicts of interests associated with its management services and compensation. While our board of directors is not expected to review or approve each investment decision, borrowing or incurrence of leverage, our independent directors will periodically review Stellus Capital Management's services and fees as well as its portfolio management decisions and portfolio performance. In connection with these reviews, our independent directors will consider whether our fees and expenses (including those related to leverage) remain appropriate.

### **Our incentive fee may induce Stellus Capital Management to make speculative investments.**

We pay Stellus Capital Management an incentive fee based, in part, upon net capital gains realized on our investments. Unlike that portion of the incentive fee based on income, there is no hurdle rate applicable to the portion of the incentive fee based on net capital gains. Additionally, under the incentive fee structure, Stellus Capital Management may benefit when capital gains are recognized and, because Stellus Capital Management will determine when to sell a holding, Stellus Capital Management will control the timing of the recognition of such capital gains. As a result, Stellus Capital Management may have a tendency to invest more capital in investments that are likely to result in 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.

### **We may be obligated to pay Stellus Capital Management incentive compensation even if we incur a loss and may pay more than 20.0% of our net capital gains because we cannot recover payments made in previous years.**

Stellus Capital Management is entitled to incentive compensation for each fiscal quarter in an amount equal to a percentage of the excess of our investment income for that quarter (before deducting incentive compensation) above a threshold return for that quarter and subject to a total return requirement. The general effect of this total return requirement is to prevent payment of the foregoing incentive compensation except to the extent 20.0% of the cumulative net increase in net assets resulting from operations over the then current and 11 preceding calendar quarters exceeds the cumulative incentive fees accrued and/or paid for the 11 preceding calendar quarters. Consequently, we may pay an incentive fee if we incurred losses more than three years prior to the current calendar quarter even if such losses have not yet been recovered in full. Thus, we may be required to pay Stellus 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. If we pay an incentive fee of 20.0% of our realized capital gains (net of all realized capital losses and unrealized capital depreciation on a cumulative basis) and thereafter experience additional realized capital losses or unrealized capital depreciation, we will not be able to recover any portion of the incentive fee previously paid.

**We operate in a highly competitive market for investment opportunities, which could reduce returns and result in losses.**

A number of entities compete with us to make the types of investments that we make. We compete with public and private funds, commercial and investment banks, commercial financing companies and, to the extent they provide an alternative form of financing, private equity and hedge funds. Many of our competitors are substantially larger and have considerably greater financial, technical and marketing resources than we do. For example, we believe some of our competitors may have 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 relationships than us. Furthermore, many of our competitors are not subject to the regulatory restrictions that the 1940 Act imposes on us as a BDC or the source-of-income, asset diversification and distribution requirements we must satisfy to maintain our RIC qualification. The competitive pressures we face may have a material adverse effect on our

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business, financial condition, results of operations and cash flows. As a result of this competition, we may not be able to take advantage of attractive investment opportunities from time to time, and we may not be able to identify and make investments that are consistent with our investment objective.

With respect to the investments we make, we do not seek to compete based primarily on the interest rates we offer, and we believe that some of our competitors may make loans with interest rates that are lower than the rates we offer.

With respect to all investments, we may lose some investment opportunities if we do not match our competitors pricing, terms and structure. However, if we match our competitors pricing, terms and structure, we may experience decreased net interest income, lower yields and increased risk of credit loss. We may also compete for investment opportunities with investment funds, accounts and investment vehicles managed by Stellus Capital Management. Although Stellus Capital Management will allocate opportunities in accordance with its policies and procedures, allocations to such investment funds, accounts and investment vehicles will reduce the amount and frequency of opportunities available to us and may not be in the best interests of us and our stockholders.

**We will be subject to corporate-level income tax and may default under our revolving credit facility if we are unable to maintain our tax treatment as a RIC under Subchapter M of the Code.**

To maintain our tax treatment as a RIC under Subchapter M of the Code, we must meet certain source-of-income, asset diversification and distribution requirements. The distribution requirement for a RIC is satisfied if we distribute at least 90% of our net ordinary income and net short-term capital gains in excess of net long-term capital losses, if any, to our stockholders on an annual basis. Because we incur debt, we will be subject to certain asset coverage ratio requirements under the 1940 Act and financial covenants under loan and credit agreements that could, under certain circumstances, restrict us from making distributions necessary to maintain our tax treatment as a RIC. If we are unable to obtain cash from other sources, we may fail to maintain our tax treatment as a RIC and, thus, may be subject to corporate-level income tax. To maintain our tax treatment 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 our tax treatment as a RIC. Because most of our investments are in private or thinly-traded public companies, any such dispositions may be made at disadvantageous prices and may result in substantial losses. No certainty can be provided, that we will satisfy the asset diversification requirements or the other requirements necessary to maintain our tax treatment as a RIC. If we fail to maintain our tax treatment as a RIC for any reason and become subject to corporate income tax, the resulting corporate income taxes could substantially reduce our net assets, the amount of income available for distributions to our stockholders and the amount of funds available for new investments. Furthermore, if we fail to maintain our tax treatment as a RIC, we may be in default under the terms of our \$140.0 million senior secured revolving credit facility with various lenders (the Credit Facility ). Such a failure could have a material adverse effect on us and our stockholders.

**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 the accrual of original issue discount. This may arise if we receive warrants in connection with the making of a loan and in other circumstances, or through contracted PIK interest, which represents contractual interest added to the loan balance and due at the end of the loan term. Such original issue discount, which could be significant relative to our overall investment activities, and increases in loan balances as a result of contracted PIK arrangements are included in income before we receive any corresponding cash payments. We also may be required to include in

income certain other amounts that we will not receive in cash.

Since in certain cases we may recognize income before or without receiving cash representing such income, we may have difficulty meeting the requirement to distribute at least 90% of our net ordinary income and net short-term capital gains in excess of net long-term capital losses, if any, to maintain our tax treatment as a RIC. In such a case, we may have to sell some of our investments at times we would not consider advantageous or raise additional debt or equity capital or reduce new investment originations to meet these

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distribution requirements. If we are not able to obtain such cash from other sources, we may fail to maintain our tax treatment as a RIC and thus be subject to corporate-level income tax.

**PIK interest payments we receive will increase our assets under management and, as a result, will increase the amount of base management fees and incentive fees payable by us to Stellus Capital Management.**

Certain of our debt investments may contain provisions providing for the payment of PIK interest. Because PIK interest results in an increase in the size of the loan balance of the underlying loan, the receipt by us of PIK interest will have the effect of increasing our assets under management. As a result, because the base management fee that we pay to Stellus Capital Management is based on the value of our gross assets, the receipt by us of PIK interest will result in an increase in the amount of the base management fee payable by us. In addition, any such increase in a loan balance due to the receipt of PIK interest will cause such loan to accrue interest on the higher loan balance, which will result in an increase in our pre-incentive fee net investment income and, as a result, an increase in incentive fees that are payable by us to Stellus Capital Management.

**Regulations governing our operation as a BDC affect our ability to, and the way in which we, raise additional capital. As a BDC, the necessity of raising additional capital may expose us to risks, including the typical risks associated with leverage.**

We may issue debt securities or preferred stock and/or borrow 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 issue senior securities in amounts such that our asset coverage ratio, as defined in the 1940 Act, equals at least 200% of our gross assets less all liabilities and indebtedness not represented by senior securities, after each issuance of senior securities. If the value of our assets declines, we may be unable to satisfy this test. If that happens, we would not be able to borrow additional funds until we were able to comply with the 200% asset coverage ratio under the 1940 Act. Also, any amounts that we use to service our indebtedness would not be available for distributions to our common stockholders. If we issue senior securities, we will be exposed to typical risks associated with leverage, including an increased risk of loss.

We are not generally able to issue and sell our common stock at a price below net asset value per share. We may, however, sell our common stock, or warrants, options or rights to acquire our common stock, at a price below then-current net asset value per share of our common stock if our board of directors determines that such sale is in our best interests, and if our stockholders approve such sale. At our 2017 Annual Meeting of Stockholders, our stockholders voted to allow us to issue common stock at a price below net asset value per share for the period ending on the earlier of the one-year anniversary of the date of the Company's 2017 Annual Meeting of Stockholders and the date of the Company's 2018 Annual Meeting of Stockholders. Our stockholders did not specify a maximum discount below net asset value at which we are able to issue our common stock, although the number of shares sold in each offering may not exceed 25% of our outstanding common stock immediately prior to such sale. In addition, we cannot issue shares of our common stock below net asset value unless our board of directors determines that it would be in our and our stockholders' best interests to do so. 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. In addition, continuous sales of common stock below net asset value may have a negative impact on total returns and could have a negative impact on the market price of our shares of common stock. If we raise additional funds by issuing common stock, then the percentage ownership of our stockholders at that time will

PIK interest payments we receive will increase our assets under management and, as a result, will increase the am

decrease, and you may experience dilution.

**Because we finance our investments with borrowed money, the potential for gain or loss on amounts invested in us is magnified and may increase the risk of investing in us.**

The use of leverage magnifies the potential for gain or loss on amounts invested. The use of leverage is generally considered a speculative investment technique and increases the risks associated with investing in our securities. If we continue to use leverage to partially finance our investments through banks, insurance companies and other lenders, you will experience increased risks of investing in our common stock. Lenders of these funds have fixed dollar claims on our assets that are superior to the claims of our common

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stockholders, and we would expect such lenders to seek recovery against our assets in the event of a default. We, through our SBIC subsidiary, intend to issue debt securities guaranteed by the SBA and sold in the capital markets. Upon any such issuance of debt securities and as a result of its guarantee of the debt securities, if any, the SBA would also have fixed dollar claims on the assets of our SBIC subsidiary that are superior to the claims of our common stockholders.

Upon the issuance of any debt securities guaranteed by the SBA, if we are unable to meet the financial obligations under our 5.75% notes due 2022 or (the 2022 Notes ) or the Credit Facility, the SBA, as a creditor, would have a superior claim to the assets of our SBIC subsidiary over our stockholders in the event we liquidate or the SBA exercises its remedies under such debentures as the result of a default by us. In addition, under the terms of the Credit Facility and any borrowing facility or other debt instrument we may enter into, we are likely to be required to use the net proceeds of any investments that we sell to repay a portion of the amount borrowed under such facility or instrument before applying such net proceeds to any other uses. 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, thereby magnifying losses or eliminating our stake in a leveraged investment. Similarly, any decrease in our revenue or income will cause our net income to decline more sharply than it would have had we not borrowed. Such a decline would also negatively affect our ability to make distributions with respect to our common stock. Our ability to service any debt depends largely on our financial performance and is subject to prevailing economic conditions and competitive pressures. Moreover, as the base management fee payable to Stellus Capital Management is payable based on the value of our gross assets, including those assets acquired through the use of leverage, Stellus Capital Management will have a financial incentive to incur leverage, which may not be consistent with our stockholders' interests. In addition, our common stockholders bear the burden of any increase in our expenses as a result of our use of leverage, including interest expenses and any increase in the base management fee payable to Stellus Capital Management.

As a BDC, we generally are required to meet a coverage ratio of total assets to total borrowings and other senior securities, which include all of our borrowings and any preferred stock that we may issue in the future, of at least 200%. If this ratio declines below 200%, we will not be able to incur additional debt until we are able to comply with the 200% asset coverage ratio under the 1940 Act. This could have a material adverse effect on our operations, and we may not be able to make distributions. The amount of leverage that we employ will depend on Stellus Capital Management's and our board of directors' assessment of market and other factors at the time of any proposed borrowing. We cannot assure you that we will be able to obtain credit at all or on terms acceptable to us.

We have received exemptive relief from the SEC to permit us to exclude the debt of our SBIC subsidiary guaranteed by the SBA from the definition of senior securities in the 200% asset coverage ratio we are required to maintain under the 1940 Act. This relief allows us increased flexibility under the 200% asset coverage test by allowing us to borrow up to \$135 million more than we would otherwise be able to borrow absent the receipt of this exemptive relief, based on our regulatory capital of \$67.5 million at December 31, 2017.

In addition, our debt facilities may impose financial and operating covenants that restrict our business activities, including limitations that hinder our ability to finance additional loans and investments or to make the distributions required to maintain our qualification as a RIC under the Code.

**Substantially all of our assets are subject to security interests under the Credit Facility or claims of the SBA with respect to SBA-guaranteed debentures we may issue and, if we default on our obligations thereunder, we may suffer adverse consequences, including foreclosure on our assets.**

Because we finance our investments with borrowed money, the potential for gain or loss on amounts invested in us



As of December 31, 2017, substantially all of our assets were pledged as collateral under the Credit Facility or are subject to a superior claim over the holders of our common stock or the 2022 Notes by the SBA pursuant to the SBA-guaranteed debentures. If we default on our obligations under the Credit Facility or the SBA-guaranteed debentures the lenders and/or the SBA may have the right to foreclose upon and sell, or otherwise transfer, the collateral subject to their security interests or their superior claim. In such event, we may be forced to sell our investments to raise funds to repay our outstanding borrowings in order to avoid foreclosure and these forced sales may be at times and at prices we would not consider advantageous.

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Moreover, such deleveraging of our company could significantly impair our ability to effectively operate our business in the manner in which we have historically operated. As a result, we could be forced to curtail or cease new investment activities and lower or eliminate the dividends that we have historically paid to our stockholders.

In addition, if the lenders exercise their right to sell the assets pledged under the Credit Facility, such sales may be completed at distressed sale prices, thereby diminishing or potentially eliminating the amount of cash available to us after repayment of the amounts outstanding under the Credit Facility.

**Because we use debt to finance our investments and may in the future issue senior securities including preferred stock and debt securities, if market interest rates were to increase, our cost of capital could increase, which could reduce our net investment income.**

Because we borrow money to make investments and may in the future issue senior securities including preferred stock and debt securities, our net investment income will depend, in part, upon the difference between the rate at which we borrow funds and the rate at which we invest those funds. As a result, we can offer no assurance that a significant change in market interest rates would not have a material adverse effect on our net investment income in the event we use debt to finance our investments. In periods of rising interest rates, our cost of funds would increase, which could reduce our net investment income. We may use interest rate risk management techniques in an effort to limit our exposure to interest rate fluctuations. 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 to the extent permitted by the 1940 Act. For example, to the extent any such instruments were to constitute senior securities under the 1940 Act, we would have to and will comply with the asset coverage requirements thereunder or, as permitted in lieu thereof, place certain assets in a segregated account to cover such instruments in accordance with SEC guidance, including, for example, Investment Company Act Release No. IC-10666, as applicable. There is otherwise no limit as to our ability to enter into such derivative transactions. In addition, a rise in the general level of interest rates typically leads to higher interest rates applicable to our debt investments. Accordingly, an increase in interest rates may result in an increase of the amount of our pre-incentive fee net investment income and, as a result, an increase in incentive fees payable to Stellus Capital Management. Adverse developments resulting from changes in interest rates or hedging transactions could have a material adverse effect on our business, financial condition and results of operations.

**Provisions in the Credit Facility or any other future borrowing facility may limit our discretion in operating our business.**

The Credit Facility is, and any future borrowing facility may be, backed by all or a portion of our loans and securities on which the lenders will or, in the case of a future facility, may have a security interest. We may pledge up to 100% of our assets and may grant a security interest in all of our assets under the terms of any debt instrument we enter into with lenders. We expect that any security interests we grant will be set forth in a guarantee and security agreement and evidenced by the filing of financing statements by the agent for the lenders. In addition, we expect that the custodian for our securities serving as collateral for such loan would include in its electronic systems notices indicating the existence of such security interests and, following notice of occurrence of an event of default, if any, and during its continuance, will only accept transfer instructions with respect to any such securities from the lender or its designee. If we were to default under the terms of any debt instrument, the agent for the applicable lenders would be able to assume control of the timing of disposition of any or all of our assets securing such debt, which would have a material adverse effect on our business, financial condition, results of operations and cash flows.

Because we use debt to finance our investments and may in the future issue senior securities including preferred st

In addition, any security interests as well as negative covenants under the Credit Facility or any other borrowing facility may limit our ability to incur additional liens or debt and may make it difficult for us to restructure or refinance indebtedness at or prior to maturity or obtain additional debt or equity financing. For example, under the terms of the Credit Facility, we have generally agreed to not incur any additional secured indebtedness, other than certain indebtedness that we may incur, in accordance with the Credit Facility, to allow us to purchase investments in U.S. Treasury Bills. In addition, we have agreed not to incur any additional indebtedness that has a maturity date prior to the maturity date of the Credit Facility. Further, if our

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borrowing base under the Credit Facility or any other borrowing facility were to decrease, we would be required to secure additional assets in an amount equal to any borrowing base deficiency. In the event that all of our assets are secured at the time of such a borrowing base deficiency, we could be required to repay advances under the Credit Facility or any other borrowing facility or make deposits to a collection account, either of which could have a material adverse impact on our ability to fund future investments and to make stockholder distributions.

In addition, under the Credit Facility or any other borrowing facility, we may be subject to limitations as to how borrowed funds may be used, which may include restrictions on geographic and industry concentrations, loan size, payment frequency and status, average life, collateral interests and investment ratings, as well as regulatory restrictions on leverage which may affect the amount of funding that may be obtained. There may also be certain requirements relating to portfolio performance, including required minimum portfolio yield and limitations on delinquencies and charge-offs, a violation of which could limit further advances and, in some cases, result in an event of default. Furthermore, we expect that the terms of the Credit Facility will contain a covenant requiring us to maintain compliance with RIC provisions at all times, subject to certain remedial provisions. Thus, a failure to maintain compliance with RIC provisions could result in an event of default under the Credit Facility. An event of default under the Credit Facility or any other borrowing facility could result in an accelerated maturity date for all amounts outstanding thereunder, which could have a material adverse effect on our business and financial condition. This could reduce our revenues and, by delaying any cash payment allowed to us under the Credit Facility or any other borrowing facility until the lenders have been paid in full, reduce our liquidity and cash flow and impair our ability to grow our business and maintain our qualification as a RIC.

**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.

**Adverse developments in the credit markets may impair our ability to enter into any other future borrowing facility.**

During the economic downturn in the United States that began in mid-2007, many commercial banks and other financial institutions stopped lending or significantly curtailed their lending activity. In addition, in an effort to stem losses and reduce their exposure to segments of the economy deemed to be high risk, some financial institutions limited refinancing and loan modification transactions and reviewed the terms of existing facilities to identify bases for accelerating the maturity of existing lending facilities. If these conditions recur (for example, as a result of a broadening of the current Euro zone credit crisis), it may be difficult for us to enter into a new borrowing facility, obtain other financing to finance the growth of our investments, or refinance any outstanding indebtedness on acceptable economic terms, or at all.

**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 may be uncertainty as to the value of our portfolio investments.**

Most of our portfolio investments will take the form of securities that are not publicly traded. The fair value of loans, securities and other investments that are not publicly traded may not be readily determinable, and we value these investments at fair value as determined in good faith by our board of directors, including to reflect significant events affecting the value of our investments. Most, if not all, of our investments (other than cash and cash equivalents) are classified as Level 3 under ASC Topic 820. This means that our portfolio valuations are based on unobservable inputs and our own assumptions about how market participants would price the asset or liability in question. Inputs into the determination of fair value of our portfolio investments require significant management judgment or estimation. Even if observable market data is available, such information may be the result of consensus pricing information or broker quotes, which include a disclaimer

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that the broker would not be held to such a price in an actual transaction. The non-binding nature of consensus pricing and/or quotes accompanied by disclaimers materially reduces the reliability of such information. We have retained the services of independent service providers to review the valuation of these loans and securities. The types of factors that the board of directors may take into account in determining the fair value of our investments generally include, as appropriate, comparison to publicly traded securities including such factors as yield, maturity and measures of credit quality, the enterprise value of a portfolio company, the nature and realizable value of any collateral, the portfolio company's ability to make payments and its earnings and discounted cash flow, the markets in which the portfolio company does business and other relevant factors. Because such valuations, and particularly valuations of private securities and private companies, are inherently uncertain, may fluctuate over short periods of time and may be based on estimates, our determinations of fair value may differ materially from the values that would have been used if a ready market for these loans and securities existed. Our net asset value could be adversely affected if our determinations regarding the fair value of our investments were materially higher than the values that we ultimately realize upon the disposal of such loans and securities.

We adjust quarterly the valuation of our portfolio to reflect our board of directors' determination of the fair value of each investment in our portfolio. Any changes in fair value are recorded in our statement of operations as net change in unrealized appreciation or depreciation.

### **We may expose ourselves to risks if we engage in hedging 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. Use of these hedging instruments may expose us to counter-party credit risk. 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 generally anticipated at an acceptable price.

### **If we fail to maintain an effective system of internal control over financial reporting, we may not be able to accurately report our financial results or prevent fraud. As a result, stockholders could lose confidence in our financial and other public reporting, which would harm our business and the trading price of our common stock.**

Effective internal controls over financial reporting are necessary for us to provide reliable financial reports and, together with adequate disclosure controls and procedures, are designed to prevent fraud. Any failure to implement required new or improved controls, or difficulties encountered in their implementation could cause us to fail to meet our reporting obligations. In addition, any testing by us conducted in connection with Section 404 of the Sarbanes-Oxley Act, or the subsequent testing by our independent registered public accounting firm (when undertaken, as noted below), may reveal deficiencies in our internal controls over financial reporting that are deemed to be material weaknesses or that may require prospective or retroactive changes to our consolidated financial statements or identify other areas for further attention or improvement. Inferior internal controls could also cause investors to lose confidence in our reported financial information, which could have a negative effect on the trading price of our common stock.

**Efforts to comply with Section 404 of the Sarbanes-Oxley Act involve significant expenditures, and non-compliance with Section 404 of the Sarbanes-Oxley Act may adversely affect us and the market price of our common stock.**

In an effort to comply with Section 404 of the Sarbanes-Oxley Act, we expect to incur additional expenses, which may negatively impact our financial performance and our ability to make distributions to our stockholders. This process also may result in a diversion of management's time and attention. We cannot be certain as to the timing of completion of any evaluation, testing and remediation actions or the impact of the same on our operations, and we are not able to ensure that the process is effective or that our internal control

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over financial reporting is or will continue to be effective in a timely manner. In the event that we are unable to maintain or achieve compliance with Section 404 of the Sarbanes-Oxley Act and related rules, we and, consequently, the market price of our common stock may be adversely affected.

We are required to disclose changes made in our internal control and procedures on a quarterly basis and our management is required to assess the effectiveness of these controls annually. An independent assessment of the effectiveness of our internal controls could detect problems that our management's assessment might not. Undetected material weaknesses in our internal controls could lead to financial statement restatements and require us to incur the expense of remediation.

### **New or modified laws or regulations governing our operations may adversely affect our business.**

We and our portfolio companies are subject to regulation by laws at the U.S. federal, state and local levels. These laws and regulations, as well as their interpretation, may change from time to time, and new laws, regulations and interpretations may also come into effect. Any such new or changed laws or regulations could have a material adverse effect on our business.

Additionally, changes to the laws and regulations governing our operations related to permitted investments may cause us to alter our investment strategy in order to avail ourselves of new or different opportunities. Such changes could result in material differences to the strategies and plans set forth in this annual report on Form 10-K and may shift our investment focus from the areas of expertise of Stellus Capital Management to other types of investments in which Stellus Capital Management may have little or no expertise or experience. Any such changes, if they occur, could have a material adverse effect on our results of operations and the value of your investment.

### **Legislative or other actions relating to taxes could have a negative effect on us.**

The rules dealing with U.S. federal income taxation are constantly under review by persons involved in the legislative process and by the IRS and the U.S. Treasury Department. The U.S. House of Representatives and U.S. Senate recently passed tax reform legislation, which the President signed into law. Such legislation makes many changes to the Internal Revenue Code, including, among other things, significant changes to the taxation of business entities, the deductibility of interest expense, and the tax treatment of capital investment. We cannot predict with certainty how any changes in the tax laws might affect us, investors or our portfolio investments. New legislation and any U.S. Treasury regulations, administrative interpretations or court decisions interpreting such legislation could significantly and negatively affect our ability to qualify for tax treatment as a RIC or the U.S. federal income tax consequences to us and our investors of such qualification, or could have other adverse consequences. Investors are urged to consult with their tax advisor regarding tax legislative, regulatory or administrative developments and proposals and their potential effect on an investment in our securities.

### **Any failure to comply with SBA regulations could have an adverse effect on our SBIC subsidiary's operations.**

On June 20, 2014, our wholly-owned subsidiary, Stellus Capital SBIC LP, received a license from the SBA to operate as an SBIC. The SBA places certain limitations on the financing terms of investments by SBICs in portfolio companies and prohibits SBICs from providing funds for certain purposes or to businesses in a few prohibited



industries. Compliance with SBIC requirements may cause our SBIC subsidiary to forgo attractive investment opportunities that are not permitted under SBA regulations.

Further, SBA regulations require that an SBIC be examined by the SBA to determine its compliance with the relevant SBA regulations at least every two years. The SBA prohibits, without prior SBA approval, a change of control of an SBIC or transfers that would result in any person (or a group of persons acting in concert) owning 10% or more of a class of capital stock of an SBIC. If our SBIC subsidiary fails to comply with applicable SBA regulations, the SBA could, depending on the severity of the violation, limit or prohibit its use of debentures, declare outstanding debentures immediately due and payable, and/or limit it from making new investments. In addition, the SBA can revoke or suspend a license for willful or repeated violation of, or willful or repeated failure to observe, any provision of the Small Business Investment Act of 1958 or any rule or regulation promulgated thereunder. These actions by the SBA would, in turn, negatively affect us because our SBIC subsidiary is our wholly-owned subsidiary.

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## **Risks Related to Our Operations**

**Because we intend to distribute substantially all of our income to our stockholders to obtain and maintain our status as a RIC, we will continue to need additional capital to finance our growth. If additional funds are unavailable or not available on favorable terms, our ability to grow may be impaired.**

We will need additional capital to fund new investments and grow our portfolio of investments. We intend to access the capital markets periodically to issue debt or equity securities or borrow from financial institutions in order to obtain such additional capital. Unfavorable economic conditions 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. A reduction in the availability of new capital could limit our ability to grow. In addition, we are required to distribute at least 90% of our net ordinary income and net short-term capital gains in excess of net long-term capital losses, if any, to our stockholders to maintain our qualification as a RIC. As a result, these earnings will not be available to fund new investments. An inability on our part to access the capital markets successfully could limit our ability to grow our business and execute our business strategy fully and could decrease our earnings, if any, which would have an adverse effect on the value of our shares of common stock.

As a BDC, we are required to meet a coverage ratio of total assets, less liabilities and indebtedness not represented by senior securities and excluding SBA-guaranteed debentures as permitted by exemptive relief obtained from the SEC, to total senior securities, which includes all of our borrowings with the exception of SBA-guaranteed debentures, of at least 200%. This requirement limits the amount that we may borrow. Since we continue to need capital to grow our investment portfolio, these limitations may prevent us from incurring debt and require us to raise additional equity at a time when it may be disadvantageous to do so. While we expect that we will be able to borrow and to issue additional debt securities and expect that we will be able to issue additional equity securities, which would in turn increase the equity capital available to us, we cannot assure you that debt and equity financing will be available to us on favorable terms, or at all. In addition, as a BDC, we generally are not permitted to issue equity securities priced below net asset value without stockholder approval. If additional funds are not available us, we may be forced to curtail or cease new investment activities, and our net asset value could decline.

**Our wholly-owned SBIC subsidiary may be unable to make distributions to us that will enable us to maintain RIC tax treatment, which could result in the imposition of an entity-level tax.**

In order for us to continue to qualify for RIC tax treatment and to minimize corporate-level taxes, we are required to distribute substantially all of our net taxable income and net capital gain income, including income from certain of our subsidiaries, which includes the income from our SBIC subsidiary. We are partially dependent on our SBIC subsidiary for cash distributions to enable us to meet the RIC distribution requirements. Our SBIC subsidiary may be limited by the Small Business Investment Act of 1958, and SBA regulations governing SBICs, from making certain distributions to us that may be necessary to maintain our tax treatment as a RIC. We may have to request a waiver of the SBA's restrictions for our SBIC subsidiary to make certain distributions to maintain our RIC tax treatment. We cannot assure you that the SBA will grant such waiver and if our SBIC subsidiary is unable to obtain a waiver, compliance with the SBA regulations may result in loss of RIC tax treatment and a consequent imposition of an entity-level tax on us.

**Our ability to enter into transactions with our affiliates will be restricted, which may limit the scope of investments available to us.**

We are prohibited under the 1940 Act from participating in certain transactions with our affiliates without the prior approval of our independent directors and, in some cases, the SEC. Any person that owns, directly or indirectly, 5% or more of our outstanding voting securities will be our affiliate for purposes of the 1940 Act, and we are generally prohibited from buying or selling any security from or to such affiliate without the prior approval of our independent directors. The 1940 Act also prohibits certain joint transactions with certain of our affiliates, which could include concurrent investments in the same portfolio company, without prior approval of our independent directors and, in some cases, of the SEC. We are prohibited from buying or selling any security from or to any person that controls us or who owns more than 25% of our voting securities or certain of that person's affiliates, or entering into prohibited joint transactions with such persons,

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absent the prior approval of the SEC. As a result of these restrictions, we may be prohibited from buying or selling any security (other than any security of which we are the issuer) from or to any portfolio company of a private fund managed by Stellus Capital Management or its affiliates without the prior approval of the SEC, which may limit the scope of investment opportunities that would otherwise be available to us.

We have received exemptive relief from the SEC to co-invest with investment funds managed by Stellus Capital Management (other than the D. E. Shaw group funds, as defined below) where doing so is consistent with our investment strategy as well as applicable law (including the terms and conditions of the exemptive order issued by the SEC). Under the terms of the relief permitting us to co-invest with other funds managed by Stellus Capital Management, a required majority (as defined in Section 57(o) of the 1940 Act) of our independent directors must make certain conclusions in connection with a co-investment transaction, including that (1) the terms of the proposed transaction, including the consideration to be paid, are reasonable and fair to us and our stockholders and do not involve overreaching of us or our stockholders on the part of any person concerned and (2) the transaction is consistent with the interests of our stockholders and is consistent with our investment objectives and strategies.

### **The involvement of our interested directors in the valuation process may create conflicts of interest.**

We make many of our portfolio investments in the form of loans and securities that are not publicly traded and for which no market based price quotation is available. As a result, our board of directors determines the fair value of these loans and securities in good faith as described elsewhere in this annual report on Form 10-K. In connection with that determination, investment professionals from Stellus Capital Management may provide our board of directors with valuations based upon the most recent portfolio company financial statements available and projected financial results of each portfolio company. While the valuation for each portfolio investment is reviewed by an independent valuation firm at least twice annually, the ultimate determination of fair value is made by our board of directors, including our interested directors, and not by such third party valuation firm. In addition, Messrs. Ladd, D Angelo and Davis, each an interested member of our board of directors, has a direct pecuniary interest in Stellus Capital Management. The participation of Stellus Capital Management's investment professionals in our valuation process, and the pecuniary interest in Stellus Capital Management by certain members of our board of directors, could result in a conflict of interest as Stellus Capital Management's management fee is based, in part, on the value of our gross assets, and incentive fees are based, in part, on realized gains and realized and unrealized losses.

### **There are conflicts related to other arrangements with Stellus Capital Management.**

We have entered into a license agreement with Stellus Capital Management under which Stellus Capital Management has agreed to grant us a non-exclusive, royalty-free license to use the name Stellus Capital. In addition, we have entered into an administration agreement with Stellus Capital Management pursuant to which we are required to pay to Stellus Capital Management our allocable portion of overhead and other expenses incurred by Stellus Capital Management in performing its obligations under such administration agreement, such as rent and our allocable portion of the cost of our chief financial officer and chief compliance officer and his staff. This will create conflicts of interest that our board of directors will monitor. For example, under the terms of the license agreement, we will be unable to preclude Stellus Capital Management from licensing or transferring the ownership of the Stellus Capital name to third parties, some of whom may compete against us. Consequently, we will be unable to prevent any damage to goodwill that may occur as a result of the activities of Stellus Capital Management or others. Furthermore, in the event the license agreement is terminated, we will be required to change our name and cease using Stellus Capital as part of our name. Any of these events could disrupt our recognition in the market place, damage any goodwill we may have

generated and otherwise harm our business.

**The investment advisory agreement and the administration agreement with Stellus Capital Management were not negotiated on an arm's length basis and may not be as favorable to us as if they had been negotiated with an unaffiliated third party.**

The investment advisory agreement and the administration agreement were negotiated between related parties. Consequently, their terms, including fees payable to Stellus Capital Management, may not be as favorable to us as if they had been negotiated with an unaffiliated third party. In addition, we may choose not

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to enforce, or to enforce less vigorously, our rights and remedies under these agreements because of our desire to maintain our ongoing relationship with Stellus Capital Management and its affiliates. Any such decision, however, would breach our fiduciary obligations to our stockholders.

**The time and resources that Stellus Capital Management devote to us may be diverted, and we may face additional competition due to the fact that Stellus Capital Management and its affiliates are not prohibited from raising money for, or managing, another entity that makes the same types of investments that we target.**

Stellus Capital Management and some of its affiliates, including our officers and our non-independent directors, are not prohibited from raising money for, or managing, another investment entity that makes the same types of investments as those we target. For example, Stellus Capital Management currently manages private credit funds that have an investment strategy that is identical to our investment strategy and with which we intend to co-invest. In addition, pursuant to sub-advisory arrangements, Stellus Capital Management provides non-discretionary advisory services to the D. E. Shaw group related to a private investment fund and a strategy of a private multi-strategy investment fund to which the D. E. Shaw group serves as investment adviser. As a result, the time and resources they could devote to us may be diverted. In addition, we may compete with any such investment entity for the same investors and investment opportunities.

**Our incentive fee arrangements with Stellus Capital Management may vary from those of other investment funds, account or investment vehicles managed by Stellus Capital Management, which may create an incentive for Stellus Capital Management to devote time and resources to a higher fee-paying fund.**

If Stellus Capital Management is paid a higher performance-based fee from any of its other funds, it may have an incentive to devote more research and development or other activities, and/or recommend the allocation of investment opportunities, to such higher fee-paying fund. For example, to the extent Stellus Capital Management's incentive compensation is not subject to a hurdle or total return requirement with respect to another fund, it may have an incentive to devote time and resources to such other fund.

**Stellus Capital Management's liability is limited under the investment advisory agreement and we have agreed to indemnify Stellus Capital Management against certain liabilities, which may lead Stellus Capital Management to act in a riskier manner on our behalf than it would when acting for its own account.**

Under the investment advisory agreement, Stellus Capital Management has not assumed any responsibility to us other than to render the services called for under that agreement. It will not be responsible for any action of our board of directors in following or declining to follow Stellus Capital Management's advice or recommendations. Under the investment advisory agreement, Stellus Capital Management, its officers, members and personnel, and any person controlling or controlled by Stellus Capital Management will not be liable to us, any subsidiary of ours, our directors, our stockholders or any subsidiary's stockholders or partners for acts or omissions performed in accordance with and pursuant to the investment advisory agreement, except those resulting from acts constituting gross negligence, willful

The investment advisory agreement and the administration agreement with Stellus Capital Management were not ne

misfeasance, bad faith or reckless disregard of the duties that Stellus Capital Management owes to us under the investment advisory agreement. In addition, as part of the investment advisory agreement, we have agreed to indemnify Stellus Capital Management and each of its officers, directors, members, managers and employees from and against any claims or liabilities, including reasonable legal fees and other expenses reasonably incurred, arising out of or in connection with our business and operations or any action taken or omitted on our behalf pursuant to authority granted by the investment advisory agreement, except where attributable to gross negligence, willful misfeasance, bad faith or reckless disregard of such person's duties under the investment advisory agreement. These protections may lead Stellus Capital Management to act in a riskier manner when acting on our behalf than it would when acting for its own account.

**Stellus Capital Management can resign as our investment adviser or administrator upon 60 days' notice and we may not be able to find a suitable replacement within that time, or at all, resulting in a disruption in our operations that could adversely affect our financial condition, business and results of operations.**

Stellus Capital Management has the right under the investment advisory agreement to resign as our investment adviser at any time upon 60 days' written notice, whether we have found a replacement or not. Similarly, Stellus Capital Management has the right under the administration agreement to resign at any time

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upon 60 days written notice, whether we have found a replacement or not. If Stellus Capital Management was to resign, we may not be able to find a new investment adviser or administrator or hire internal management with similar expertise and ability to provide the same or equivalent services on acceptable terms within 60 days, or at all. If we are unable to do so quickly, our operations are likely to experience a disruption, our financial condition, business and results of operations as well as our ability to pay distributions to our stockholders are likely to be adversely affected and the market price of our shares may decline. In addition, the coordination of our internal management and investment or administrative activities, as applicable, is likely to suffer if we are unable to identify and reach an agreement with a single institution or group of executives having the expertise possessed by Stellus Capital Management. Even if we are able to retain comparable management, whether internal or external, the integration of such management and their lack of familiarity with our investment objective may result in additional costs and time delays that may adversely affect our business, financial condition, results of operations and cash flows.

**If we fail to maintain our status as a BDC, our business and operating flexibility could be significantly reduced.**

We qualify as a BDC under the 1940 Act. The 1940 Act imposes numerous constraints on the operations of BDCs. For example, BDCs are required to invest at least 70.0% of their total assets in specified types of securities, primarily in private companies or thinly-traded U.S. public companies, cash, cash equivalents, U.S. government securities and other high quality debt investments that mature in one year or less. Failure to comply with the requirements imposed on BDCs by the 1940 Act could cause the SEC to bring an enforcement action against us and/or expose us to claims of private litigants. In addition, upon approval of a majority of our stockholders, we may elect to withdraw their respective election as a BDC. If we decide to withdraw our election, or if we otherwise fail to qualify, or maintain our qualification, as a BDC, we may be subject to the substantially greater regulation under the 1940 Act as a closed-end investment company. Compliance with these regulations would significantly decrease our operating flexibility and could significantly increase our cost of doing business.

**If we do not invest a sufficient portion of our assets in qualifying assets, we could fail to maintain our qualification as a BDC or be precluded from investing according to our current business strategy.**

As a BDC, we may not acquire any assets other than qualifying assets unless, at the time of and after giving effect to such acquisition, at least 70% of our total assets are qualifying assets.

We believe that most of the investments that we may acquire in the future will constitute qualifying assets. However, we may be precluded from investing in what we believe to be attractive investments if such investments are not qualifying assets for purposes of the 1940 Act. If we do not invest a sufficient portion of our assets in qualifying assets, we could violate the 1940 Act provisions applicable to BDCs. As a result of such violation, specific rules under the 1940 Act could prevent us, for example, from making follow-on investments in existing portfolio companies (which could result in the dilution of our position).

If we do not maintain our status as a BDC, we would be subject to regulation as a registered closed-end investment company under the 1940 Act. As a registered closed-end investment company, we would be subject to substantially more regulatory restrictions under the 1940 Act which would significantly decrease our operating flexibility.



**We may experience fluctuations in our annual and quarterly operating results.**

We could experience fluctuations in our annual and quarterly operating results due to a number of factors, including the interest rate payable on the loans and debt securities we acquire, the default rate on such loans and 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 and general economic conditions. In light of these factors, results for any period should not be relied upon as being indicative of performance in future periods.

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**Our board of directors may change our investment objective, operating policies and strategies without prior notice or stockholder approval.**

Our board of directors has the authority, except as otherwise provided in the 1940 Act, to modify or waive certain of our operating policies and strategies without prior notice and without stockholder approval. However, absent stockholder approval, we may not change the nature of our business so as to cease to be, or withdraw our election as, a BDC. We cannot predict the effect any changes to our current operating policies and strategies would have on our business, operating results and the market price of our common stock. Nevertheless, any such changes could adversely affect our business and impair our ability to make distributions to our stockholders.

**Pending legislation may allow us to incur additional leverage.**

As a BDC under the 1940 Act, we are generally not permitted to incur indebtedness unless immediately after such borrowing we have an asset coverage for total borrowings of at least 200% (i.e., the amount of debt may not exceed 50% of the value of our assets). Legislation introduced in the U.S. House of Representatives would modify this section of the 1940 Act and increased the amount of debt that BDCs may incur by modifying the asset coverage percentage from 200% to 150%. As a result, we may be able to incur additional indebtedness in the future and therefore your risk of an investment in our common stock may increase.

**Our board of directors is authorized to reclassify any unissued shares of common stock into one or more classes of preferred stock, which could convey special rights and privileges to its owners.**

Under Maryland General Corporation Law and our charter, our board of directors is authorized to classify and reclassify any authorized but unissued shares of stock into one or more classes of stock, including preferred stock. Prior to issuance of shares of each class or series, the board of directors will be required by Maryland law and our charter to set the terms, preferences, conversion or other rights, voting powers, restrictions, limitations as to stockholder distributions, qualifications and terms or conditions of redemption for each class or series. Thus, the board of directors could authorize the issuance of shares of preferred stock with terms and conditions which could have the effect of delaying, deferring or preventing a transaction or a change in control that might involve a premium price for holders of our common stock or that otherwise might be in their best interest. The cost of any such reclassification would be borne by our common stockholders. Certain matters under the 1940 Act require the separate vote of the holders of any issued and outstanding preferred stock. For example, the 1940 Act provides that holders of preferred stock are entitled to vote separately from holders of common stock to elect two preferred stock directors. We currently have no plans to issue preferred stock. The issuance of preferred shares convertible into shares of common stock may also reduce the net income and net asset value per share of our common stock upon conversion, provided, that we will only be permitted to issue such convertible preferred stock to the extent we comply with the requirements of Section 61 of the 1940 Act, including obtaining common stockholder approval. These effects, among others, could have an adverse effect on your investment in our common stock.

**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.**

The Maryland General Corporation Law and our charter and bylaws contain provisions that may discourage, delay or make more difficult a change in control of Stellus Capital Investment Corporation or the removal of our directors. We are subject to the Maryland Business Combination Act, subject to any applicable requirements of the 1940 Act. Our board of directors has adopted a resolution exempting from the Business Combination Act any business combination between us and any other person, subject to prior approval of such business combination by our board of directors, including approval by a majority of our independent directors. If the resolution exempting business combinations is repealed or our board of directors does not approve a business combination, the Business Combination Act may discourage third parties from trying to acquire control of us and increase the difficulty of consummating such an offer. Our bylaws exempt from the Maryland Control Share Acquisition Act acquisitions of our stock by any person. If we amend our bylaws to repeal the exemption from the Control Share Acquisition Act, the Control Share Acquisition Act also may make it more difficult for a third party to obtain control of us and increase the difficulty of consummating such a transaction.

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We have also adopted measures that may make it difficult for a third party to obtain control of us, including provisions of our charter classifying our board of directors in three classes serving staggered three-year terms, and authorizing our board of directors to classify or reclassify shares of our stock in one or more classes or series, to cause the issuance of additional shares of our stock, to amend our charter without stockholder approval and to increase or decrease the number of shares of stock that we have authority to issue. These provisions, as well as other provisions of our charter and bylaws, may delay, defer or prevent a transaction or a change in control that might otherwise be in the best interests of our stockholders.

**We are highly dependent on information systems and systems failures could significantly disrupt our business, which may, in turn, negatively affect the market price of our common stock and our ability to make distributions to our stockholders.**

Our business is highly dependent on the communications and information systems of Stellus Capital Management. In addition, certain of these systems are provided to Stellus Capital Management by third party service providers. Any failure or interruption of such systems, including as a result of the termination of an agreement with any such third party service provider, could cause delays or other problems in our activities. This, in turn, could have a material adverse effect on our operating results and negatively affect the market price of our common stock and our ability to make distributions to our stockholders.

**The failure in cyber security systems, as well as the occurrence of events unanticipated in the Company's disaster recovery systems and management continuity planning could impair the Company's ability to conduct business effectively.**

The occurrence of a disaster such as a cyber attack, a natural catastrophe, an industrial accident, a terrorist attack or war, events unanticipated in the Company's disaster recovery systems, or a support failure from external providers, could have an adverse effect on the Company's ability to conduct business and on the Company's results of operations and financial condition, particularly if those events affect the Company's computer-based data processing, transmission, storage, and retrieval systems or destroy data. If a significant number of the Company's managers were unavailable in the event of a disaster, the Company's ability to effectively conduct its business could be severely compromised.

We depend heavily upon computer systems to perform necessary business functions. Despite the Company's implementation of a variety of security measures, its computer systems could be subject to cyber attacks and unauthorized access, such as physical and electronic break-ins or unauthorized tampering. Like other companies, the Company may experience threats to its data and systems, including malware and computer virus attacks, unauthorized access, system failures and disruptions. If one or more of these events occurs, it could potentially jeopardize the confidential, proprietary and other information processed and stored in, and transmitted through, the Company's computer systems and networks, or otherwise cause interruptions or malfunctions in its operations, which could result in damage to our reputation, financial losses, litigation, increased costs, regulatory penalties and/or customer dissatisfaction or loss.

We are highly dependent on information systems and systems failures could significantly disrupt our business, which

## **Risks Related to Economic Conditions**

**Global economic, political and market conditions may adversely affect our business, results of operations and financial condition, including our revenue growth and profitability.**

The U.S. and global capital markets experienced extreme volatility and disruption during the economic downturn that began in mid-2007, and the U.S. economy was in a recession for several consecutive calendar quarters during the same period. In 2010, a financial crisis emerged in Europe, triggered by high budget deficits and rising direct and contingent sovereign debt, which created concerns about the ability of certain nations to continue to service their sovereign debt obligations. Risks resulting from such debt crisis and any future debt crisis in Europe or any similar crisis elsewhere could have a detrimental impact on the global economic recovery, sovereign and non-sovereign debt in certain countries and the financial condition of financial institutions generally. In July and August 2015, Greece reached agreements with its creditors for bailouts that provide aid in exchange for certain austerity measures. These and similar austerity measures may adversely affect world economic conditions and have an adverse impact on our business and that of our portfolio companies. In the second quarter of 2015, stock prices in China experienced a significant drop, resulting primarily from continued sell-off of shares trading in Chinese markets. In August 2015, Chinese authorities sharply devalued China's currency.

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In June 2016, the United Kingdom held a referendum in which voters approved an exit from the European Union, and the implications of the United Kingdom's pending withdrawal from the European Union are unclear at present. In November 2016, voters in the United States elected a new president and the implications of a new presidential administration are unclear at present. These market and economic disruptions affected, and these and other similar market and economic disruptions may in the future affect, the U.S. capital markets, which could adversely affect our business and that of our portfolio companies and the broader financial and credit markets and have reduced the availability of debt and equity capital for the market as a whole and to financial firms, in particular. At various times, these disruptions resulted in, and may in the future result, a lack of liquidity in parts of the debt capital markets, significant write-offs in the financial services sector and the repricing of credit risk.

As a result of the 2016 U.S. election, the Republican Party currently controls both the executive and legislative branches of government, which increases the likelihood that legislation may be adopted that could significantly affect the regulation of U.S. financial markets. Areas subject to potential change, amendment or repeal include the Dodd-Frank Act, the Consumer Protection Act, the Volcker Rule, and the authority of the Federal Reserve and the Financial Stability Oversight Council. The United States may also potentially withdraw from or renegotiate various trade agreements and take other actions that would change current trade policies of the United States. We cannot predict which, if any, of these actions will be taken or, if taken, their effect on the financial stability of the United States. Such actions could have a significant adverse effect on our business, financial condition and results of operations.

The United Kingdom referendum decision to leave the European Union may create significant risks and uncertainty for global markets and our investments.

The recent decision made in the United Kingdom referendum to leave the European Union has led to volatility in global financial markets, and in particular in the markets of the United Kingdom and across Europe, and may also lead to weakening in consumer, corporate and financial confidence in the United Kingdom and Europe. The extent and process by which the United Kingdom will exit the European Union, and the longer term economic, legal, political and social framework to be put in place between the United Kingdom and the European Union are unclear at this stage and are likely to lead to ongoing political and economic uncertainty and periods of exacerbated volatility in both the United Kingdom and in wider European markets for some time. In particular, the decision made in the United Kingdom referendum may lead to a call for similar referenda in other European jurisdictions which may cause increased economic volatility and uncertainty in the European and global markets. This volatility and uncertainty may have an adverse effect on the economy generally and on our ability, and the ability of our portfolio companies, to execute our respective strategies and to receive attractive returns.

In particular, currency volatility may mean that our returns and the returns of our portfolio companies will be adversely affected by market movements and may make it more difficult, or more expensive, for us to implement appropriate currency hedging. Potential declines in the value of the British Pound and/or the euro against other currencies, along with the potential downgrading of the United Kingdom's sovereign credit rating, may also have an impact on the performance of any of our portfolio companies located in the United Kingdom or Europe.

## **Risks Related to our Investments**

**Economic recessions or downturns could impair our portfolio companies, which would harm our operating results.**

Many of the portfolio companies in which we make, and expect to make, investments, including those currently included in our portfolio, are likely to be susceptible to economic slowdowns or recessions and may be unable to repay our loans during such periods. Therefore, the number of our non-performing assets is likely to increase and the value of our portfolio is likely to decrease during such periods. Adverse economic conditions may decrease the value of collateral securing some of our loans and debt securities 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 our investments and harm our operating results.

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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 assets, which could trigger cross-defaults under other agreements and jeopardize our portfolio company's ability to meet its obligations under the loans and debt securities that we hold. We may incur expenses to the extent necessary to seek recovery upon default or to negotiate new terms with a defaulting portfolio company. In addition, lenders in certain cases can be subject to lender liability claims for actions taken by them when they become too involved in the borrower's business or exercise control over a borrower. It is possible that we could become subject to a lender's liability claim, including as a result of actions taken if we render significant managerial assistance to the borrower. Furthermore, if one of our portfolio companies were to file for bankruptcy protection, a bankruptcy court might re-characterize our debt holding and subordinate all or a portion of our claim to claims of other creditors, even though we may have structured our investment as senior secured debt. The likelihood of such a re-characterization would depend on the facts and circumstances, including the extent to which we provided managerial assistance to that portfolio company.

### **Our investments in leveraged portfolio companies may be risky, and we could lose all or part of our investment.**

Investment in leveraged companies involves a number of significant risks. Leveraged companies in which we invest may have limited financial resources and may be unable to meet their obligations under their loans and debt securities that we hold. Such developments may be accompanied by a deterioration in the value of any collateral and a reduction in the likelihood of our realizing any guarantees that we may have obtained in connection with our investment. Smaller leveraged companies also may have less predictable operating results and may require substantial additional capital to support their operations, finance their expansion or maintain their competitive position.

### **We may hold the loans and debt securities of leveraged companies that may, due to the significant operating volatility typical of such companies, enter into bankruptcy proceedings.**

Leveraged companies may experience bankruptcy or similar financial distress. The bankruptcy process has a number of significant inherent risks. Many events in a bankruptcy proceeding are the product of contested matters and adversary proceedings and are beyond the control of the creditors. A bankruptcy filing by a portfolio company may adversely and permanently affect that company. If the proceeding is converted to a liquidation, the value of the portfolio company may not equal the liquidation value that was believed to exist at the time of the investment. The duration of a bankruptcy proceeding is also difficult to predict, and a creditor's return on investment can be adversely affected by delays until the plan of reorganization or liquidation ultimately becomes effective. The administrative costs in connection with a bankruptcy proceeding are frequently high and would be paid out of the debtor's estate prior to any return to creditors. Because the standards for classification of claims under bankruptcy law are vague, our influence with respect to the class of securities or other obligations we own may be lost by increases in the number and amount of claims in the same class or by different classification and treatment. In the early stages of the bankruptcy process, it is often difficult to estimate the extent of, or even to identify, any contingent claims that might be made. In addition, certain claims that have priority by law (for example, claims for taxes) may be substantial.

### **Our investments in private and middle-market portfolio companies are risky, and we could lose all or part of our investment.**

Investment in private and middle-market companies involves a number of significant risks. Generally, little public information exists about these companies, and we rely on the ability of Stellus Capital Management's investment



professionals to obtain adequate information to evaluate the potential returns from investing in these 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 investments. Middle-market companies may have limited financial resources and may be unable to meet their obligations under their loans and debt securities that we hold, which may be accompanied by a deterioration in the value of any collateral and a reduction in the likelihood of our realizing any guarantees we may have obtained in connection with our investment. In addition, such companies typically have shorter operating histories, narrower product lines and smaller market shares than larger businesses, which tend to render them more

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vulnerable to competitors' actions and market conditions, as well as general economic downturns. Additionally, middle-market companies 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 material adverse impact on one or more of the portfolio companies we invest in and, in turn, on us. Middle-market companies also may be parties to litigation and may be engaged in rapidly changing businesses with products subject to a substantial risk of obsolescence. In addition, our executive officers, directors and investment adviser may, in the ordinary course of business, be named as defendants in litigation arising from our investments in portfolio companies.

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

Most of our assets are invested in illiquid loans and securities, and a substantial portion of our investments in leveraged companies are subject to legal and other restrictions on resale or are otherwise less liquid than more broadly traded public securities. The illiquidity of these 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. Also, as noted above, we may be limited or prohibited in our ability to sell or otherwise exit certain positions in our portfolio as such a transaction could be considered a joint transaction prohibited by the 1940 Act.

**Price declines and illiquidity in the corporate debt markets may 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 our board of directors. As part of the valuation process, we may take into account the following types of factors, if relevant, in determining the fair value of our investments:

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 and the markets in which it does business;

comparisons of financial ratios of peer companies that are public;

comparable merger and acquisition transactions; and

the principal market and enterprise values.

When an external event such as a purchase transaction, public offering or subsequent equity sale occurs, we use the pricing indicated by the external event to corroborate our valuation. We record decreases in the market values or fair values of our investments as unrealized depreciation. Declines in prices and liquidity in the corporate debt markets may result in significant net unrealized depreciation in our portfolio. The effect of all of these factors on our portfolio may reduce 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 effect on our business, financial condition, results of operations and cash flows.



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**We are a non-diversified investment company within the meaning of the 1940 Act, and therefore we are not limited with respect to the proportion of our assets that may be invested in securities of a single issuer.**

We are classified as a non-diversified investment company within the meaning of the 1940 Act, which means that we are not limited by the 1940 Act with respect to the proportion of our assets that we may invest in securities of a single issuer. Beyond the asset diversification requirements associated with our qualification as a RIC under the Code, we do not have fixed guidelines for diversification. To the extent that we assume large positions in the securities of a small number of issuers or our investments are concentrated in relatively few industries, our net asset value may fluctuate to a greater extent than that of a diversified investment company as a result of changes in the financial condition or the market's assessment of the issuer. We may also be more susceptible to any single economic or regulatory occurrence than a diversified investment company.

**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 seeking to:

increase or maintain in whole or in part our position as a creditor or equity ownership percentage in a portfolio company;

exercise warrants, options or convertible securities that were acquired in the original or subsequent financing; or preserve or enhance the value of our investment.

We have discretion to make follow-on investments, subject to the availability of capital resources. Failure on our part 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 level of risk, because we prefer other opportunities or because we are inhibited by compliance with BDC requirements of the 1940 Act or the desire to maintain our qualification as a RIC. Our ability to make follow-on investments may also be limited by our compliance with the conditions under the exemptive relief order we received from the SEC related to co-investments with investment funds managed by Stellus Capital Management or Stellus Capital Management's allocation policy.

**Because we generally do not hold controlling equity interests in our portfolio companies, we may not be able to exercise control over our portfolio companies or to prevent decisions by management of our portfolio companies that could decrease the value of our investments.**

We do not hold controlling equity positions in any of the portfolio companies included in our portfolio and, although we may do so in the future, we do not currently intend to hold controlling equity positions in our portfolio companies (including those included in our portfolio). As a result, we are subject to the risk that a portfolio company may make business decisions with which we disagree, and that the management and/or stockholders of a portfolio company may take risks or otherwise act in ways that are adverse to our interests. Due to the lack of liquidity of the debt and equity investments that we hold in our portfolio companies, we may not be able to dispose of our investments in the event we disagree with the actions of a portfolio company and may therefore suffer a decrease in the value of our investments.

We are a non-diversified investment company within the meaning of the 1940 Act, and therefore we are ~~not~~ limited

## **Defaults by our portfolio companies will 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 assets. This could trigger cross-defaults under other agreements and jeopardize such portfolio company's ability to meet its obligations under the loans or 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.

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**Prepayments of our debt investments by our portfolio companies could adversely impact our results of operations and ability to make stockholder distributions and result in a decline in the market price of our shares.**

We are subject to the risk that the debt investments we make in our portfolio companies may be repaid prior to maturity. We expect that our investments will generally allow for repayment at any time subject to certain penalties.

When this occurs, we intend to generally reinvest these proceeds in temporary investments, pending their future investment in accordance with our investment strategy. These temporary investments will typically have substantially lower yields than the debt being prepaid, and we could experience significant delays in reinvesting these amounts. Any future investment may also be at lower yields than the debt that was repaid. As a result, our results of operations could be materially adversely affected if one or more of our portfolio companies elects to prepay amounts owed to us. Additionally, prepayments could negatively impact our ability to make, or the amount of, stockholder distributions with respect to our common stock, which could result in a decline in the market price of our shares.

**The interest rates of our floating-rate loans to our portfolio companies that extend beyond 2021 might be subject to change based on recent regulatory changes**

LIBOR, the London Interbank Offered Rate, is the basic rate of interest used in lending transactions between banks on the London interbank market and is widely used as a reference for setting the interest rate on loans globally. We typically use LIBOR as a reference rate in floating-rate loans we extend to portfolio companies such that the interest due to us pursuant to a term loan extended to a portfolio company is calculated using LIBOR. The terms of our debt investments generally include minimum interest rate floors which are calculated based on LIBOR.

On July 27, 2017, the United Kingdom's Financial Conduct Authority, which regulates LIBOR, announced that it intends to phase out LIBOR by the end of 2021. It is unclear if at that time whether LIBOR will cease to exist or if new methods of calculating LIBOR will be established such that it continues to exist after 2021. The U.S. Federal Reserve, in conjunction with the Alternative Reference Rates Committee, a steering committee comprised of large U.S. financial institutions, is considering replacing U.S. dollar LIBOR with a new index calculated by short term repurchase agreements, backed by Treasury securities. The future of LIBOR at this time is uncertain. If LIBOR ceases to exist, we may need to renegotiate the credit agreements extending beyond 2021 with our portfolio companies that utilize LIBOR as a factor in determining the interest rate to replace LIBOR with the new standard that is established.

**The effect of global climate change may impact the operations of our portfolio companies.**

There may be evidence of global climate change. Climate change creates physical and financial risk and some of our portfolio companies may be adversely affected by climate change. For example, the needs of customers of energy companies vary with weather conditions, primarily temperature and humidity. To the extent weather conditions are affected by climate change, energy use could increase or decrease depending on the duration and magnitude of any changes. Increases in the cost of energy could adversely affect the cost of operations of our portfolio companies if the use of energy products or services is material to their business. A decrease in energy use due to weather changes may affect some of our portfolio companies' financial condition, through decreased revenues. Extreme weather conditions in general require more system backup, adding to costs, and can contribute to increased system stresses, including service interruptions.

In December 2015, the United Nations, of which the U.S. is a member, adopted a climate accord with the long-term goal of limiting global warming and the short-term goal of significantly reducing greenhouse gas emissions. As a result, our portfolio companies, particularly those operating in the energy sector, may be subject to new or strengthened regulations or legislation which could increase their operating costs and/or decrease their revenues

**Our portfolio companies may incur debt that ranks equally with, or senior to, our investments in such companies.**

We invest a portion of our capital in second lien and subordinated loans issued by our portfolio companies. The portfolio companies usually have, or may be permitted to incur, other debt that ranks equally with, or senior to, the loans in which we invest. By their terms, such debt instruments may provide that the

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holders are entitled to receive payment of interest or principal on or before the dates on which we are entitled to receive payments in respect of the loans in which we invest. Also, in the event of insolvency, liquidation, dissolution, reorganization or bankruptcy of a portfolio company, holders of debt instruments 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 senior creditors, a portfolio company may not have any remaining assets to use for repaying its obligation to us. In the case of debt ranking equally with loans in which we invest, we would have to share any distributions on an equal and ratable basis with other creditors holding such debt in the event of an insolvency, liquidation, dissolution, reorganization or bankruptcy of the relevant portfolio company.

Additionally, certain loans that we make to portfolio companies may be secured on a second priority basis by the same collateral securing senior secured debt of such companies. The first priority liens on the collateral will secure the portfolio company's obligations under any outstanding senior debt and may secure certain other future debt that may be permitted to be incurred by the portfolio company under the agreements governing the loans. The holders of obligations secured by first priority liens on the collateral will generally control the liquidation of, and be entitled to receive proceeds from, any realization of the collateral to repay their obligations in full before us. In addition, the value of the collateral in the event of liquidation will depend on market and economic conditions, the availability of buyers and other factors. There can be no assurance that the proceeds, if any, from sales of all of the collateral would be sufficient to satisfy the loan obligations secured by the second priority liens after payment in full of all obligations secured by the first priority liens on the collateral. If such proceeds were not sufficient to repay amounts outstanding under the loan obligations secured by the second priority liens, then we, to the extent not repaid from the proceeds of the sale of the collateral, will only have an unsecured claim against the portfolio company's remaining assets, if any.

We may also make unsecured loans to portfolio companies, meaning that such loans will not benefit from any interest in collateral of such companies. Liens on such portfolio companies' collateral, if any, will secure the portfolio company's obligations under its outstanding secured debt and may secure certain future debt that is permitted to be incurred by the portfolio company under its secured loan agreements. The holders of obligations secured by such liens will generally control the liquidation of, and be entitled to receive proceeds from, any realization of such collateral to repay their obligations in full before us. In addition, the value of such collateral in the event of liquidation will depend on market and economic conditions, the availability of buyers and other factors. There can be no assurance that the proceeds, if any, from sales of such collateral would be sufficient to satisfy our unsecured loan obligations after payment in full of all secured loan obligations. If such proceeds were not sufficient to repay the outstanding secured loan obligations, then our unsecured claims would rank equally with the unpaid portion of such secured creditors' claims against the portfolio company's remaining assets, if any.

The rights we may have with respect to the collateral securing the loans we make to our portfolio companies with senior debt outstanding may also be limited pursuant to the terms of one or more intercreditor agreements that we enter into with the holders of such senior debt. Under a typical intercreditor agreement, at any time that obligations that have the benefit of the first priority liens are outstanding, any of the following actions that may be taken in respect of the collateral will be at the direction of the holders of the obligations secured by the first priority liens:

- the ability to cause the commencement of enforcement proceedings against the collateral;
- the ability to control the conduct of such proceedings;
- the approval of amendments to collateral documents;
- releases of liens on the collateral; and
- waivers of past defaults under collateral documents.

We may not have the ability to control or direct such actions, even if our rights are adversely affected.





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**If we make subordinated investments, the obligors or the portfolio companies may not generate sufficient cash flow to service their debt obligations to us.**

We may make subordinated investments that rank below other obligations of the obligor in right of payment. Subordinated investments are subject to greater risk of default than senior obligations as a result of adverse changes in the financial condition of the obligor or economic conditions in general. If we make a subordinated investment in a portfolio company, the portfolio company may be highly leveraged, and its relatively high debt-to-equity ratio may create increased risks that its operations might not generate sufficient cash flow to service all of its debt obligations.

**The disposition of our investments may result in contingent liabilities.**

Substantially all of our investments involve loans and private securities. In connection with the disposition of an investment in loans and private securities, we may be required to make representations about the business and financial affairs of the portfolio company typical of those made in connection with the sale of a business. We may also be required to indemnify the purchasers of such investment to the extent that any such representations turn out to be inaccurate or with respect to potential liabilities. These arrangements may result in contingent liabilities that ultimately result in funding obligations that we must satisfy through our return of distributions previously made to us.

**We may not realize gains from our equity investments.**

When we invest in loans and debt securities, we may acquire warrants or other equity securities of portfolio companies as well. We may also invest in equity securities directly. To the extent we hold equity investments, we will attempt to dispose of them and realize gains upon our disposition of them. However, the equity interests we receive may not appreciate in value and, may decline in value. As a result, we may not be able to realize gains from our equity interests, and any gains that we do realize on the disposition of any equity interests may not be sufficient to offset any other losses we experience.

**Our investments in software companies are subject to many risks, including regulatory concerns, litigation risks and intense competition.**

As of December 31, 2017, our investments in software companies represented 13.18% of our total portfolio, at fair value. Our investments in software companies are subject to substantial risks. For example, our portfolio companies face intense competition since their businesses are rapidly evolving and intensely competitive, and are subject to changing technology, shifting user needs, and frequent introductions of new products and services. Software companies have many competitors in different industries, including general purpose search engines, vertical search engines and e-commerce sites, social networking sites, traditional media companies, and providers of online products and services. Potential competitors to our portfolio companies in the software industries range from large and established companies to emerging start-ups. Further, such companies are subject to laws that were adopted prior to the advent of the Internet and related technologies and, as a result, do not contemplate or address the unique issues of the Internet and related technologies. The laws that do reference the Internet are being interpreted by the courts, but their applicability and scope remain uncertain. For example, the laws relating to the liability of providers of online services are currently unsettled both within the United States, and abroad. Claims have been threatened and filed under both U.S. and foreign laws for defamation, invasion of privacy and other tort claims, unlawful activity, copyright and trademark infringement, or other theories based on the nature and content of the materials searched and the ads posted by a company's users, a company's products and services, or content generated by a company's users. Further, the growth of software companies into a variety of new fields implicate a variety of new regulatory issues and

If we make subordinated investments, the obligors or the portfolio companies may not generate sufficient cash flow

may subject such companies to increased regulatory scrutiny, particularly in the United States and Europe. As a result, these portfolio company investments face considerable risk. This could, in turn, materially adversely affect the value of the software companies in our portfolio.

**Changes in healthcare laws and other regulations applicable to some of our portfolio companies businesses may constrain their ability to offer their products and services.**

Changes in healthcare or other laws and regulations applicable to the businesses of some of our portfolio companies may occur that could increase their compliance and other costs of doing business, require

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significant systems enhancements, or render their products or services less profitable or obsolete, any of which could have a material adverse effect on their results of operations. There has also been an increased political and regulatory focus on healthcare laws in recent years, and new legislation could have a material effect on the business and operations of some of our portfolio companies.

## **Risks Relating to Our Common Stock**

**There is a risk that you may not receive distributions or that our distributions may not grow over time and a portion of our distributions may be a return of capital.**

We intend to make distributions on a monthly basis to our stockholders out of assets legally available for distribution (i.e., not subject to any legal restrictions under Maryland law on the distribution thereof). We cannot assure you that we will achieve investment results that will allow us to make a specified level of cash distributions or year-to-year increases in cash distributions. All distributions will be made at the discretion of our board of directors and will depend on our earnings, financial condition, maintenance of RIC status, compliance with applicable BDC, SBA regulations and such other factors as our board of directors may deem relative from time to time. We cannot assure you that we will make distributions to our stockholders in the future.

Our ability to pay distributions might be adversely affected by the impact of one or more of the risk factors described in this annual report on Form 10-K. Due to the asset coverage test applicable to us under the 1940 Act as a BDC, we may be limited in our ability to make distributions. In addition, restrictions and provisions in our Credit Facility, the 2022 Notes and any future credit facilities, as well as in the terms of any debt securities we issue, may limit our ability to make distributions in certain circumstances.

When we make distributions, we will be required to determine the extent to which such distributions are paid out of current or accumulated earnings and profits. Distributions in excess of current and accumulated earnings and profits will be treated as a non-taxable return of capital to the extent of an investor's basis in our stock and, assuming that an investor holds our stock as a capital asset, thereafter as a capital gain.

**Stockholders may experience dilution in their ownership percentage if they do not participate in our dividend reinvestment plan.**

All distributions declared in cash payable to stockholders that are participants in our dividend reinvestment plan are generally automatically reinvested in shares of our common stock. As a result, stockholders that do not participate in the dividend reinvestment plan may experience dilution over time. Stockholders who receive distributions in shares of common stock may experience accretion to the net asset value of their shares if our shares are trading at a premium and dilution if our shares are trading at a discount. The level of accretion or discount would depend on various factors, including the proportion of our stockholders who participate in the plan, the level of premium or discount at which our shares are trading and the amount of the distribution payable to a stockholder.

**Our shares might trade at premiums that are unsustainable or at discounts from net asset value.**

Shares of BDCs like us may, during some periods, trade at prices higher than their net asset value per share and, during other periods, as frequently occurs with closed-end investment companies, trade at prices lower than their net asset value per share. The perceived value of our investment portfolio may be affected by a number of factors including perceived prospects for individual companies we invest in, market conditions for common stock generally, for initial public offerings and other exit events for venture capital backed companies, and the mix of companies in our investment portfolio over time. Negative or unforeseen developments affecting the perceived value of companies in our investment portfolio could result in a decline in the trading price of our common stock relative to our net asset value per share.

The possibility that our shares will trade at a discount from net asset value or at premiums that are unsustainable are risks separate and distinct from the risk that our net asset value per share will decrease. The risk of purchasing shares of a BDC that might trade at a discount or unsustainable premium is more pronounced for investors who wish to sell their shares in a relatively short period of time because, for those investors, realization of a gain or loss on their investments is likely to be more dependent upon changes in premium or discount levels than upon increases or decreases in net asset value per share.

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**Investing in our securities may involve an above average degree of risk.**

The investments we make in accordance with our investment objective may result in a higher amount of risk, and higher volatility or loss of principal, than alternative investment options. Our investments in portfolio companies may be speculative and, therefore, an investment in our securities may not be suitable for someone with lower 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 BDCs or other companies in our sector, which is not necessarily related to the operating performance of these companies;

changes in regulatory policies or tax guidelines, particularly with respect to RICs, BDCs and SBICs;

loss of our qualification as a RIC or BDC or the status of our SBIC subsidiary as a SBIC;

changes in earnings or variations in operating results;

changes in the value of our portfolio of investments;

changes in accounting guidelines governing valuation of our investments;

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

departure of Stellus Capital Management's key personnel;

operating performance of companies comparable to us; and

general economic trends and other external factors.

**Risks Relating to Our Debt Securities**

**The 2022 Notes are unsecured and therefore are effectively subordinated to any secured indebtedness we have incurred or may incur in the future.**

The 2022 Notes are not and will not be secured by any of our assets or any of the assets of any future subsidiaries and rank equally in right of payment of our future unsubordinated, unsecured senior indebtedness. As a result, the 2022 Notes are effectively subordinated to any secured indebtedness we or our subsidiaries have incurred and may incur in the future (or any indebtedness that is initially unsecured to which we subsequently grant security) to the extent of the value of the assets securing such indebtedness. In any liquidation, dissolution, bankruptcy or other similar proceeding,

the holders of any of our existing or future secured indebtedness and the secured indebtedness of any future subsidiaries may assert rights against the assets pledged to secure that indebtedness in order to receive full payment of their indebtedness before the assets may be used to pay other creditors, including the holders of the 2022 Notes. As of December 31, 2017 we had \$40.8 million outstanding under the Credit Facility. The indebtedness under the Credit Facility is effectively senior to the 2022 Notes to the extent of the value of the assets securing such indebtedness.

**The 2022 Notes are structurally subordinated to the indebtedness and other liabilities of any future subsidiaries.**

The 2022 Notes are obligations exclusively of Stellus Capital Investment Corporation and not of our subsidiaries.

None of our subsidiaries are or will be a guarantor of the 2022 Notes and the 2022 Notes are not required to be

guaranteed by any subsidiaries we may acquire or create in the future. Except to the extent we are a creditor with recognized claims against our subsidiaries, all claims of creditors of our subsidiaries will have priority over our equity interests in such subsidiaries (and therefore the claims of our creditors, including holders of the 2022 Notes) with respect to the assets of such subsidiaries. Even if we are recognized as a

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creditor of one or more of our subsidiaries, our claims would still be effectively subordinated to any security interests in the assets of any such subsidiary and to any indebtedness or other liabilities of any such subsidiary senior to our claims. Consequently, the 2022 Notes are structurally subordinated to all indebtedness, including any future SBA-guaranteed debentures, and other liabilities of any of our subsidiaries and any subsidiaries that we may in the future acquire or establish. In addition, our subsidiaries may incur substantial additional indebtedness in the future, all of which would be structurally senior to the 2022 Notes.

**The indenture under which the 2022 Notes is issued contains limited protection for holders of the 2022 Notes.**

The indenture under which the 2022 Notes is issued offers limited protection to holders of the 2022 Notes. The terms of the indenture and the 2022 Notes do not restrict our or any of our subsidiaries' ability to engage in, or otherwise be a party to, a variety of corporate transactions, circumstances or events that could have an adverse impact on your investment in the 2022 Notes. In particular, the terms of the indenture and the 2022 Notes do not place any restrictions on our or our subsidiaries' ability to:

issue securities or otherwise incur additional indebtedness or other obligations, including (1) any indebtedness or other obligations that would be equal in right of payment to the 2022 Notes, (2) any indebtedness or other obligations that would be secured and therefore rank effectively senior in right of payment to the 2022 Notes to the extent of the values of the assets securing such debt, (3) indebtedness of ours that is guaranteed by one or more of our subsidiaries and which therefore is structurally senior to the 2022 Notes and (4) securities, indebtedness or obligations issued or incurred by our subsidiaries or that would be senior to our equity interests in those entities and therefore rank structurally senior to the 2022 Notes with respect to the assets of our subsidiaries, in each case other than an incurrence of indebtedness or other obligation that would cause a violation of Section 18(a)(1)(A) as modified by Section 61(a)(1) of the 1940 Act or any successor provisions, whether or not we continue to be subject to such provisions of the 1940 Act, but giving effect, in each case, to any exemptive relief granted to us by the SEC.

Currently, these provisions generally prohibit us from making additional borrowings, including through the issuance of additional debt or the sale of additional debt securities, unless our asset coverage, as defined in the 1940 Act, equals at least 200% after such borrowings;

pay dividends on, or purchase or redeem or make any payments in respect of, capital stock or other securities ranking junior in right of payment to the 2022 Notes, including subordinated indebtedness, in each case other than dividends, purchases, redemptions or payments that would cause a violation of Section 18(a)(1)(B) as modified by (i) Section 61(a)(1) of the 1940 Act or any successor provisions and (ii) the exception set forth below, despite the fact that we are not currently subject to such provisions of the 1940 Act in connection with the offer and sale of the 2022 Notes, except that we will be permitted to declare a cash dividend or distribution notwithstanding the prohibition contained in Section 18(a)(1)(B) as modified by Section 61(a)(1) of the 1940 Act, but only up to such amount as is necessary in order for us to maintain our status as a regulated investment company under Subchapter M of the Internal Revenue Code of 1986 and, provided that, any such prohibition will not apply until such time as our asset coverage has been below the minimum asset coverage required pursuant to clause (i) above for more than six consecutive months. If Section 18(a)(1)(B) as modified by Section 61(a)(1) of the 1940 Act were currently applicable to us in connection with this offering, these provisions would generally prohibit us from declaring any cash dividend or distribution upon any class of our capital stock, or purchasing any such capital stock if our asset coverage, as defined in the 1940 Act, were below 200% at the time of the declaration of the dividend or distribution or the purchase and after deducting the amount of such dividend, distribution or purchase;

sell assets (other than certain limited restrictions on our ability to consolidate, merge or sell all or substantially all of our assets);

enter into transactions with affiliates;

The indenture under which the 2022 Notes is issued contains limited protection for holders of the 2022 Notes.



create liens (including liens on the shares of our subsidiaries) or enter into sale and leaseback transactions;

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make investments; or  
create restrictions on the payment of dividends or other amounts to us from our subsidiaries.  
In addition, the indenture does not require us to offer to purchase the 2022 Notes in connection with a change of control or any other event.

Furthermore, the terms of the indenture and the 2022 Notes do not protect holders of the 2022 Notes in the event that we experience changes (including significant adverse changes) in our financial condition, results of operations or credit ratings, as they do not require that we or our subsidiaries adhere to any financial tests or ratios or specified levels of net worth, revenues, income, cash flow, or liquidity.

Our ability to recapitalize, incur additional debt and take a number of other actions that are not limited by the terms of the 2022 Notes may have important consequences for holders of the 2022 Notes, including making it more difficult for us to satisfy our obligations with respect to the 2022 Notes or negatively affecting the trading value of the 2022 Notes.

Other debt we issue or incur in the future could contain more protections for its holders than the indenture and the 2022 Notes, including additional covenants and events of default. For example, the indenture under which the 2022 Notes is issued does not contain cross-default provisions that are contained in the Credit Facility. The issuance or incurrence of any such debt with incremental protections could affect the market for and trading levels and prices of the 2022 Notes.

**An active trading market for the 2022 Notes may not develop, which could limit the market price of the 2022 Notes. Moreover, the 2022 Notes are not expected to be rated, which may subject them to greater volatility than rated 2022 Notes and particularly, greater than similar securities with an investment grade rating.**

Although we have listed the 2022 Notes on the NYSE under the symbol SCA, we cannot provide any assurances that an active trading market will develop or be maintained for the 2022 Notes. The 2022 Notes are not rated which would impact their trading and subject them to greater price volatility. To the extent they are rated and received a non-investment grade rating, their price and trading activity could be negatively impacted. Moreover, if a rating agency assigns the 2022 Notes a non-investment grade rating, the 2022 Notes may be subject to greater price volatility than securities of similar maturity without such a non-investment grade rating. Certain of the underwriters have advised us that they intend to make a market in the 2022 Notes, but they are not obligated to do so. The underwriters may discontinue any market-making in the 2022 Notes at any time at their sole discretion. Accordingly, we cannot assure you that a liquid trading market will develop for the 2022 Notes, that you will be able to sell your 2022 Notes at a particular time or that the price you receive when you sell will be favorable. To the extent an active trading market does not develop, the liquidity and trading price for the 2022 Notes may be harmed. Accordingly, you may be required to bear the financial risk of an investment in the 2022 Notes for an indefinite period of time.

**We may choose to redeem the 2022 Notes when prevailing interest rates are relatively low.**

On or after September 15, 2019, we may choose to redeem the 2022 Notes from time to time, especially when prevailing interest rates are lower than the rate borne by the 2022 Notes. If prevailing rates are lower at the time of redemption, holders of the 2022 Notes may not be able to reinvest the redemption proceeds in a comparable security

An active trading market for the 2022 Notes may not develop, which could limit the market price of the 2022 Notes.

at an effective interest rate as high as the interest rate on the 2022 Notes being redeemed. Our redemption right also may adversely impact a Noteholder's ability to sell the 2022 Notes as the optional redemption date or period approaches.

**If we default on our obligations to pay our other indebtedness, we may not be able to make payments on the 2022 Notes.**

As of December 31, 2017, we had approximately \$40.8 million of indebtedness outstanding under the Credit Facility. Any default under the agreements governing our indebtedness, including a default under the Credit Facility or other indebtedness to which we may be a party that is not waived by the required lenders, and the remedies sought by the holders of such indebtedness could make us unable to pay principal, premium, if any, and interest on the 2022 Notes and substantially decrease the market value of the 2022 Notes. If we

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are unable to generate sufficient cash flow and are otherwise unable to obtain funds necessary to meet required payments of principal, premium, if any, and interest on our indebtedness, or if we otherwise fail to comply with the various covenants, including financial and operating covenants, in the instruments governing our indebtedness (including the Credit Facility), we could be in default under the terms of the agreements governing such indebtedness. In the event of such default, the holders of such indebtedness could elect to declare all the funds borrowed thereunder to be due and payable, together with accrued and unpaid interest, the lenders under the Credit Facility or other debt we may incur in the future could elect to terminate their commitments, cease making further loans and institute foreclosure proceedings against our assets, and we could be forced into bankruptcy or liquidation. Our ability to generate sufficient cash flow in the future is, to some extent, 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 the Credit Facility or otherwise, in an amount sufficient to enable us to meet our payment obligations under the 2022 Notes and our other debt and to fund other liquidity needs.

If our operating performance declines and we are not able to generate sufficient cash flow to service our debt obligations, we may in the future need to refinance or restructure our debt, including any 2022 Notes sold, sell assets, reduce or delay capital investments, seek to raise additional capital or seek to obtain waivers from the required lenders under the Credit Facility or other debt that we may incur in the future to avoid being in default. If we are unable to implement one or more of these alternatives, we may not be able to meet our payment obligations under the 2022 Notes and our other debt. If we breach our covenants under the Credit Facility or other debt and seek a waiver, we may not be able to obtain a waiver from the required lenders. If this occurs, we would be in default under the Credit Facility or other debt, the lenders could exercise their rights as described above, and we could be forced into bankruptcy or liquidation. If we are unable to repay debt, lenders having secured obligations could proceed against the collateral securing the debt. Because the Credit Facility has, and any future credit facilities will likely have, customary cross-default provisions, if the indebtedness under the 2022 Notes, the Credit Facility or under any future credit facility is accelerated, we may be unable to repay or finance the amounts due.

## **Item 1B. Unresolved Staff Comments**

Not applicable.

## **Item 2. Properties**

We do not own any real estate or other physical properties materially important to our operation. Our headquarters are located at 4400 Post Oak Parkway, Suite 2200, Houston, Texas. We also maintain offices in Charlotte, North Carolina and in the Washington, D.C. area. All locations are provided to us by Stellus Capital Management pursuant to the administration agreement. We believe that our office facilities are suitable and adequate for our business as we contemplate conducting it.

## **Item 3. Legal Proceedings**

We and Stellus Capital Management are not currently subject to any material legal proceedings, nor, to our knowledge, is any material legal proceeding threatened against us. From time to time, we may be a party to certain legal proceedings in the ordinary course of business, including proceedings relating to the enforcement of our rights under contracts with our portfolio companies. While the outcome of these legal proceedings cannot be predicted with certainty, we do not expect that these proceedings will have a material effect upon our financial condition or results of

If we default on our obligations to pay our other indebtedness, we may not be able to make payments on the 2022 N

operations.

## **Item 4. Mine Safety Disclosures**

Not applicable.

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Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

**Price Range of Common Stock**

Our common stock is traded on the New York Stock Exchange under the symbol SCM. The following table sets forth the range of high and low sales prices of our common stock as reported on the New York Stock Exchange.

	Price Range	
	High	Low
<b>Fiscal 2015</b>		
First quarter	\$ 12.68	\$ 11.80
Second quarter	\$ 12.58	\$ 11.36
Third quarter	\$ 11.84	\$ 9.87
Fourth quarter	\$ 10.93	\$ 9.53
<b>Fiscal 2016</b>		
First quarter	\$ 10.22	\$ 7.85
Second quarter	\$ 10.59	\$ 9.82
Third quarter	\$ 11.54	\$ 10.35
Fourth quarter	\$ 12.33	\$ 10.35
<b>Fiscal 2017</b>		
First quarter	\$ 14.57	\$ 12.09
Second quarter	\$ 14.55	\$ 13.25
Third quarter	\$ 13.85	\$ 13.30
Fourth quarter	\$ 14.29	\$ 12.19
<b>Fiscal 2018</b>		
First quarter (from January 1, 2018 to March 2, 2018)	\$ 13.00	\$ 11.34

The last reported sale price for our common stock on the New York Stock Exchange on March 2, 2018 was \$11.43 per share. As of March 2, 2018, we had 10 shareholders of record.

Shares of BDCs may trade at a market price that is less than the value of the net assets attributable to those shares. The possibility that our shares of common stock will trade at a discount from net asset value per share or at premiums that are unsustainable over the long term are separate and distinct from the risk that our net asset value per share will decrease. It is not possible to predict whether the common stock will trade at, above, or below net asset value per share.

**Dividends**

Our dividends, if any, are determined by our board of directors. We have elected to be treated for federal income tax purposes as a RIC under Subchapter M of the Code. As a RIC, we will not be taxed on our investment company taxable income or realized net capital gains, to the extent that such taxable income or gains are distributed, or deemed to be distributed, to stockholders as dividends on a timely basis.

To maintain our qualification for RIC tax treatment, we must, among other things, distribute at least 90% of our net ordinary income and realized net short-term capital gains in excess of realized net long-term capital losses, if any.

Depending on the level of taxable income earned in a tax year, we may choose to carry forward taxable income in excess of current year distributions into the next tax year and pay a 4% excise tax on such income. Any such carryover taxable income must be distributed through a dividend declared prior to filing the final tax return related to the year which generated such taxable income to avoid paying U.S. federal corporate income tax on the carryover amount. We may, in the future, make actual distributions to our stockholders of our net capital gains. We can offer no assurance that we will achieve results that will permit the payment of any cash distributions and, if we issue senior securities, we may be prohibited from making distributions if

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doing so causes us to fail to maintain the asset coverage ratios stipulated by the 1940 Act or if distributions are limited by the terms of any of our borrowings.

We have adopted an opt out dividend reinvestment plan ( DRIP ) for our common stockholders. As a result, if we make cash distributions, then stockholders cash distributions will be automatically reinvested in additional shares of our common stock, unless they specifically opt out of the dividend reinvestment plan so as to receive cash distributions.

The following table reflects the distributions per share that our board of directors has declared on our common stock since December 2012, none of which are expected to include return of capital:

Date Declared	Record Date	Payment Date	Per Share
December 7, 2012	December 21, 2012	December 27, 2012	\$ 0.1812
March 7, 2013	March 21, 2013	March 28, 2013	\$ 0.3400
June 7, 2013	June 21, 2013	June 28, 2013	\$ 0.3400
August 21, 2013	September 5, 2013	September 27, 2013	\$ 0.3400
November 22, 2013	December 9, 2013	December 23, 2013	\$ 0.3400
December 27, 2013	January 15, 2014	January 24, 2014	\$ 0.0650
January 20, 2014	January 31, 2014	February 14, 2014	\$ 0.1133
January 20, 2014	February 28, 2014	March 14, 2014	\$ 0.1133
January 20, 2014	March 31, 2014	April 15, 2014	\$ 0.1133
April 17, 2014	April 30, 2014	May 15, 2014	\$ 0.1133
April 17, 2014	May 30, 2014	June 16, 2014	\$ 0.1133
April 17, 2014	June 30, 2014	July 15, 2014	\$ 0.1133
July 7, 2014	July 31, 2014	August 15, 2014	\$ 0.1133
July 7, 2014	August 29, 2014	September 15, 2014	\$ 0.1133
July 7, 2014	September 30, 2014	October 15, 2014	\$ 0.1133
October 15, 2014	October 31, 2014	November 14, 2014	\$ 0.1133
October 15, 2014	November 28, 2014	December 15, 2014	\$ 0.1133
October 15, 2014	December 31, 2014	January 15, 2015	\$ 0.1133
January 22, 2015	February 2, 2015	February 13, 2015	\$ 0.1133
January 22, 2015	February 27, 2015	March 13, 2015	\$ 0.1133
January 22, 2015	March 31, 2015	April 15, 2015	\$ 0.1133
April 15, 2015	April 30, 2015	May 15, 2015	\$ 0.1133
April 15, 2015	May 29, 2015	June 15, 2015	\$ 0.1133
April 15, 2015	June 30, 2015	July 15, 2015	\$ 0.1133
July 8, 2015	July 31, 2015	August 14, 2015	\$ 0.1133
July 8, 2015	August 31, 2015	September 15, 2015	\$ 0.1133
July 8, 2015	September 20, 2015	October 15, 2015	\$ 0.1133
October 14, 2015	October 30, 2015	November 13, 2015	\$ 0.1133
October 14, 2015	November 30, 2015	December 15, 2015	\$ 0.1133
October 14, 2015	December 31, 2015	January 15, 2016	\$ 0.1133
January 13, 2016	January 29, 2016	February 15, 2016	\$ 0.1133
January 13, 2016	February 29, 2016	March 15, 2016	\$ 0.1133
January 13, 2016	March 31, 2016	April 15, 2016	\$ 0.1133
April 15, 2016	April 29, 2016	May 13, 2016	\$ 0.1133
April 15, 2016	May 31, 2016	June 15, 2016	\$ 0.1133
April 15, 2016	June 30, 2016	July 15, 2016	\$ 0.1133



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July 7, 2016	July 29, 2016	August 15, 2016	\$ 0.1133
July 7, 2016	August 31, 2016	September 15, 2016	\$ 0.1133
July 7, 2016	September 30, 2016	October 14, 2016	\$ 0.1133
October 7, 2016	October 31, 2016	November 15, 2016	\$ 0.1133

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Date Declared	Record Date	Payment Date	Per Share
October 7, 2016	November 30, 2016	December 15, 2016	\$ 0.1133
October 7, 2016	December 30, 2016	January 13, 2017	\$ 0.1133
January 13, 2017	January 31, 2017	February 15, 2017	\$ 0.1133
January 13, 2017	February 28, 2017	March 15, 2017	\$ 0.1133
January 13, 2017	March 31, 2017	April 14, 2017	\$ 0.1133
April 14, 2017	April 28, 2017	May 15, 2017	\$ 0.1133
April 14, 2017	May 31, 2017	June 15, 2017	\$ 0.1133
April 14, 2017	June 30, 2017	July 14, 2017	\$ 0.1133
July 7, 2017	July 31, 2017	August 15, 2017	\$ 0.1133
July 7, 2017	August 31, 2017	September 15, 2017	\$ 0.1133
July 7, 2017	September 29, 2017	October 13, 2017	\$ 0.1133
October 12, 2017	October 31, 2017	November 15, 2017	\$ 0.1133
October 12, 2017	November 30, 2017	December 15, 2017	\$ 0.1133
October 12, 2017	December 29, 2017	January 12, 2018	\$ 0.1133
			\$ 7.0446

**Recent Sales of Unregistered Securities**

None.

**Use of Proceeds from Recent Sales of Registered Securities**

During April 2017, the Company sold 3,162,500 shares of its common stock (the April Offering ) for net proceeds of \$43,060,618, which was used to repay borrowings under the Credit Facility. Subsequently, the Credit Facility was redrawn to fund additional equity in the SBIC Subsidiary and fund new transactions.

During August and September 2017, the Company issued unsecured notes totaling \$48,875,000, the proceeds of which were used to redeem the existing unsecured notes and repay borrowings under the Credit Facility.

For the year ended December 31, 2017, the Company sold 303,422 additional shares of common stock through an at-the-market sales program (the ATM Program ) for net proceeds of \$4,014,887, which was used to repay borrowings under the Credit Facility.

**Purchases of Equity Securities**

None.

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## **Stock Performance Graph**

This graph compares the return on our common stock with that of the Standard & Poor's 500 Stock Index, the Russell 2000 Financial Services Index, and the Raymond James BDC Index, for the period from inception through March 2, 2018. The graph assumes that, at inception, a person invested \$100 in each of our common stock, the S&P 500 Index, the Russell 2000 Financial Services Index, and the Raymond James BDC Index. The graph measures total stockholder return, which takes into account both changes in stock price and dividends. It assumes that dividends paid are invested in like securities.

The graph and other information furnished under this Part II Item 5 of this Form 10-K shall not be deemed to be soliciting material or to be filed with the SEC or subject to Regulation 14A or 14C, or to the liabilities of Section 18 of the 1934 Act. The stock price performance included in the above graph is not necessarily indicative of future stock price performance.

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## Item 6. Selected Financial Data

The following selected financial data for the years ended December 31, 2017, 2016, 2015, 2014 and 2013, set forth below was derived from our financial statements which have been audited by Grant Thornton LLP, our independent registered public accounting firm. The data should be read in conjunction with our financial statements and related notes thereto and Management's Discussion and Analysis of Financial Condition and Results of Operations included elsewhere in this report.

The data should be read in conjunction with our financial statements and related notes thereto and Management's Discussion and Analysis of Financial Condition and Results of Operations included elsewhere in this report.

Statement of Operations Data:	For the year ended December 31, 2017	For the year ended December 31, 2016	For the year ended December 31, 2015	For the year ended December 31, 2014	For the year ended December 31, 2013
Total investment income	\$39,648,193	\$39,490,197	\$35,158,559	\$32,324,847	\$29,400,736
Total expenses, net of fee waiver	\$21,677,433	\$22,177,996	\$18,611,431	\$15,812,750	\$13,389,007
Net investment income	\$17,970,760	\$17,312,201	\$16,547,128	\$16,512,097	\$16,011,729
Net increase in net assets resulting from operations	\$22,613,257	\$23,199,062	\$7,670,536	\$10,179,142	\$17,544,997
<b>Per Share Data:</b>					
Net asset value	\$13.81	\$13.69	\$13.19	\$13.94	\$14.54
Net investment income	\$1.21	\$1.39	\$1.33	\$1.34	\$1.33
Net increase in net assets resulting from operations	\$1.52	\$1.86	\$0.61	\$0.83	\$1.45
Distributions declared	\$1.36	\$1.36	\$1.36	\$1.43	\$1.33
<b>Balance Sheet Data:</b>					
	At December 31, 2017	At December 31, 2016	At December 31, 2015	At December 31, 2014	At December 31, 2013
Investments at fair value	\$371,839,772	\$365,625,891	\$349,017,697	\$315,965,434	\$277,504,510
Cash and cash equivalents	\$25,110,718	\$9,194,129	\$10,875,790	\$2,046,563	\$13,663,542
Total assets <sup>(2)</sup>	\$400,260,855	\$379,878,729	\$365,368,412	\$323,776,402	\$296,541,900
Total liabilities <sup>(2)</sup>	\$180,013,613	\$208,996,944	\$200,717,308	\$149,826,950	\$120,650,386
Total net assets	\$220,247,242	\$170,881,785	\$164,651,104	\$173,949,452	\$175,891,514
<b>Other Data:</b>					
Number of portfolio companies at period end	48	45	39	32	26
Weighted average yield on debt investments at period end <sup>(1)(3)</sup>	10.8	% 11.0	% 10.6	% 10.9	% 11.4

(1) Computed using the effective interest rates for all of our debt investments, including accretion of original issue discount.

(2)

ASU No. 2015-03 Simplifying the Presentation of Debt Issuance Costs was effective for the quarter ended March 31, 2016. Total assets and total liabilities for the periods prior to the effective date have been modified from their respective filings to conform to this presentation.

The weighted average yield of our debt investments is not the same as a return on investment for our stockholders but, rather, relates to a portion of our investment portfolio and is calculated before the payment of all of our (3) subsidiaries fees and expenses. The weighted average yield was computed using the effective interest rates for all of our debt investment restated as an interest rate payable annually in arrears and is computed including cash and payment in kind, or PIK interest, as well as accretion of original issue discount.

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Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

**Forward-Looking Statements**

Some of the statements in this annual report on Form 10-K constitute forward-looking statements, which relate to future events or our future performance or financial condition. The forward-looking statements contained in this annual report on Form 10-K involve risks and uncertainties, including statements as to:

our future operating results;  
our business prospects and the prospects of our portfolio companies;  
the effect of investments that we expect to make;  
our contractual arrangements and relationships with third parties;  
actual and potential conflicts of interest with Stellus Capital Management;  
the dependence of our future success on the general economy and its effect on the industries in which we invest;  
the ability of our portfolio companies to achieve their objectives;  
the use of borrowed money to finance a portion of our investments;  
the adequacy of our financing sources and working capital;  
the timing of cash flows, if any, from the operations of our portfolio companies;  
the ability of Stellus Capital Management to locate suitable investments for us and to monitor and administer our investments;  
the ability of Stellus Capital Management to attract and retain highly talented professionals;  
our ability to maintain our qualification as a RIC and as a BDC; and  
the effect of future changes in laws or regulations (including the interpretation of these laws and regulations by regulatory authorities) and conditions in our operating areas, particularly with respect to business development companies or RICs.

Such forward-looking statements may include statements preceded by, followed by or that otherwise include the words may, might, will, intend, should, could, can, would, expect, believe, estimate, anticipate or similar words.

We have based the forward-looking statements included in this annual report on Form 10-K on information available to us on the date of this annual report on Form 10-K. Actual results could differ materially from those anticipated in our forward-looking statements, and future results could differ materially from historical performance. We undertake no obligation to revise or update any forward-looking statements, whether as a result of new information, future events or otherwise, unless required by law or SEC rule or regulation. 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 annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K.

**Overview**

We were organized as a Maryland corporation on May 18, 2012 and formally commenced operations on November 7, 2012. Our investment objective is to maximize the total return to our stockholders in the form of current income and capital appreciation through debt and related equity investments in middle-market companies.

We are an externally managed, non-diversified, closed-end investment company that has elected to be regulated as a BDC under the 1940 Act. As a BDC, we are required to comply with certain regulatory requirements.



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For instance, 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. Qualifying assets include investments in eligible portfolio companies. Under the relevant SEC rules, the term eligible portfolio company includes all private operating companies, operating companies whose securities are not listed on a national securities exchange, and certain public operating companies that have listed their securities on a national securities exchange and have a market capitalization of less than \$250 million, in each case organized and with their principal of business in the United States.

We have elected to be treated for tax purposes as a RIC under Subchapter M of the Code. To maintain our qualification as a RIC, we must, among other things, meet certain source-of-income and asset diversification requirements. As of December 31, 2017, we were in compliance with the RIC requirements. As a RIC, we generally will not have to pay corporate-level taxes on any income we distribute to our stockholders.

## Portfolio Composition and Investment Activity

### Portfolio Composition

We originate and invest primarily in privately-held middle-market companies (typically those with \$5.0 million to \$50.0 million of EBITDA) through first lien, second lien, unitranche and mezzanine debt financing, often times with a corresponding equity investment.

As of December 31, 2017, we had \$371.8 million (at fair value) invested in 48 companies. As of December 31, 2017, our portfolio included approximately 38% of first lien debt, 48% of second lien debt, 7% of mezzanine debt and 7% of equity investments at fair value. The composition of our investments at cost and fair value as of December 31, 2017 was as follows:

	Cost	Fair Value
Senior Secured First Lien <sup>(1)</sup>	\$ 140,915,106	\$ 141,006,923
Senior Secured Second Lien	181,164,730	178,432,850
Unsecured Debt	27,903,141	27,430,000
Equity	18,470,229	24,969,999
Total Investments	\$ 368,453,206	\$ 371,839,772

(1) Includes unitranche investments, which account for 13.2% of our investment portfolio at fair value. As of December 31, 2016, we had \$365.6 million (at fair value) invested in 45 companies. As of December 31, 2016, our portfolio included approximately 31% of first lien debt, 45% of second lien debt, 20% of mezzanine debt and 4% of equity investments at fair value. The composition of our investments at cost and fair value as of December 31, 2016 was as follows:

	Cost	Fair Value
Senior Secured First Lien <sup>(1)</sup>	\$ 113,264,200	\$ 113,482,205
Senior Secured Second Lien	163,112,172	162,486,388
Unsecured Debt	70,919,986	70,725,412
Equity	14,920,893	18,931,886
Total Investments	\$ 362,217,251	\$ 365,625,891



- (1) Includes unitranche investments, which account for 8.4% of our investment portfolio at fair value.
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The following is a summary of geographical concentration of our investment portfolio as of December 31, 2017:

	Cost	Fair Value	% of Total Investments at fair value	
Texas	\$ 109,043,496	\$ 108,445,000	29.16	%
New Jersey	34,531,876	34,595,527	9.30	%
New York	28,939,268	29,365,000	7.90	%
Canada	26,315,677	26,440,000	7.11	%
California	25,519,753	25,930,000	6.97	%
Illinois	24,250,169	25,700,000	6.91	%
Massachusetts	22,534,191	22,247,850	5.98	%
Arizona	13,565,958	13,840,000	3.72	%
North Carolina	12,248,770	12,499,167	3.36	%
Ohio	10,112,627	9,990,000	2.69	%
Tennessee	9,848,614	9,950,000	2.68	%
Missouri	9,152,087	9,530,000	2.56	%
Georgia	5,929,223	8,329,998	2.24	%
Pennsylvania	7,848,470	8,058,746	2.17	%
Arkansas	7,397,881	7,618,484	2.05	%
Minnesota	5,421,770	5,420,000	1.46	%
Puerto Rico	8,827,864	5,080,000	1.37	%
Washington	4,172,743	4,520,000	1.22	%
Alabama	1,206,682	2,880,000	0.77	%
Utah	1,293,782	880,000	0.24	%
Florida	242,304	420,000	0.11	%
Virginia	50,001	100,000	0.03	%
	\$ 368,453,206	\$ 371,839,772	100.0	%

The following is a summary of geographical concentration of our investment portfolio as of December 31, 2016:

	Cost	Fair Value	% of Total Investments at fair value	
Texas	\$ 74,433,626	\$ 73,576,277	20.12	%
New York	42,102,392	41,930,666	11.47	%
Colorado	27,855,053	28,979,651	7.93	%
California	28,298,845	28,606,727	7.81	%
Massachusetts	22,467,254	22,944,663	6.28	%
Georgia	20,626,735	22,469,217	6.15	%
New Jersey	20,710,728	20,804,704	5.69	%
Illinois	17,554,821	17,590,281	4.81	%
Alabama	16,191,841	16,584,379	4.54	%
Missouri	14,096,725	14,441,599	3.95	%
Tennessee	12,310,883	12,045,701	3.29	%
Arkansas	9,912,815	10,102,283	2.76	%
Pennsylvania	8,035,182	8,301,104	2.27	%

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Puerto Rico	8,712,537	8,229,054	2.25	%
Florida	7,453,847	7,431,820	2.03	%
Canada	6,765,448	6,692,648	1.83	%
Minnesota	6,362,834	6,374,800	1.74	%
North Carolina	4,920,321	5,000,000	1.37	%
Washington	4,158,696	4,211,990	1.15	%
Virginia	4,029,530	4,060,519	1.11	%
Arizona	3,408,099	3,410,583	0.93	%
Utah	1,291,083	1,311,789	0.36	%
Ohio	517,956	525,436	0.14	%
	\$ 362,217,251	\$ 365,625,891	100.0	%

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The following is a summary of industry concentration of our investment portfolio as of December 31, 2017:

	Cost	Fair Value	% of Total Investments at fair value	
Software	\$ 48,560,675	\$ 48,997,850	13.18	%
Healthcare & Pharmaceuticals	41,192,879	37,829,167	10.17	%
High Tech Industries	36,058,477	35,460,000	9.54	%
Finance	26,500,097	28,330,000	7.62	%
Services: Business	23,386,714	25,749,999	6.93	%
Capital Equipment	24,300,027	24,170,000	6.50	%
Media: Broadcasting & Subscription	21,680,239	23,665,000	6.36	%
Chemicals, Plastics, & Rubber	20,825,458	21,145,000	5.69	%
Services: Consumer	17,862,616	18,070,000	4.86	%
Construction & Building	17,913,413	17,980,000	4.84	%
Education	17,197,396	17,335,526	4.66	%
Consumer Goods: Durable	16,559,947	16,798,484	4.52	%
Consumer goods: non-durable	13,250,000	13,250,000	3.56	%
Retail	8,288,083	8,280,000	2.23	%
Automotive	7,848,470	8,058,746	2.17	%
Transportation: Cargo	6,785,894	6,840,000	1.84	%
Energy: Oil & Gas	6,766,968	6,700,000	1.80	%
Insurance	5,410,226	5,500,000	1.48	%
Beverage, Food, & Tobacco	3,964,242	3,580,000	0.96	%
Hotel, Gaming, & Leisure	3,284,942	3,420,000	0.92	%
Environmental Industries	766,442	580,000	0.16	%
Services: Government	50,001	100,000	0.03	%
	\$ 368,453,206	\$ 371,839,772	100.0	%

The following is a summary of industry concentration of our investment portfolio as of December 31, 2016:

	Cost	Fair Value	% of Total Investments at fair value	
Finance	\$ 56,663,586	\$ 57,504,930	15.73	%
Software	36,199,915	36,730,618	10.06	%
Media: Broadcasting & Subscription	36,001,876	36,637,803	10.02	%
Healthcare & Pharmaceuticals	35,002,051	35,583,505	9.73	%
Services: Business	24,105,217	25,884,879	7.08	%
Consumer goods: non-durable	20,763,612	21,165,542	5.79	%
Chemicals, Plastics, & Rubber	18,957,486	19,146,954	5.24	%
Retail	18,973,041	19,095,787	5.22	%
Education	17,325,046	17,498,701	4.79	%
Telecommunications	16,403,791	16,009,390	4.38	%
High Tech Industries	16,486,738	15,382,000	4.21	%
Beverage, Food, & Tobacco	12,437,795	12,700,000	3.47	%
Consumer Goods: Durable	11,881,630	11,991,250	3.28	%

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Automotive	8,035,182	8,301,104	2.27	%
Services: Consumer	8,453,847	8,153,879	2.23	%
Transportation: Cargo	6,765,448	6,692,648	1.83	%
Energy: Oil & Gas	7,320,058	6,654,662	1.82	%
Services: Government	4,029,530	4,060,519	1.11	%
Hotel, Gaming, & Leisure	3,408,099	3,410,583	0.93	%
Construction & Building	2,485,347	2,495,701	0.68	%
Environmental Industries	517,956	525,436	0.14	%
	\$ 362,217,251	\$ 365,625,891	100.0	%

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At December 31, 2017, our average portfolio company investment at amortized cost and fair value was approximately \$7.7 million and \$7.4 million, respectively, and our largest portfolio company investment by amortized cost and fair value was approximately \$22.5 million and \$22.2 million, respectively. At December 31, 2016, our average portfolio company investment at amortized cost and fair value was approximately \$8.0 million and \$8.1 million, respectively, and our largest portfolio company investment by amortized cost and fair value was approximately \$22.5 million and \$22.9 million, respectively.

At December 31, 2017, 87% of our debt investments bore interest based on floating rates (subject to interest rate floors), such as LIBOR, and 13% bore interest at fixed rates. At December 31, 2016, 77% of our debt investments bore interest based on floating rates (subject to interest rate floors), such as LIBOR, and 23% bore interest at fixed rates.

The weighted average yield on all of our debt investments as of December 31, 2017 and December 31, 2016 was approximately 10.8% and 11.0%, respectively. The weighted average yield was computed using the effective interest rates for all of our debt investments, including accretion of original issue discount. The weighted average yield of our debt investments is not the same as a return on investment for our stockholder but, rather relates to a portion of our investment portfolio and is calculated before the payment of all of our subsidiaries' fees and expenses.

As of December 31, 2017 and December 31, 2016, we had cash and cash equivalents of \$25.1 million and \$9.2 million, respectively.

## **Investment Activity**

During the year ended December 31, 2017, we made \$172.2 million of investments in 14 new portfolio companies and two to existing portfolio companies. During the year ended December 31, 2017, we received \$172.3 million in proceeds principally from prepayments of our investments, including \$7.2 million from amortization of certain other investments.

During the year ended December 31, 2016, we made \$65.7 million of investments in 10 new portfolio companies and five existing portfolio companies. During the year ended December 31, 2016, we received \$55.9 million in proceeds principally from prepayments of our investments, including \$9.9 million from amortization of certain other investments.

Our level of investment activity can vary substantially from period to period depending on many factors, including the amount of debt and equity capital to middle market companies, the level of merger and acquisition activity, the general economic environment and the competitive environment for the types of investments we make.

## **Asset Quality**

In addition to various risk management and monitoring tools, Stellus Capital Management uses an investment rating system to characterize and monitor the credit profile and expected level of returns on each investment in our portfolio.

This investment rating system uses a five-level numeric scale. The following is a description of the conditions associated with each investment category:

Investment Category 1 is used for investments that are performing above expectations, and whose risks remain favorable compared to the expected risk at the time of the original investment.

Investment Category 2 is used for investments that are performing within expectations and whose risks remain neutral compared to the expected risk at the time of the original investment. All new loans are initially rated 2.

Investment Category 3 is used for investments that are performing below expectations and that require closer monitoring, but where no loss of return or principal is expected. Portfolio companies with a rating of 3 may be out of compliance with financial covenants.

Investment Category 4 is used for investments that are performing substantially below expectations and whose risks have increased substantially since the original investment. These investments are often in work out. Investments with a rating of 4 are those for which some loss of return but no loss of principal is expected.

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Investment Category 5 is used for investments that are performing substantially below expectations and whose risks have increased substantially since the original investment. These investments are almost always in work out. Investments with a rating of 5 are those for which some loss of return and principal is expected.

Investment Category	As of December 31, 2017			As of December 31, 2016		
	Fair Value (dollars in millions)	% of Total Portfolio	Number of Portfolio Companies	Fair Value (dollars in millions)	% of Total Portfolio	Number of Portfolio Companies
1	\$ 25.9	7 %	5	\$ 73.5	20 %	6
2	306.7	82 %	36	239.8	66 %	32
3	37.0	10 %	5	50.7	14 %	5
4	1.9	1 %	1	0.9	%	1
5	0.4	%	1	0.7	%	1
Total	\$ 371.9	100 %	48	\$ 365.6	100 %	45

## Loans and Debt Securities on Non-Accrual Status

We will not accrue interest on loans and debt securities if we have reason to doubt our ability to collect such interest. As of December 31, 2017, we had 2 loan on non-accrual status, which represents approximately 1.2% of the portfolio at cost and 0.3% at fair value. As of December 31, 2016, we had two loans on non-accrual status, which represented approximately 0.7% of the portfolio at cost and 0.4% at fair value.

## Results of Operations

An important measure of our financial performance is net increase (decrease) in net assets resulting from operations, which includes net investment income (loss), net realized gain (loss) and net unrealized appreciation (depreciation). Net investment income (loss) is the difference between our income from interest, dividends, fees and other investment income and our operating expenses including interest on borrowed funds. Net realized gain (loss) on investments is the difference between the proceeds received from dispositions of portfolio investments and their amortized cost. Net unrealized appreciation (depreciation) on investments is the net change in the fair value of our investment portfolio.

## Comparison of the Years ended December 31, 2017, 2016, and 2015

### Revenues

We generate revenue in the form of interest income on debt investments and capital gains and distributions, if any, on investment securities that we may acquire in portfolio companies. Our debt investments typically have a term of five to seven years and bear interest at a fixed or floating rate. Interest on our debt securities is generally payable quarterly. Payments of principal on our debt investments may be amortized over the stated term of the investment, deferred for several years or due entirely at maturity. In some cases, our debt investments may pay interest in-kind, or PIK. Any outstanding principal amount of our debt securities and any accrued but unpaid interest will generally become due at the maturity date. The level of interest income we receive is directly related to the balance of interest-bearing investments multiplied by the weighted average yield of our investments. We expect that the total dollar amount of interest and any dividend income that we earn to increase as the size of our investment portfolio increases. In addition,



we may generate revenue in the form of prepayment fees, commitment, loan origination, structuring or due diligence fees, fees for providing significant managerial assistance and consulting fees.

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The following shows the breakdown of investment income for the years ended December 31, 2017, 2016, and 2015 (in millions).

	Year ended December 31, 2017	Year ended December 31, 2016	Year ended December 31, 2015
	(dollars in millions)		
Interest Income	\$ 37.6	\$ 38.0	\$ 34.3
PIK Income	0.5	0.2	0.4
Miscellaneous fees	1.6	1.3	0.5
	\$ 39.7	\$ 39.5	\$ 35.2

The increase in interest income from the respective periods were due primarily to growth in the overall investment portfolio.

**Expenses**

Our primary operating expenses include the payment of fees to Stellus Capital Management under the investment advisory agreement, our allocable portion of overhead expenses under the administration agreement and other operating costs described below. We bear all other out-of-pocket costs and expenses of our operations and transactions, which may include:

- the cost of calculating our net asset value, including the cost of any third-party valuation services;
- the cost of effecting sales and repurchases of shares of our common stock and other securities;
- fees payable to third parties relating to making investments, including out-of-pocket fees and expenses (such as travel expenses) associated with performing due diligence and reviews of prospective investments;
- transfer agent and custodial fees;
- out-of-pocket fees and expenses associated with marketing efforts;
- federal and state registration fees and any stock exchange listing fees;
- U.S. federal, state and local taxes;
- independent directors' fees and expenses;
- brokerage commissions;
- fidelity bond, directors' and officers' liability insurance and other insurance premiums;
- direct costs, such as printing, mailing, long distance telephone and staff;
- fees and expenses associated with independent audits and outside legal costs;
- costs associated with our reporting and compliance obligations under the 1940 Act and other applicable U.S. federal and state securities laws; and
- other expenses incurred by Stellus Capital Management or us in connection with administering our business, including payments under the administration agreement that are based upon our allocable portion of overhead (subject to the review of our board of directors).

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The following shows the breakdown of operating expenses for the years ended December 31, 2017, 2016 and 2015 (in millions).

	Year ended December 31, 2017	Year ended December 31, 2016	Year ended December 31, 2015
<b>Operating Expenses</b>			
Management Fees	\$ 6.3	\$ 6.3	\$ 5.8
Valuation Fees	0.3	0.4	0.4
Administrative services expenses	1.3	1.0	1.0
Incentive fees	2.9	4.3	4.0
Professional fees	1.3	0.7	0.6
Directors fees	0.3	0.3	0.3
Insurance expense	0.4	0.5	0.5
Interest expense and other fees	7.9	8.0	6.2
Deferred offering costs		0.3	
Other general and administrative	0.6	0.4	0.4
<b>Total Operating Expenses</b>	<b>\$ 21.3</b>	<b>\$ 22.2</b>	<b>\$ 19.2</b>
Loss on extinguishment of debt	0.4		
Waiver of Incentive Fees			(0.6 )
<b>Total Expenses, net of fee waivers</b>	<b>\$ 21.7</b>	<b>\$ 22.2</b>	<b>\$ 18.6</b>

The decrease in operating expense from 2016 to 2017 was due to: 1) lower incentive fees, due to an increase in net assets, which increased the pre-incentive fee net investment income threshold needed to reach the hurdle rate (see Note 2 for discussion on incentive fee calculation), 2) the offset of an increase in professional fees, primarily related to increased costs of Sarbanes-Oxley compliance and 3) the offset of a one-time loss on extinguishment from our Credit Facility modification and payoff of our 6.50% Notes ( the 2019 Notes ). See Notes 9 and 11 for discussion on debt modifications during 2017.

The increase in operating expense from 2015 to 2016 was due to: 1) increased interest and fees on our SBA-guaranteed debentures, which were fully drawn in the fourth quarter of 2015, 2) an increase in management and incentive fees due to portfolio growth and 3) deferred offering costs, which were fully expensed in the second quarter of 2016.

While under no obligation to do so, the Advisor waived incentive fees of \$646,333 for the year ended December 31, 2015 to support an annualized dividend yield of 9.0% based on the \$15.00 price per share of our common stock in the Offering. Such waiver in no way implies that the Advisor will waive incentive fees in any future period. The Advisor did not waive incentive fees during the years ended December 31, 2017 and 2016.

## Net Investment Income

Net investment income was \$18.0 million, or \$1.21 per common share based on 14,870,981 weighted-average common shares outstanding at December 31, 2017. Net investment income was \$17.3 million, or \$1.39 per common share based on 12,479,959 weighted-average common shares outstanding at December 31, 2016. Net investment income was \$16.5 million, or \$1.33 per common share based on 12,479,961 weighted-average common shares outstanding at December 31, 2015.

Net investment income for the year ended December 31, 2017 increased compared to the year ended December 31, 2016 as a result of lower incentive fees which declined year over year due to higher net assets, which makes it more difficult to clear the incentive fee hurdle.

### **Net Realized Gains and Losses**

We measure realized gains or losses by the difference between the net proceeds from the repayment, sale or other disposition and the amortized cost basis of the investment, using the specific identification method, without regard to unrealized appreciation or depreciation previously recognized.

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Proceeds from repayments of investments and amortization of other certain investments for the year ended December 31, 2017 totaled \$172.3 million and net realized gain totaled \$4.7 million. Proceeds from repayments of investments and amortization of other certain investments for the year ended December 31, 2016 totaled \$55.9 million and net realized loss totaled \$13.1 million, \$12.2 million of which is related to the realized loss of our term loan in Binder and Binder. Proceeds from the sales and repayments of investments and amortization of other certain investments for the year ended December 31, 2015 totaled \$93.3 million and net realized gains totaled \$0.4 million.

### **Net Change in Unrealized Appreciation (Depreciation) of Investments**

Net change in unrealized appreciation primarily reflects the change in portfolio investment values during the reporting period, including the reversal of previously recorded appreciation or depreciation when gains or losses are realized.

Net change in unrealized appreciation (depreciation) on investments and cash equivalents for the year ended December 31, 2017, 2016 and 2015 totaled (\$0.02) million, \$18.6 million, and (\$9.2) million, respectively.

There was relatively no change in unrealized appreciation (depreciation) in 2017. The change in unrealized appreciation in 2016 was due primarily to two factors: (1) the reversal of \$8.3 million of unrealized depreciation accrued in prior years resulting from realized losses and (2) \$10.3 million from tightening interest rate spreads in 2016. The change in unrealized depreciation in 2015 was due primarily to unrealized depreciation on our one non-accrual investment as well as unrealized depreciation on other investments in the portfolio due to a widening of market interest rate spreads.

### **Provision for Taxes on Unrealized Appreciation on Investments**

We have direct wholly owned subsidiaries that have elected to be taxable entities (the Taxable Subsidiaries). The Taxable Subsidiaries permit us to hold equity investments in portfolio companies which are pass through entities for tax purposes and continue to comply with the source-of-income requirements contained in RIC tax provisions of the Code. The Taxable Subsidiaries are not consolidated with us for income tax purposes and may generate income tax expense, benefit, and the related tax assets and liabilities, as a result of their ownership of certain portfolio investments. The income tax expense, or benefit, if any, and related tax assets and liabilities are reflected in our consolidated financial statements. For the year ended December 31, 2017, 2016 and 2015, we recognized a benefit (provision) for income tax at our taxable subsidiaries of \$9.0 thousand, \$0.4 million, and \$(0.1) million. As of December 31, 2017 and 2016, a deferred tax liability of \$0 and \$8.0 thousand, respectively, were included on the Consolidated Statement of Assets and Liabilities.

### **Net Increase in Net Assets Resulting from Operations**

Net increase in net assets resulting from operations totaled \$22.6 million, or \$1.52 per common share based on weighted-average shares of 14,870,981 for the year ended December 31, 2017, as compared to \$23.2 million, or \$1.86 per common share based on weighted-average shares of 12,479,959 common shares outstanding for the year ended December 31, 2016, as compared to \$7.7 million, or \$0.61 per common share based on weighted-average shares of 12,479,961 common shares outstanding for the year ended December 31, 2015.

The decrease in net assets resulting from operations for the year ended December 31, 2017 as compared to the year ended December 31, 2016 was due primarily to a higher unrealized appreciation in 2016 partially offset by realized gains and increased net investment income in 2017. Similarly, the increase in net assets resulting from operations for the year ended December 31, 2016 as compared to the year ended December 31, 2015 was due primarily to higher

unrealized appreciation in 2016.

## **Financial condition, liquidity and capital resources**

### **Cash Flows from Operating and Financing Activities**

Our operating activities provided net cash of \$19.2 million for the year ended December 31, 2017, primarily in connection with the income earned on portfolio investments, offset by the purchase and

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origination of portfolio investments. Our financing activities for the year ended December 31, 2017 used cash of \$3.3 million primarily from repayments on our credit facility.

Our operating activities provided net cash of \$8.8 million for the year ended December 31, 2016, primarily in connection with the sale and repayment of portfolio investments, offset by the purchase and origination of portfolio investments. Our financing activities for the year ended December 31, 2016 used cash of \$10.5 million primarily from repayments on our credit facility.

Our operating activities used net cash of \$24.4 million for the year ended December 31, 2015, primarily in connection with the purchase and origination of portfolio investments. Our financing activities for the year ended December 31, 2015 provided cash of \$33.3 million primarily from the issuance of our SBA-guaranteed debentures.

Our liquidity and capital resources are derived from the Credit Facility, the 2022 Notes, SBA-guaranteed debentures and cash flows from operations, including investment sales and repayments, and income earned. Our primary use of funds from operations includes investments in portfolio companies and other operating expenses we incur, as well as the payment of dividends to the holders of our common stock. We used, and expect to continue to use, these capital resources as well as proceeds from turnover within our portfolio and from public and private offerings of securities to finance our investment activities.

Although we expect to fund the growth of our investment portfolio through the net proceeds from future public and private equity offerings and issuances of senior securities or future borrowings to the extent permitted by the 1940 Act, our plans to raise capital may not be successful. In this regard, if our common stock trades at a price below our then-current net asset value per share, we may be limited in our ability to raise equity capital given that we cannot sell our common stock at a price below net asset value per share unless our stockholders approve such a sale and our board of directors makes certain determinations in connection therewith. A proposal, approved by our stockholders at our 2017 annual stockholders meeting, authorizes us to sell shares equal to up to 25% of our outstanding common stock of our common stock below the then current net asset value per share of our common stock in one or more offerings.

This authorization will expire on the earlier of May 24, 2018, the one year anniversary of our 2017 annual stockholders meeting or the date of our 2018 annual stockholders meeting. We would need similar future approval from our stockholders to issue shares below the then current net asset value per share any time after the expiration of the current approval. In addition, we intend to distribute between 90% and 100% of our taxable income to our stockholders in order to satisfy the requirements applicable to RICs under Subchapter M of the Code. Consequently, we may not have the funds or the ability to fund new investments, to make additional investments in our portfolio companies, to fund our unfunded commitments to portfolio companies or to repay borrowings. In addition, the illiquidity of our portfolio investments may make it difficult for us to sell these investments when desired and, if we are required to sell these investments, we may realize significantly less than their recorded value.

Also, as a BDC, we generally are required to meet a coverage ratio of total assets, less liabilities and indebtedness not represented by senior securities, to total senior securities, which include all of our borrowings and any outstanding preferred stock, of at least 200%. We have received exemptive relief from the SEC to permit us to exclude the debt of our SBIC subsidiary guaranteed by the SBA from the definition of senior securities in the 200% asset coverage test under the 1940 Act. This requirement limits the amount that we may borrow. We were in compliance with the asset coverage ratios at all times. As of December 31, 2017 and December 31, 2016, our asset coverage ratio was 346% and 221%, respectively. The amount of leverage that we employ will depend on our assessment of market conditions and other factors at the time of any proposed borrowing, such as the maturity, covenant package and rate structure of the proposed borrowings, our ability to raise funds through the issuance of shares of our common stock and the risks of such borrowings within the context of our investment outlook. Ultimately, we only intend to use leverage if the expected returns from borrowing to make investments will exceed the cost of such borrowing. As of December 31,

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2017 and December 31, 2016, we had cash and cash equivalents of \$25.1 million and \$9.2 million, respectively.

During April 2017, the Company sold 3,162,500 shares of its common stock (the April Offering ) for net proceeds of \$43,060,618. For the year ended December 31, 2017, the Company sold 303,422 shares of its

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common stock under the ATM program for net proceeds of \$4,014,887. These proceeds were used to repay borrowings under the Credit Facility, Subsequently, the Credit Facility was redrawn to fund the remaining equity in the SBIC Subsidiary and fund new transactions.

### **Credit Facility**

On November 7, 2012, the Company entered into a revolving credit facility (the Original Facility ) with various lenders. SunTrust Bank, one of the lenders, served as administrative agent under the Original Facility. The Original Facility, as amended on November 21, 2014 and August 31, 2016, provided for borrowings in an aggregate amount of \$120.0 million on a committed basis with an accordion feature that allowed the Company to increase the aggregate commitments up to \$195.0 million, subject to new or existing lenders agreeing to participate in the increase, and other customary conditions. The Company terminated the Original Facility on October 11, 2017 in conjunction with securing and entering into a new senior secured revolving credit agreement, dated as of October 10, 2017, with ZB, N.A., dba Amegy Bank and various other lenders (the Credit Facility ).

The Credit Facility provides for borrowings up to a maximum of \$140.0 million on a committed basis with an accordion feature that allows the Company to increase the aggregate commitments up to 195.0 million, subject to new or existing lenders agreeing to participate in the increase and other customary conditions.

Borrowings under the Credit Facility bear interest, subject to the Company's election, on a per annum basis equal to (i) LIBOR plus 2.50% with no LIBOR floor or (ii) 1.50% plus an alternate base rate based on the highest of the Prime Rate, Federal Funds Rate plus 0.5% or one month LIBOR plus 1.0%. The Company pays unused commitment fees of 0.50% per annum on the unused lender commitments. Interest is payable quarterly in arrears. Any amounts borrowed under the Credit Facility will mature, and all accrued and unpaid interest thereunder will be due and payable, on October 1, 2021. This represents an interest rate reduction of 12.5 basis points and a three year extension of maturity over the Original Facility. See Note 9 for further discussion on the modification.

The Company's obligations to the lenders are secured by a first priority security interest in its portfolio of securities and cash not held at the SBIC subsidiary, but excluding short term investments. The Original Facility contained certain affirmative and negative covenants, including but not limited to: (i) maintaining a minimum liquidity test of at least 85% of adjusted borrowing base, (ii) maintaining an asset coverage ratio of at least 2.0 to 1.0, and (iii) maintaining a minimum shareholder's equity. The Original Facility required that the Company meet certain conditions in connection with incurring additional indebtedness, including that the Company have a minimum asset coverage ratio of 2.2 to 1.0 after giving effect to such borrowing. Additional conditions stated that (i) the aggregate amount of PIK interest during the most recently ended fiscal quarter of the borrower did not exceed 2% of the aggregate amount of interest income that the borrower had received on all investments in the borrowing base during such fiscal quarter; (ii) the sum of the value of all non-accrual investments did not exceed 5% of the value of all investments in the borrowing base and (iii) the borrower maintained a minimum liquidity test of at least 80% of adjusted borrowing base. The Company met these conditions while the Original Facility was outstanding.

The Credit Facility no longer provides advances on non-performing assets or equity positions. The Credit Facility also does not require a minimum asset coverage test to incur additional indebtedness nor does it have a maximum of PIK interest or non-accrual investments allowable under the borrowing base. Other changes under the Credit Facility include: a) the amendment of the minimum liquidity test to \$10.0 million, including cash, liquid investments, and undrawn availability b) the addition of a minimum interest coverage ratio of 2.0 to 1.0 at all times. As of December 31, 2017, these conditions were met.

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As of December 31, 2017 and December 31, 2016, the outstanding balance under the Credit Facility and Original Facility was \$40.8 million and \$116.0 million, respectively. The carrying amount of the amount outstanding under the Credit Facility approximates its fair value. The Company incurred total costs of \$3.1 million in connection with obtaining, amending, and maintaining the Original Facility. The Company incurred costs of \$1.2 million in connection with the Credit Facility, which are being amortized over the life of the facility. Additionally, \$0.3 million of costs from the Original Facility will continue to be amortized over the remaining life of the Credit Facility. The Company expensed \$0.1 million of fees related to the

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modification in the year ended December 31, 2017 as a loss on extinguishment of debt, which represents a proportionate amount of fees attributable to SunTrust bank exiting the Original Facility. As of December 31, 2017 and December 31, 2016, \$1.4 million and \$0.8 million of such prepaid loan structure fees and administration fees had yet to be amortized, respectively. These prepaid loan fees are presented on our consolidated statement of assets and liabilities as a deduction from the debt liability attributable to the Credit Facility as required by ASU No. 2015-3. See Note 1 for further discussion.

For the year ended December 31, 2017, the weighted average effective interest rate under the Credit Facility and the Original Facility was approximately 3.7% (approximately 5.0% including commitment fees and other loan fees, but excluding \$0.1 million of loss on extinguishment of debt). The average borrowings under the Credit Facility and the Original Facility for the year ended December 31, 2017 were \$60.1 million.

For the year ended December 31, 2016, the weighted average effective interest rate under the Original Facility was approximately 3.2% (approximately 3.7% including commitment fees and other loan fees). The average borrowings under the Original Facility for the year ended December 31, 2016 were \$106.6 million.

For the year ended December 31, 2015, the weighted average effective interest rate under the Original Facility was approximately 2.9% (approximately 3.5% including commitment fees and other loan fees). The average borrowings under the Original Facility for the year ended December 31, 2015 were \$102.8 million.

Interest is paid quarterly in arrears. The following table summarizes the interest expense and amortized loan fees on the Credit Facility and Original Facility for the years ended December 31, 2017, 2016, and 2015 (in millions):

	For the year ended December 31, 2017	For the year ended December 31, 2016	For the year ended December 31, 2015
	(dollars in millions)		
Interest expense	\$ 2.3	\$ 3.4	\$ 3.0
Loan fee amortization	0.4	0.5	0.5
Commitment fees on unused portion	0.3		0.1
Total interest and financing expenses	\$ 3.0	\$ 3.9	\$ 3.6
Loss on extinguishment of debt	0.1		
Cash paid for interest and unused fees	\$ 2.5	\$ 3.4	\$ 3.1

**SBA-guaranteed debentures**

Due to the SBIC subsidiary's status as a licensed SBIC, we have the ability to issue debentures guaranteed by the SBA at favorable interest rates. Under the regulations applicable to SBIC funds, an SBIC can have outstanding debentures guaranteed by the SBA subject to a regulatory leverage limit, up to two times the amount of regulatory capital. As of December 31, 2017 and December 31, 2016, the SBIC subsidiary had \$67.5 million and \$38.0 million, respectively, in regulatory capital, as such term is defined by the SBA.

As a BDC, we are only allowed to employ leverage to the extent that our asset coverage, as defined in the 1940 Act, equals at least 200% after giving effect to such leverage. The amount of leverage that we employ at any time depends on our assessment of the market and other factors at the time of any proposed borrowing.

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On August 12, 2014, we obtained exemptive relief from the SEC to permit us to exclude the debt of the SBIC subsidiary guaranteed by the SBA from our 200% asset coverage test under the 1940 Act. The exemptive relief provides us with increased flexibility under the 200% asset coverage test by permitting us to borrow up to \$135.0 million more than we would otherwise be able to absent the receipt of this exemptive relief.

On a stand-alone basis, the SBIC subsidiary held \$162.0 million and \$104.6 million in assets at December 31, 2017 and December 31, 2016, respectively, which accounted for approximately 40.4% and 27.5% of our total consolidated assets at December 31, 2017 and December 31, 2016, respectively.

Debentures guaranteed by the SBA have fixed interest rates that equal prevailing 10-year Treasury Note rates plus a market spread and have a maturity of ten years with interest payable semi-annually. The principal

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amount of the debentures is not required to be paid before maturity, but may be pre-paid at any time with no prepayment penalty. As of December 31, 2017 and December 31, 2016, the SBIC subsidiary had \$90.0 million and \$65.0 million, respectively, of SBA-guaranteed debentures outstanding, which mature ten years from issuance. The first maturity related to the SBA-guaranteed debentures does not occur until 2025, and the remaining weighted average duration of all of our outstanding SBA-guaranteed debentures is approximately 8.5 years as of December 31, 2017.

As of December 31, 2017 and December 31, 2016, the carrying amount of the SBA-guaranteed debentures approximated their fair value. The fair values of the SBA-guaranteed debentures are determined in accordance with ASC 820, which defines fair value in terms of the price that would be paid to transfer a liability in an orderly transaction between market participants at the measurement date under current market conditions. The fair value of the SBA-guaranteed debentures are estimated based upon market interest rates for our own borrowings or entities with similar credit risk, adjusted for nonperformance risk, if any. At December 31, 2017 and December 31, 2016 the SBA-guaranteed debentures would be deemed to be Level 3, as defined in Note 6.

As of December 31, 2017, the Company had incurred \$3.1 million in financing costs related to the SBA-guaranteed debentures. As of December 31, 2017 and December 31, 2016, \$2.2 million and \$1.7 million of prepaid financing costs had yet to be amortized, respectively. These prepaid loan fees are presented on the consolidated statement of assets and liabilities as a deduction from the debt liability as required by ASU No. 2015-3. See Note 1 for further discussion.

For the year ended December 31, 2017, the weighted average effective interest rate for the SBA-guaranteed debentures was approximately 3.1% (approximately 3.6% including loan fees). The average borrowings of the SBA-guaranteed debentures for the year ended December 31, 2017 were \$67.3 million.

For the year ended December 31, 2016, the weighted average effective interest rate for the SBA-guaranteed debentures was approximately 2.9% (approximately 3.4% including loan fees). The average borrowings of the SBA-guaranteed debentures for the year ended December 31, 2016 were \$65.0 million.

For the year ended December 31, 2015, the weighted average effective interest rate for the SBA-guaranteed debentures was approximately 2.2% (approximately 3.0% including loan fees). The average borrowings of the SBA-guaranteed debentures for the year ended December 31, 2015 were \$25.4 million.

The following table summarizes the interest expenses incurred and paid on the SBA-guaranteed debentures for the years ended December 31, 2017, 2016, and 2015 (in millions):

	For the year ended December 31, 2017	For the year ended December 31, 2016	For the year ended December 31, 2015
	(dollars in millions)		
Interest expense	\$ 2.1	\$ 1.9	\$ 0.6
Debenture fee amortization	0.3	0.3	0.2
Total interest and financing expenses	\$ 2.4	\$ 2.2	\$ 0.8
Cash paid for interest	\$ 2.0	\$ 1.5	\$ 0.3

## Notes

On May 5, 2014, the Company closed a public offering of \$25.0 million in aggregate principal amount of 6.50% notes (the 2019 Notes ) due April 30, 2019. On August 21, 2017, the Company caused notices to be issued to the holders of its 2019 Notes regarding the Company's exercise of its option to redeem all of the issued and outstanding 2019 Notes, pursuant to the Base Indenture dated as of May 5, 2014, between the Company and U.S. Bank National Association, as trustee, and the First Supplemental Indenture dated as of May 5, 2014. The Company redeemed all \$25.0 million in aggregate principal amount of the 2019 Notes on September 20, 2017. The 2019 Notes were redeemed at 100% of their principal amount, plus the accrued and unpaid interest thereon through the redemption date. As a result of the redemption, the Company recognized a loss on the extinguishment of debt of \$0.3 million for the year ended December 31, 2017, due to the write off of the remaining deferred financing costs on the 2019 Notes.

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The following table summarizes the interest expense and deferred financing costs on the 2019 Notes for the years ended December 31, 2017, 2016 and 2015 (in millions):

	For the year ended December 31, 2017	For the year ended December 31, 2016	For the year ended December 31, 2015
	(dollars in millions)		
Interest expense	\$ 1.2	\$ 1.6	\$ 1.6
Deferred financing costs	0.1	0.2	0.2
Total interest and financing expenses	\$1.3	\$ 1.8	\$1.8
Loss on extinguishment of debt	0.3		
Cash paid for interest	\$ 1.4	\$ 1.6	\$ 1.6

On August 21, 2017, the Company issued \$42.5 million in aggregate principal amount of 5.75% fixed-rate notes due 2022 (the 2022 Notes) and together with the 2019 Notes, the Notes). On September 8, 2017, the Company issued an additional \$6.4 million in aggregate principal amount of the 2022 Notes pursuant to a full exercise of the underwriters overallotment option. The 2022 Notes will mature on September 15, 2022, and may be redeemed in whole or in part at any time or from time to time at the Company's option on or after September 15, 2019 at a redemption price equal to 100% of the outstanding principal, plus accrued and unpaid interest. Interest is payable quarterly beginning December 15, 2017.

The Company used all of the net proceeds from this offering to fully redeem the \$25.0 million in aggregate principal amount of the 2019 Notes and a portion of the amount outstanding under the Original Facility. As of December 31, 2017 and 2016, the aggregate carrying amount of all Notes was \$48.9 million and as of \$25.0 million and the fair value of the Notes was approximately \$49.5 million and \$25.2 million, respectively. The 2022 Notes are listed on New York Stock Exchange under the trading symbol SCA. The fair value of the Notes is based on the closing price of the security, which is a Level 2 input under ASC 820 due to sufficient trading volume.

In connection with the issuance and maintenance of the 2022 Notes, we have incurred \$1.7 million of fees which are being amortized over the term of the 2022 Notes, of which \$1.6 million remains to be amortized as of December 31, 2017. These financing costs are presented on the consolidated statement of assets and liabilities as a deduction from the debt liability as required by ASU No. 2015-3.

The following table summarizes the interest expense and deferred financing costs on the 2022 Notes for the years ended December 31, 2017, 2016 and 2015 (in millions):

	For the year ended December 31, 2017	For the year ended December 31, 2016	For the year ended December 31, 2015
	(dollars in millions)		
Interest expense	\$ 1.0	\$	\$

Deferred financing costs		0.1		
Total interest and financing expenses	\$	1.1	\$	\$
Cash paid for interest	\$	0.9	\$	\$

## Contractual Obligations

As of December 31, 2017, our future fixed commitments for cash payments on contractual obligations for each of the next five years and thereafter are as follows:

	Total	2018	2019	2020	2021	2022	2023 and thereafter
	(dollars in thousands)						
Credit facility payable	\$40,750	\$	\$	\$	\$40,750	\$	\$
Notes payable	48,875					\$48,875	
SBA-guaranteed debentures	90,000						\$90,000
	\$179,625	\$	\$	\$	\$40,750	\$48,875	\$90,000

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## **Off-Balance Sheet Arrangements**

We may be a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financial needs of our portfolio companies. As of December 31, 2017, our only off-balance sheet arrangements consisted of \$8.7 million of unfunded commitments to provide debt financing to four of our portfolio companies. As of December 31, 2016, our only off-balance sheet arrangements consisted of a \$1.9 million unfunded commitments to provide debt financing to two of our portfolio companies.

## **Regulated Investment Company Status and Dividends**

We have elected to be treated as a RIC under Subchapter M of the Code. So long as we maintain our status as a RIC, we will not be taxed on our investment company taxable income or realized net capital gains, to the extent that such taxable income or gains are distributed, or deemed to be distributed, to stockholders as dividends on a timely basis.

Taxable income generally differs from net income for financial reporting purposes due to temporary and permanent differences in the recognition of income and expenses, and generally excludes net unrealized appreciation or depreciation until realized. Dividends declared and paid by us in a year may differ from taxable income for that year as such dividends may include the distribution of current year taxable income or the distribution of prior year taxable income carried forward into and distributed in the current year. Distributions also may include returns of capital.

To qualify for RIC tax treatment, we must, among other things, distribute, with respect to each taxable year, at least 90% of our investment company net taxable income (i.e., our net ordinary income and our realized net short-term capital gains in excess of realized net long-term capital losses, if any). If we maintain our qualification as a RIC, we must also satisfy certain distribution requirements each calendar year in order to avoid a federal excise tax on our undistributed earnings of a RIC.

We intend to distribute to our stockholders between 90% and 100% of our annual taxable income (which includes our taxable interest and fee income). However, the covenants contained in the Credit Facility may prohibit us from making distributions to our stockholders, and, as a result, could hinder our ability to satisfy the distribution requirement. In addition, we may retain for investment some or all of our net taxable capital gains (i.e., realized net long-term capital gains in excess of realized net short-term capital losses) and treat such amounts as deemed distributions to our stockholders. If we do this, our stockholders will be treated as if they received actual distributions of the capital gains we retained and then reinvested the net after-tax proceeds in our common stock. Our stockholders also may be eligible to claim tax credits (or, in certain circumstances, tax refunds) equal to their allocable share of the tax we paid on the capital gains deemed distributed to them. To the extent our taxable earnings for a fiscal taxable year fall below the total amount of our dividends for that fiscal year, a portion of those dividend distributions may be deemed a return of capital to our stockholders.

We may not be able to achieve operating results that will allow us to make distributions at a specific level or to increase the amount of these distributions from time to time. In addition, we may be limited in our ability to make distributions due to the asset coverage test for borrowings applicable to us as a business development company under the 1940 Act and due to provisions in Credit Facility. We cannot assure stockholders that they will receive any distributions or distributions at a particular level.

In accordance with certain applicable Treasury regulations and guidance published by the Internal Revenue Service, a RIC may treat a distribution of its own stock as fulfilling its RIC distribution requirements if each stockholder may elect to receive his or her entire distribution in either cash or stock of the RIC, subject to a limitation that the aggregate

amount of cash to be distributed to all stockholders must be at least 20% of the aggregate declared distribution. If too many stockholders elect to receive cash, the cash available for distribution must be allocated among the shareholders electing to receive cash must receive a pro rata amount of cash (with the balance of the distribution paid in stock). In no event will any stockholder, electing to receive cash, receive less than the lesser of (a) the portion of the distribution such shareholder has elected to receive in cash or (b) an amount equal to his or her entire distribution time the percentage limitation on cash available for distribution. If these and certain other requirements are met, for U.S. federal income tax purposes, the amount of the dividend paid in stock will be equal to the amount of cash that could have been

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received instead of stock. We have no current intention of paying dividends in shares of our stock in accordance with these Treasury regulations or published guidance.

## **Recent Accounting Pronouncements**

See Note 1 to the financial statements for a description of recent accounting pronouncements, if any, including the expected dates of adoption and the anticipated impact on the financial statements.

## **Critical Accounting Policies**

The preparation of our financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. Changes in the economic environment, financial markets and any other parameters used in determining such estimates could cause actual results to differ. In addition to the discussion below, our significant accounting policies are further described in the notes to the financial statements.

## **Valuation of portfolio investments**

As a business development company, we generally invest in illiquid loans and securities including debt and equity securities of middle-market companies. Under procedures established by our board of directors, we value investments for which market quotations are readily available at such market quotations. We obtain these market values from an independent pricing service or at the mean between the bid and ask prices obtained from at least two brokers or dealers (if available, otherwise by a principal market maker or a primary market dealer). Debt and equity securities that are not publicly traded or whose market prices are not readily available are valued at fair value as determined in good faith by our board of directors. Such determination of fair values may involve subjective judgments and estimates, although we engage independent valuation providers to review the valuation of each portfolio investment that does not have a readily available market quotation at least once each quarter. Investments purchased within 90 days of maturity are valued at cost plus accreted discount, or minus amortized premium, which approximates value. With respect to unquoted securities, our board of directors, together with our independent valuation advisors, values each investment considering, among other measures, discounted cash flow models, comparisons of financial ratios of peer companies that are public and other factors.

When an external event such as a purchase transaction, public offering or subsequent equity sale occurs, our board of directors uses the pricing indicated by the external event to corroborate and/or assist us in our valuation. Because there is not a readily available market for substantially all of the investments in our portfolio, we value most of our portfolio investments at fair value as determined in good faith by our board of directors using a documented valuation policy and a consistently applied valuation process. Due to the inherent uncertainty of determining the fair value of investments that do not have a readily available market value, the fair value of our investments may differ significantly from the values that would have been used had a readily available market value existed for such investments, and the differences could be material.

With respect to investments for which market quotations are not readily available, our board of directors undertakes a multi-step valuation process each quarter, as described below:

Our quarterly valuation process begins with each portfolio company or investment being initially valued by the investment professionals of Stellus Capital Management responsible for the portfolio investment;

Preliminary valuation conclusions are then documented and discussed with our senior management and Stellus Capital Management;

The audit committee of our board of directors then reviews these preliminary valuations;

At least once each quarter, the valuation for each portfolio investment is reviewed by an independent valuation firm; and

The board of directors then discusses valuations and determines the fair value of each investment in our portfolio in good faith, based on the input of Stellus Capital Management, the independent valuation firm and the audit committee.

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### **Revenue recognition**

We record interest income on an accrual basis to the extent that we expect to collect such amounts. For loans and debt securities with contractual PIK interest, which represents contractual interest accrued and added to the loan balance that generally becomes due at maturity, we do not accrue PIK interest if the portfolio company valuation indicates that such PIK interest is not collectible. We will not accrue interest on loans and debt securities if we have reason to doubt our ability to collect such interest. Loan origination fees, original issue discount and market discount or premium are capitalized, and we then accrete or amortize such amounts using the effective interest method as interest income. Upon the prepayment of a loan or debt security, any unamortized loan origination is recorded as interest income. We record prepayment premiums on loans and debt securities as interest income. Dividend income, if any, will be recognized on the ex-dividend date.

We have investments in our portfolio that contain a PIK interest provision. Any PIK interest is added to the principal balance of such investments and is recorded as income, if the portfolio company valuation indicates that such PIK interest is collectible. In order to maintain our status as a RIC, substantially all of this income must be paid out to stockholders in the form of dividends, even if we have not collected any cash.

### **Net realized gains or losses and net change in unrealized appreciation or depreciation**

We measure realized gains or losses by the difference between the net proceeds from the repayment, sale, or other disposition and the amortized cost basis of the investment, without regard to unrealized appreciation or depreciation previously recognized. Net change in unrealized appreciation or depreciation reflects the change in portfolio investment values during the reporting period, including any reversal of previously recorded unrealized appreciation or depreciation, when gains or losses are realized.

### **Unrealized Gains Incentive Fee**

Under GAAP, the Company calculates the unrealized gains incentive fee payable to the Advisor as if the Company had realized all investments at their fair values as of the reporting date. Accordingly, the Company accrues a provisional unrealized gains incentive fee taking into account any unrealized gains or losses. As the provisional incentive fee is subject to the performance of investments until there is a realization event, the amount of provisional unrealized gains incentive fee accrued at a reporting date may vary from the incentive fee that is ultimately realized and the differences could be material.

### **Recent Developments**

#### **Investment Portfolio**

On January 2, 2018, the Company invested \$10.0 million in the second lien term loan of ICD Intermediate HoldCo2, LLC, a financial company which connects corporate treasury departments with money market and short duration bond funds. Additionally, the Company invested \$0.5 million in the equity of the company.

On January 26, 2018, the Company made an additional investment of \$7.1 million in the first lien term loan of BW DME Acquisition LLC, (StateServ Medical, LLC).

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On January 30, 2018, the Company received a dividend of \$1.35 million from MTC Parent, L.P. (Millennium Trust).

On January 31, 2018, the Company invested \$11.0 million in the first lien term loan of Price for Profit, LLC, an advisory services and specialized technology platform services company. We also committed to fund a \$1.5 million revolver. Additionally, the Company invested \$0.8 million in the equity of the company.

On January 31, 2018, the Company made an additional investment of \$3.2 million in the first lien term loan of Energy Labs Inc.

On February 5, 2018, the Company invested \$20.5 million in the first lien term loan of Fast Growing Trees, LLC, an online provider of hybrid trees and plants. We also committed to fund a \$1.0 million revolver. Additionally, the Company invested \$1.0 million in the equity of the company.

On February 6, 2018, the Company made an additional investment of \$8.3 million in the first lien debt of Furniture Factory Holdings, LLC.

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**SBIC Subsidiary**

On January 2, 2018, the Company contributed \$7.5 million to the SBIC Subsidiary, bringing total capital contributions to \$75.0 million.

**Credit Facility**

The outstanding balance under the Credit Facility as of March 2, 2018 was \$83.1 million.

**Dividend Redistribution Investment Program ( DRIP )**

Since December 31, 2017, the Company has issued 7,932 shares through the DRIP.

**Dividend Declared**

On January 11, 2018, the Company's board of directors declared a regular monthly dividend for each of January 2018, February 2018 and March 2018.

Declared	Ex-Dividend Date	Record Date	Payment Date	Amount per Share
1/11/2018	1/30/2018	1/31/2018	2/15/2018	\$ 0.1133
1/11/2018	2/27/2018	2/28/2018	3/15/2018	\$ 0.1133
1/11/2018	3/28/2018	3/29/2018	4/13/2018	\$ 0.1133

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**Quantitative and Qualitative Disclosures About Market Risk**

We are subject to financial market risks, including changes in interest rates. For the years ended December 31, 2017 and 2016, 87% and 77% of the loans in our portfolio bore interest at floating rates, respectively. These floating rate loans typically bear interest in reference to LIBOR, which are indexed to 30-day or 90-day LIBOR rates, subject to an interest rate floor. As of December 31, 2017 and 2016, the weighted average interest rate floor on our floating rate loans was 0.92% and 0.89%, respectively. Assuming that the Statement of Assets and Liabilities as of December 31, 2017 were to remain constant and no actions were taken to alter the existing interest rate sensitivity, a hypothetical 1% increase in LIBOR would increase our interest income approximately \$2.8 million, due to the current floors in place.

A hypothetical decrease in LIBOR would decrease our interest income by \$1.7 million.

Changes in interest rates will also affect our cost of funding. Our interest expense will be affected by changes in the published LIBOR rate in connection with the Credit Facility. At December 31, 2017, based on our applicable levels of our Credit Facility, a 1% increase in interest rates would decrease our net investment income by \$0.3 million.

Although we believe that this measure is indicative of our sensitivity to interest rate changes, it does not adjust for potential changes in credit quality, size and composition of the assets on the balance sheet and other business developments that could affect net increase in net assets resulting from operations, or net income. Accordingly, no assurances can be given that actual results would not differ materially from the potential outcome simulated by this estimate. We may hedge against interest rate fluctuations by using standard hedging instruments such as futures, options and forward contracts subject to the requirements of the 1940 Act. While hedging activities may insulate us against adverse changes in interest rates, they may also limit our ability to participate in the benefits of lower interest rates with respect to our portfolio of investments. For the years ended December 31, 2017 and December 31, 2016, we did not engage in hedging activities.





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## **Report of Independent Registered Public Accounting Firm**

Board of Directors and Shareholders  
Stellus Capital Investment Corporation

### **Opinion on the financial statements**

We have audited the accompanying consolidated statements of assets and liabilities of Stellus Capital Investment Corporation (a Maryland corporation) and subsidiaries (the Company), including the consolidated schedules of investments, as of December 31, 2017 and 2016, the related consolidated statements of operations, changes in net assets, and cash flows for each of the three years in the period ended December 31, 2017, and the related notes, schedule and financial highlights (collectively referred to as the financial statements). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2017 and 2016, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2017, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the Company's internal control over financial reporting as of December 31, 2017, based on criteria established in the 2013 *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 6, 2018 expressed an unqualified opinion.

### **Basis for opinion**

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/ GRANT THORNTON LLP

We have served as the Company's auditor since 2012.

Dallas, Texas  
March 6, 2018

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## FORM OF SOX 404 AUDIT REPORT

**Grant Thornton LLP**  
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### Report of Independent Registered Public Accounting Firm

Board of Directors and Shareholders  
Stellus Capital Investment Corporation

#### Opinion on internal control over financial reporting

We have audited the internal control over financial reporting of Stellus Capital Investment Corporation (a Maryland corporation) and subsidiaries (the Company) as of December 31, 2017, based on criteria established in the 2013 *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2017, based on criteria established in the 2013 *Internal Control - Integrated Framework* issued by COSO.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the consolidated financial statements of the Company as of and for the year ended December 31, 2017, and our report dated March 6, 2018 expressed an unqualified opinion on those financial statements.

#### Basis for opinion

The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

## **Definition and limitations of internal control over financial reporting**

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

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Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ GRANT THORNTON LLP

Dallas, Texas  
March 6, 2018

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**PART I FINANCIAL INFORMATION**  
**STELLUS CAPITAL INVESTMENT CORPORATION**  
**CONSOLIDATED STATEMENTS OF ASSETS AND**  
**LIABILITIES**

	December 31, 2017	December 31, 2016
<b>ASSETS</b>		
Non-Controlled, affiliated investments, at fair value (amortized cost of \$1,052,185 and \$0, respectively)	\$990,000	\$
Non-controlled, non-affiliated investments, at fair value (amortized cost of \$367,401,021 and \$362,217,251, respectively)	370,849,772	365,625,891
Cash and cash equivalents	25,110,718	9,194,129
Receivable for sales and repayments of investments	26,891	
Interest receivable	2,922,204	4,601,742
Accounts receivable		748
Prepaid expenses	361,270	456,219
<b>Total Assets</b>	<b>\$400,260,855</b>	<b>\$379,878,729</b>
<b>LIABILITIES</b>		
Notes payable	\$47,306,488	\$24,565,891
Credit facility payable	39,332,479	115,171,208
SBA-guaranteed debentures	87,818,813	63,342,036
Dividends payable	1,806,671	1,413,982
Base management fees payable	1,621,592	1,608,295
Incentive fees payable	371,647	1,353,271
Interest payable	1,021,173	973,812
Unearned revenue	139,304	19,955
Administrative services payable	327,033	272,511
Deferred tax liability		8,593
Other accrued expenses and liabilities	268,413	267,390
<b>Total Liabilities</b>	<b>\$180,013,613</b>	<b>\$208,996,944</b>
Commitments and contingencies (Note 7)		
<b>Net Assets</b>	<b>\$220,247,242</b>	<b>\$170,881,785</b>
<b>NET ASSETS</b>		
Common Stock, par value \$0.001 per share (200,000,000 and 100,000,000 shares authorized, 15,945,879 and 12,479,959 shares issued and outstanding, respectively)	\$15,946	\$12,480
Paid-in capital	228,066,762	180,994,723
Accumulated net realized loss from investments, net of cumulative dividends of \$4,251,819, and \$1,899,274, respectively	(10,786,240 )	(13,089,671 )
Distributions in excess of net investment income	(435,794 )	(435,794 )
	3,386,568	3,400,047

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Net Unrealized appreciation on investments and cash equivalents, net of provision for taxes of \$0 and \$8,593, respectively.<sup>(1)</sup>

<b>NET ASSETS</b>	\$220,247,242	\$170,881,785
<b>Total Liabilities and Net Assets</b>	\$400,260,855	\$379,878,729
<b>Net Asset Value Per Share</b>	\$13.81	\$13.69

(1) See Note 13 for a discussion of Deferred Taxes.

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# STELLUS CAPITAL INVESTMENT CORPORATION

## CONSOLIDATED STATEMENTS OF OPERATIONS

	For the year ended December 31, 2017	For the year ended December 31, 2016	For the year ended December 31, 2015
<b>INVESTMENT INCOME</b>			
Interest income	\$38,071,449	\$38,176,617	\$34,643,791
Other income	1,576,744	1,313,580	514,768
<b>Total Investment Income</b>	<b>\$39,648,193</b>	<b>\$39,490,197</b>	<b>\$35,158,559</b>
<b>OPERATING EXPENSES</b>			
Management fees	\$6,255,911	\$6,281,863	\$5,841,267
Valuation fees	336,300	397,330	356,971
Administrative services expenses	1,245,727	1,045,648	1,029,368
Incentive fees	2,911,392	4,275,436	3,975,198
Professional fees	1,274,066	712,524	596,357
Directors fees	331,000	324,000	333,000
Insurance expense	429,897	471,427	473,963
Interest expense and other fees	7,855,211	7,992,185	6,177,015
Deferred offering costs		261,761	
Other general and administrative expenses	621,204	415,822	474,625
<b>Total Operating Expenses</b>	<b>\$21,260,708</b>	<b>\$22,177,996</b>	<b>\$19,257,764</b>
Loss on extinguishment of debt	416,725		
Waiver of Incentive Fee			(646,333 )
<b>Total Operating Expenses, net of fee waivers</b>	<b>\$21,677,433</b>	<b>\$22,177,996</b>	<b>\$18,611,431</b>
<b>Net Investment Income</b>	<b>\$17,970,760</b>	<b>\$17,312,201</b>	<b>\$16,547,128</b>
<b>Net Realized Gain on Investments and Cash Equivalents</b>	<b>\$4,655,976</b>	<b>\$(13,089,671)</b>	<b>\$421,726</b>
<b>Net Change in Unrealized Appreciation (Depreciation) on Investments and Cash Equivalents</b>	<b>\$(22,072 )</b>	<b>\$18,603,401</b>	<b>\$(9,204,717 )</b>
<b>Benefit (provision) for taxes on unrealized gain on investments</b>	<b>\$8,593</b>	<b>\$373,131</b>	<b>\$(93,601 )</b>
<b>Net Increase in Net Assets Resulting from Operations</b>	<b>\$22,613,257</b>	<b>\$23,199,062</b>	<b>\$7,670,536</b>
<b>Net Investment Income Per Share</b>	<b>\$1.21</b>	<b>\$1.39</b>	<b>\$1.33</b>
<b>Net Increase in Net Assets Resulting from Operations Per Share</b>	<b>\$1.52</b>	<b>\$1.86</b>	<b>\$0.61</b>
<b>Weighted Average Shares of Common Stock Outstanding</b>	<b>14,870,981</b>	<b>12,479,959</b>	<b>12,479,961</b>
<b>Distributions Per Share</b>	<b>\$1.36</b>	<b>\$1.36</b>	<b>\$1.36</b>

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# STELLUS CAPITAL INVESTMENT CORPORATION

## CONSOLIDATED STATEMENTS OF CHANGES IN NET ASSETS

	For the year ended December 31, 2017	For the year ended December 31, 2016	For the year ended December 31, 2015
<b>Increase in Net Assets Resulting from Operations</b>			
Net investment income	\$17,970,760	\$17,312,201	\$16,547,128
Net realized gain on investments and cash equivalents	4,655,976	(13,089,671 )	421,726
Net change in unrealized appreciation on investments and cash equivalents	(22,072 )	18,603,401	(9,204,717 )
Benefit (provision) for taxes on unrealized appreciation on investments	8,593	373,131	(93,601 )
<b>Net Increase in Net Assets Resulting from Operations</b>	\$22,613,257	\$23,199,062	\$7,670,536
<b>Stockholder distributions from:</b>			
Net investment income	(17,970,760 )	(16,968,350 )	(16,547,158 )
Net realized capital gains	(2,352,545 )		(421,726 )
<b>Total Distributions</b>	<b>\$(20,323,305 )</b>	<b>\$(16,968,350 )</b>	<b>\$(16,968,884 )</b>
<b>Capital share transactions</b>			
Issuance of common stock	48,741,549		
Partial share redemption	(142 )	(31 )	
Sales load	(1,358,880 )		
Offering costs	(307,022 )		
<b>Net increase in net assets resulting from capital share transactions</b>	<b>\$47,075,505</b>	<b>\$(31 )</b>	<b>\$</b>
<b>Total increase (decrease) in net assets</b>	<b>\$49,365,457</b>	<b>\$6,230,681</b>	<b>\$(9,298,348 )</b>
<b>Net assets at beginning of period</b>	<b>\$170,881,785</b>	<b>\$164,651,104</b>	<b>\$173,949,452</b>
<b>Net assets at end of period (includes \$435,794, \$435,794 and \$779,643 of distributions in excess of net investment income, respectively)</b>	<b>\$220,247,242</b>	<b>\$170,881,785</b>	<b>\$164,651,104</b>

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# STELLUS CAPITAL INVESTMENT CORPORATION

## CONSOLIDATED STATEMENTS OF CASH FLOWS

	For the year ended December 31, 2017	For the year ended December 31, 2016	For the year ended December 31, 2015
<b>Cash flows from operating activities</b>			
Net increase in net assets resulting from operations	\$22,613,257	\$23,199,062	\$7,670,536
Adjustments to reconcile net increase in net assets resulting from operations to net cash used in operating activities:			
Purchases of investments	(172,171,246)	(65,661,034)	(133,661,491)
Proceeds from sales and repayments of investments	172,260,541	55,949,177	93,289,529
Net change in unrealized appreciation (depreciation) on investments	22,072	(18,603,401)	9,204,717
Deferred tax benefit	(8,593 )	(373,130 )	93,601
Increase in investments due to PIK	(499,596 )	(243,766 )	(439,052 )
Amortization of premium and accretion of discount, net	(1,196,566 )	(1,128,511 )	(1,034,240 )
Amortization of loan structure fees	455,893	523,835	472,003
Amortization of deferred financing costs	251,826	326,190	210,064
Loss on extinguishment of debt	416,725		
Amortization of loan fees on SBA-guaranteed debentures	333,027	184,783	204,980
Net realized (gain)/loss on investments	(4,655,976 )	13,089,341	(421,726 )
Deferred offering costs		261,761	
Changes in other assets and liabilities			
Decrease in interest receivable	1,679,538	118,289	362,634
Decrease in receivable for affiliated transaction			
(Increase) decrease in accounts receivable	748	6,936	(6,988 )
(Increase) decrease in prepaid expenses and fees	94,949	19,230	(56,166 )
Increase in management fees payable	13,297	89,516	158,760
Increase (decrease) in incentive fees payable	(981,624 )	745,315	(513,600 )
Increase (decrease) in administrative services payable	54,522	(125,288 )	(193,945 )
Increase in interest payable	47,361	403,623	223,985
Increase (decrease) in unearned revenue	119,349	(16,922 )	(120,526 )
Increase in dividend payable	392,689		
Increase in other accrued expenses and liabilities	1,022	71,714	112,224
Net cash provided by operating activities	\$19,243,216	\$8,836,720	\$(24,444,701 )



TABLE OF CONTENTS**STELLUS CAPITAL INVESTMENT CORPORATION****CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)**

	For the year ended December 31, 2017	For the year ended December 31, 2016	For the year ended December 31, 2015
<b>Cash flows from financing activities</b>			
Proceeds from notes issued	48,875,000		
Proceeds from SBA-guaranteed debentures	25,000,000		47,567,813
Financing costs paid on notes issued	(1,688,961 )		
Financing costs paid on Credit Facility	(1,158,616 )	(50,000 )	
Financing costs paid on SBA-guaranteed debentures	(856,250 )		(325,000 )
Proceeds from the issuance of common stock	48,741,549		
Sales load for common stock issued	(1,358,880 )		
Offering costs paid for common stock issued	(307,022 )		
Stockholder distributions paid	(20,323,305 )	(16,968,350 )	(16,968,885 )
Borrowings under credit facility	194,250,000	56,500,000	105,000,000
Repayments of credit facility	(269,500,000)	(50,000,000)	(102,000,000)
Repayments of Notes issued	(25,000,000 )		
Partial Share Redemption	(142 )	(31 )	
Net cash provided by (used in) financing activities	\$(3,326,627 )	\$(10,518,381 )	\$33,273,928
Net increase (decrease) in cash and cash equivalents	15,916,589	(1,681,661 )	8,829,227
Cash and cash equivalents balance at beginning of period	9,194,129	10,875,790	2,046,563
Cash and cash equivalents balance at end of period	\$25,110,718	\$9,194,129	\$10,875,790
<b>Non-cash operating activities</b>			
Conversion from debt to equity	\$864,101	\$	\$
Non-cash purchase of investment through repayment of investment	\$	\$	\$4,251,032
<b>Supplemental financing activities</b>			
Excise tax paid	\$37,648	\$	\$
Fees paid on SBA-guaranteed debentures through proceeds	\$856,250	\$	\$1,182,187
Cash paid for interest expense	\$6,762,104	\$6,548,754	\$5,010,984

TABLE OF CONTENTS**Stellus Capital Investment Corporation****Consolidated Schedule of Investments  
December 31, 2017**

Footnotes	Security	Coupon	LIBOR floor	Cash	PIKMaturity	Headquarters/ Industry	Principal Amount/ Shares	Amortized Cost	Fair Value
(2)						Houston, TX			
(4)	Equity					Energy: Oil & Gas	1,000 shares	\$1,052,185	\$990,000
								1,052,185	990,000
(2)						Deer Park, TX			
(2)(12)	Second Lien	L+10.50%	1.00%	12.20%	3/5/2020	Chemicals, Plastics, & Rubber	\$5,325,237	5,272,397	5,220,000
(4)	Equity						375,000 units	375,000	180,000
								5,647,397	5,400,000
						Amsterdam, OH			
(4)	Equity					Environmental Industries	766 shares	766	579,000
(4)	Equity						766 shares	765,676	579,000

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								766,442	580,000
						Atlanta, GA			
(4)	Equity					Services: Business	254,250 units	254,250	820,000
(4)	Equity						750,000 units	750,000	2,410,000
								1,004,250	3,230,000
(7)						Chicago, IL			
(2)(12)	First Lien	L+6.25%	1.00%	7.94%	6/29/2022	Healthcare & Pharmaceuticals	\$6,879,167	6,816,044	6,870,000
(2)(4)	Equity						73,529 shares	500,000	620,000
								7,316,044	7,490,000
(2)(12)	Second Lien	L+10.00%	1.00%	11.70%	9/27/2022	Austin TX Insurance	\$5,000,000	4,910,226	5,000,000
(4)	Equity						500,000 units	500,000	500,000
								5,410,226	5,500,000
(8)						Hauppauge, NY			
(4)	Unsecured					Services: Consumer	\$400,000	400,000	380,000
(2)(12)(13)	First Lien	L+6.00%	1.00%	9.43%	8/24/2022	Tempe, AZ Healthcare & Pharmaceuticals	\$9,550,000	9,281,016	9,310,000
(4)	Equity						1,000,000 shares	1,000,000	1,110,000
								10,281,016	10,420,000

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**Stellus Capital Investment Corporation**

**Consolidated Schedule of Investments (continued)  
December 31, 2017**

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**Stellus Capital Investment Corporation**

**Consolidated Schedule of Investments (continued)  
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**Stellus Capital Investment Corporation**

**Consolidated Schedule of Investments (continued)  
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**Stellus Capital Investment Corporation**

**Consolidated Schedule of Investments (continued)  
December 31, 2017**

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## Stellus Capital Investment Corporation

### Consolidated Schedule of Investments (continued) December 31, 2017

- (1) See Note 1 of the Notes to the Consolidated Financial Statements for a discussion of the methodologies used to value securities in the portfolio.
- Investments held by the SBIC Subsidiary, which include \$5,258,500 of cash and \$155,769,170 of investments (at par) are excluded from the obligations to the lenders of the Credit Facility. The Company's obligations to the
- (2) lenders of the Credit Facility, as defined in Note 9, are secured by a first priority security interest in all investments and cash and cash equivalents, except for investments held by the SBIC Subsidiary.
- (3) These loans have LIBOR or Euro Floors that are higher than the current applicable LIBOR or Euro rates; therefore, the floors are in effect.
- (4) Security is non-income producing.
- The investment is not a qualifying asset under the Investment Company Act of 1940, as amended. The Company may not acquire any non-qualifying assets unless, at the time of the acquisition, qualifying assets represent at least
- (5) 70% of the Company's total assets. Qualifying assets represent approximately 86% of the Company's total assets as of December 31, 2017.
- (6) Represents a PIK security. At the option of the issuer, interest can be paid in cash or cash and PIK. The percentage of PIK shown is the maximum PIK that can be elected by the issuer.
- Excluded from the investment is an undrawn revolver commitment in an amount not to exceed \$666,666, with an
- (7) interest rate of LIBOR plus 6.25% and a maturity of June 29, 2022. This investment is accruing an unused commitment fee of 0.50% per annum.
- In the fourth quarter of 2016, Binder & Binder National Social Security Disability, emerged from Chapter 11 Bankruptcy in the U.S. Bankruptcy Court, Southern District of New York. The investment's fair value has been
- (8) adjusted to reflect the court-approved unsecured claim distribution proceeds that have been awarded to the Company. As of this time, the Company does not expect to receive any additional repayment other than the court awarded amount.
- Excluded from the investment is an undrawn revolver commitment in an amount not to exceed \$1,750,000, with an
- (9) interest rate of LIBOR plus 6.50% and a maturity of December 22, 2022. This investment is accruing an unused commitment fee of 0.50% per annum.

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## Stellus Capital Investment Corporation

### Consolidated Schedule of Investments (continued) December 31, 2017

Excluded from the investment is an undrawn commitment in an amount not to exceed \$520,000, with an interest (10) rate of LIBOR plus 8.00% and a maturity of September 30, 2018. This investment is accruing an unused commitment fee of 0.50% per annum.

(11) Interest compounds annually on this loan at a rate of 11%. The interest does not increase the principal balance.

(12) These loans have LIBOR floors that are lower than the applicable LIBOR rates; therefore, the floors are not in effect.

(13) These loans are last-out term loans with contractual rates higher than the applicable LIBOR rates; therefore, the floors are not in effect.

Excluded from the investment is an undrawn commitment in an amount not to exceed \$5,750,000, with an interest (14) rate of LIBOR plus 7.62% and a maturity of July 26, 2022. This investment is accruing an unused commitment fee of 0.50% per annum.

(15) Investment has been on non-accrual since November 1, 2017.

**Abbreviation Legend**

PIK Payment-In-Kind

L LIBOR

Euro Euro Dollar

TABLE OF CONTENTS**Stellus Capital Investment Corporation****Consolidated Schedule of Investments  
December 31, 2016**

Footnotes	Security	Coupon	LIBOR floor	Cash	PIK	Maturity	Headquarters/ Industry	Principal Amount/ Shares	Amortized Cost	Fa V
(2)							Deer Park, TX			
(2)(3)	Second Lien	L+10.50%	1.00%	11.50%		3/5/2020	Chemicals, Plastics, & Rubber	\$5,325,237	\$5,252,426	\$
(4)	Equity							375,000 units	375,000	3
									5,627,426	5
							Amsterdam, OH			
(4)	Equity						Environmental Industries	517 shares	517	5
(4)	Equity							517 shares	517,439	5
									517,956	5
							Denver, CO			
(3)	Second Lien	L+8.50%	1.25 %	9.75 %		4/3/2019	Beverage, Food, & Tobacco	\$8,000,000	7,928,373	8
							Hauppauge, NY			
(4)(14)	Unsecured						Services: Consumer	\$1,000,000	1,000,000	7
							Rochester, NY			
(3)	Second Lien	L+9.50%	1.00 %	10.50 %		6/5/2019	Telecommunications	\$7,500,000	7,422,928	7
(4)	Equity							8,932 units	525,000	1

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										7,947,928	
								Murrysville, PA			
(12)	First Lien	L+8.50%	0.50	%	9.03	%	12/31/2020	Automotive	\$101,911	100,207	
(2)(12)	First Lien	L+8.50%	0.50	%	9.03	%	12/31/2020		\$7,949,027	7,785,147	
(4)	Equity								149,828 shares	149,828	
										8,035,182	
								Camden, NJ			
(13)	First Lien	L+6.50%	1.00	%	8.99	%	7/16/2020	Education	\$12,500,000	12,404,725	
								New York, NY			
(5)	Unsecured	12.00	%		12.00	%	5/31/2018	Finance	\$12,500,000	12,401,505	
(5)	Unsecured	12.00	%		12.00	%	5/31/2018		\$2,000,000	1,980,173	
(5)	Unsecured	12.00	%		12.00	%	5/31/2018		\$5,000,000	4,960,146	
(4)(5)	Equity								38,893 units	557,143	
										19,898,967	
								Arlington, TX			
(2)(13)	First Lien	L+6.00%	1.00	%	9.40	%	11/10/2020	Consumer goods: non-durable	\$8,750,000	8,626,143	
								Liberty, MO			
(2)(12)	Second Lien	L+10.50%	0.50	%	11.50	%	12/31/2020	Chemicals, Plastics, & Rubber	\$9,000,000	8,876,203	
(4)	Equity								250 shares	250,000	
										9,126,203	

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**Stellus Capital Investment Corporation**

**Consolidated Schedule of Investments (continued)  
December 31, 2016**

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**Stellus Capital Investment Corporation**

**Consolidated Schedule of Investments (continued)  
December 31, 2016**

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**Stellus Capital Investment Corporation**

**Consolidated Schedule of Investments (continued)  
December 31, 2016**

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**Stellus Capital Investment Corporation**

**Consolidated Schedule of Investments (continued)  
December 31, 2016**

(1) See Note 1 of the Notes to Consolidated Financial Statements for a discussion of the methodologies used to value securities in the portfolio.

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## Stellus Capital Investment Corporation

### Consolidated Schedule of Investments (continued) December 31, 2016

The Company's obligations to the lenders of the Credit Facility are secured by a first priority security interest in all non-controlled nonaffiliated investments and cash and cash equivalents, but exclude \$3,457,351 of cash and cash equivalents and \$100,252,693 of investments (at par) that are held by Stellus Capital SBIC LP. See Note 1 of the Notes to the Consolidated Financial Statements for discussion.

(2) These loans have LIBOR or Euro Floors which are higher than the current applicable LIBOR or Euro rates; therefore, the floors are in effect.

(3) (4) Security is non-income producing.

The investment is not a qualifying asset under the Investment Company Act of 1940, as amended. The Company may not acquire any non-qualifying assets unless, at the time of the acquisition, qualifying assets represent at least 70% of the Company's total assets. Qualifying assets represent approximately 85% of the Company's total assets.

(5) Represents a payment-in-kind security. At the option of the issuer, interest can be paid in cash or cash and PIK.

(6) The percentage of PIK shown is the maximum PIK that can be elected by the issuer.

(7) Investment has been on non-accrual since December 1, 2016.

(8) Investment is in payment default.

Excluded from the investment is an undrawn revolver commitment in an amount not to exceed \$875,000, with an interest rate of LIBOR plus 9.00% and a maturity of October 22, 2019. This investment is accruing an unused commitment fee of 0.50% per annum.

(9) Excluded from the investment is an undrawn commitment in an amount not to exceed \$1,000,000, with an interest rate of LIBOR plus 8.00% and a maturity of September 30, 2018. This investment is accruing an unused commitment fee of 0.50% per annum.

(10) Variable rate loans bear interest at a rate that may be determined by reference to either LIBOR (which can include one-, two-, three- or six month LIBOR) or an alternate base rate (which can include the Federal Funds Effective Rate or the Prime Rate), at the borrower's option, which rates reset periodically based on the terms of the loan agreement.

(11) These loans have LIBOR floors which are lower than the applicable LIBOR rates; therefore, the floors are not in effect.

(12) These loans are last-out term loans with contractual rates higher than the applicable LIBOR rates; therefore, the floors are not in effect.

(13) In the fourth quarter of 2016 Binder, emerged from Chapter 11 Bankruptcy in the U.S. Bankruptcy Court, Southern District of New York. The investment's cost has been adjusted to reflect the court-approved unsecured claim distribution proceeds that have been awarded to the Company. As of this time we do not expect to receive any additional repayment other than what the court has awarded.

(14) Interest compounds annually on this loan at a rate of 11%. The interest does not increase the principal balance.

#### Abbreviation Legend

PIK Payment-In-Kind

L LIBOR

Euro Euro Dollar



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# STELLUS CAPITAL INVESTMENT CORPORATION

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017

### NOTE 1 NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES

#### Nature of Operations

Stellus Capital Investment Corporation ( we , us , our and the Company ) was formed as a Maryland corporation on March 18, 2012 ( Inception ) and is an externally managed, closed-end, non-diversified investment management company. The Company is applying the guidance of Accounting Standards Codification ( ASC ) Topic 946, Financial Services Investment Companies. The Company has elected to be regulated as a business development company under the Investment Company Act of 1940, as amended (the 1940 Act ) and treated as a regulated investment company ( RIC ) under Subchapter M of the Internal Revenue Code of 1986, as amended (the Code ) for U.S. federal income tax purposes. The Company s investment activities are managed by our investment adviser Stellus Capital Management, LLC ( Stellus Capital or the Advisor ).

As of December 31, 2017 the Company has issued a total of 15,945,879 shares and raised \$235,649,244 in gross proceeds since inception, incurring \$7,566,536 in offering expenses and sales load fees for net proceeds from offerings of \$228,082,708. The Company s shares are currently listed on the New York Stock Exchange under the symbol SCM . See Note 4 for further details.

The Company has established wholly owned subsidiaries: SCIC Consolidated Blocker 1, Inc., SCIC CC Blocker 1, Inc., SCIC ERC Blocker 1, Inc., SCIC SKP Blocker 1, Inc. and SCIC APE Blocker 1, Inc., and SCIC Hollander Blocker 1, Inc., which are structured as Delaware entities, to hold equity or equity-like investments in portfolio companies organized as limited liability companies, or LLCs (or other forms of pass-through entities) (collectively, the Taxable Subsidiaries ). The Taxable Subsidiaries are consolidated for U.S. generally accepted accounting principles ( U.S GAAP ) reporting purposes, and the portfolio investments held by them are included in the consolidated financial statements.

On June 14, 2013, we formed Stellus Capital SBIC LP (the SBIC subsidiary ), a Delaware limited partnership, and its general partner, Stellus Capital SBIC GP, LLC., a Delaware limited liability company, as wholly owned subsidiaries of the Company. On June 20, 2014, the SBIC subsidiary received a license from the Small Business Administration ( SBA ) to operate as a Small Business Investment Company ( SBIC ) under Section 301(c) of the Small Business Investment Company Act of 1958. The SBIC subsidiary is consolidated for U.S. GAAP reporting purposes, and the portfolio investments held by it are included in the consolidated financial statements.

The SBIC license allows the SBIC subsidiary to obtain leverage by issuing SBA-guaranteed debentures, subject to the issuance of a capital commitment by the SBA and other customary procedures. SBA-guaranteed debentures are

non-recourse, interest only debentures with interest payable semi-annually and have a ten year maturity. The principal amount of SBA-guaranteed debentures is not required to be paid prior to maturity but may be prepaid at any time without penalty. The interest rate of SBA-guaranteed debentures is fixed on a semi-annual basis at a market-driven spread over U.S. Treasury Notes with 10-year maturities. The SBA, as a creditor, will have a superior claim to the SBIC's assets over the Company's stockholders in the event the Company liquidates the SBIC subsidiary or the SBA exercises its remedies under the SBA-guaranteed debentures issued by the SBIC subsidiary upon an event of default.

See footnote (2) of the Consolidated Schedule of Investments. SBA regulations currently limit the amount that an SBIC may borrow to a maximum of \$150 million when it has at least \$75 million in regulatory capital, as such term is defined by the SBA, receives a capital commitment from the SBA and has been through an examination by the SBA subsequent to licensing. As of December 31, 2017, the SBIC subsidiary had \$67.5 million of regulatory capital, as such term is defined by the SBA, and has received commitments from the SBA of \$90.0 million. As December 31, 2017 and December 31, 2016, the SBIC subsidiary had \$90.0 million and \$65.0 million of SBA-guaranteed debentures outstanding, respectively.

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# STELLUS CAPITAL INVESTMENT CORPORATION

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017

### NOTE 1 NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES (continued)

The Company's investment objective is to maximize the total return to its stockholders in the form of current income and capital appreciation through debt and related equity investments in middle-market companies. The Company seeks to achieve its investment objective by originating and investing primarily in private U.S. middle-market companies (typically those with \$5.0 million to \$50.0 million of EBITDA (earnings before interest, taxes, depreciation and amortization)) through first lien, second lien, unitranche and mezzanine debt financing, with corresponding equity co-investments. It sources investments primarily through the extensive network of relationships that the principals of Stellus Capital have developed with financial sponsor firms, financial institutions, middle-market companies, management teams and other professional intermediaries.

### Summary of Significant Accounting Policies

#### **Basis of Presentation**

The accompanying consolidated financial statements have been prepared on the accrual basis of accounting in conformity with accounting principles generally accepted in the United States of America ( GAAP ) and pursuant to the requirements for reporting on Form 10-K and Article 10 of regulation S-X.

In the opinion of management, the consolidated financial results included herein contain all adjustments, consisting solely of normal recurring accruals, considered necessary for the fair presentation of financial statements for the periods included herein. Certain reclassifications have been made to certain prior period balances to conform with current presentation.

In accordance with Regulation S-X under the Securities Act of 1933 and Securities Exchange Act of 1934, the Company does not consolidate portfolio company investments.

The accounting records of the Company are maintained in U.S. dollars.

#### **Portfolio Investment Classification**

The Company classifies its portfolio investments with the requirements of the 1940 Act, (a) Control Investments are defined as investments in which the Company owns more than 25% of the voting securities or has rights to maintain greater than 50% of the board representation, (b) Affiliate Investments are defined as investments in which the



Company owns between 5% and 25% of the voting securities and does not have rights to maintain greater than 50% of the board representation, and (c) Non-controlled, non-affiliate investments are defined as investments that are neither Control Investments or Affiliate Investments.

## Cash and Cash Equivalents

At December 31, 2017, cash balances held at two separate institutions totaling \$4,058,467 and \$927,976 exceeded FDIC insurance protection levels of \$250,000 by \$3,808,467 and \$677,976, subjecting the Company to risk related to the uninsured balance. In addition, at December 31, 2017, the Company held \$20,124,275 in cash equivalents which are carried at cost, which approximates fair value. All of the Company's cash and cash equivalents are held at large established high credit quality financial institutions and management believes that risk of loss associated with any uninsured balances is remote.

Cash consists of bank demand deposits. We deem certain U.S. Treasury Bills and other high-quality, short-term debt securities as cash equivalents. At the end of each fiscal quarter, we may take proactive steps to ensure we are in compliance with the RIC diversification requirements under Subchapter M of the Internal Revenue Code, which are dependent upon the composition of our total assets at quarter end. We may accomplish this in several ways, including purchasing U.S. Treasury Bills and closing out positions after quarter-end or temporarily drawing down on the Credit Facility (see footnote 9). On December 31, 2017 and December 31, 2016, we held no U.S. Treasury Bills.

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# STELLUS CAPITAL INVESTMENT CORPORATION

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017

### NOTE 1 NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES (continued)

#### Fair Value Measurements

We account for substantially all of our financial instruments at fair value in accordance with ASC Topic 820 Fair Value Measurements and Disclosures ( ASC Topic 820 ). ASC Topic 820 defines fair value, establishes a framework used to measure fair value, and requires disclosures for fair value measurements, including the categorization of financial instruments into a three-level hierarchy based on the transparency of valuation inputs. ASC Topic 820 requires disclosure of the fair value of financial instruments for which it is practical to estimate such value. We believe that the carrying amounts of our financial instruments such as cash, receivables and payables approximate the fair value of these items due to the short maturity of these instruments. This is considered a Level 1 valuation technique. The carrying values of our Credit Facility and SBIC debentures approximate fair value because the interest rates adjusts to the market interest rates (Level 3 input). The carrying value of our Notes is based on the closing price of the security (level 2 input). See Note 6 to the consolidated financial statements for further discussion regarding the fair value measurements and hierarchy.

#### Consolidation

As permitted under Securities and Exchange Commission ( SEC ) Regulation S-X and ASC Topic 946, we generally do not consolidate our investment in a portfolio company other than an investment company subsidiary. Accordingly, we consolidated the results of the SBIC subsidiary and the Taxable Subsidiaries. All intercompany balances have been eliminated upon consolidation.

#### Use of Estimates

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

#### Deferred Financing Costs

Deferred financing costs, prepaid loan fees on SBA-guaranteed debentures and prepaid loan structure fees consist of fees and expenses paid in connection with the closing of our Credit Facility, notes and SBA-guaranteed debentures

and are capitalized at the time of payment. These costs are amortized using the straight line method over the term of the respective instrument.

### **Offering Costs**

Offering costs consist of fees and expenses incurred in connection with the offer and sale of the Company's common stock and bonds, including legal, accounting, printing fees and other related expenses, as well as costs incurred in connection with the filing of a shelf registration statement. These costs are capitalized when incurred and recognized as a reduction of offering proceeds when the offering is consummated. During the second quarter ended June 30, 2016, the Company determined that it was no longer likely to issue shares under its current shelf registration statement, as a result, the Company expense \$261,761 of previously capitalized deferred offering costs for the year ended December 31, 2016. The Company incurred \$307,022 in connection with the offering of our common stock in a public offering in April 2017 (the April Offering) and the At-the-Market (ATM) offering program that began in August 2017 (the ATM Program). These costs are shown on the Consolidated Statement of Changes in Net Assets and Liabilities as a reduction to Paid-in Capital as of December 31, 2017. See Note 4 for further discussion.

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# STELLUS CAPITAL INVESTMENT CORPORATION

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017

### NOTE 1 NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES (continued)

#### Investments

As a business development company ( BDC ), the Company will generally invest in illiquid loans and securities including debt and equity securities of middle-market companies. Under procedures established by the board of directors, the Company intends to value investments for which market quotations are readily available at such market quotations. The Company will obtain these market values from an independent pricing service or at the median between the bid and ask prices obtained from at least two brokers or dealers (if available, otherwise by a principal market maker or a primary market dealer). Debt and equity securities that are not publicly traded or whose market prices are not readily available will be valued at fair value as determined in good faith by our board of directors. Such determination of fair values may involve subjective judgments and estimates. The Company also engages independent valuation providers to review the valuation of each portfolio investment that does not have a readily available market quotation at least twice annually.

Investments purchased within 90 days of maturity will be valued at cost plus accreted discount, or minus amortized premium, which approximates value. With respect to unquoted securities, our board of directors, together with our independent valuation advisors, will value each investment considering, among other measures, discounted cash flow models, comparisons of financial ratios of peer companies that are public and other factors. When an external event such as a purchase transaction, public offering or subsequent equity sale occurs, the board will use the pricing indicated by the external event to corroborate and/or assist us in our valuation. Because the Company expects that there will not be a readily available market for many of the investments in our portfolio, the Company expects to value most of our portfolio investments at fair value as determined in good faith by the board of directors using a documented valuation policy and a consistently applied valuation process. Due to the inherent uncertainty of determining the fair value of investments that do not have a readily available market value, the fair value of our investments may differ significantly from the values that would have been used had a readily available market value existed for such investments, and the differences could be material.

In following these approaches, the types of factors that will be taken into account in fair value pricing investments will include, as relevant, but not be limited to:

- 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 and the markets in which it does business;  
comparisons of financial ratios of peer companies that are public;  
comparable merger and acquisition transactions; and  
the principal market and enterprise values.

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**STELLUS CAPITAL INVESTMENT CORPORATION**

**NOTES TO THE CONSOLIDATED FINANCIAL  
STATEMENTS**

**December 31, 2017**

**NOTE 1 NATURE OF OPERATIONS AND SIGNIFICANT  
ACCOUNTING POLICIES (continued)**

**Revenue Recognition**

We record interest income on an accrual basis to the extent such interest is deemed collectible. Payment-in-kind ( PIK ) interest, represents contractual interest accrued and added to the loan balance that generally becomes due at maturity.

We will not accrue any form of interest on loans and debt securities if we have reason to doubt our ability to collect such interest. Loan origination fees, original issue discount and market discount or premium are capitalized, and we then accrete or amortize such amounts using the effective interest method as interest income. Upon the prepayment of a loan or debt security, any unamortized loan origination fee is recorded as interest income. We record prepayment premiums on loans and debt securities as other income. Dividend income, if any, will be recognized on the ex-dividend date.

In order to maintain our status as a RIC, substantially all of this income must be paid out to stockholders in the form of dividends, even if we have not collected any cash.

**Net Realized Gains or Losses and Net Change in Unrealized Appreciation or  
Depreciation**

We measure realized gains or losses by the difference between the net proceeds from the repayment, sale or disposition and the amortized cost basis of the investment, without regard to unrealized appreciation or depreciation previously recognized. Net change in unrealized appreciation or depreciation reflects the change in portfolio investment values during the reporting period, including any reversal of previously recorded unrealized appreciation or depreciation, when gains or losses are realized.

**Investment Transaction Costs**

Costs that are material associated with an investment transaction, including legal expenses, are included in the cost basis of purchases and deducted from the proceeds of sales unless such costs are reimbursed by the borrower.

**Receivables and Payables for Unsettled Securities Transaction**

The Company records all investments on a trade date basis.

## U.S. Federal Income Taxes

The Company has elected to be treated as a RIC under subchapter M of the Internal Revenue Code of 1986, as amended, and to operate in a manner so as to qualify for the tax treatment applicable to RICs. In order to qualify for tax treatment as a RIC, among other things, the Company is required to timely distribute to its stockholders at least 90% of investment company taxable income, as defined by the Code, for each year. So long as the Company maintains its tax treatment as a RIC, it generally will not pay corporate-level U.S. federal income taxes on any ordinary income or capital gains that it distributes at least annually to its stockholders as dividends. Rather, any tax liability related to income earned by the Company represents obligations of the Company's investors and will not be reflected in the financial statements of the Company.

To avoid a 4% U.S. federal excise tax on undistributed earnings, the Company is required to distribute each calendar year the sum of (i) 98% of its ordinary income for such calendar year (ii) 98.2% of its net capital gains for the one-year period ending December 31 (iii) any income recognized, but not distributed, in preceding years and on which the Company paid no federal income tax or the Excise Tax Avoidance Requirement. For this purpose, however, any net ordinary income or capital gain net income retained by us that is subject to corporate income tax for the tax year ending in that calendar year will be considered to have been distributed by year end (or earlier if estimated taxes are paid). The Company, at its discretion, may choose not to distribute all of its taxable income for the calendar year and pay a non-deductible 4% excise tax on this income. If the Company chooses to do so, all other things being equal, this would increase expenses and reduce the amount available to be distributed to stockholders. To the extent that the Company determines

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# STELLUS CAPITAL INVESTMENT CORPORATION

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017

### NOTE 1 NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES (continued)

that it is estimated current year annual taxable income will be in excess of estimated current year dividend distributions from such taxable income, the Company accrues excise taxes on estimated excess taxable income as taxable income is earned. For the years ended December 31, 2017 and December 31, 2016, the Company incurred an excise tax expense of \$42,402 and \$22,663 respectively.

The Company evaluates tax positions taken or expected to be taken in the course of preparing its tax returns to determine whether the tax positions are more-likely-than-not of being sustained by the applicable tax authority. Tax positions deemed to meet a more-likely-than-not threshold would be recorded as a tax provision or expense in the applicable period.

As of December 31, 2017 and December 31, 2016, the Company had not recorded a liability for any uncertain tax positions. Management's evaluation of uncertain tax positions may be subject to review and adjustment at a later date based upon factors including, but not limited to, an on-going analysis of tax laws, regulations and interpretations thereof. The Company's policy is to include interest and penalties related to income taxes, if applicable, in general and administrative expenses. Any such expenses for the year ended December 31, 2017 were de minimis.

On December 22, 2017, the Tax Cuts and Jobs Act legislation was signed into law. The Tax Cuts and Jobs Act includes significant changes to the U.S. corporate tax system, including a reduction in the U.S. corporate income tax rate from 35% to 21%. ASC 740, Income Taxes, requires the effect of changes in tax rates and laws on deferred tax balances to be recognized in the period in which the legislation is enacted. As such, we have incorporated the effect of the change in tax rate, which impacts our Taxable Subsidiaries, as of December 31, 2017.

The Taxable Subsidiaries are direct wholly owned subsidiaries of the Company that have elected to be taxable entities.

The Taxable Subsidiaries permit the Company to hold equity investments in portfolio companies which are pass through entities for tax purposes and continue to comply with the source-of-income requirements contained in RIC tax provisions of the Code. The Taxable Subsidiaries are not consolidated with the Company for income tax purposes and may generate income tax expense, benefit, and the related tax assets and liabilities, as a result of their ownership of certain portfolio investments. The income tax expense, or benefit, if any, and related tax assets and liabilities are reflected in the Company's consolidated financial statements.

The Taxable Subsidiaries use the liability method in accounting for income taxes. Deferred tax assets and liabilities are recorded for temporary differences between the tax basis of assets and liabilities and their reported amounts in the financial statements, using statutory tax rates in effect for the year in which the temporary differences are expected to reverse. A valuation allowance is provided against deferred tax assets when it is more likely than not that some



portion or all of the deferred tax asset will not be realized.

Taxable income generally differs from net income for financial reporting purposes due to temporary and permanent differences in the recognition of income and expenses. Taxable income generally excludes net unrealized appreciation or depreciation, as investment gains or losses are not included in taxable income until they are realized.

For the years ended December 31, 2017, 2016 and 2015, the Company recorded deferred income tax benefit (expense) of \$8,593, \$373,131 and \$(93,601), respectively, related to the Taxable Subsidiaries. In addition, as of December 31, 2017 and December 31, 2016, the Company had a deferred tax liability of \$0 and \$8,593, respectively. See Note 13, Income Taxes, for a schedule of the deferred tax asset and valuation allowance reducing the deferred tax asset and the deferred tax liability.

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# STELLUS CAPITAL INVESTMENT CORPORATION

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017

### NOTE 1 NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES (continued)

#### Earnings per Share

Basic per share calculations are computed utilizing the weighted average number of shares of common stock outstanding for the period. The Company has no common stock equivalents. As a result, there is no difference between diluted earnings per share and basic per share amounts.

#### Paid In Capital

The Company records the proceeds from the sale of its common stock on a net basis to (i) capital stock and (ii) paid in capital in excess of par value, excluding all commissions and marketing support fees.

#### Recently Issued Accounting Standards

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606). The guidance in this ASU supersedes the revenue recognition requirements in Revenue Recognition (Topic 605). Under the new guidance, an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The new guidance will significantly enhance comparability of revenue recognition practices across entities, industries, jurisdictions and capital markets. Additionally, the guidance requires improved disclosures as to the nature, amount, timing and uncertainty of revenue that is recognized. In March 2016, the FASB issued ASU 2016-08, *Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)*, which clarified the implementation guidance on principal versus agent considerations. In April 2016, the FASB issued ASU 2016-10, *Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing*, which clarified the implementation guidance regarding performance obligations and licensing arrangements. In May 2016 the FASB issued ASU No. 2016-12, *Revenue from Contracts with customers (Topic 606) Narrow-Scope Improvements and Practical Expedients*, which clarified guidance on assessing collectability, presenting sales tax, measuring noncash consideration, and certain transition matters. In December 2016, the FASB issued ASU No. 2016-20, *Revenue from Contracts with Customers (Topic 606) Technical Corrections and Improvements*, which provided disclosure relief, and clarified the scope and application of the revenue standard and related cost guidance. The new guidance will be effective for the annual reporting period beginning after December 15, 2017, including interim periods within that reporting period. Note, the guidance exempts interest income from the above guidance, indicating recognition will remain the same. We have completed our analysis on the above guidance and has concluded on the recognition treatment of other income streams such as repayment penalty

fees, origination fees, miscellaneous fees etc. Stellus will continue to recognize origination fees over the life of the loan. Repayment penalty fees will be recognized immediately if a repayment is made and miscellaneous fees such as administration fees will be recognized on the contract renewal date or other discrete point in time per the credit agreement. Per the Topic 606 update, Stellus' timing of its revenue recognition will remain the same for the identified revenue streams as previously reported.

In August 2014, the FASB issued ASU No. 2014-15 Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern. In connection with the preparation of interim and annual reports, the Company's management will evaluate whether conditions or events exist that raise substantial doubt about the entity's ability to continue as a going concern within one year after the date that the financial statements are issued (or within one year after the date the financial statements are available to be issued, when applicable), and, if so, disclose that fact. Additionally, the Company's management must evaluate and disclose whether its plans will alleviate that doubt. The guidance was effective for the Company beginning January 1, 2016. The Company has adopted the guidance as of January 1, 2016 and there is no impact on its consolidated financial statements.

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# STELLUS CAPITAL INVESTMENT CORPORATION

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017

### NOTE 1 NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES (continued)

In November 2015, the FASB issued ASU 2015-17 Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes. ASU 2015-17 requires entities to present deferred tax assets and deferred tax liabilities as noncurrent in a classified balance sheet. It simplifies the current guidance, which required entities to separately present deferred tax assets and liabilities as current or noncurrent in a classified balance sheet. The guidance was effective for the Company January 1, 2017. The Company has adopted the guidance as of January 1, 2017 and there is no material impact on its consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15 Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments. ASU 2016-15 is intended to reduce diversity in practice in how certain transactions are classified in the statement of cash flows. The new guidance addresses the classification of various transactions including debt prepayment or debt extinguishment costs, settlement of zero-coupon debt instruments, contingent consideration payments made after a business combination, distributions received from equity method investments, beneficial interests in securitization transactions, and others. The update is effective for annual periods beginning after December 31, 2017, and interim periods within those annual periods. Early adoption is permitted, including adoption in an interim period. The Company early adopted the guidance as of January 1, 2017 and there is no material impact of this new standard on our consolidated financial statements.

From time to time, new accounting pronouncements are issued by the Financial Accounting Standards Board ( FASB ) or other standards setting bodies that are adopted by the Company as of the specified effective date. We believe the impact of the recently issued standards and any that are not yet effective will not have a material impact on our consolidated financial statements upon adoption.

### NOTE 2 RELATED PARTY ARRANGEMENTS

#### Investment Advisory Agreement

The Company entered into an investment advisory agreement with Stellus Capital. Pursuant to this agreement, the Company has agreed to pay to Stellus Capital a base annual fee of 1.75% of gross assets, including assets purchased with borrowed funds or other forms of leverage and excluding cash and cash equivalents, and an annual incentive fee.

For the years ended December 31, 2017, 2016 and 2015, the Company recorded an expense for base management fees of \$6,255,911, \$6,281,863, and \$5,841,267 respectively. As of December 31, 2017 and December 31, 2016,

respectively, \$1,621,592 and \$1,608,295 were payable to Stellus Capital.

The incentive fee has two components, investment income and capital gains, as follows:

### **Investment Income Incentive Fee**

The investment income component ( Investment Income Incentive Fee ) is calculated, and payable, quarterly in arrears based on the Company's pre-incentive fee net investment income for the immediately preceding calendar quarter, subject to a cumulative total return requirement and to deferral of non-cash amounts. The pre-incentive fee net investment income, which is expressed as a rate of return on the value of the Company's net assets attributable to the Company's common stock, for the immediately preceding calendar quarter, will have a 2.0% (which is 8.0% annualized) hurdle rate (also referred to as the Hurdle ). Pre-incentive fee net investment income means interest income, dividend income and any other income accrued during the calendar quarter, minus the Company's operating expenses for the quarter excluding the incentive fee. Pre-incentive fee net investment income includes, in the case of investments with a deferred interest feature (such as original issue discount, debt instruments with PIK interest and zero coupon securities), accrued income that the Company has not yet received in cash. The Advisor receives no incentive fee for any calendar quarter in which the Company's pre-incentive fee net investment income does not exceed the Hurdle. Subject to the cumulative total return requirement described below, the Advisor receives 100% of

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# STELLUS CAPITAL INVESTMENT CORPORATION

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017

### NOTE 2 RELATED PARTY ARRANGEMENTS (continued)

the Company's pre-incentive fee net investment income for any calendar quarter with respect to that portion of the pre-incentive net investment income for such quarter, if any, that exceeds the Hurdle but is less than 2.5% (which is 10.0% annualized) of net assets (also referred to as the Catch-up ) and 20.0% of the Company's pre-incentive fee net investment income for such calendar quarter, if any, greater than 2.5% (10.0% annualized) of net assets.

The foregoing incentive fee is subject to a total return requirement, which provides that no incentive fee in respect of the Company's pre-incentive fee net investment income is payable except to the extent 20.0% of the cumulative net increase in net assets resulting from operations over the then current and 11 preceding calendar quarters exceeds the cumulative incentive fees accrued and/or paid for the 11 preceding quarters. In other words, any Investment Income

Incentive Fee that is payable in a calendar quarter is limited to the lesser of (i) 20% of the amount by which the Company's pre-incentive fee net investment income for such calendar quarter exceeds the 2.0% hurdle, subject to the Catch-up, and (ii) (x) 20% of the cumulative net increase in net assets resulting from operations for the then current and 11 preceding quarters *minus* (y) the cumulative incentive fees accrued and/or paid for the 11 preceding calendar quarters. For the foregoing purpose, the cumulative net increase in net assets resulting from operations is the amount, if positive, of the sum of pre-incentive fee net investment income, realized gains and losses and unrealized appreciation and depreciation of the Company for the then current and 11 preceding calendar quarters. In addition, the Advisor is not paid the portion of such incentive fee that is attributable to deferred interest until the Company actually receives such interest in cash.

For the years ended December 31, 2017, 2016 and 2015, the Company incurred \$2,911,392, \$4,275,436, and \$3,975,198, respectively, of Investment Income Incentive Fees. As of December 31, 2017 and 2016, \$371,647 and \$1,353,271, respectively, of such incentive fees were payable to the Advisor, of which \$175,738 and \$1,162,714, respectively, were currently payable (as explained below). As of December 31, 2017 and December 31, 2016, \$195,909 and \$190,557, respectively, of incentive fees incurred but not paid by the Company were generated from deferred interest (i.e. PIK, certain discount accretion and deferred interest) and are not payable until such amounts are received in cash.

While under no obligation to do so, the Advisor waived incentive fees of \$646,333 for the year ended December 31, 2015 to support an annualized dividend yield of 9.0% based on the \$15.00 price per share of our common stock in the Offering. Such waiver in no way implies that the Advisor will waive incentive fees in any future period. The Advisor did not waive incentive fees during the years ended December 31, 2016 and 2017.

## **Capital Gains Incentive Fee**

The Company also pays the Advisor an incentive fee based on capital gains (the Capital Gains Incentive Fee ). The Capital Gains Incentive Fee is determined and payable in arrears as of the end of each calendar year (or upon termination of the investment management agreement, as of the termination date). The Capital Gains Incentive Fee is equal to 20.0% of the Company s cumulative aggregate realized capital gains from inception through the end of that calendar year, computed net of the cumulative aggregate realized capital losses and cumulative aggregate unrealized capital depreciation through the end of such year. The aggregate amount of any previously paid Capital Gains Incentive Fees is subtracted from such Capital Gains Incentive Fee calculated.

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U.S. GAAP requires that the incentive fee accrual considers the cumulative aggregate realized gains and losses and unrealized capital appreciation or depreciation of investments or other financial instruments in the calculation, as an incentive fee would be payable if such realized gains and losses and unrealized capital appreciation or depreciation were realized, even though such realized gains and losses and unrealized capital appreciation or depreciation is not permitted to be considered in calculating the fee actually payable under the investment management agreement (the Capital Gains Incentive Fee ). There can be no assurance that unrealized appreciation or depreciation will be realized in the future. Accordingly, such fee, as calculated and accrued, would not necessarily be payable under the investment management agreement, and may never be paid based upon the computation of incentive fees in subsequent periods.

For the years ended December 31, 2017, and 2016, the Company incurred no Capital Gains Incentive Fee. As of December 31, 2017 and December 31, 2016, no Capital Gains Incentive Fees were payable to the Advisor.

The following tables summarize the components of the incentive fees discussed above:

	For the year ended December 31, 2017	For the year ended December 31, 2016	For the year ended December 31, 2015
Investment Income Incentive Fee Incurred	\$ 2,911,392	\$ 4,275,436	\$ 3,975,198
Investment Income Incentive Fee Waived			(646,333 )
Net Incentive Fee Expense	\$ 2,911,392	\$ 4,275,436	\$ 3,328,865

	December 31, 2017	December 31, 2016
Investment Income Incentive Fee Currently Payable	\$ 175,738	\$ 1,162,714
Investment Income Incentive Fee Deferred	195,909	190,557
Incentive Fee Payable	\$ 371,647	\$ 1,353,271

**Director Fees**

For the years ended December 31, 2017, 2016 and 2015, the Company recorded an expense relating to director fees of \$331,000, \$324,000, and \$333,000, respectively. As of December 31, 2017 and 2016, the Company owed its independent directors no unpaid director fees.



## Co-Investments

We received exemptive relief from the SEC to co-invest with investment funds managed by Stellus Capital Management where doing so is consistent with our investment strategy as well as applicable law (including the terms and conditions of the exemptive order issued by the SEC). Under the terms of the relief permitting us to co-invest with other funds managed by Stellus Capital Management, a required majority (as defined in Section 57(o) of the 1940 Act) of our independent directors must make certain conclusions in connection with a co-investment transaction, including (1) the terms of the proposed transaction, including the consideration to be paid, are reasonable and fair to us and our stockholders and do not involve overreaching of us or our stockholders on the part of any person concerned and (2) the transaction is consistent with the interests of our stockholders and is consistent with our investment objectives and strategies. We intend to co-invest, subject to the conditions included in the exemptive order we received from the SEC, with a private credit fund managed by Stellus Capital Management that has an investment strategy that is identical to our investment strategy. We believe that such co-investments may afford us additional investment opportunities and an ability to achieve greater diversification.

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# STELLUS CAPITAL INVESTMENT CORPORATION

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017

### NOTE 2 RELATED PARTY ARRANGEMENTS (continued)

#### License Agreement

We have entered into a license agreement with Stellus Capital Management under which Stellus Capital Management has agreed to grant us a non-exclusive, royalty-free license to use the name Stellus Capital. Under this agreement, we have a right to use the Stellus Capital name for so long as Stellus Capital Management or one of its affiliates remains our investment adviser. Other than with respect to this limited license, we have no legal right to the Stellus Capital name. This license agreement will remain in effect for so long as the investment advisory agreement with Stellus Capital Management is in effect.

#### Administration Agreement

The Company entered into an administration agreement with Stellus Capital Management pursuant to which Stellus Capital Management will furnish the Company with office facilities and equipment and will provide the Company with the clerical, bookkeeping, recordkeeping and other administrative services necessary to conduct day-to-day operations. Under this administration agreement, Stellus Capital Management will perform, or oversee the performance of, its required administrative services, which includes, among other things, being responsible for the financial records which it is required to maintain and preparing reports to its stockholders and reports filed with the SEC.

For the years ended December 31, 2017, 2016 and 2015, the Company recorded expenses of \$1,117,011, \$922,531, and \$744,657, respectively, related to the administration agreement. These are included in the Administrative Services expenses line on the Consolidated Statement of Operations. As of December 31, 2017 and December 31, 2016, \$279,141 and \$232,169, respectively, remained payable to Stellus Capital relating to the administration agreement.

#### Indemnification

The investment advisory agreement provides that, absent willful misfeasance, bad faith or gross negligence in the performance of its duties or by reason of the reckless disregard of its duties and obligations under the investment advisory agreement, Stellus Capital Management and its officers, managers, partners, agents, employees, controlling persons and members, and any other person or entity affiliated with it, are entitled to indemnification from the Company for any damages, liabilities, costs and expenses (including reasonable attorneys fees and amounts reasonably paid in settlement) arising from the rendering of Stellus Capital Management's services under the investment advisory agreement or otherwise as our investment adviser.



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Distributions are generally declared by the Company's board of directors each calendar quarter and recognized as distribution liabilities on the ex-dividend date. The Company intends to distribute net realized gains (i.e., net capital gains in excess of net capital losses), if any, at least annually. The stockholder distributions, if any, will be determined by the board of directors. Any distribution to stockholders will be declared out of assets legally available for distribution. The following table reflects the Company's dividends declared and paid or to be paid on its common stock:

Date Declared	Record Date	Payment Date	Per Share
<b>Fiscal 2012</b>			
December 7, 2012	December 21, 2012	December 27, 2012	\$ 0.1812
<b>Fiscal 2013</b>			
March 7, 2013	March 21, 2013	March 28, 2013	\$ 0.3400
June 7, 2013	June 21, 2013	June 28, 2013	\$ 0.3400
August 21, 2013	September 5, 2013	September 27, 2013	\$ 0.3400
November 22, 2013	December 9, 2013	December 23, 2013	\$ 0.3400
<b>Fiscal 2014</b>			
December 27, 2013	January 15, 2014	January 24, 2014	\$ 0.0650
January 20, 2014	January 31, 2014	February 14, 2014	\$ 0.1133
January 20, 2014	February 28, 2014	March 14, 2014	\$ 0.1133
January 20, 2014	March 31, 2014	April 15, 2014	\$ 0.1133
April 17, 2014	April 30, 2014	May 15, 2014	\$ 0.1133
April 17, 2014	May 30, 2014	June 16, 2014	\$ 0.1133
April 17, 2014	June 30, 2014	July 15, 2014	\$ 0.1133
July 7, 2014	July 31, 2014	August 15, 2014	\$ 0.1133
July 7, 2014	August 29, 2014	September 15, 2014	\$ 0.1133
July 7, 2014	September 30, 2014	October 15, 2014	\$ 0.1133
October 15, 2014	October 31, 2014	November 14, 2014	\$ 0.1133
October 15, 2014	November 28, 2014	December 15, 2014	\$ 0.1133
October 15, 2014	December 31, 2014	January 15, 2015	\$ 0.1133
<b>Fiscal 2015</b>			
January 22, 2015	February 2, 2015	February 13, 2015	\$ 0.1133
January 22, 2015	February 27, 2015	March 13, 2015	\$ 0.1133
January 22, 2015	March 31, 2015	April 15, 2015	\$ 0.1133
April 15, 2015	April 30, 2015	May 15, 2015	\$ 0.1133

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April 15, 2015	May 29, 2015	June 15, 2015	\$ 0.1133
April 15, 2015	June 30, 2015	July 15, 2015	\$ 0.1133
July 8, 2015	July 31, 2015	August 14, 2015	\$ 0.1133
July 8, 2015	August 31, 2015	September 15, 2015	\$ 0.1133
July 8, 2015	September 20, 2015	October 15, 2015	\$ 0.1133
October 14, 2015	October 30, 2015	November 13, 2015	\$ 0.1133
October 14, 2015	November 30, 2015	December 15, 2015	\$ 0.1133
October 14, 2015	December 31, 2015	January 15, 2016	\$ 0.1133

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Date Declared	Record Date	Payment Date	Per Share
<b>Fiscal 2016</b>			
January 13, 2016	January 29, 2016	February 15, 2016	\$ 0.1133
January 13, 2016	February 29, 2016	March 15, 2016	\$ 0.1133
January 13, 2016	March 31, 2016	April 15, 2016	\$ 0.1133
April 15, 2016	April 29, 2016	May 13, 2016	\$ 0.1133
April 15, 2016	May 31, 2016	June 15, 2016	\$ 0.1133
April 15, 2016	June 30, 2016	July 15, 2016	\$ 0.1133
July 7, 2016	July 29, 2016	August 15, 2016	\$ 0.1133
July 7, 2016	August 31, 2016	September 15, 2016	\$ 0.1133
July 7, 2016	September 30, 2016	October 14, 2016	\$ 0.1133
October 7, 2016	October 31, 2016	November 15, 2016	\$ 0.1133
October 7, 2016	November 30, 2016	December 15, 2016	\$ 0.1133
October 7, 2016	December 30, 2016	January 13, 2017	\$ 0.1133
<b>Fiscal 2017</b>			
January 13, 2017	January 31, 2017	February 15, 2017	\$ 0.1133
January 13, 2017	February 28, 2017	March 15, 2017	\$ 0.1133
January 13, 2017	March 31, 2017	April 14, 2017	\$ 0.1133
April 14, 2017	April 28, 2017	May 15, 2017	\$ 0.1133
April 14, 2017	May 31, 2017	June 15, 2017	\$ 0.1133
April 14, 2017	June 30, 2017	July 14, 2017	\$ 0.1133
July 7, 2017	July 31, 2017	August 15, 2017	\$ 0.1133
July 7, 2017	August 31, 2017	September 15, 2017	\$ 0.1133
July 7, 2017	September 29, 2017	October 13, 2017	\$ 0.1133
October 12, 2017	October 31, 2017	November 15, 2017	\$ 0.1133
October 12, 2017	November 30, 2017	December 15, 2017	\$ 0.1133
October 12, 2017	December 29, 2017	January 12, 2018	\$ 0.1133
<b>Total</b>			\$ 7.0446

Unless the stockholder elects to receive its distributions in cash, the Company intends to make such distributions in additional shares of the Company common stock under the Company's dividend reinvestment plan. Although distributions paid in the form of additional shares of the Company's common stock will generally be subject to U.S. federal, state and local taxes in the same manner as cash distributions, investors participating in the Company's dividend reinvestment plan will not receive any corresponding cash distributions with which to pay any such applicable taxes. Any distributions reinvested through the issuance of shares through the Company's dividend

reinvestment plan will increase the Company's gross assets on which the base management fee and the incentive fee are determined and paid to Stellus Capital. No new shares were issued in connection with the distributions made during the years ended December 31, 2017 and 2016.

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The table below illustrates the number of common stock shares the Company issued since inception through various equity offerings.

Issuance of Common Stock	Number of Shares	Gross Proceeds <sup>(1)</sup>	Underwriting fees	Offering Expenses	Net Proceeds	Offering Price
<b>Year ended December 31, 2012</b>	12,035,023	\$ 180,522,093	\$4,959,720	\$835,500	\$ 174,726,873	\$ 14.90
<b>Year ended December 31, 2013</b>	63,998	899,964			899,964	\$ 14.06
<b>Year ended December 31, 2014</b>	380,936	5,485,780	75,510	29,904	5,380,366	\$ 14.47
<b>Year ended December 31, 2015</b>						
<b>Year ended December 31, 2016</b>						
<b>Year ended December 31, 2017</b>	3,465,922	48,741,407	1,358,880	307,022	47,075,505	\$ 14.06
<b>Total</b>	15,945,879	\$ 235,649,244	\$ 6,394,110	\$ 1,172,426	\$ 228,082,708	

(1) Net of partial share redemptions. Such share redemptions reduced gross proceeds by 142, 29 and 31 in 2017, 2016, and 2015, respectively.

The Company issued no shares of common stock during the years ended December 31, 2017 and 2016 in connection with the DRIP.

The Company issued 3,162,500 and 303,422 additional shares of common stock during the year ended December 31, 2017 in connection with the April Offering and ATM Program, respectively. Gross proceeds resulting from the April Offering totaled \$44,591,250 and underwriting and other expenses related to the April Offering totaled \$1,530,632.

The average offering price for the April Offering was \$14.10. Gross proceeds resulting from the ATM Program totaled \$4,150,299 and underwriting and other expenses related to the offering totaled \$135,270. The average offering price of shares issued in the ATM Program was \$13.68.

**NOTE 5 NET INCREASE IN NET ASSETS PER COMMON SHARE**

The following information sets forth the computation of net increase in net assets resulting from operations per common share for the years ended December 31, 2017, 2016 and 2015.

For the year ended	For the year ended	For the year ended
December 31,	December 31,	December 31,



	2017	2016	2015
Net increase in net assets resulting from operations	\$ 22,613,257	\$ 23,199,062	\$ 7,670,536
Weighted average common shares	14,870,981	12,479,959	12,479,961
Basic and diluted earnings per common share	\$ 1.52	\$ 1.86	\$ 0.61

## **NOTE 6 PORTFOLIO INVESTMENTS AND FAIR VALUE**

In accordance with the authoritative guidance on fair value measurements and disclosures under GAAP, the Company discloses the fair value of its investments in a hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements).

The guidance establishes three levels of the fair value hierarchy as follows:

- Level 1 Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities;
- Level 2 Quoted prices in markets that are not considered to be active or financial instruments for which significant inputs are observable, either directly or indirectly;

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(continued)**

Level 3 Prices or valuations that require inputs that are both significant to the fair value measurement and unobservable.

The level of an asset or liability within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. However, the determination of what constitutes observable requires significant judgment by management.

The Company considers whether the volume and level of activity for the asset or liability have significantly decreased and identifies transactions that are not orderly in determining fair value. Accordingly, if the Company determines that either the volume and/or level of activity for an asset or liability has significantly decreased (from normal conditions for that asset or liability) or price quotations or observable inputs are not associated with orderly transactions, increased analysis and management judgment will be required to estimate fair value. Valuation techniques such as an income approach might be appropriate to supplement or replace a market approach in those circumstances.

At December 31, 2017, the Company had investments in 48 portfolio companies. The total cost and fair value of the investments were \$368,453,206 and \$371,839,772 respectively. The composition of our investments as of December 31, 2017 is as follows:

	Cost	Fair Value
Senior Secured First Lien <sup>(1)</sup>	\$ 140,915,106	\$ 141,006,923
Senior Secured Second Lien	181,164,730	178,432,850
Unsecured Debt	27,903,141	27,430,000
Equity	18,470,229	24,969,999
Total Investments	\$ 368,453,206	\$ 371,839,772

(1) Includes unitranche investments, which account for 13.2% of our investment portfolio at fair value.

At December 31, 2016, the Company had investments in 45 portfolio companies. The total cost and fair value of the investments were \$362,217,251 and \$365,625,891, respectively. The composition of our investments as of December 31, 2016 is as follows:

	Cost	Fair Value
Senior Secured First Lien <sup>(1)</sup>	\$ 113,264,200	\$ 113,482,205
Senior Secured Second Lien	163,112,172	162,486,388

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Unsecured Debt	70,919,986	70,725,412
Equity	14,920,893	18,931,886
Total Investments	\$ 362,217,251	\$ 365,625,891

(1) Includes unitranche investments, which account for 8.4% of our investment portfolio at fair value.

The Company's investment portfolio may contain loans that are in the form of lines of credit or revolving credit facilities, which require the Company to provide funding when requested by portfolio companies in accordance with the terms of the underlying loan agreements. As of December 31, 2017 and December 31, 2016, the Company had four and two such investments with aggregate unfunded commitments of \$8,686,667 and \$1,875,000, respectively.

The Company maintains sufficient liquidity to fund such unfunded loan commitments should the need arise.

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(continued)**

The fair values of our investments disaggregated into the three levels of the fair value hierarchy based upon the lowest level of significant input used in the valuation as of December 31, 2017 are as follows:

	Quoted Prices in Active Markets for Identical Securities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Senior Secured First Lien	\$	\$	\$ 141,006,923	\$ 141,006,923
Senior Secured Second Lien			178,432,850	178,432,850
Unsecured Debt			27,430,000	27,430,000
Equity			24,969,999	24,969,999
Total Investments	\$	\$	\$ 371,839,772	\$ 371,839,772

The fair values of our investments disaggregated into the three levels of the fair value hierarchy based upon the lowest level of significant input used in the valuation as of December 31, 2016 are as follows:

	Quoted Prices in Active Markets for Identical Securities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Senior Secured First Lien	\$	\$	\$ 113,482,205	\$ 113,482,205
Senior Secured Second Lien		17,965,000	144,521,388	162,486,388
Unsecured Debt			70,725,412	70,725,412
Equity			18,931,886	18,931,886
Total Investments	\$	\$ 17,965,000	\$ 347,660,891	\$ 365,625,891

The aggregate values of Level 3 portfolio investments changed during the year ended December 31, 2017 are as follows:

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	Senior Secured Loans-First Lien	Senior Secured Loans-Second Lien	Unsecured Debt	Equity	Total
Fair value at beginning of period	\$ 113,482,205	\$ 144,521,388	\$ 70,725,412	\$ 18,931,886	\$ 347,660,891
Purchases of investments	85,892,733	73,388,500	6,203,400	6,686,613	172,171,246
Payment-in-kind interest	113,723	319,629	66,244		499,596
Sales and Redemptions	(57,242,106 )	(47,725,650 )	(49,578,812 )	(9,369,308 )	(163,915,876)
Transfer from Term Loan to Equity	(864,101 )			864,101	
Net Realized Losses	(626,949 )			5,367,925	4,740,976
Change in unrealized depreciation included in earnings	(126,190 )	(2,146,961 )	(278,564 )	2,488,782	(62,933 )
Amortization of premium and accretion of discount, net	377,608	525,944	292,320		1,195,872
Transfer from Level 2		9,550,000			9,550,000
Fair value at end of period	\$ 141,006,923	\$ 178,432,850	\$ 27,430,000	\$ 24,969,999	\$ 371,839,772
Change in unrealized depreciation on Level 3 investments still held as of December 31, 2017	\$(498,183 )	\$(1,679,419 )	\$(278,567 )	\$ 3,465,063	\$ 1,008,894

During the year ended December 31, 2017, there was one transfer from Level 2 to Level 3 because the observable inputs were not available in 2017. During the year ended December 31, 2016, there were two transfers from Level 3 to Level 2 as additional broker quotes became available. Transfers are reflected at the value of the securities at the beginning of the period.

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(continued)**

The aggregate values of Level 3 portfolio investments changed during the year ended December 31, 2016 are as follows:

	Senior Secured Loans-First Lien	Senior Secured Loans-Second Lien	Unsecured Debt	Equity	Total
Fair value at beginning of period	\$ 131,908,961	\$ 131,972,581	\$ 72,212,282	\$ 12,923,873	\$ 349,017,697
Purchases of investments	25,009,310	35,664,883	1,354,073	3,632,768	65,661,034
Payment-in-kind interest	112,952	22,874	107,940		243,766
Sales and Redemptions	(44,947,647 )	(9,850,061 )	(122,094 )	(1,019,375 )	(55,939,177 )
Net Realized Losses	(674,702 )		(12,200,353)	(214,286 )	(13,089,341 )
Change in unrealized depreciation included in earnings	1,653,933	2,684,245	9,085,283	3,608,906	17,032,367
Amortization of premium and accretion of discount, net	419,398	392,196	288,281		1,099,875
Transfer to Level 2		(16,365,330 )			(16,365,330 )
Fair value at end of period	\$ 113,482,205	\$ 144,521,388	\$ 70,725,412	\$ 18,931,886	\$ 347,660,891
Change in unrealized depreciation on Level 3 investments still held as of December 31, 2016	\$ 1,399,408	\$ 2,588,122	\$ 9,084,789	\$ 3,686,972	\$ 16,759,291

The following is a summary of geographical concentration of our investment portfolio as of December 31, 2017:

	Cost	Fair Value	% of Total Investments at fair value
Texas	\$ 109,043,496	\$ 108,445,000	29.16 %
New Jersey	34,531,876	34,595,527	9.30 %
New York	28,939,268	29,365,000	7.90 %
Canada	26,315,677	26,440,000	7.11 %
California	25,519,753	25,930,000	6.97 %

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Illinois	24,250,169	25,700,000	6.91	%
Massachusetts	22,534,191	22,247,850	5.98	%
Arizona	13,565,958	13,840,000	3.72	%
North Carolina	12,248,770	12,499,167	3.36	%
Ohio	10,112,627	9,990,000	2.69	%
Tennessee	9,848,614	9,950,000	2.68	%
Missouri	9,152,087	9,530,000	2.56	%
Georgia	5,929,223	8,329,998	2.24	%
Pennsylvania	7,848,470	8,058,746	2.17	%
Arkansas	7,397,881	7,618,484	2.05	%
Minnesota	5,421,770	5,420,000	1.46	%
Puerto Rico	8,827,864	5,080,000	1.37	%
Washington	4,172,743	4,520,000	1.22	%
Alabama	1,206,682	2,880,000	0.77	%
Utah	1,293,782	880,000	0.24	%
Florida	242,304	420,000	0.11	%
Virginia	50,001	100,000	0.03	%
	\$368,453,206	\$371,839,772	100.0	%

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(continued)**

The following is a summary of geographical concentration of our investment portfolio as of December 31, 2016:

	Cost	Fair Value	% of Total Investments at fair value	
Texas	\$ 74,433,626	\$ 73,576,277	20.12	%
New York	42,102,392	41,930,666	11.47	%
Colorado	27,855,053	28,979,651	7.93	%
California	28,298,845	28,606,727	7.81	%
Massachusetts	22,467,254	22,944,663	6.28	%
Georgia	20,626,735	22,469,217	6.15	%
New Jersey	20,710,728	20,804,704	5.69	%
Illinois	17,554,821	17,590,281	4.81	%
Alabama	16,191,841	16,584,379	4.54	%
Missouri	14,096,725	14,441,599	3.95	%
Tennessee	12,310,883	12,045,701	3.29	%
Arkansas	9,912,815	10,102,283	2.76	%
Pennsylvania	8,035,182	8,301,104	2.27	%
Puerto Rico	8,712,537	8,229,054	2.25	%
Florida	7,453,847	7,431,820	2.03	%
Canada	6,765,448	6,692,648	1.83	%
Minnesota	6,362,834	6,374,800	1.74	%
North Carolina	4,920,321	5,000,000	1.37	%
Washington	4,158,696	4,211,990	1.15	%
Virginia	4,029,530	4,060,519	1.11	%
Arizona	3,408,099	3,410,583	0.93	%
Utah	1,291,083	1,311,789	0.36	%
Ohio	517,956	525,436	0.14	%
	\$ 362,217,251	\$ 365,625,891	100.0	%

The following is a summary of industry concentration of our investment portfolio as of December 31, 2017:

Cost	Fair Value
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			% of Total Investments at fair value	
Software	\$ 48,560,675	\$ 48,997,850	13.18	%
Healthcare & Pharmaceuticals	41,192,879	37,829,167	10.17	%
High Tech Industries	36,058,477	35,460,000	9.54	%
Finance	26,500,097	28,330,000	7.62	%
Services: Business	23,386,714	25,749,999	6.93	%
Capital Equipment	24,300,027	24,170,000	6.50	%
Media: Broadcasting & Subscription	21,680,239	23,665,000	6.36	%
Chemicals, Plastics, & Rubber	20,825,458	21,145,000	5.69	%
Services: Consumer	17,862,616	18,070,000	4.86	%
Construction & Building	17,913,413	17,980,000	4.84	%
Education	17,197,396	17,335,526	4.66	%
Consumer Goods: Durable	16,559,947	16,798,484	4.52	%
Consumer goods: non-durable	13,250,000	13,250,000	3.56%	

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(continued)**

	Cost	Fair Value	% of Total Investments at fair value	
Retail	8,288,083	8,280,000	2.23	%
Automotive	7,848,470	8,058,746	2.17	%
Transportation: Cargo	6,785,894	6,840,000	1.84	%
Energy: Oil & Gas	6,766,968	6,700,000	1.80	%
Insurance	5,410,226	5,500,000	1.48	%
Beverage, Food, & Tobacco	3,964,242	3,580,000	0.96	%
Hotel, Gaming, & Leisure	3,284,942	3,420,000	0.92	%
Environmental Industries	766,442	580,000	0.16	%
Services: Government	50,001	100,000	0.03	%
	\$ 368,453,206	\$ 371,839,772	100.0	%

The following is a summary of industry concentration of our investment portfolio as of December 31, 2016:

	Cost	Fair Value	% of Total Investments at fair value	
Finance	\$ 56,663,586	\$ 57,504,930	15.73	%
Software	36,199,915	36,730,618	10.06	%
Media: Broadcasting & Subscription	36,001,876	36,637,803	10.02	%
Healthcare & Pharmaceuticals	35,002,051	35,583,505	9.73	%
Services: Business	24,105,217	25,884,879	7.08	%
Consumer goods: non-durable	20,763,612	21,165,542	5.79	%
Chemicals, Plastics, & Rubber	18,957,486	19,146,954	5.24	%
Retail	18,973,041	19,095,787	5.22	%
Education	17,325,046	17,498,701	4.79	%
Telecommunications	16,403,791	16,009,390	4.38	%
High Tech Industries	16,486,738	15,382,000	4.21	%
Beverage, Food, & Tobacco	12,437,795	12,700,000	3.47	%
Consumer Goods: Durable	11,881,630	11,991,250	3.28	%
Automotive	8,035,182	8,301,104	2.27	%

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Services: Consumer	8,453,847	8,153,879	2.23	%
Transportation: Cargo	6,765,448	6,692,648	1.83	%
Energy: Oil & Gas	7,320,058	6,654,662	1.82	%
Services: Government	4,029,530	4,060,519	1.11	%
Hotel, Gaming, & Leisure	3,408,099	3,410,583	0.93	%
Construction & Building	2,485,347	2,495,701	0.68	%
Environmental Industries	517,956	525,436	0.14	%
	\$ 362,217,251	\$ 365,625,891	100.0	%

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(continued)**

The following provides quantitative information about Level 3 fair value measurements as of December 31, 2017:

Description:	Fair Value	Valuation Technique	Unobservable Inputs	Range (Average) <sup>(1)(3)</sup>
First lien debt	\$ 141,006,923	Income/Market <sup>(2)</sup> approach	HY credit spreads, Risk free rates Market multiples	-3.73% to 5.53% (-0.81%) 0.24% to 1.12% (0.54%) 11x to 13x (12x) <sup>(4)</sup>
Second lien debt	\$ 178,432,850	Income/Market <sup>(2)</sup> approach	HY credit spreads, Risk free rates Market multiples	-2.52% to 4.78% (-0.58%) -0.28% to 1.01% (0.39%) 8x to 8x (8x) <sup>(4)</sup>
Unsecured debt	\$ 27,430,000	Income/Market approach <sup>(2)</sup>	HY credit spreads, Risk free rates Market multiples	-0.67% to 3.93% (0.89%) 0.12% to 1.18% (0.52%) 1x to 14x (13x) <sup>(4)</sup>
Equity investments	\$ 24,969,999	Market approach <sup>(5)</sup>	Underwriting EBITDA Multiple	1x to 15x (9x)
Total Long Term Level 3 Investments	\$ 371,839,772			

(1) Weighted average based on fair value as of December 31, 2017.

(2) Inclusive of but not limited to (a) the market approach which is used to determine sufficient enterprise value, and (b) the income approach which is based on discounting future cash flows using an appropriate market yield.

(3) The Company calculates the price of the loan by discounting future cash flows, which include forecasted future LIBOR rates based on the published forward LIBOR curve at the valuation date, using an appropriate yield calculated as of the valuation date. This yield is calculated based on the loan's yield at the original investment and is adjusted as of the valuation date based on: changes in comparable credit spreads, changes in risk free interest rates

(per swap rates), and changes in credit quality (via an estimated shadow rating). Significant movements in any of these factors would result in a significantly lower or higher fair value measurement. As an example, the Range (Average) for a first lien debt instruments in the table above indicates that the change in the HY spreads between the date a loan closed and the valuation date ranged from -3.73% (-373 basis points) to 5.53% (553 basis points). The average of all changes was -0.81%.

(4) Median of LTM (last twelve months) EBITDA multiples of comparable companies.

The primary significant unobservable input used in the fair value measurement of the Company's equity investments is the EBITDA multiple (the Multiple). Significant increases (decreases) in the Multiple in isolation would result in a significantly higher (lower) fair value measurement. To determine the Multiple for the market (5) approach, the Company considers current market trading and/or transaction multiple, portfolio company performance (financial ratios) relative to public and private peer companies and leverage levels, among other factors. Changes in one or more of these factors can have a similar directional change on other factors in determining the appropriate Multiple to use in the market approach.

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(continued)**

The following provides quantitative information about Level 3 fair value measurements as of December 31, 2016:

Description:	Fair Value	Valuation Technique	Unobservable Inputs	Range (Average) <sup>(1)(3)</sup>
First lien debt	\$ 113,482,205	Income/Market <sup>(2)</sup> approach	HY credit spreads, Risk free rates	-2.01% to 0.69% (-0.66%) -0.21% to 0.83%
Second lien debt	\$ 144,521,388	Income/Market <sup>(2)</sup> approach	Market multiples HY credit spreads, Risk free rates	(0.16%) 7x to 14x (10x) <sup>(4)</sup> -7.34% to 6.67% (0.00%) -0.60% to 0.79%
Unsecured debt	\$ 70,725,412	Income/Market approach <sup>(2)</sup>	Market multiples HY credit spreads, Risk free rates	(0.00%) 5x to 19x (11x) <sup>(4)</sup> -0.91% to 0.03% (-0.36%) -0.36% to 0.95%
Equity investments	\$ 18,931,886	Market approach <sup>(5)</sup>	Market multiples Underwriting EBITDA Multiple	(0.10%) 7x to 13x (10x) <sup>(4)</sup> 1x to 13x (9x)
Total Long Term Level 3 Investments	\$ 347,660,891			

(1) Weighted average based on fair value as of December 31, 2016.

(2) Inclusive of but not limited to (a) the market approach which is used to determine sufficient enterprise value, and (b) the income approach which is based on discounting future cash flows using an appropriate market yield.

(3) The Company calculates the price of the loan by discounting future cash flows, which include forecasted future LIBOR rates based on the published forward LIBOR curve at the valuation date, using an appropriate yield calculated as of the valuation date. This yield is calculated based on the loan's yield at the original investment and is adjusted as of the valuation date based on: changes in comparable credit spreads, changes in risk free interest rates (per swap rates), and changes in credit quality (via an estimated shadow rating). Significant movements in any of

these factors would result in a significantly lower or higher fair value measurement. As an example, the Range (Average) for second lien debt instruments in the table above indicates that the change in the HY spreads between the date a loan closed and the valuation date ranged from -2.01% (201 basis points) to 0.69% (69 basis points). The average of all changes was -0.66%.

(4) Median of LTM (last twelve months) EBITDA multiples of comparable companies.

The primary significant unobservable input used in the fair value measurement of the Company's equity investments is the EBITDA multiple (the Multiple). Significant increases (decreases) in the Multiple in isolation would result in a significantly higher (lower) fair value measurement. To determine the Multiple for the market

(5) approach, the Company considers current market trading and/or transaction multiple, portfolio company performance (financial ratios) relative to public and private peer companies and leverage levels, among other factors. Changes in one or more of these factors can have a similar directional change on other factors in determining the appropriate Multiple to use in the market approach.

## **NOTE 7 COMMITMENTS AND CONTINGENCIES**

The Company is currently not subject to any material legal proceedings, nor, to our knowledge, is any material legal proceeding threatened against us. From time to time, we may be a party to certain legal proceedings in the ordinary course of business, including proceedings relating to the enforcement of our rights under contracts with our portfolio companies. While the outcome of these legal proceedings cannot be predicted with certainty, we do not expect that these proceedings will have a material effect upon our business, financial condition or results of operations.

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As of December 31, 2017, the Company had \$8,686,667 of unfunded commitments to provide debt financing to four existing portfolio companies. As of December 31, 2016 the Company had \$1,875,000 of unfunded commitments to provide debt financing to two existing portfolio companies. The Company maintains sufficient liquidity to fund such unfunded loan commitments should the need arise.

**NOTE 8 FINANCIAL HIGHLIGHTS**

	For the year ended December 31, 2017	For the year ended December 31, 2016	For the year ended December 31, 2015	For the year ended December 31, 2014	For the year ended December 31, 2013
<b>Per Share Data:<sup>(1)</sup></b>					
Net asset value at beginning of year/period	\$13.69	\$13.19	\$13.94	\$14.54	\$14.45
Net investment income	1.21	1.39	1.33	1.34	1.33
Change in unrealized appreciation (depreciation)		1.49	(0.74 )	(0.53 )	0.03
Realized gain (loss)	0.31	(1.05 )	0.03	0.04	0.09
Benefit (Provision) for taxes on unrealized appreciation		0.03	(0.01 )	(0.02 )	
Total from investment operations	1.52	1.86	0.61	0.83	1.45
Sales Load	(0.09 )			(0.01 )	
Offering Costs	(0.02 )				
Stockholder distributions from:					
Net investment income	(1.20 )	(1.36 )	(1.33 )	(1.31 )	(1.36 )
Net realized capital gains	(0.16 )		(0.03 )	(0.12 )	
Other <sup>(3)</sup>	0.07			0.01	
Net asset value at the end of year/period	\$13.81	\$13.69	\$13.19	\$13.94	\$14.54
Per share market value at end of year/period	\$13.14	\$12.06	\$9.64	\$11.78	\$14.95
	20.29 %	42.83 %	(7.76 )%	(13.09 )%	0.42 %



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Total return based on market value<sup>(4)</sup>

Weighted average shares outstanding at the end of period	14,870,981	12,479,959	12,479,961	12,281,178	12,059,293
<b>Ratio/Supplemental Data:</b>					
Net assets at the end of year/period	\$220,247,242	\$170,881,785	\$164,651,104	\$173,949,452	\$175,891,514
Weighted average net assets	\$195,211,550	\$165,189,142	\$173,453,813	\$176,458,141	\$175,398,660
Annualized ratio of gross operating expenses to net assets <sup>(7)(8)</sup>	11.10	% 13.20	% 11.16	% 9.92	% 8.65
Annualized ratio of net operating expenses to net assets <sup>(7)(8)</sup>	11.10	% 13.20	% 10.78	% 9.12	% 7.63
Annualized ratio of interest expense and other fees to net assets <sup>(9)</sup>	4.02	% 4.84	% 3.56	% 3.01	% 1.78
Annualized ratio of net investment income before fee waiver to net assets <sup>(7)</sup>	9.21	% 10.71	% 9.11	% 8.40	% 8.11
Annualized ratio of net investment income to net assets <sup>(7)</sup>	9.21	% 10.71	% 9.49	% 9.19	% 9.13
Portfolio Turnover <sup>(5)</sup>	48	% 16	% 29	% 19	% 41
Notes Payable	48,875,000	25,000,000	25,000,000	25,000,000	110,000,000
Credit Facility Payable	40,750,000	116,000,000	109,500,000	106,500,000	9,000,000
SBA-guaranteed debentures	90,000,000	65,000,000	65,000,000	16,250,000	
Asset Coverage Ratio <sup>(6)</sup>	3.46x	2.21x	2.22x	2.32x	2.48x

(1) Financial highlights are based on weighted average shares outstanding as of year/period ended.

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# STELLUS CAPITAL INVESTMENT CORPORATION

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2017

### NOTE 8 FINANCIAL HIGHLIGHTS (continued)

- (2) The per share impact of the Company's reinvestment of stockholder distributions has an impact to net assets of less than \$0.01 per share during the applicable period.  
Includes the impact of different share amounts as a result of calculating certain per share data based on weighted
- (3) average shares outstanding during the period and certain per share data based on shares outstanding as of the period end.
- (4) Total return on market value is based on the change in market price per share since the end of the prior quarter and includes dividends paid. The total returns are not annualized.
- (5) Calculated as the lesser of purchases or paydowns divided by average portfolio balance and is not annualized.  
Asset coverage ratio is equal to (i) the sum of (a) net assets at the end of the period and (b) total debt outstanding at
- (6) the end of the period, divided by (ii) total debt outstanding at the end of the period. SBA-guaranteed debentures are excluded from the numerator and denominator.  
These ratios include the impact of the benefit (provision) for income taxes related to net unrealized loss (gain) on certain investments of \$8,593, \$373,131, and (\$93,601) for the years ended December 31, 2017, 2016 and 2015 respectively, which are not reflected in net investment income, gross operating expenses or net operating expenses.
- (7) The benefit (provision) for income taxes related to net realized loss or unrealized loss (gain) on investments at taxable subsidiaries to net assets for the years ended December 31, 2017, 2016 and 2015 is less than (0.01)%, (0.23)%, and 0.05%, respectively.
- (8) Deferred offering costs of \$261,761 for the year ended December 31, 2016 are not annualized.
- (9) Excludes debt extinguishment costs of \$416,725 for the year ended December 31, 2017. Including these costs, this ratio would be 4.24%.

### NOTE 9 CREDIT FACILITIES

On November 7, 2012, the Company entered into a revolving credit facility (the "Original Facility") with various lenders. SunTrust Bank, one of the lenders, served as administrative agent under the Original Facility. The Original Facility, as amended on November 21, 2014 and August 31, 2016, provided for borrowings in an aggregate amount of \$120,000,000 on a committed basis with an accordion feature that allowed the Company to increase the aggregate commitments up to \$195,000,000, subject to new or existing lenders agreeing to participate in the increase, and other customary conditions. The Company terminated the Original Facility on October 11, 2017 in conjunction with securing and entering into the Credit Facility as defined below.

On October 11, 2017, the Company entered in to a new senior secured revolving credit agreement, dated as of October 10, 2017, with ZB, N.A., dba Amegy Bank and various other leaders (the "Credit Facility"). The Credit Facility provides for borrowings up to a maximum of \$140,000,000 on a committed basis with an accordion feature that allows the Company to increase the aggregate commitments up to \$195,000,000, subject to new or existing lenders agreeing to participate in the increase and other customary conditions.



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Borrowings under the Credit Facility bear interest, subject to the Company's election, on a per annum basis equal to (i) LIBOR plus 2.50% with no LIBOR floor or (ii) 1.50% plus an alternate base rate based on the highest of the Prime Rate, Federal Funds Rate plus 0.5% or one month LIBOR plus 1.0%. The Company pays unused commitment fees of 0.50% per annum on the unused lender commitments. Interest is payable quarterly in arrears. Any amounts borrowed under the Credit Facility will mature, and all accrued and unpaid interest thereunder will be due and payable, on October 10, 2021. This represents an interest rate reduction of 12.5 basis points and a three year extension of maturity over the Original Facility. The following table explains the modifications:

	Original Facility		Credit Facility	
Agent	SunTrust		Amegy	
Term	Dec 2012	Oct 2017	Oct 2017	Oct 2021
Principal	Commitment	\$ 120,000,000	Commitment	\$ 140,000,000
	LIBOR Margin:	2.625%	LIBOR Margin:	2.50%
Interest	ABR Margin:	1.625%	ABR Margin:	1.50%
	Unused Fee:	0.50	Unused Fee:	0.50
Fees	Admin Fee:	\$ 50,000/Annual	Admin Fee:	\$ 35,000/Annual

The Company's obligations to the lenders are secured by a first priority security interest in its portfolio of securities and cash not held at the SBIC subsidiary, but excluding short term investments. The Original Facility contained certain affirmative and negative covenants, including but not limited to: (i) maintaining a minimum liquidity test of at least 85% of adjusted borrowing base, (ii) maintaining an asset coverage ratio of at least 2.0 to 1.0, and (iii) maintaining a minimum shareholder's equity. The Original Facility required that the Company meet certain conditions in connection with incurring additional indebtedness, including that the Company have a minimum asset coverage ratio of 2.2 to 1.0 after giving effect to such borrowing. Additional conditions stated that (i) the aggregate amount of PIK interest during the most recently ended fiscal quarter of the borrower did not exceed 2% of the aggregate amount of interest income that the borrower had received on all investments in the borrowing base during such fiscal quarter;

(ii) the sum of the value of all non-accrual investments did not exceed 5% of the value of all investments in the borrowing base and (iii) the borrower maintained a minimum liquidity test of at least 80% of adjusted borrowing base.

The Company met these conditions while the Original Facility was outstanding.

The Credit Facility no longer provides advances on non-performing assets or equity positions. The Credit Facility also does not require a minimum asset coverage test to incur additional indebtedness nor does it have a maximum of PIK interest or non-accrual investments allowable under the borrowing base. Other changes under the Credit Facility include: a) the amendment of the minimum liquidity test to \$10,000,000, including cash, liquid investments, and undrawn availability b) the addition of a minimum interest coverage ratio of 2.0 to 1.0 at all times. As of December

31, 2017, these conditions were met.

As of December 31, 2017 and December 31, 2016, the outstanding balance under the Credit Facility and Original Facility was \$40,750,000 and \$116,000,000 respectively. The carrying amount of the amount outstanding under the Credit Facility approximates its fair value. The Company incurred total costs of \$3,067,715 in connection with obtaining, amending, and maintaining the Original Facility. The Company incurred costs of \$1,158,616 in connection with the Credit Facility, which are being amortized over the life of the facility. Additionally, \$341,979 of costs from the Original Facility will continue to be amortized over the remaining life of the Revised Facility. The Company expensed \$113,993 of fees related to the modification in the year ended December 31, 2017 as a loss on extinguishment of debt, which represents a proportionate amount of fees attributable to SunTrust bank exiting the Original Facility. As of December 31, 2017 and December 31, 2016, \$1,417,521 and \$828,792 of such prepaid loan structure fees and administration fees had

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yet to be amortized, respectively. These prepaid loan fees are presented on our consolidated statement of assets and liabilities as a deduction from the debt liability attributable to the Credit Facility as required by ASU No. 2015-3.

The following is a summary of the amounts outstanding for the Facilities, net of prepaid loan structure fees:

	December 31, 2017	December 31, 2016
Credit Facility payable	\$ 40,750,000	\$ 116,000,000
Prepaid loan structure fees	1,417,521	828,792
Credit facility payable, net of prepaid loan structure fees	\$ 39,332,479	\$ 115,171,208

For the year ended December 31, 2017, the weighted average effective interest rate under the Credit Facility and the Original Facility was approximately 3.7% (approximately 5.0% including commitment fees and other loan fees, but excluding \$113,994 of loss on extinguishment of debt). The average borrowings under the Credit Facility and the Original Facility for the year ended December 31, 2017 were \$60,053,425.

For the year ended December 31, 2016, the weighted average effective interest rate under the Original Facility was approximately 3.2% (approximately 3.7% including commitment fees and other loan fees). The average borrowings under the Original Facility for the year ended December 31, 2016 were \$106,601,093.

For the year ended December 31, 2015, the weighted average effective interest rate under the Original Facility was approximately 2.9% (approximately 3.5% including commitment fees and other loan fees). The average borrowings under the Original Facility for the year ended December 31, 2015 were \$102,800,824.

Interest is paid quarterly in arrears. The following table summarizes the interest expense and amortized loan fees on the Credit Facility and Original Facility for the years ended December 31, 2017, 2016, and 2015:

	For the year ended December 31, 2017	For the year ended December 31, 2016	For the year ended December 31, 2015
Interest expense	\$ 2,247,048	\$ 3,383,572	\$ 2,962,885
Loan fee amortization	416,612	471,501	473,398
Commitment fees on unused portion	311,174	66,787	87,052

Administration fees	39,282	52,335	48,605
Total interest and financing expenses	\$ 3,014,116	\$ 3,974,195	\$ 3,571,940
Loss on extinguishment of debt	113,993		
Cash paid for interest and unused fees	\$ 2,476,340	\$ 3,423,226	\$ 3,096,966

## **NOTE 10 SBA-GUARANTEED DEBENTURES**

Due to the SBIC subsidiary's status as a licensed SBIC, we have the ability to issue debentures guaranteed by the SBA at favorable interest rates. Under the regulations applicable to SBIC funds, an SBIC can have outstanding debentures guaranteed by the SBA subject to a regulatory leverage limit, up to two times the amount of regulatory capital. As of December 31, 2017 and December 31, 2016, the SBIC subsidiary had \$67,500,000 and \$38,000,000, respectively, in regulatory capital, as such term is defined by the SBA.

As a BDC, we are only allowed to employ leverage to the extent that our asset coverage, as defined in the 1940 Act, equals at least 200% after giving effect to such leverage. The amount of leverage that we employ at any time depends on our assessment of the market and other factors at the time of any proposed borrowing.

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# STELLUS CAPITAL INVESTMENT CORPORATION

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

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### NOTE 10 SBA-GUARANTEED DEBENTURES (continued)

On August 12, 2014, we obtained exemptive relief from the SEC to permit us to exclude the debt of the SBIC subsidiary guaranteed by the SBA from our 200% asset coverage test under the 1940 Act. The exemptive relief provides us with increased flexibility under the 200% asset coverage test by permitting us to borrow up to \$135,000,000 more than we would otherwise be able to absent the receipt of this exemptive relief.

On a stand-alone basis, the SBIC subsidiary held \$161,992,327 and \$104,622,902 in assets at December 31, 2017 and December 31, 2016, respectively, which accounted for approximately 40.4% and 27.5% of our total consolidated assets at December 31, 2017 and December 31, 2016, respectively.

Debentures guaranteed by the SBA have fixed interest rates that equal prevailing 10-year Treasury Note rates plus a market spread and have a maturity of ten years with interest payable semi-annually. The principal amount of the debentures is not required to be paid before maturity, but may be pre-paid at any time with no prepayment penalty. As of December 31, 2017 and December 31, 2016, the SBIC subsidiary had \$90,000,000 and \$65,000,000, respectively, of SBA-guaranteed debentures outstanding, which mature ten years from issuance. The first maturity related to the SBIC-guaranteed debentures does not occur until 2025, and the remaining weighted average duration of all of our outstanding SBA-guaranteed debentures is approximately 8.5 years as of December 31, 2017.

As of December 31, 2017 and December 31, 2016, the carrying amount of the SBA-guaranteed debentures approximated their fair value. The fair values of the SBA-guaranteed debentures are determined in accordance with ASC 820, which defines fair value in terms of the price that would be paid to transfer a liability in an orderly transaction between market participants at the measurement date under current market conditions. The fair value of the SBA-guaranteed debentures are estimated based upon market interest rates for our own borrowings or entities with similar credit risk, adjusted for nonperformance risk, if any. At December 31, 2017 and December 31, 2016 the SBA-guaranteed debentures would be deemed to be Level 3, as defined in Note 6.

As of December 31, 2017, the Company has incurred \$3,082,500 since receiving our license in 2014 in financing costs related to SBA-guaranteed debentures. As of December 31, 2017 and December 31, 2016, \$2,181,187 and \$1,657,964 of prepaid financing costs had yet to be amortized, respectively. These prepaid loan fees are presented on the consolidated statement of assets and liabilities as a deduction from the debt liability as required by ASU No. 2015-3. See Note 1 for further discussion.

The following is a summary of the SBA-guaranteed debentures, net of prepaid loan fees:



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	December 31, 2017	December 31, 2016
SBA-guaranteed debentures payable	\$ 90,000,000	\$ 65,000,000
Prepaid loan fees	2,181,187	1,657,964
SBA-guaranteed debentures, net of prepaid loan fees	\$ 87,818,813	\$ 63,342,036

For the year ended December 31, 2017, the weighted average effective interest rate for the SBA-guaranteed debentures was approximately 3.1% (approximately 3.6% including loan fees). The average borrowings of SBA-guaranteed debentures for the year ended December 31, 2017 were \$67,328,767.

For the year ended December 31, 2016, the weighted average effective interest rate for the SBA-guaranteed debentures was approximately 2.9% (approximately 3.4% including loan fees). The average borrowings of SBA-guaranteed debentures for the year ended December 31, 2016 were \$65,000,000.

For the year ended December 31, 2015, the weighted average effective interest rate for the SBA-guaranteed debentures was approximately 2.2% (approximately 3.0% including loan fees). The average borrowings of SBA-guaranteed debentures for the year ended December 31, 2015 were \$25,437,671.

TABLE OF CONTENTS**STELLUS CAPITAL INVESTMENT CORPORATION****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****December 31, 2017****NOTE 10 SBA-GUARANTEED DEBENTURES (continued)**

The following table summarizes the interest expenses incurred and paid on the SBA-guaranteed debentures for the years ended December 31, 2017, 2016, and 2015:

	For the year ended December 31, 2017	For the year ended December 31, 2016	For the year ended December 31, 2015
Interest expense	\$ 2,067,308	\$ 1,877,017	\$ 560,031
Debenture fee amortization	333,027	326,191	204,980
Total interest and financing expenses	\$ 2,400,335	\$ 2,203,208	\$ 765,011
Cash paid for interest	\$ 2,019,095	\$ 1,500,528	\$ 289,018

**NOTE 11 NOTES**

On May 5, 2014, the Company closed a public offering of \$25,000,000 in aggregate principal amount of 6.50% notes (the 2019 Notes ) due April 30, 2019. On August 21, 2017, the Company caused notices to be issued to the holders of its 2019 Notes regarding the Company's exercise of its option to redeem all of the issued and outstanding 2019 Notes, pursuant to Section 1101 of the Base Indenture dated as of May 5, 2014, between the Company and U.S. Bank National Association, as trustee, and Section 1.01(h)(i) of the First Supplemental Indenture dated as of May 5, 2014. The Company redeemed all \$25,000,000 in aggregate principal amount of the 2019 Notes on September 20, 2017. The 2019 Notes were redeemed at 100% of their principal amount, plus the accrued and unpaid interest thereon through the redemption date. As a result of the redemption, the Company recognized a loss on the extinguishment of debt of \$302,732 for the year ended December 31, 2017, due to the write off of the remaining deferred financing costs on the 2019 Notes.

The following table summarizes the interest expense and deferred financing costs on the 2019 Notes for the years ended December 31, 2017, 2016 and 2015:

	For the year ended December 31, 2017	For the year ended December 31, 2016	For the year ended December 31, 2015
Interest expense	\$ 1,169,097	\$ 1,625,000	\$ 1,625,000
Deferred financing costs	131,377	184,933	209,703

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Administration fees	5,000	4,850	5,361
Total interest and financing expenses	\$ 1,305,474	\$ 1,814,783	\$ 1,840,064
Loss on extinguishment of debt	302,732		
Cash paid for interest	\$ 1,376,736	\$ 1,625,000	\$ 1,625,000

On August 21, 2017, the Company issued \$42,500,000 in aggregate principal amount of 5.75% fixed-rate notes due 2022 (the 2022 Notes ). On September 8, 2017, the Company issued an additional \$6,375,000 in aggregate principal amount of the 2022 Notes pursuant to a full exercise of the underwriters overallotment option. The 2022 Notes will mature on September 15, 2022, and may be redeemed in whole or in part at any time or from time to time at the Company s option on or after September 15, 2019 at a redemption price equal to 100% of the outstanding principal, plus accrued and unpaid interest. Interest is payable quarterly beginning December 15, 2017.

The Company used all of the net proceeds from this offering to fully redeem the 2019 Notes and a portion of the amount outstanding under the Original Facility. As of December 31, 2017 and 2016, the aggregate carrying amount of all Notes was \$48,875,000 and \$25,000,000. If the Company had adopted the fair value option under ASC 825, the fair value of the Notes would be approximately \$49,520,150 and \$25,200,000, respectively. The 2022 Notes are listed on New York Stock Exchange under the trading symbol

TABLE OF CONTENTS**STELLUS CAPITAL INVESTMENT CORPORATION****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****December 31, 2017****NOTE 11 NOTES (continued)**

SCA . The fair value of the Notes is based on the closing price of the security, which is a Level 2 input under ASC 820 due to sufficient trading volume.

In connection with the issuance and maintenance of the 2022 Notes, we have incurred \$1,688,961 of fees which are being amortized over the term of the 2022 Notes, of which \$1,568,512 remains to be amortized as of December 31, 2017. These financing costs are presented on the consolidated statement of assets and liabilities as a deduction from the debt liability as required by ASU No. 2015-3.

The following table summarizes the interest expense and deferred financing costs on the 2022 Notes for the years ended December 31, 2017, 2016 and 2015:

	For the year ended December 31, 2017	For the year ended December 31, 2016	For the year ended December 31, 2015
Interest expense	\$ 1,014,835	\$	\$
Deferred financing costs	118,066		
Administration fees	2,383		
Total interest and financing expenses	\$ 1,135,284	\$	\$
Cash paid for interest	\$ 889,932	\$	\$

The following is a summary of the Notes Payable, net of deferred financing costs:

	December 31, 2017	December 31, 2016
Notes payable	\$ 48,875,000	\$ 25,000,000
Deferred financing costs	1,568,512	434,109
Notes payable, net of deferred financing costs	\$ 47,306,488	\$ 24,565,891

The indenture and supplements thereto relating to each of the 2019 Notes and 2022 Notes contain certain covenants, including but not limited to (i) a requirement that the Company comply with the asset coverage requirements of the 1940 Act or any successor provisions, and (ii) a requirement to provide financial information to the holders of the notes and the trustee under the indenture if the Company should no longer be subject to the reporting requirements under the Exchange Act.



TABLE OF CONTENTS**STELLUS CAPITAL INVESTMENT CORPORATION****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****December 31, 2017****NOTE 12 SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED)**

The following table sets forth the results of operations for the years ended December 31, 2017, 2016, and 2015. Results for any quarter are not necessarily indicative of results for the full year or for any future quarter.

	2017			
	Qtr. 1	Qtr. 2	Qtr. 3	Qtr. 4
Total Investment Income	\$9,863,980	\$10,394,365	\$9,978,345	\$9,411,503
Net Investment Income	\$4,143,627	\$4,938,459	\$4,475,952	\$4,412,722
Net Increase in Net Assets from Operations	\$6,024,752	\$6,044,766	\$5,636,598	\$4,907,141
Total Investment Income per share <sup>(1)</sup>	\$0.79	\$0.68	\$0.64	\$0.59
Net Investment Income per share <sup>(1)</sup>	\$0.33	\$0.32	\$0.29	\$0.28
Net Increase in Net Assets from Operations per share <sup>(1)</sup>	\$0.48	\$0.39	\$0.36	\$0.31

	2016			
	Qtr. 1	Qtr. 2	Qtr. 3	Qtr. 4
Total Investment Income	\$9,467,833	\$9,623,169	\$10,202,753	\$10,196,442
Net Investment Income	\$4,099,290	\$3,945,102	\$4,608,743	\$4,659,066
Net Increase in Net Assets from operations	\$2,523,849	\$5,029,920	\$9,927,466	\$5,717,827
Total Investment Income per share <sup>(1)</sup>	\$0.76	\$0.77	\$0.82	\$0.82
Net Investment Income per share <sup>(1)</sup>	\$0.33	\$0.32	\$0.37	\$0.37
Net Increase in Net Assets from Operations per share <sup>(1)</sup>	\$0.20	\$0.41	\$0.80	\$0.45

	2015			
	Qtr. 1	Qtr. 2	Qtr. 3	Qtr. 4
Total Investment Income	\$8,714,091	\$8,690,462	\$8,602,813	\$9,151,193
Net Investment Income	\$3,843,415	\$3,995,487	\$3,819,631	\$4,888,595
Net Increase in Net Assets from Operations	5,393,374	\$4,000,993	\$(624,337 )	\$(1,099,494)
Total Investment Income per share <sup>(1)</sup>	\$0.70	\$0.70	\$0.69	\$0.73
Net Investment Income per share <sup>(1)</sup>	\$0.31	\$0.32	\$0.31	\$0.39
	\$0.43	\$0.32	\$(0.05 )	\$(0.09 )

Net Increase in Net Assets from Operations per share<sup>(1)</sup>

(1) Per share amounts are calculated using weighted average shares outstanding during the period.

## **NOTE 13 INCOME TAXES**

As of December 31, 2017 and December 31, 2016, the Company had \$394,559 and \$1,307,452, respectively, of undistributed ordinary income.<sup>(1)</sup> Undistributed capital gains were \$723,753 and \$0 for the periods ended December 31, 2017 and December 31, 2016, respectively. All of the undistributed ordinary income as of December 31, 2017 will have been distributed within the required period of time such that the Company will not have to pay corporate-level U.S. federal income tax for the year ended December 31, 2017. We will be subject to a 4% nondeductible U.S. federal excise tax on our undistributed income to the extent we did not distribute an amount equal to at least 98% of our net ordinary income plus 98.2% of our capital gain net income attributable to the period. The Company has accrued \$42,402 and \$22,663 of U.S. federal excise tax for the years ended December 31, 2017 and December 31, 2016, respectively.

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TABLE OF CONTENTS**STELLUS CAPITAL INVESTMENT CORPORATION****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****December 31, 2017****NOTE 13 INCOME TAXES (continued)**

Ordinary dividend distributions from a RIC do not qualify for the reduced maximum tax rate on qualified dividend income from domestic corporations, except to the extent that the RIC received the income in the form of qualifying dividends from domestic corporations and qualified foreign corporations. The tax character<sup>(2)</sup> of distributions paid in the years ended December 31, 2017 and 2016 was as follows:

	December 31, 2017	December 31, 2016
Ordinary income	\$ 17,823,305	\$ 16,968,350
Qualified dividends	1,500,000	
Distributions of long-term capital gains <sup>(2)</sup>	1,000,000	
Total distributions accrued or paid to common stockholders	\$ 20,323,305	\$ 16,968,350

The Company's taxable income for each period is an estimate and will not be finally determined until the Company files its tax return for each year. Therefore, final taxable income earned in each period, and the undistributed ordinary income and capital gains for each period carried forward for distribution in the following period, may be different than this estimate.

Distributions of long-term capital gains of \$1,000,000 as of December 31, 2017 differs from distributions of net capital gains on the Consolidated Statement of Changes in Net Assets because certain long-term capital gains were recognized in Taxable Subsidiaries. The qualified dividend amount equal to \$1,500,000 is derived from a long-term capital gain transaction and represents a cash distribution from the Taxable Subsidiary to the Company. Additional differences arise because certain prepayment gains are characterized differently for tax reporting purposes.

Listed below is a reconciliation of Net increase in net assets resulting from operations to taxable income and total distributions declared to common stockholders for the years ended December 31, 2017, 2016 and 2015.

	December 31, 2017	December 31, 2016	December 31, 2015
Net increase in net assets resulting from operations (includes NII, Realized Gain/(Loss), Unrealized Gain/(Loss) and Taxes)	\$ 22,613,257	\$ 23,199,062	\$ 7,670,536
Net change in net unrealized appreciation (depreciation)	22,072	(18,603,401)	9,204,717
Income tax provision (benefit)	(8,593)	(373,131)	93,601



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Pre-tax (income) expense, (gain) loss reported at Taxable Subsidiaries, not consolidated for tax purposes	(4,721,039 )	13,451,549	
Book income and tax income differences, including debt origination, interest accrual, income from pass-through investments, dividends, realized gains (losses) and changes in estimates	1,835,779	583,041	(73,772 )
Estimated taxable income	\$19,741,476	\$18,257,120	\$16,895,082
Taxable income earned in prior year and carried forward for distribution in current year	(106,530 )	(1,395,300 )	(1,321,498 )
Taxable income earned prior to period end and carried forward for distribution next period	(1,118,312 )	(1,307,452 )	(18,682 )
Dividend payable as of period end and paid in following period	1,806,671	1,413,982	1,413,982
Total distributions accrued or paid to common stockholders	\$20,323,305	\$16,968,350	\$16,968,884

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TABLE OF CONTENTS**STELLUS CAPITAL INVESTMENT CORPORATION****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS****December 31, 2017****NOTE 13 INCOME TAXES (continued)**

The aggregate gross unrealized appreciation and depreciation, the net unrealized appreciation, and the aggregate cost of the Company's portfolio company securities for federal income tax purposes as of December 31, 2017 and December 31, 2016 were as follows:

	2017	2016
Aggregate cost of portfolio securities for federal income tax purposes	\$368,453,206	\$362,217,251
Gross unrealized appreciation of portfolio company securities	10,263,285	7,011,949
Gross unrealized depreciation of portfolio company securities	(6,876,717 )	(3,603,309 )
Net unrealized appreciation (depreciation) of portfolio company securities, before tax	\$3,386,568	\$3,408,640

As of December 31, 2017, the Taxable Subsidiaries had generated unrealized losses in investments, net operating loss ( NOL ) carryovers and capital loss carryovers creating a net deferred tax asset equal to \$1,567,062, as reflected below.

Due to the nature of the Taxable Subsidiaries' holdings, a valuation allowance was established when management determined it is more likely than not that some of the deferred tax assets will not be realized prior to expiration. Although our future projections indicate that we may be able to realize some of these deferred tax assets, due to the degree of uncertainty of these projections, management has recorded a deferred tax asset valuation allowance of \$1,567,062. The deferred tax asset and deferred tax liability amounts, before valuation allowance, reflected below, take into account the reduction in corporate income tax rate from 35% to 21% as enacted by the Tax Cuts and Jobs Act of 2017 ( Tax Reform ). Before the effect of Tax Reform, the ending net deferred tax asset would have been approximately \$2,612,000, compared to the reflected ending net deferred tax asset of \$1,567,062, before valuation allowance. Therefore the reduction in corporate tax rates had the effect of reducing the Taxable Subsidiaries' net deferred tax asset by approximately \$1,045,000. This reduction also resulted in a reduction in the required valuation allowance in an equal amount, resulting in \$0 net change in tax expense arising as a result of the Tax Reform rate reduction.

	2017	2016
Deferred Tax Asset	\$2,779,563	\$4,529,046
Deferred Tax Liability	\$(1,212,501)	\$(392,922 )
Total Deferred Tax Asset (Liability) before Valuation Allowance	1,567,062	4,136,124
Deferred Tax Valuation Allowance	\$(1,567,062)	\$(4,144,717)
Net Deferred Tax Asset (Liability)	\$0	\$(8,593 )

Although the Company files federal and state tax returns, its major tax jurisdiction is federal. The 2014, 2015 and 2016 federal income tax and excise tax returns for the Company remain subject to examination by the Internal Revenue Service.

## **NOTE 14 SUBSEQUENT EVENTS**

### **Investment Portfolio**

On January 2, 2018, the Company invested \$10.0 million in the second lien term loan of ICD Intermediate Holdco 2, LLC, a financial company which connects corporate treasury departments with money market and short duration bond funds. Additionally, the Company invested \$0.5 million in the equity of the company.

On January 26, 2018, the Company made an additional investment of \$7.1 million in the first lien term loan of BW DME Acquisition LLC, (StateServ Medical, LLC).

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# STELLUS CAPITAL INVESTMENT CORPORATION

## NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS December 31, 2017

### NOTE 14 SUBSEQUENT EVENTS (continued)

On January 30, 2018, the Company received a dividend of \$1.35 million from MTC Parent, L.P. (Millennium Trust).

On January 31, 2018, the Company invested \$11.0 million in the first lien term loan of Price for Profit, LLC, an advisory services and specialized technology platform services company. We also committed to fund a \$1.5 million revolver. Additionally, the Company invested \$0.8 million in the equity of the company.

On January 31, 2018, the Company made an additional investment of \$3.2 million in the first lien term loan of Energy Labs Inc.

On February 5, 2018, the Company invested \$20.5 million in the first lien term loan of Fast Growing Trees, LLC, an online provider of hybrid trees and plants. We also committed to fund a \$1.0 million revolver. Additionally, the Company invested \$1.0 million in the equity of the company.

On February 6, 2018, the Company made an additional investment of \$8.3 million in the first lien debt of Furniture Factory Holdings, LLC.

#### **Credit Facility**

The outstanding balance under the Credit Facility as of March 2, 2018 was \$83.1 million.

#### **SBIC Subsidiary**

On January 2, 2018, the Company contributed \$7.5 million to the SBIC Subsidiary, bringing total contributed capital to \$75 million.

#### **Dividend Redistribution Investment Program (DRIP)**

Since December 31, 2017, the Company has issued 7,932 shares through the DRIP.

#### **Dividend Declared**

On January 11, 2018, the Company's board of directors declared a regular monthly dividend for each of January 2018, February 2018 and March 2018 as follows:

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Declared	Ex-Dividend Date	Record Date	Payment Date	Amount per Share
1/11/2018	1/30/2018	1/31/2018	2/15/2018	\$ 0.1133
1/11/2018	2/27/2018	2/28/2018	3/15/2018	\$ 0.1133
1/11/2018	3/28/2018	3/29/2018	4/13/2018	\$ 0.1133

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**CONSENT OF INDEPENDENT REGISTERED PUBLIC  
ACCOUNTING FIRM**

Board of Directors and Shareholders  
Stellus Capital Investment Corporation

**Opinion on financial statement schedule**

We have issued our reports dated March 6, 2018, with respect to the consolidated financial statements and internal control over financial reporting included in the Annual Report of Stellus Capital Investment Corporation on Form 10-K for the year ended December 31, 2017. We consent to the incorporation by reference of said reports in the Registration Statement of Stellus Capital Investment Corporation on Form N-2 (File No. **333-216138**)

/s/ GRANT THORNTON LLP

Dallas, Texas  
March 6, 2018

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**Schedule 12-14**

**STELLUS CAPITAL INVESTMENT CORPORATION**

**Consolidated Schedule of Investments in and Advances to Affiliates**

**December 31, 2017**

(dollars in thousands)

This schedule should be read in conjunction with Stellus's consolidated financial statements, including the consolidated schedule of investments and notes to the consolidated financial statements.

(1) The principal amount, the ownership detail for equity investments accrual status is included in the consolidated schedule of investments.

Represents the total amount of interest, fees and dividends credited to income for the portion of the period for which an investment was included in Control or Affiliate categories, respectively. For investments transferred

(2) between Control and Affiliate categories during the period, any income or investment balances related to the time period it was in the category other than the one shown at period end is included in Amounts from investments transferred from other 1940 Act classifications during the period.

(3) Gross additions include increases in the cost basis of investments resulting from new portfolio investments, follow-on investments and accrued PIK interest, and the exchange of one or more existing securities for one or more new securities. Gross additions also include net increases in unrealized appreciation or net decreases in net unrealized depreciation as well as the movement of an existing portfolio company into this category and out of a different category.

(4) Gross reductions include decreases in the cost basis of investments resulting from principal repayments or sales and the exchange of one or more existing securities for one or more new securities. Gross reductions also include net increases in net unrealized depreciation or net decreases in unrealized appreciation as well as the movement of an existing portfolio company out of this category and into a different category.

(5) On February 1, 2017, the Company's first lien term in Glori Energy Production, Inc. was converted to a non-controlled, affiliated equity position.

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Item 9. Changes in and Disagreements with Independent Registered Public Accounting Firm on Accounting and Financial Disclosure

None.

Item 9A.

Controls and Procedures.

**(a) Evaluation of Disclosure Controls and Procedures**

As of December 31, 2017 (the end of the period covered by this report), we, including our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) of the 1934 Act). Based on that evaluation, our management, including our Chief Executive Officer and Chief Financial Officer, concluded that our disclosure controls and procedures were effective and provided reasonable assurance that information required to be disclosed in our periodic SEC filings is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. However, in evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

**(b) Management's Report on Internal Control Over Financial Reporting**

Management is responsible for establishing and maintaining adequate internal control over financial reporting as such term is defined in Exchange Act Rule 13a-15(f), and for performing an assessment of the effectiveness of internal control over financial reporting as of December 31, 2017. Internal control over financial reporting is a process designed by, or under the supervision of, our principal executive and principal financial officers, or persons performing similar functions, and effected by our Board of Directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Our internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures are being made only in accordance with authorizations; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of our assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

Management performed an assessment of the effectiveness of our internal control over financial reporting as of December 31, 2017 based upon the criteria set forth in the 2013 Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission ( COSO ). Based on our assessment, management determined that our internal control over financial reporting was effective as of December 31, 2017.



**(c) Report of the Independent Registered Public Accounting Firm**

Our independent registered public accounting firm Grant Thornton, LLP, has issued an attestation report on the effectiveness of our internal control over financial reporting as of December 31, 2017, which is set forth above under the heading Reports of Independent Registered Public Accounting Firm in Item 8.

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**(d) Changes in Internal Controls Over Financial Reporting**

There have been no changes in our internal control over financial reporting that occurred during the fourth fiscal quarter of 2017 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting (as defined in Rule 13(a)-15(f) of the Exchange Act).

Item 9B.

None.

Other Information.

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**PART III**

We will file a definitive Proxy Statement for our 2018 Annual Meeting of Stockholders with the SEC, pursuant to Regulation 14A, not later than 120 days after the end of our fiscal year. Accordingly, certain information required by Part III has been omitted under General Instruction G(3) to the annual report on Form 10-K. Only those sections of our definitive Proxy Statement that specifically address the items set forth herein are incorporated by reference.

Item 10. Directors, Executive Officers and Corporate Governance

The information required by Item 10 is hereby incorporated by reference from the Company's definitive Proxy Statement relating to the Company's 2018 Annual Meeting of Stockholders, to be filed with the Securities and Exchange Commission within 120 days following the end of the Company's fiscal year.

We have adopted a code of business conduct and ethics that applies to our directors, officers and employees. This code of ethics is published on our website at [www.stelluscapital.com](http://www.stelluscapital.com). We intend to disclose any future amendments to, or waivers from, this code of conduct within four business days of the waiver or amendment through a website posting.

Item 11. Executive Compensation

The information required by Item 11 is hereby incorporated by reference from the Company's definitive Proxy Statement relating to the Company's 2018 Annual Meeting of Stockholders, to be filed with the Securities and Exchange Commission within 120 days following the end of the Company's fiscal year.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information required by Item 12 is hereby incorporated by reference from the Company's definitive Proxy Statement relating to the Company's 2018 Annual Meeting of Stockholders, to be filed with the Securities and Exchange Commission within 120 days following the end of the Company's fiscal year.

Item 13. Certain Relationships and Related Transactions, and Director Independence

The information required by Item 13 is hereby incorporated by reference from the Company's definitive Proxy Statement relating to the Company's 2018 Annual Meeting of Stockholders, to be filed with the Securities and Exchange Commission within 120 days following the end of the Company's fiscal year.

Item 14. Principal Accountant Fees and Services

The information required by Item 14 is hereby incorporated by reference from the Company's definitive Proxy Statement relating to the Company's 2018 Annual Meeting of Stockholders, to be filed with the Securities and Exchange Commission within 120 days following the end of the Company's fiscal year.

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**PART IV**

Item 15. Exhibits, Financial Statement Schedules  
**a. Documents Filed as Part of this Report**

The following financial statements are set forth in Item 8:

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<u>Report of Independent Registered Public Accounting Firm</u>	<u>81</u>
<u>Consolidated Statements of Assets and Liabilities as of December 31, 2017 and December 31, 2016</u>	<u>84</u>
<u>Consolidated Statements of Operations for the years ended December 31, 2017, 2016, and 2015</u>	<u>85</u>
<u>Consolidated Statements of Changes in Net Assets for the years ended December 31, 2017, 2016, and 2015</u>	<u>86</u>
<u>Consolidated Statements of Cash Flows for the years ended December 31, 2017, 2016, and 2015</u>	<u>87</u>
<u>Consolidated Schedule of Investments as of December 31, 2017 and December 31, 2016</u>	<u>89</u>
<u>Notes to Consolidated Financial Statements</u>	<u>102</u>

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**b. Exhibits**

The following exhibits are filed as part of this report or hereby incorporated by reference to exhibits previously filed with the SEC:

- 3.1 Articles of Amendment and Restatement (Incorporated by reference to Exhibit (a)(1) to the Registrant's Registration Statement on Form N-2 (File No. 333-184195), filed on October 23, 2012).
- 3.3 Bylaws (Incorporated by reference to Exhibit (b)(1) to the Registrant's Registration Statement on Form N-2 (File No. 333-184195), filed on October 23, 2012).
- 4.1 Form of Stock Certificate (Incorporated by reference to Exhibit (d) to the Registrant's Registration Statement on Form N-2 (File No. 333-184195), filed on October 23, 2012).
- 4.2 Form of Indenture (Incorporated by reference to Exhibit (d)(2) to the Registrant's Registration Statement on Form N-2 (File No. 333-189938, filed January 29, 2014).
- 4.3 First Supplemental Indenture between the Registrant and U.S. Bank National Association, dated May 5, 2014, (Incorporated by reference to Exhibit (d)(8) to the Registrant's Registration Statement on Form N-2 (File No. 333-189938), filed on May 2, 2014).
- 4.4 Second Supplemental Indenture between the Registrant and U.S. Bank National Association, date August 21, 2017, (Incorporated by reference on exhibit (d)(6) to the Registrant's Registration Statement on Form N-2 (File No. 333-216138), filed on August 23, 2017).
- 4.5 Form of Global Note with respect to the 6.50% Note due 2019 (Incorporated by reference to Exhibit 4.3).
- 4.6 Form of Global Note with respect to the 5.75% Note due 2022 (Incorporated by reference to Exhibit 4.4).
- 10.1 Form of Investment Advisory Agreement between Registrant and Stellus Capital Management, LLC (Incorporated by reference to Exhibit (g)(1) to the Registrant's Registration Statement on Form N-2 (File No. 333-184195), filed on October 23, 2012).
- 10.2 Custody Agreement between Registrant and ZB, National Association (Incorporated by reference to Exhibit 10.1 to the Registrant's Current Report on Form 8-K (File No. 814-00971), filed on November 7, 2017).
- 10.3 Administration Agreement between Registrant and Stellus Capital Management, LLC (Incorporated by reference to Exhibit (k)(1) to the Registrant's Registration Statement on Form N-2 (File No. 333-184195), filed on October 23, 2012).
- 10.4 Dividend Reinvestment Plan (Incorporated by reference to Exhibit (e) to the Registrant's Registration Statement on Form N-2 (File No. 333-184195), filed on October 23, 2012).
- 10.5 Form of License Agreement between the Registrant and Stellus Capital Management (Incorporated by reference to Exhibit (k)(2) to the Registrant's Registration Statement on Form N-2 (File No. 333-184195), filed on October 23, 2012).
- 10.6 Form of Indemnification Agreement between the Registrant and the directors (Incorporated by reference to Exhibit (k)(3) to the Registrant's Registration Statement on Form N-2 (File No. 333-184195), filed on October 23, 2012).
- 10.7 Form of Purchase Agreement between the Registrant, D.E. Shaw Direct Capital Portfolios, L.L.C. and DC Funding SPV, L.L.C. (Incorporated by reference to Exhibit (k)(4) to the Registrant's Registration Statement on Form N-2 (File No. 333-184195), filed on November 7, 2012).
- 10.8

Form of Senior Secured Revolving Credit Agreement among the Registrant and SunTrust Bank (Incorporated by reference to Exhibit (k)(5) to the Registrant's Registration Statement on Form N-2 (File No. 333-184195), filed on November 7, 2012).

10.9 Form of Guarantee and Security Agreement among the Registrant and SunTrust Bank (Incorporated by reference to Exhibit (k)(6) to the Registrant's Registration Statement on Form N-2 (File No. 333-184195), filed on November 7, 2012).

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<u>10.12</u>	<u>Form of Letter Agreement between the Registrant, D.E. Shaw Direct Capital Portfolios, L.L.C. and DC Funding SPV, L.L.C. (Incorporated by reference to Exhibit (k)(9) to the Registrant's Registration Statement on Form N-2 (File No. 333-184195), filed on November 7, 2012).</u>
<u>10.13</u>	<u>Commitment Increase Letter Agreement between Registrant, Cadence Bank, N.A., State Street Bank and Trust Company, Amegy Bank, N.A. and SunTrust Bank (Incorporated by reference to Exhibit 10.1 to the Registrant's Current Report on Form 8-K (File No. 814-00971), filed on July 30, 2013).</u>
<u>10.14</u>	<u>Form of Senior Secured Revolving Credit Agreement, between the Registrant, as a borrower, the lenders party hereto and ZB, N.A. dba Amegy Bank, as administrative agent (Incorporated by reference to the Exhibit 10.1 to the Registrant's Current Report on Form 8-K (File No 814-00971), filed on October 13, 2017).</u>
<u>10.15</u>	<u>Form of Guarantee and Security Agreement, the Registrant, ZB, N.A., dba Amegy Bank, as administrative agent, and ZB, N.A. dba Amegy Bank, as collateral agent (Incorporated by reference to Exhibit 10.2 to the Registrant's Current Report on Form 8-K (File No. 814-00971), filed on October 13, 2017).</u>
11.1	Computation of Per Share Earnings (included in the notes to the audited financial statements contained in this report).
<u>14.1</u>	<u>Code of Ethics (Incorporated by reference to Exhibit (r)(1) to the Registrant's Registration Statement on Form N-2 (File No. 333-184195), filed on October 23, 2012).</u>
	Subsidiaries of the Registrant and jurisdiction of incorporation/organizations:
	Stellus Capital SBIC, LP Delaware
21.1	SKP Blocker I, Inc. Delaware
	ERC Blocker, Inc. Delaware
	SCIC-Consolidated Blocker 1, Inc. Delaware
	SCIC-CC Blocker 1, Inc. Delaware
	SCIC-APE Blocker 1, Inc. Delaware
	SCIC-Hollandar Blocker 1, Inc. Delaware
<u>31.1*</u>	<u>Certification of Chief Executive Officer pursuant to Rule 13a-14 of the Securities Exchange Act of 1934, as amended.</u>
<u>31.2*</u>	<u>Certification of Chief Financial Officer pursuant to Rule 13a-14 of the Securities Exchange Act of 1934, as amended.</u>
<u>32.1*</u>	<u>Certification of Chief Executive Officer pursuant to Section 906 of The Sarbanes-Oxley Act of 2002.</u>
<u>32.2*</u>	<u>Certification of Chief Financial Officer pursuant to Section 906 of The Sarbanes-Oxley Act of 2002.</u>

\*

Filed herewith.

**c. Financial statement schedules**

No financial statement schedules are filed herewith because (1) such schedules are not required or (2) the information has been presented in the aforementioned financial statements.

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## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

STELLUS CAPITAL INVESTMENT  
CORPORATION

/s/ Robert T. Ladd

Date: March 6, 2018

Robert T. Ladd  
**Chief Executive Officer and President**

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacity and on the dates indicated.

/s/ Robert T. Ladd

Date: March 6, 2018

**Robert T. Ladd**  
**Chief Executive Officer, President and**  
**Chairman of the Board of Directors**

/s/ W. Todd Huskinson

Date: March 6, 2018

**W. Todd Huskinson**  
**Chief Financial Officer, Chief Compliance Officer**  
**and Secretary**  
**(Principal Accounting and Financial Officer)**

/s/ Dean D Angelo

Date: March 6, 2018

**Dean D Angelo**  
**Director**

/s/ Joshua T. Davis

Date: March 6, 2018

**Joshua T. Davis**  
**Director**

/s/ J. Tim Arnoult

Date: March 6, 2018

**J. Tim Arnoult**  
**Director**

/s/ Bruce R. Bilger

Date: March 6, 2018

**Bruce R. Bilger**  
**Director**

Date: March 6, 2018

/s/ Paul Keglevic

**Paul Keglevic**



**Director**

/s/ William C. Repko

Date: March 6, 2018

**William C. Repko**

**Director**

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