Stellus Capital Investment Corp
Form 10-Q
November 12, 2013

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

FORM 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended September 30, 2013

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 or other Jurisdiction of Incorporation or Organization)	46-0937320 **(I.R.S. Employer Identification No.)**

4400 Post Oak Parkway, Suite 2200
Houston, Texas 77027

(Address of Principal Executive Offices) (Zip Code)

(713) 292-5400

(Registrant s Telephone Number, Including Area Code)

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 x No o

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 o No o

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 definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer	Accelerated filer
o	o
Non-accelerated filer	Smaller reporting company
x	o
(do not check if a smaller reporting company)	

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

The number of shares of the issuer s Common Stock, $0.001 par value, outstanding as of November 12, 2013 was 12,082,222.

STELLUS CAPITAL INVESTMENT CORPORATION

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements

STELLUS CAPITAL INVESTMENT CORPORATION

STATEMENTS OF ASSETS AND LIABILITIES

	September 30, 2013 (Unaudited)	December 31, 2012
ASSETS		
Non-controlled, non-affiliated investments, at fair value (amortized cost of $242,598,120 and $195,455,671, respectively)	$243,625,309	$195,451,256
Cash and cash equivalents	23,585,780	62,131,686
Interest receivable	4,150,618	2,573,831
Prepaid loan structure fees	1,684,565	1,947,820
Prepaid expenses	52,480	438,384
Total Assets	273,098,752	262,542,977
LIABILITIES		
Payable for investments purchased		4,750,000
Credit facility payable	85,000,000	38,000,000
Short-term loan	8,999,933	45,000,943
Base management fees payable	1,140,676	527,034
Incentive fees payable	1,262,914	
Accrued offering costs		147,123
Interest payable	292,159	66,477
Directors' fees payable	76,000	29,452
Other accrued expenses and liabilities	267,625	175,993
Total Liabilities	97,039,307	88,697,022
Net Assets	$176,059,445	$173,845,955
NET ASSETS		
Common Stock, par value $0.001 per share (100,000,000 shares authorized, 12,082,222 and 12,035,023 shares issued and outstanding, respectively)	$12,082	$12,035
Paid-in capital	175,384,594	174,714,838
Accumulated undistributed net realized gain	1,007,978	
Distributions in excess of net investment income	(1,372,398)	(874,986)
Unrealized appreciation (depreciation) on investments and cash equivalents	1,027,189	(5,932)
Net Assets	$176,059,445	$173,845,955
Total Liabilities and Net Assets	$273,098,752	$262,542,977
Net Asset Value Per Share	$14.57	$14.45

See Notes to Unaudited Financial Statements.

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STELLUS CAPITAL INVESTMENT CORPORATION

STATEMENTS OF OPERATIONS (unaudited)

	For the three months ended September 30, 2013	For the three months ended September 30, 2012	For the nine months ended September 30, 2013	For the period from Inception (May 18, 2012) through September 30, 2012
INVESTMENT INCOME				
Interest income	$7,604,636	$	$20,640,265	$
Other income	312,995		1,065,033	
Total Investment Income	7,917,631		21,705,298	
OPERATING EXPENSES				
Management fees	1,140,675		3,065,877	
Valuation fees	154,785		358,495	
Administrative services expenses	220,249		619,825	
Incentive fees	746,637		2,296,873	
Professional fees	254,533	138,365	477,995	264,993
Directors' fees	76,000		254,000	
Insurance expense	119,695		354,933	
Interest expense and other fees	968,674		2,253,433	
Other general and administrative expenses	102,388		229,832	
Total Operating Expenses	3,783,636	138,365	9,911,263	264,993
Net Investment Income (Loss)	4,133,995	(138,365)	11,794,035	(264,993)
Net Realized Gain on Investments and Cash Equivalents	5,061		1,007,978	
Net Change in Unrealized Appreciation (Depreciation) on Investments and Cash Equivalents	(313,635)		1,033,121	
Net Increase (Decrease) in Net Assets Resulting from Operations	$3,825,421	$(138,365)	$13,835,134	$(264,993)
Net Investment Income Per Share	$0.34	$	$0.98	$
Net Increase in Net Assets Resulting from Operations Per Share	$0.32	$	$1.15	$
Weighted Average Shares of Common Stock Outstanding	12,066,548		12,051,013	

See Notes to Unaudited Financial Statements.

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STELLUS CAPITAL INVESTMENT CORPORATION

STATEMENTS OF CHANGES IN NET ASSETS

	For the nine months ended September 30, 2013 (Unaudited)	For the Period from Inception (May 18, 2012) through September 30, 2012 (Unaudited)
Increase in Net Assets Resulting from Operations		
Net investment income (loss)	$ 11,794,035	$ (264,993)
Net realized gain on investments and cash equivalents	1,007,978	
Net change in unrealized appreciation on investments and cash equivalents	1,033,121	
Net Increase (Decrease) in Net Assets Resulting from Operations	13,835,134	(264,993)
Stockholder distributions		
Distributions	(12,291,447)	
Capital share transactions		
Issuance of common stock	669,803	
Net increase in net assets resulting from capital share transactions	669,803	
Total increase (decrease) in net assets	2,213,490	(264,993)
Net assets at beginning of period	173,845,955	
Net assets at end of period (includes $869,640 and $0 of undistributed net investment income)	$ 176,059,445	$ (264,993)

See Notes to Unaudited Financial Statements.

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STELLUS CAPITAL INVESTMENT CORPORATION

STATEMENTS OF CASH FLOWS

	For the nine months ended September 30, 2013 (Unaudited)	For the Period from Inception (May 18, 2012) through September 30, 2012 (Unaudited)
Cash flows from operating activities		
Net increase (decrease) in net assets resulting from operations	$13,835,134	$(264,993)
Adjustments to reconcile net increase in net assets resulting from operations to net cash used in operating activities:		
Purchases of investments	(129,073,679)	
Proceeds from sales and repayments of investments	84,105,057	
Net change in unrealized appreciation on investments	(1,031,604)	
Increase in investments due to PIK	(854,644)	
Accretion of discount	(308,299)	
Net realized gain on investments	(1,010,884)	
Changes in other assets and liabilities		
Increase in interest receivable	(1,576,787)	
Decrease in prepaid expenses and fees	649,159	
Decrease in payable for investments purchased	(4,750,000)	
Increase in management fees payable	613,642	
Increase in directors' fees payable	46,548	
Increase in incentive fees payable	1,262,914	
Increase in interest payable	225,682	
Increase in other accrued expenses and liabilities	91,632	264,993
Net cash used in operating activities	(37,776,129)	
Cash flows from financing activities		
Offering costs paid	(147,123)	
Stockholder distributions paid	(11,621,644)	
Borrowings under credit facility	47,000,000	
Paydowns of short-term loan	(36,001,010)	
Net cash used in financing activities	(769,777)	
Net decrease in cash and cash equivalents	(38,545,906)	
Cash and cash equivalents balance at beginning of period	62,131,686	
Cash and cash equivalents balance at end of period	$23,585,780	$
Non-cash items		
Shares issued pursuant to Dividend Reinvestment Plan	$669,803	$

See Notes to Unaudited Financial Statements.

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STELLUS CAPITAL INVESTMENT CORPORATION

SCHEDULE OF INVESTMENTS (unaudited) SEPTEMBER 30, 2013

See Notes to Unaudited Financial Statements.

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

(2) Represents a payment-in-kind 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 company.

(3) The investment is not a qualifying asset under the Investment Company Act of 1940, as amended.

(4) Security is non-income producing.

(5) This investment also includes a delayed draw term loan commitment in an amount not to exceed $12,500,000, an interest rate of 12.25%, and a maturity of May 31, 2018. This investment is accruing an unused commitment fee of 0.50% per annum.

(6) This investment also includes an undrawn revolving loan commitment in an amount not to exceed $2,000,000, an interest rate of LIBOR plus 7.5%, and a maturity of September 30, 2018. This investment is accruing an unused commitment fee of 0.50% per annum.

(7) This investment amended its maturity to 2/15/19 on 8/15/13. The interest rate was amended from 11% cash pay plus 2% PIK to 12.5% cash pay.

(8) This investment amended its maturity to 1/31/19 on 7/23/13. The interest rate was amended from 12% cash pay plus 2% PIK to 12% cash pay.

(9) This investment amended its maturity to 9/30/18 on 9/30/13.

(10) The Company s obligations to the lenders of the Credit Facility are secured by a first priority security interest in all non-controlled, non-affiliated investments and cash, but exclude cash equivalents.

Abbreviation Legend
PIK Payment-In-Kind

See Notes to Unaudited Financial Statements.

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Stellus Capital Investment Corporation

Schedule of Investments
December 31, 2012

See Notes to Unaudited Consolidated Financial Statements.

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

(2) Coupon is subject to Prime and LIBOR floors.

(3) Represents a payment-in-kind security which pays a portion of interest in additional par.

(4) The investment is not a qualifying asset under the Investment Company Act of 1940, as amended.

(5) Security is non-income producing.

(6) Common shares position will settle after December 31, 2012.

(7) The loan will settle after December 31, 2012.

(8) This instrument also includes an undrawn revolving loan commitment in an amount not to exceed $2,000,000, an interest rate of LIBOR plus 7.5%, and a maturity of March 23, 2016. This investment is accruing an unused fee of 0.50% per annum.

Abbreviation Legend

PIK Payment-In-Kind

See Notes to Unaudited Consolidated Financial Statements.

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STELLUS CAPITAL INVESTMENT CORPORATION

NOTES TO THE FINANCIAL STATEMENTS
September 30, 2013
(Unaudited)

NOTE 1 NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations

Stellus Capital Investment Corporation (the Company) was formed as a Maryland corporation on May 18, 2012 (Inception) and is an externally managed, closed-end, non-diversified management investment company. The Company has elected to be treated as a business development company under the Investment Company Act of 1940, as amended (the 1940 Act) and as a regulated investment company (RIC) for U.S. federal income tax purposes. The Company s investment activities are managed by Stellus Capital Management, LLC (Stellus Capital or the Advisor).

On November 7, 2012, the Company priced its initial public offering (the Offering), at a price of $15.00 per share. Through its initial public offering the Company sold 9,200,000 shares (including 1,200,000 shares through the underwriters exercise of the overallotment option) for gross proceeds of $138,000,000. As of September 30, 2013, the Company has raised $180,409,145 including (i) $500,010 of seed capital contributed by Stellus Capital, (ii) $12,749,990 in a private placement to certain purchasers, including persons and entities associated with Stellus Capital, and (iii) $29,159,145 in connection with the acquisition of the Company s initial portfolio. The Company s shares are currently listed on the New York Stock Exchange under the symbol SCM .

Immediately prior to the pricing of the Offering the Company acquired its initial portfolio of assets for $165,235,169 in cash and $29,159,145 in shares of the Company s common stock, or $194,394,314 in total. The cash portion of the acquisition of the initial portfolio was financed by (i) borrowing $152,485,179 under a credit facility (Bridge Facility) with Sun Trust and (ii) using the $12,749,990 of proceeds received in connection with the private placement. The Bridge Facility had a maturity date of not more than 7 days after the pricing date of the Offering. Borrowings under the Bridge Facility bore interest at the highest of (i) a prime rate, (ii) the Federal Funds Rate plus 0.50% and (iii) Libor plus 1.00%. The Company used the net proceeds from the Offering together with borrowings under the Company s Credit Facility (see Note 9) to repay in full the outstanding indebtedness under the Bridge Facility, at which point the Bridge Facility terminated.

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 its investment adviser 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 unaudited consolidated financial statements are presented in conformity with U.S. GAAP for interim financial information and pursuant to the requirements for reporting on Form 10-Q and Article 10 of Regulation S-X. Accordingly, certain disclosures accompanying annual financial statements prepared in accordance with U.S. GAAP are omitted. In the opinion of management, the unaudited 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 interim periods included herein. The results of operations for the three and nine months ended September 30, 2013 and September 30, 2012 are not necessarily indicative of the operating results to be expected for the full year. Also, the unaudited

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STELLUS CAPITAL INVESTMENT CORPORATION

NOTES TO THE FINANCIAL STATEMENTS
September 30, 2013
(Unaudited)

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

financial statements and notes should be read in conjunction with the audited financial statements and notes thereto for the year ended December 31, 2012. Financial statements prepared on a U.S. GAAP basis require management to make estimates and assumptions that affect the amounts and disclosures reported in the financial statements and accompanying notes. Such estimates and assumptions could change in the future as more information becomes known, which could impact the amounts reported and disclosed herein.

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.

As of September 30, 2012, the Company had not yet begun investment operations. Stellus Capital Management purchased the initial 100 shares for $500,010 in September 2012. As such any per share data is not calculable as of September 30, 2012.

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 September 30, 2013, cash balances totaling $13,335,847 exceeded FDIC insurance protection levels, subjecting the Company to risk related to the uninsured balance. All of the Company s cash deposits 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 September 30, 2013, we held $10 million of U.S. Treasury Bills with a 25 day maturity purchased using $1 million in margin cash and the proceeds from a $9 million short term loan from Raymond James. The loan had an effective annual interest rate of approximately 1%. On October 1, 2013, we sold the remaining Treasury Bills, repaid the remainder of the loan from Raymond James and received back the $1 million margin payment (net of fees and expenses of $1,125).

On December 31, 2012, we held $50 million of U.S. Treasury Bills with a 30 day maturity purchased using $5 million in cash and the proceeds from a $45 million short term loan from Raymond James. The loan had an effective annual interest rate of approximately 1%. On January 2, 2013, we sold the Treasury Bills, repaid the $45 million loan from Raymond James and received back the $5 million margin payment (net of fees and expenses of $8,943).

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

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STELLUS CAPITAL INVESTMENT CORPORATION

NOTES TO THE FINANCIAL STATEMENTS September 30, 2013 (Unaudited)

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

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 consist of fees and expenses paid in connection with the closing of credit facilities and are capitalized at the time of payment. Deferred financing costs are amortized using the straight line method over the term of the credit facility.

Investments

As a business development company, 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 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 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, although the Company will also engage independent valuation providers to review the valuation of each portfolio investment that does not have a readily available market quotation at least once quarterly. Investments purchased within 60 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;

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STELLUS CAPITAL INVESTMENT CORPORATION

NOTES TO THE FINANCIAL STATEMENTS September 30, 2013 (Unaudited)

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

- comparisons of financial ratios of peer companies that are public;
- comparable merger and acquisition transactions; and
- the principal market and enterprise values.

Determination of fair values involves subjective judgments and estimates not susceptible to substantiation by auditing procedures. Under current auditing standards, the notes to our financial statements refer to the uncertainty with respect to the possible effect of such valuations, and any change in such valuations, on our financial statements.

Revenue Recognition

We record interest income on an accrual basis to the extent such interest is deemed collectible. 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 fee 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.

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.

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 or sale 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.

Payment-in-Kind Interest

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.

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.

Payable for Unsettled Securities Transaction

The Company records all investments on a trade date basis.

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STELLUS CAPITAL INVESTMENT CORPORATION

NOTES TO THE FINANCIAL STATEMENTS September 30, 2013 (Unaudited)

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

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 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 status 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.

As of September 30, 2013 and December 31, 2012, the Company had $869,640 and $0, respectively, of undistributed ordinary income and gains. The character of the Company s distributions is determined annually, based upon its taxable income for the full year and based upon distributions made for the full year. A determination of the character of distributions made on an interim basis may not be representative of the final determination based upon taxable income computed for the full year.

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 benefit or expense in the applicable period. Although the Company files federal and state tax returns, its major tax jurisdiction is federal. The 2012 federal tax year for the Company remains subject to examination by the Internal Revenue Service.

As of September 30, 2013 and December 31, 2012, the Company had not recorded a liability for any unrecognized 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. There were no such expenses for the three months and nine months ended September 30, 2013.

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 unvested shares as of September 30, 2013 or December 31, 2012. As a result, there is no difference between diluted earnings per share and basic per share amounts.

Recently Issued Accounting Standards

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. The Company believes that the impact of recently issued standards that are not yet effective will not have a material impact on its 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 consisting of two parts. The first part of the annual incentive fee,

STELLUS CAPITAL INVESTMENT CORPORATION

NOTES TO THE FINANCIAL STATEMENTS September 30, 2013 (Unaudited)

NOTE 2 RELATED PARTY ARRANGEMENTS (continued)

which is calculated and payable quarterly in arrears, equals 20.0% of the pre-incentive fee net investment income (as defined in the agreement) for the immediately preceding quarter, subject to a hurdle rate of 2.0% per quarter (8.0% annualized) and a catch-up feature. The net pre-incentive fee investment income used to calculate this part of the incentive fee is also included in the amount of our gross assets used to calculate the 1.75% base management fee.

For the three months and nine months ended September 30, 2013, the Company incurred base management fees payable to the Advisor of $1,140,675 and $3,065,877, respectively.

For the three and nine months ended September 30, 2013, the Company incurred $808,352 and $1,889,838, respectively, of incentive fees related to pre-incentive fee net investment income. As of September 30, 2013, $1,262,914 of such incentive fees are currently payable to the Advisor, and $38,938 of pre-incentive fee net investment income incentive fees incurred by the Company were generated from deferred interest (i.e. PIK and certain discount accretion) and are not payable until such amounts are received in cash.

The second part of the annual incentive fee is calculated 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) and equals 20.0% of the aggregate cumulative realized gains from inception through the end of each calendar year, computed net of aggregate cumulative realized losses and aggregate cumulative unrealized depreciation through the end of such year, less the aggregate amount of any previously paid realized gain incentive fees. The realized gains incentive fee consists of fees related to both realized gains and unrealized gains (described in more detail below). For the three and nine months ended September 30, 2013, the Company adjusted its realized gains incentive fee accrual related to realized gains by $(69,639) and $47,961, respectively and related to unrealized gains by $7,925 and $359,074, respectively.

The total realized gains incentive fee payable to the Company s Advisor under the investment management agreement as of September 30, 2013 and December 31, 2012 was $407,305 and $0, respectively. The realized gains incentive fee related to realized gains payable to the Company s Advisor under the investment management agreement as of September 30, 2013 and December 31, 2012 was $47,961 and $0, respectively.

With respect to the incentive fee expense accrual relating to the unrealized gains incentive fee, GAAP requires that the realized gains incentive fee accrual consider the cumulative aggregate unrealized appreciation in the calculation, as a realized gains incentive fee would be payable if such unrealized appreciation were realized, even though such unrealized appreciation is not permitted to be considered in calculating the fee actually payable under the investment management agreement. For accounting purposes in accordance with GAAP only, in order to reflect the potential realized gains incentive fee that would be payable for a given period as if all unrealized gains were realized, the Company s accrual for unrealized gains incentive fees includes an amount related to unrealized appreciation of

$359,074 and $0 as of September 30, 2013 and December 31, 2012, respectively. There can be no assurance that such unrealized appreciation 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 realized gains incentive fees in subsequent periods.

For the years ending December 31, 2012 and December 31, 2013, the Advisor has agreed to waive its incentive fee to the extent required to support an annualized dividend yield of 9.0% (to be paid on a quarterly basis) based on the price per share of our common stock in connection with the Offering. For the three and nine months ended September 30, 2013, the advisor waived incentive fees related to pre-incentive fee net investment income of approximately $0.5 million and $1.3 million, respectively.

As of September 30, 2013 and December 31, 2012, the Company was not due any amount from Stellus Capital for reimbursement of expenses paid for by the Company that were the responsibility of Stellus Capital. Any such amounts due to the Company would be included in the Statement of Assets and Liabilities.

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NOTE 2 RELATED PARTY ARRANGEMENTS (continued)

As of September 30, 2013 and December 31, 2012, the Company owed its independent directors $76,000 and $29,452, respectively, in total for unpaid director fees.

As agreed to in the Amended and Restated Side Agreement made and entered into as of November 12, 2012 by and between Stellus Capital and Raymond James & Associates, Inc. and Stifel, Nicolaus & Company, Incorporated, Stellus Capital has agreed to pay on behalf of the Company, 2.41% of the 6% underwriters sales load, or $3,320,280 in total, in connection with the Offering. Of this amount, $1,940,280 was paid on November 14, 2012, $460,000 was paid on March 25, 2013, $460,000 was paid on June 28, 2013 and the remaining $460,000 was paid on September 25, 2013.

License Agreement

We have entered into a license agreement with Stellus Capital under which Stellus Capital 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 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 is in effect.

NOTE 3 DISTRIBUTIONS

The Company intends to make quarterly distributions of available net investment income to its stockholders. The Company intends to distribute net realized gains (*i.e.*, net realized gains in excess of net realized losses), if any, at least annually. The quarterly 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	Amount Per Share
December 7, 2012[1]	December 21, 2012	December 27, 2012	$0.18
March 7, 2013	March 21, 2013	March 28, 2013	$0.34
June 7, 2013	June 21, 2013	June 28, 2013	$0.34
August 21, 2013	September 5, 2013	September 27, 2013	$0.34

(1) The amount of the initial distribution was equal to an annualized dividend yield of 9.0% based on the price per share of our common stock in connection with our initial public offering and is proportionately reduced to reflect the number of days remaining in the quarter after completion of the Offering.

Unless the stockholder elects to receive its distributions in cash, the Company intends to make such distributions in additional shares of the Company s 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. If a stockholder holds shares of the Company s common stock in the name of a broker or financial intermediary, the stockholder should contact such broker or financial intermediary regarding their election to receive distributions in cash in lieu of shares of the Company s common stock. 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. Of the total distributions of $12,291,447 made to shareholders through September 30, 2013, $11,621,644 was made in cash and the remainder in shares.

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NOTE 4 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;

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 September 30, 2013, the Company had investments in 23 portfolio companies. The total cost and fair value of the investments were $242,598,120 and $243,625,309, respectively. The composition of our investments as of September 30, 2013 is as follows:

	Cost	Fair Value
Senior Secured First Lien	$ 60,321,841	$ 60,606,097
Senior Secured Second Lien	78,381,468	79,195,140
Unsecured Debt	102,180,525	101,914,951

Equity	1,714,286	1,909,121
Total Investments	$ 242,598,120	$ 243,625,309

At December 31, 2012, the Company had investments in 15 portfolio companies. The total cost and fair value of the investments were $195,455,671 and $195,451,256, respectively. The composition of our investments as of December 31, 2012 is as follows:

	Cost	Fair Value
Senior Secured First Lien	$ 44,014,214	$ 44,014,214
Senior Secured Second Lien	38,597,293	38,597,622
Unsecured Debt	111,129,878	111,125,134
Equity	1,714,286	1,714,286
Total Investments	$ 195,455,671	$ 195,451,256

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

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STELLUS CAPITAL INVESTMENT CORPORATION

NOTES TO THE FINANCIAL STATEMENTS
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(Unaudited)

NOTE 4 PORTFOLIO INVESTMENTS AND FAIR VALUE (continued)

accordance with the terms of the underlying loan agreements. As of September 30, 2013 and December 31, 2012, the Company had two and one such investments with aggregate unfunded commitments of $14,500,000 and $2,000,000, respectively. The Company maintains sufficient liquidity to fund such unfunded loan commitments should the need arise.

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 September 30, 2013 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	$	$	$ 60,606,097	$ 60,606,097
Senior Secured	Second Lien		26,625,590	52,569,550	79,195,140
Unsecured Debt				101,914,951	101,914,951
Equity				1,909,121	1,909,121
Total Investments		$	$ 26,625,590	$ 216,999,719	$ 243,625,309

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, 2012 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	$	$	$ 44,014,214	$ 44,014,214
Senior Secured	Second Lien		12,120,000	26,477,622	38,597,622

Unsecured Debt			111,125,134	111,125,134
Equity			1,714,286	1,714,286
Total Investments	$	$ 12,120,000	$ 183,331,256	$ 195,451,256

The aggregate values of Level 3 portfolio investments changed during the nine months ended September 30, 2013 are as follows:

	Senior Secured Loans First Lien	Senior Secured Loans Second Lien	Unsecured Debt	Equity	Total
Fair value at beginning of period	$44,014,214	$26,477,622	$111,125,134	$1,714,286	$183,331,256
Purchases of investments	37,536,081	63,547,500	15,054,742		116,138,323
Sales and Redemptions	(21,401,931)	(25,703,125)	(25,000,000)		(72,105,056)
Realized Gains	11,545	209,677	903,322		1,124,544
Change in unrealized appreciation/(depreciation) included in earnings	284,255	564,712	(260,830)	194,835	782,972
Accretion of discount	161,933	49,736	92,582		304,251
Transfer from Level 2					
Transfer to Level 2		(12,576,571)			(12,576,571)
Fair value at end of period	$60,606,097	$52,569,551	$101,914,950	$1,909,121	$216,999,719
Change in unrealized appreciation/(depreciation) on Level 3 investments still held as of September 30, 2013	$284,255	$501,232	$(260,830)	$194,835	$719,492

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NOTES TO THE FINANCIAL STATEMENTS September 30, 2013 (Unaudited)

NOTE 4 PORTFOLIO INVESTMENTS AND FAIR VALUE (continued)

During the nine months ended September 30, 2013, there were no transfers from Level 2 to Level 3.

During the nine months ended September 30, 2013, there were two transfers from Level 3 to Level 2 due to quoted prices available for the financial instruments.

The aggregate values of Level 3 portfolio investments changed during the period from Inception through December 31, 2012 are as follows:

	Senior Secured Loans First Lien	Senior Secured Loans Second Lien	Unsecured Debt	Equity	Total
Fair value at beginning of period	$	$	$	$	$
Purchases of investments	97,066,024	16,477,500	124,507,797	1,714,286	239,765,607
Sales and Redemptions	(53,057,372)		(13,400,740)		(66,458,112)
Change in unrealized appreciation (depreciation) included in earnings			(4,744)		(4,744)
Accretion of discount	5,562	122	22,821		28,505
Transfer from Level 2		10,000,000			10,000,000
Transfer to Level 2					
Fair value at end of period	$44,014,214	$26,477,622	$111,125,134	$1,714,286	$183,331,256
Change in unrealized appreciation (depreciation) on Level 3 investments still held as of December 31, 2012	$	$	$(4,744)	$	$(4,744)

The following is a summary of geographical concentration of our investment portfolio as of September 30, 2013:

	Cost	Fair Value	% of Total Investments
Colorado	$ 36,243,568	$ 36,870,097	15.13 %
Minnesota	34,794,479	35,027,004	14.38 %
Canada	27,961,549	28,143,492	11.55 %

New York	25,298,910	25,298,910	10.38	%
Kentucky	16,870,095	17,245,099	7.08	%
Florida	16,893,530	16,893,530	6.93	%
Texas	16,536,414	16,508,037	6.78	%
Indiana	11,169,118	11,169,118	4.59	%
Massachusetts	10,000,000	10,088,000	4.14	%
Pennsylvania	9,659,583	9,417,001	3.87	%
New Jersey	9,161,316	9,161,316	3.76	%
Puerto Rico	8,702,234	8,231,865	3.38	%
Missouri	7,923,260	8,120,000	3.33	%
Illinois	7,390,621	7,390,500	3.03	%
Virginia	2,513,997	2,585,190	1.06	%
Georgia	1,479,446	1,476,150	0.61	%
	$ 242,598,120	$ 243,625,309	100.00	%

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NOTES TO THE FINANCIAL STATEMENTS
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NOTE 4 PORTFOLIO INVESTMENTS AND FAIR VALUE (continued)

The following is a summary of geographical concentration of our investment portfolio as of December 31, 2012:

	Cost	Fair Value	% of Total Investments
Pennsylvania	$ 33,708,952	$ 33,704,209	17.24 %
Canada	20,778,456	20,778,456	10.63 %
Colorado	19,532,633	19,532,633	9.99 %
Kentucky	17,095,646	17,095,646	8.75 %
Florida	16,639,880	16,639,880	8.51 %
South Carolina	15,000,000	15,000,000	7.67 %
New York	13,000,000	13,000,000	6.65 %
Texas	12,119,671	12,120,000	6.20 %
Massachusetts	10,000,000	10,000,000	5.12 %
Utah	9,902,063		