

THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

Capital Southwest Corp. (NASDAQ:CSWC)



MICHAEL S. SARNAR joined Capital Southwest in 2015 and currently serves as Chief Executive Officer, bringing over 30 years of experience in finance, treasury, and BDCs. Leveraging his extensive background in financial services, Mr. Sarnar has built best-in-class teams and innovative solutions to support the company's growth. Under his leadership, his team has raised over \$2 billion in debt and equity financing and secured Investment Company Ratings from Moody's Investor Services and Fitch Ratings. As CEO, Mr. Sarnar is responsible for the firm's strategic direction. He serves as Chair of the Investment Committee and is a member of the CSWC board of directors. Before joining Capital Southwest, he spent 15 years at American Capital, Ltd., holding various financial leadership roles, including Senior Vice President of Treasury. Mr. Sarnar received a Bachelor in Business Administration/Accounting from James Madison University and a

Master in Finance from George Washington University's School of Business and Public Management. He is a Certified Public Accountant. Mr. Sarnar lives in Dallas with his wife and three sons.

SECTOR — FINANCIAL SERVICES

TWST: Would you give me a little bit of the background of Capital Southwest? When it was started, why it was started, and what was going on at the time?

Mr. Sarnar: Even before I go there, I'll give you my background. I'm one of the oldest BDC professionals in the industry with over 30 years of experience with BDCs. Previous to joining Capital Southwest, I worked at American Capital where I was one of the initial employees in 2000. Even before that, my first gig was auditing Allied Capital when it was the only BDC around. So if there's one thing I know in this world, it's BDCs.

The Capital Southwest story is one of the more interesting stories. Capital Southwest began when it went public in 1961. So it's certainly the oldest BDC, but it didn't start that way. There were no BDCs until 1988. It was organized as an SBIC, which was the first SBIC in the country. It invested in minority equity positions. It raised \$15 million in equity in 1961 and never went back to the debt or equity markets. By the early 2000s, that \$15 million had grown to over a billion dollars.

So it was very successful in what it did. But along the way, it converted to a BDC in 1988. We think we were the first BDC. Essentially, upon conversion to a BDC, it was almost locked in its own structure. Because if you're familiar with BDCs, the requirement is that you are a granular investor in non-financial investments. This company, Capital Southwest, by 2010 had a value of about \$1.2

billion and had about a dozen companies that were worth that \$1.2 billion. So it was extremely lumpy.

So this company grew and during the years 2000 to 2012, the BDC market started being built out. Before that, it was just Capital Southwest, and then Allied and another company, MCG, but it wasn't an industry. Then some of the bigger players like Apollo and American Capital came along and a number of the large shops started building out externally managed BDCs. Once that happened, the BDCs began paying distributions. Capital Southwest, however, because it was all equity, wasn't able to distribute earnings and was trading at a 40% to 50% discount to its net asset value. Look at that in relation to all the other BDCs that were trading at or above book and paying distributions, and you see it was essentially locked in its structure.

In 2012, we got a letter from one of our large shareholders who is still in our company today, that told us, "You need to do something. You either sell the company or reorganize or do something." So half the board quit because they realized they didn't have answers, and the others were mostly pushed out. They hired a new CEO to figure out what to do with this very successful company that was locked in its structure and trading at such a deep discount and came up with the idea. They hired me and two other people to figure out what to do with the organization.

We decided to spin out those assets. There were six or seven other companies aside from the top six, and we spun out the six companies into a new publicly traded company called CSW

Industrials. We sold some of the other small investments and left \$285 million in cash. On October 1, 2015, post-spin, we began as a lower middle market lender — a BDC with \$285 million in cash and three employees. That's kind of where the story starts. I joined early 2015, after the shareholder letter but before the spin-out was configured and executed upon.

TWST: Would you give us a sense of the size of your current portfolio?

Mr. Sarner: Our portfolio today is a little over \$2 billion in assets. We have about 140 portfolio companies. We invest in the lower middle market, which differentiates us from most of the lenders in the market. Our average deal is somewhere between \$3 million in EBITDA and maybe as large as \$15 million of EBITDA. So generally smallish companies. Most all of them are sponsor-backed. These are founders that have brought the company to a certain place and are now either wanting to sell and leave the business or are looking for help to grow. This might be an aging founder who has a deep bench of professionals underneath him. But most of the time it's a management team that's been very successful but has taken it only so far, and now they need expertise in the way of a sponsor as well as additional growth capital.

billions of phones, and it's not expensive enough for Apple to want to trade it out, so it has a nice foothold. Others have some sort of unique product. For example, we have a company that sells heated snow and ice-melting mats to both commercial and residential customers. What we like about it is it's a unique business model; it has a reason to exist.

Alongside our debt, we invest a small equity co-investment. So our typical deal will include \$15 million of debt, maybe a \$5 million revolving credit facility, and then a million dollars of equity. So we've seen over the last six months, we've had \$50 million of gains on \$3 million of equity cost value. We have two other companies that are in the market today for \$2 million equity cost value that are valued over \$50 million. So you can see we're investing with these small businesses, taking an equity stake, and partnering alongside equity sponsors. The equity sponsors are providing operational expertise and junior capital to support these companies. If a company was to go bump in the night and struggle, we as the senior lender will encourage the sponsor to put in additional equity to support the business so that we can work together to maximize value. In nearly all instances sponsors are willing to support the business to ensure success. Our due diligence process goes beyond just

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So they'll sell, call it 60% - 80% of the business, and hold on to 20% to 40% in rollover equity. They'll partner with the sponsor, so upon completion of the sale, they'll get a large distribution. Think of this as a 50-something-year-old man or woman who's grown this business for the last 20 years. They're going to ring the bell and get a check for \$20 to \$50 million and then they're going to continue working for the company to build it out to the next level alongside the sponsor with the hopes of ringing the bell one more time.

Our average EBITDA size when we originate a deal is \$6 million, but the average size of our portfolio companies is \$20 million. We think of three ways these companies grow. One, we professionalize them when we bring in a sponsor, so you usually see some low-hanging fruit to add a million or two million dollars easily. Then there's the organic growth because these businesses are generally very successful and still going to grow. And then the third piece is M&A. Some have identified competitors that they'd love to buy or they're partnering with the sponsor to identify other footholds to help grow the business.

TWST: What makes a company a good acquisition for you?

Mr. Sarner: For starters, we're looking for strong cash flow. The management team is essential. Financial integrity is necessary. You need to have a team that has bench strength. So we're not trying to invest in a company where one guy or gal is the story. We want to see several parties that are marketing, sales, operations. We want to see a deep bench. We also say these companies have to have a reason to exist. So we're not investing in commodity businesses.

We've done loans with companies that do a small part of an Apple iPhone. It could be a 10-cent product that's sold into the

diligencing the portfolio company, we also diligence the sponsors to ensure they are “good actors” and will act in good faith to ensure a favorable outcome for all investors in the deal.

TWST: Are you focusing on a certain sector or are you more sector-agnostic?

Mr. Sarner: Though we're agnostic, we partner with sponsors that have a strong industry focus. We want to be diversified for two reasons. One, the BDC setup is meant to be a diverse universe of loans without any concentrations. Also from a leverage perspective, you're going to get a better borrowing rate if you have a more diversified asset composition. Our strategy is to partner with sponsors with industry focus and expertise. While we don't consider ourselves industry experts in any one industry, we partner with industry experts. For example, if we're looking at a health care deal, we are not going to look at a sponsor doing a health care deal when they're into restaurants. You play to the sponsor's strength, whatever it is. If they're health care, then you're looking for their health care deal. We have a team of 42 people — which is smallish but growing — who are professionals with experience investing in both debt and equity. We break the country into four quadrants and assign deal professionals to cover each quadrant. We track both the deals that we don't win as well as deals that we do. There are deals that we see in the market in periodicals but that we never even heard of or were not shown to us that are added to our quarterly marketing list. We then send our deal guys to work visiting and creating relationships with these new sponsors.

When we started this in 2015, we had maybe a handful of sponsors. Over the last 10 years, we've done deals with over 160 sponsors, and we've done multiple deals with almost 40 sponsors.

We're seeing most of their deal flow. The real art is being a good partner to your sponsor, being able to do what you say and make it to close on time. Sponsors tend to like to work with us because we've got deep experience in the lower middle market, so we add value on the diligence side. We're sharing our materials with them and they do the same with us.

TWST: Walk us through the general investment process.

Mr. Sarner: Regarding the process, it generally takes 90 to 120 days for a deal to close and typically it goes like this: We get a 10- to 15-page pitchbook, a teaser, either from a broker, directly from a founder, or through the sponsor. We'll review it and decide whether it's something that passes our screen. If it does, we sign an NDA and get a more detailed CIM, which is the report that's sent out that's got a detailed listing of everything regarding the company. Then it goes to our deal guys. We'll have a three-to-five person deal team on each credit that will break down the investment based on the materials they were given. If they like it, they bring it to the investment committee on Mondays and we will go through it for 30 minutes and discuss the credit, the sponsor, the structure, the pricing, and decide whether this is a deal we want to pursue.

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So if we like the deal, we give guidance to the deal team and they'll then submit an indication of interest, an IOI, of where we potentially would be interested. Then we either do or do not get pushed to the next level. At the initial stage, there's probably 20 to 30 lenders looking at it. Sponsors typically advance five to eight lenders to the management-meeting stage. Given our longstanding relationships with many of these sponsors, our decision to submit an IOI is generally sufficient to secure a spot in the next round. The main exceptions are situations where the deal is priced extremely tightly or where the structure lacks the full covenant package that we require.

So if we move on to that next stage, we'll have a management meeting where our deal teams will go out to the company and listen to a pitch and do a deeper dive. Then they'll come back to decide whether internally, after everything we heard, we want to have an initial investment committee and then submit a binding term sheet. That's a 50-to-70 page report that our deal team puts together and we spend two to three hours together combing through. Then if we like it and the investment committee wants to move forward, we'll give the deal team specific covenants, terms and pricing. We essentially are indicating to the deal team, based on the facts and opinions laid out in the committee reports as well as our discussion, that we are supportive of this deal and commit to this term sheet assuming we can confirm these three to five points are correct in the final underwriting process. As I mentioned above, if we commit to a term sheet, and the investment thesis is confirmed, we have never walked away from a deal. And that matters greatly to a sponsor. There are plenty of other firms that retrade deals with sponsors or vice versa, and that is known in the market.

After the initial investment committee we submit our term sheet and wait to find out if we are selected. Often times there will be some horse trading on terms, but generally speaking we put our best foot forward on the executed term sheet. From there we either win or don't win. If selected, then we'll go through from initial to final where you do all the confirmatory diligence and make sure that what we said was true, is true. That'll take another, call it four weeks or so. Typically 90 to 120 days after we've seen an investment, we close that deal.

TWST: Do all the deals have sponsors?

Mr. Sarner: Ninety-three percent of our deals do. The other 7% are either directly from the founder or through a broker. I just announced publicly we just hired a business development MD and he's got relationships in the non-sponsored world. We have immediately seen a huge influx of non sponsored founder-based businesses. The bar to invest, however, in a non-sponsored deal is much higher since there will be limited equity support and no sponsor expertise. However, these deals tend to have higher yields and provide us with larger equity upside through warrants or preferred equity. But overall, we will always lean heavily toward sponsor deals. Building new sponsor relationships can take years to

get them to show you their deal flow. It typically works like this. We cold call them, then we have a short conversation. We say next time we're in town we'd love to meet with you. Then we follow up when we're in town and get a 30-minute coffee. Initially we don't generally see all deals from a new sponsor. They may show us deals that are a bit more difficult to see how we think and act. We will try and be commercial on these deals as best we can. We may provide an IOI which is appropriately conservative, but may be too tight in terms of structure to actually win the deal. After a few rounds of getting to know each other and exchanging IOIs and perhaps term sheets, we will start seeing most if not all of their deal flow. Once we do, we believe we bring strong diligence expertise to the table which our sponsors appreciate. We're not an asset accumulator. If you focus on the BDC space, there's a lot of businesses where all they do is buy what used to be broadly syndicated loans but is now private credit. But they're just investing in huge companies and allocating assets across their different funds.

This is our only fund, so every asset that goes on our balance sheet means the world to us. For us, it's not a marketing pitch. It's truly why we trade at the second-highest price-to-book in the industry. It's because people understand that we're perfectly aligned with shareholders being internally managed and all of these credits are not pieces that we're allocating and getting fees off of.

TWST: About how many deals do you do a year?

Mr. Sarner: It's about 2% of the deals we've seen on an annual basis, which is very small because we have such a tight screening process. Right now that's about 30 deals a year. Two years ago we saw about 800 deals and we did, I think, 16 deals. The next year was a thousand. This year, because we've added two

MDs, so I think we're probably looking at 1,500 to 1,700 deals. The pipeline has opened up. Of the 1,700, I think 700 of them we won't even bring to the one-pager phase. So it's the other thousand from which we review in depth. It is a lot of work. That's why a year ago we had 27 people and today we have 42. We're growing considerably to ensure we have adequate staff to properly diligence all investment opportunities.

TWST: How much capital do you have on hand to fund those deals?

Mr. Sarner: In dry powder today, we have about \$500 million. We have a few debt products that we utilize. We have a revolving line of credit with ING Capital which is approximately \$500 million, I think we have \$200 and something drawn. We also have two licenses with the SBA, SBIC licenses. One is fully drawn, which is \$175 million. The other one, I think we've drawn \$20 or \$30 million, so we still have another \$150 million to be drawn. We have another credit facility with Deutsche Bank for \$150 million which is mostly undrawn. Then we raise bonds for additional debt and equity through our ATM program all the time.

Since we trade meaningfully above book, we are continually raising capital. The name of the game here in BDC land is to trade above book. Trade above book value so that you can raise equity on an accretive basis and continue to methodically grow. Of the 55 or 60 BDCs, only five of them currently trade above book. All the others are doing is recycling capital. Whereas we're trading at a 34% premium to book. I'm raising equity every day of the week and drawing off my credit facility, which is why we've grown from nothing to \$2 billion in 10 years.

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We honestly think because we have appropriately scaled the business, and have built such strong sponsor relationships, that we'll probably be able to grow the balance sheet another billion dollars in the next 18 months or so. There's few competitors that are perfectly dedicated to our space, the \$3 to \$15 million in EBITDA. The gorilla in the space for the lower and middle market is Main Street Capital, they have about \$6 billion in AUM, and we partner together on a lot of deals. After the two of us, then you've got the upper and large middle market lenders that invest in companies somewhere between \$30 million to \$150 million in EBITDA. That's a very different animal.

TWST: What were some of your biggest wins in the last year?

Mr. Sarner: We've had several meaningful wins recently. We closed three large exits and have two more in process.

A recent exit from the portfolio includes a sponsor backed trading platform, originally financed with \$18 million of debt and \$2 million of equity in 2019. At the time of our investment, the company was generating \$13 million in EBITDA. 6 years later, through organic growth, improvements to the company spearheaded by the sponsor and additional financing provided to the company by CSWC, it grew to over \$100 million in EBITDA and was sold at a substantial multiple.

Another example is a company currently in the market that we are particularly proud of. It's a transportation business we originated in 2018. It was a non sponsored, founder led deal, and the company began struggling right out of the gate. We provided capital support and took a 22% equity stake in the company. At the time, the business generated \$3 million of EBITDA. Today, this company generates \$40 million in EBITDA and is in the market with an expected sale multiple well in excess of its closing multiple.

Another aspect of our past and future success comes from our three-person operations team, which works alongside our deal professionals and provides an objective, hands-on view of each business. That operational expertise has been invaluable. Our operations and deal team works closely with the CEOs and CFOs throughout a turnaround, and the results speak for themselves.

These outcomes highlight the strength of our model: a lower middle market focus, permanent capital, and the ability to work patiently and constructively with companies through challenges. It allows us to create long term solutions and generate meaningful value for our shareholders.

TWST: You released your 3Q results in February. What would you like people to take away from that?

Mr. Sarner: The big picture is what we're producing relative to the market. The relative market is having issues with SOFR coming down and spread compression, such that 29 of the 42 comps of ours cut their dividend. We've been planning for this for the past 3 years. Today our earnings are still perfectly covering our regular dividend. So our net investment income, which is what you distribute your dividends out of, we're still achieving above 100%

coverage. It says we planned accordingly to the rate reductions and have made investments that meet our return thresholds. We believe this illustrates the discipline with which we operate.

Our operating leverage is very low. Our operating expenses — so that's our non-interest expense, so salaries, general and administrative and professional services expenses divided by our assets — is the second lowest in the entire industry. That's a strong metric as the efficiencies translate to higher dividends for our shareholders. Our corporate leverage, is extremely conservative at, I think, 0.89 relative 1.1 is the average of our brethren. So low leverage, low operating costs, a strong dividend coverage. We have an extremely strong balance sheet.

TWST: What are some of the major challenges that lie ahead for the BDC world?

Mr. Sarner: The biggest one is what you read about every day, the AI risk. When I look at some of the software — the negativity or overhang on software — some of that's probably overplayed, probably it's more temporary. But what isn't temporary is figuring out where to invest in companies that are either going to utilize AI to essentially run a more efficient shop and create more earnings, or the companies, quite frankly, that are just going to go away. Specifically,

these companies that we're investing in, sponsors own them and then they want to sell them in three to five years. Do they have a future or is AI going to replace them?

I'll give you a good example. We just looked at a deal the other day, an international company that essentially has human capital for translation services. Businesses all over the world that need a translator can call these guys up, no matter where they are, and these guys will show up. I don't know that that's going to exist in three to five years and so we passed on it, even though the company's doing extremely well and is geographically diverse across the globe. But you can't make a bet on a company like that.

If you back up three to five years ago, we were really asking similar questions about COVID and its impacts to the supply chain. You weren't certain where the bottom was and needed to determine where things would land. So now you've got AI, which has similar dynamics in terms of winners and losers. In addition, there's the tariffs and oil shock from the war in the Middle East. The current investing environment has grown increasingly difficult to manage when you don't know what's next. We're trying to figure it out on a daily basis, whether the changes to certain industries will be a tailwind or a headwind.

TWST: Given the uncertainty around tariffs, interest rates, rising inflation, geopolitical turbulence — what steps should BDCs be taking to weather the storm?

Mr. Sarner: The one thing you can absolutely control right now is leverage. In periods of uncertainty—whether heading into a potential recession or navigating the unknowns after major dislocations—minimizing leverage is essential. Historically, this is where our company has stood out. We're one of the few firms that consistently trade above book value, and that strength gives us the ability to raise equity at any time to de-risk the balance sheet when conditions warrant it. That flexibility has made us more resilient than peers and better positioned to manage elevated risk. If you're below book as a BDC, you're not allowed to raise equity. If you are over levered, and you don't have access to the equity markets, you can't raise debt or you will fall out of BDC compliance. So maintaining conservative leverage is a must. They should all also be selective about what they invest in, in terms of yields that meet their return on equity to continue to pay a dividend.

When you're evaluating an industry, you can't just read the internet and assume you understand the full picture. Industries evolve through tectonic shifts driven by technology, policy, and geopolitics. It's never as simple as tariffs or interest rates. Health care is a perfect example. For years it was considered a safe, reliable investment pipeline for most funds. But the landscape has changed meaningfully, especially following the Big Beautiful Bill, with major implications on the Medicaid side.

Because of this, we spend an extraordinary amount of time reviewing health care opportunities to ensure we truly understand the risk profile. That means deep diligence, engaging industry experts who can provide objective, ground-level insight, and conducting market research to validate or challenge our assumptions. In an

environment defined by structural change, rigorous diligence isn't optional—it's the only way to reach sound conclusions.

TWST: Before we let you go, what's the most important thing that investors should know about Capital Southwest?

Mr. Sarner: I would say it's our conservative bent in a variety of ways. I've already noted low leverage, significant liquidity. The average asset in our portfolio as a percentage of total assets is less than 1%. So we're highly granular and extremely diversified. And we don't have to grow. As an internally managed BDC, my compensation is a base and bonus and shares, the same shares that my shareholders own. So I don't get paid if I grow assets; I get paid if net asset value grows and if our stock price grows. And so I have perfect alignment with shareholders.

There are only five internally managed BDCs. The rest are external, which means there's a manager who owns a contract to manage the BDC. They get paid a 2% fee for all of the assets at the BDC, so they may not be primarily concerned with whether the BDC does well or not; they just want the BDC to grow. Capital Southwest is fully aligned with our shareholders. The way I manage this business is designed to grow and create value for you—and when we create value for you, we create value for me. Our incentives move in the same direction, which is exactly how it should be. The other thing to mention is that we have full covenants in all of our deals. So our deals are highly structured with leverage, capex and interest coverage covenants, such that our smaller companies are conservatively structured and start extremely lowly levered. So our average leverage is 3.5 times on a company that's usually worth about eight times, so 30% to 40% loan-to-value. The rest of the market is essentially levering at somewhere between 4.5 and seven times without covenants that dictate how these companies can perform.

Sometimes we hear feedback around what we call “small company bias”. That these companies are really small and thus more risky. While that might be the case, these companies are being run by quality sponsors with tremendous track records. They've been in business usually 20 years, and they're structured so conservatively that there's so much room to grow. There's a huge upside with these companies. That's very different than the upper middle market and the middle market where companies are levered highly and have more room to fall than they do to grow, which is based on how they come out of the gates from a structure perspective.

TWST: Thank you. (ED)

MICHAEL SARNER

President & CEO Capital Southwest Corp.

8333 Douglas Avenue, Suite 1100

Dallas, TX 75225

(214) 238-5700

www.capitalsouthwest.com

e-mail: msarner@capitalsouthwest.com