This 3DAdvisors Report Covers:
✓ **Insider Trading**: Insider Trading Behavior
✓ **Accounting**: Quality of Earnings Issues
✓ **Governance:** Corporate Governance Issues

Known Accounting Issues Given Context by Insiders
American Capital Strategies, Ltd. (NASDAQ:ACAS)

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American Capital Strategies, Ltd. is a buyout and mezzanine fund that is principally engaged in providing senior debt, subordinated debt, preferred equity and common equity to middle-market companies in need of capital for management buyouts, including employee stock ownership plan buyouts, growth, acquisitions, liquidity and restructurings. The Company's ability to fund the entire capital structure is an advantage in completing middle-market transactions. American Capital generally invests up to $50 million in each transaction, and, through its subsidiary, American Capital Financial Services, Inc., will arrange and secure capital for larger transactions. Its loans typically range from $5 million to $50 million, mature in five to 10 years and require monthly or quarterly interests payments at fixed rates or variable interest rates based on the prime rate, plus a margin.

Summary of 3DAdvisors Findings for ACAS

- **Insider Trading:** Insiders sell big chunk of holdings in abrupt sentiment reversal
- **Accounting:** The need for cash results in multiple stock offerings and dilution
- **Accounting:** Covering the dividend is a closely followed issue: with good reason
- **Accounting:** Valuation of portfolio investments looks creative
- **Accounting:** Timing of sale, and booking of gains, is suspect
- **Accounting:** Disclosure provides some interesting detail on deal structure
- **Governance:** Various corporate disclosures, or lack thereof, are worrisome

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Discussion of 3DAdvisors Findings

A convergence of sharp selling by a number of key American Capital Strategies insiders is what originally caught our attention and we subsequently covered the unusual insider selling in the *Insider Research Bulletin* of 3/26/04. This particular group of executives, all of whom have been with the Company since its earliest days, began unloading significant chunks of their holdings suddenly and within the same time window. With reductions running as high as 48% to 79% for some of them, it would seem that the risk runs high that some type of schism may have developed among the management team as founder and largest shareholder, Malon Wilkus, has not sold shares. This insider trading profile naturally led us to review both the Company's business model and accounting and governance behaviors. Although American Capital has been well followed for several known accounting issues, the insider trading and governance behavior we have uncovered have provided important context and add emphasis to those accounting issues.

Insider Trading: Insiders sell big chunk of holdings in abrupt sentiment reversal

American Capital Strategies is a story of relatively restrained insiders diverging from their historical trading behavior. From February 12th through March 1st, five insiders (all five of the firm's non-director executives) sold 535,781 shares between $33.28 and $34.33. This is a strange reversal of sentiment for American Capital insiders, who had only sold 110,000 shares between 2002 and 2003, and in fact, purchased 295,000 shares as a group during that period. Since 1998, insiders had sold just over 800,000 shares in total, which is the first reason the 535,781 shares sold in just three weeks this year grabbed our attention. In addition to the volume, two of the Company's three most senior executives, the chief financial and chief operating officers, sold 49% and 79% of their actionable holdings, respectively (exercisable options plus stock held). The COO in fact exercised six series of options (that were not even close to expiration) to acquire the shares to sell, and came very close to skimming one option, having accepted a very slim spread between the strike and market prices.

This type of insider activity is a signal that some change has occurred which has caused the abrupt behavior shift. Company disclosures provide little direction to indicate whether there is a falling out in the upper management ranks or increases in management's perception of the Company's risk profile, or both. It would seem, however, that the collective actions of these key operating insiders has more to say about the situation than American Capital is willing to offer:

- **Roland Cline (56)** – Senior V.P., Managing Director. Last time we saw Cline selling shares was back in May 2001. He then surfaced buying 2,106 shares between October 2002 and August 2003 after the issue dropped from the mid-$30s in May 2002 down to $17 by October. Recently, Cline sold 34,947 shares on March 1st at $33.28. The timing of the sale is interesting; he sold the shares immediately after the six-month period he was required to hold the shares under the short-swing rule of Section 16(b) ended. **His transactions trimmed his holdings by 21.5%.**

- **John Erickson (44)** – Executive V.P., CFO. Since joining the Company in 1998, Erickson had only sold twice – in May 2001 (25,000 shares) and August 2001 (35,640 shares). Recently, Erickson displayed more aggressive behavior as he sold 229,490 shares between February 12th and February 17th from $33.42 to $34.42. **The sales reduced his actionable position (exercisable options and common stock) by 49%.**

- **Ira Wagner (51)** – Executive V.P., COO. Since making his only prior sale in November 2001, Wagner acquired shares from both open-market purchases and option exercises from September 2002 through August 2003. In all, he accumulated 3,500 shares, which he recently sold back, along with the majority of his holdings. From February 12th through February 17th, Wagner sold 229,490 shares, grossing roughly $7.7 million. In order to sell such a large position, he exercised six non-expiring option series (expiration dates: 2/10, 5/10, 5/11 @ $25.75, 5/11 @ $26.10, 12/11, 5/12). Wagner was also very close to skimming one of the option series he exercised, having paid $29.87 for the shares and selling them for $33.40. **His position reduction, however, speaks the loudest as he slashed his holdings by 79% with these recent trades.**

- **Darin Winn (40)** – Senior V.P., Managing Director. Winn sold 27,000 shares on February 12th and February 13th at roughly $33.50. This was Winn's first sale since joining the Company in 1998, and it **reduced his holdings by 12%**. His only prior transaction was a 1,200-share open-market purchase in October 2002 at $17.50.

- **Gordon O'Brien (38)** – Senior V.P., Managing Director. Like Cline, O'Brien was a buyer during the share's 2002 weakness, picking up 3,010 shares at an average price of $17.90. He recently reversed his sentiment, having sold 43,186 shares from February 12th through February 17th. This was O'Brien's first sale since filing in 1998 and he **reduced his position by 16% in the process.**

To this, it should be noted that the Company in the past loaned insiders cash to pay for option exercises. To date, only the $6.8 million loan to Chairman Malon Wilkus remains on the books. It should also be noted that the above selling insiders had no loans outstanding at the time of their recent sales so it is clear that they were not acting to pay off outstanding loan balances.

Accounting: The need for cash results in multiple stock offerings and dilution

In maintaining its status as a regulated investment company, American Capital is required to pay out annually 90% or more of its investment company taxable income and 98% of its net realized short-term capital gains to shareholders. Given the high proportion of non-cash income the Company generates (see below), this is no small matter.

A well-known fact among informed American Capital observers is the apparent dependence of the Company on outside capital in order to sustain its ample 8% dividend. Indeed, the Company went to the public offering well five times, between January of 2003 and February of 2004, raising a total of $585 million. By the end of 2003, the Company's most recent shelf registration (totaling $740 million), filed that June, was exhausted. So was the Company's ability to sell more shares as the 67 million outstanding shares was within spitting distance of the 70 million share authorization cap. The Company moved quickly, and in a big way, to increase the authorized share limit to 200 million. Immediately following shareholder approval, the Company filed a shelf registration covering the proposed sale of $1.75 billion in either Common or Preferred shares or Debt Securities.

The attendant dilution, which comes with the increased level of equity offerings, is no small matter. While net income increased 37% in F/Y 2003, dividend income per share rose by a much lesser amount, just 8.5%, while EPS actually dropped by just under one percent for the period. The dramatic dilution effect of coming stock offerings, given the recent $1.75 billion shelf registration, will only serve to greatly exacerbate this situation in the near to intermediate term.

Accounting: Covering the dividend is a closely followed issue: with good reason

A much-discussed topic in the financial community, with regards to American Capital, is the ability of the Company to maintain it's per share dividend payout levels, a feat that will clearly become increasingly difficult as more and more stock continues to be sold in public offerings. One of the interesting components of the Company's earnings picture is the non-cash Payment-In-Kind (PIK) interest and dividends where notes or dividends are issued in lieu of interest payments. PIK non-cash interest and dividends totaled $26.1 million in 2003, or 22% of Net Earnings Per Share (Net increase in S/E resulting from Operations). Actual collections of PIK interest and dividends for the year (from bookings in prior periods) totaled just $6 million. The Company is quick to point out that the issuance of PIK interest and dividends is critical to its mix, as it needs them to stay competitive in its industry. So far, however, actual PIK collections, from prior periods, have fallen far short of matching up with the amount of new non-cash PIK income being booked each year. The fact stands that in the past three years (2001 through 2003) booked PIK-related non-cash income totaling $48.1 million vs. actual cumulative collections (during the same period) totaling just $15.3 million.

Original Issue Discount accretion also plays a significant role here. Accretion of loan discounts added $13.2 million of non-cash income to the picture in 2003. These, combined with PIK dividends and interest, bring the total of non-cash income recognized in F/Y 2003 to $39.3 million, or almost 31% of Net Earnings Per Share. It is quite evident to most that making the $153 million dividend in F/Y 2003 with only 69% of the $117.4 million generated out of Cash From Operations required a significant application of other resources.

On its own web site, the Company has posted a question and answer section designed to answer some of the many questions circulating about its ability to maintain its dividend:

- *Does American Capital have to raise capital to pay its dividends?* The Company says "No", showing how, on a cumulative basis, it has received more cash (since 1997) than it has needed to cover both operating expenses and the cash dividends paid out. Nothing is explained, however, about period-to-period coverages or the situation going forward.

- *Can American Capital maintain its dividend if it cannot raise additional capital?* American Capital refrains from saying it does not pay dividends out of funds raised from new capital, instead choosing to dance around the issue, in a tree-hopping sort of exercise, using various models where, given the correct assumptions, the dividend always should find coverage without the need of new capital. In one of its textbook-type models, which assumes a near-perfect world, the Company contends that a BDC can invest in assets that pay interest, on a current basis, plus earn non-cash interest (PIK) and still maintain its dividend "year after year, while never raising additional debt or equity capital". The Company goes on to say, using assumptions that capital gains exceed losses that their model allows for actual increases in dividend payments even if it does not raise additional capital. Of course it is well known that the implication of needing new capital in order to maintain current dividend levels has been the primary focus of the Company's critics.

- *Are Dividends Paid from Cash Flows from operations?* The Company says yes, but in the very next question, *"Has American Capital used principal repayments from Portfolio Companies to pay its dividends?"*, the answer is also "Yes". The bottom line (which the Company admits): that operating cash flow is not adequate to cover the dividend.

American Capital likes to stress that its model is "simple", and indeed the Company's explanations make everything look bulletproof. However, the fact stands that it needs fees generated from new investments, plus any related realized gains, in order to fill the cash deficit between Cash From Operations and the Dividend Payout. Internally generated cash items are simply not sufficient for the Company to be able to make new investments. Consequently, the Company must constantly seek outside funds to maintain its current dividend payout level. In spite of the fact that the Company steadfastly maintains that it doesn't need cash from stock offerings to maintain its dividend payout level, it is quite apparent that, without new capital injections, the payout is clearly in jeopardy, unless (according to the Company's textbook model explaining this) all things work perfectly at all times.

Yet, in all of this there is evidence that current American Capital shareholders are becoming less inclined to increase their investments as, each year, fewer of them have been willing to reinvest their dividends in shares of ACAS common. In 2003, the Company's shareholders reinvested just $803,000 of dividends; down from $961,000 and $1,048,000 in 2002 and 2001, respectively. At just a half of one percent this was clearly a miniscule percentage of the $153 million paid out in 2003. In 2002, shareholders reinvested just under one percent of their dividends, in 2001, 1.4%.

Further pressure on the dividend may come from the fact that the Company has (off balance sheet) commitments under loan agreements to fund up to $40.1 million in F/Y 2004 to various portfolio companies in the form of Working Capital and Acquisition Credit facilities.

Accounting: Valuation of portfolio investments looks creative

American Capital's investment portfolio is valued each quarter by its own team (called FACT), which consists of 17 "CPA and accounting professionals". The board of directors has the ultimate responsibility of approving of valuations recommended by the FACT team. This valuation process, which has been going on without the scrutiny of outside appraisers with expertise in valuing non-liquid securities, has, no doubt, been raising plenty of eyebrows. Possibly as a result, the Company has recently (as of late last year) moved to appoint Houlihan Lokey to independently review 25% of the portfolio each quarter. The Company provides no further details of the scope of Houlihan Lokey's appointment. We also note that Houlihan Lokey, while well known as experts in the valuation of non-traded securities, is also well known as investment bankers that do a sizable number of middle market deals. With the Company providing few details about the Houilhan Lokey engagement, we immediately get concerned about the potential for conflicts of interest.

There are a number of curious practices employed by American Capital with regard to non-performing notes it holds from its portfolio companies. The Company has a loan grading scale of 1 to 4 with 4 representing loans with the least amount of risk. The 1 and 2 categories indicate troubled loans. The Company stops accruing interest on loans "when it is determined that interest is no longer collectible." The Company however determines whether a loan is collectible internally. We noted, with great interest, that as of 12/31/03, American Capital had loans with 10 companies, with face amount of $98.4 million (fair value, as established by American Capital of $28.9 million) that were on a non-accrual status. Five of the companies' loans were grade 2 with the remainder grade 1. Making matters more interesting, $64 million of these loans contained PIK features (see above).

The total of loans on non-accrual basis, however, would have been much higher at year-end had the Company not exchanged $83 million of additional loans, which had been on a non-accrual basis, into non-interest bearing preferred stock or debt (the majority went to preferred). American Capital did not make it easy to understand the valuation basis by which each exchange took place. In each disclosure, the subject company's name was withheld and the Company would provide only the details of the exchange in the following manner:

> "In the third quarter of 2003, we recapitalized one portfolio company by exchanging $19.8 (million) of subordinated debt into non-income producing preferred stock. Prior to the recapitalization, the subordinated debt was on a non-accrual basis".

The list goes on, with five such recapitalizations during F/Y 2003 all of which swapped non-performing debt into non-interest bearing vehicles (mostly preferred). Clearly, in this manner the Company was able to cull a large portion of its non-performing loans from the rogues' list. But what were the transfer values? A thorough review of changes in the status of American Capital's portfolio investments, year-to-year, shed some interesting light on at least one:

In the case of Iowa Mold Tooling Company, it is quite evident that about $15 million in subordinated debt was converted into a like dollar value of preferred stock between F/Y end 2002 and F/Y end 2003:

Table 1. Mold Tool Company Debt and Equity Structure for 2002 and 2003 (Thousands $). Source: ACAS SEC Filings

	2002		**2003**	
	Cost	**Fair Value**	**Cost**	**Fair Value**
Senior Debt	$ -	$ -	$ -	$ -
Subordinated Debt	$ 30,262	$ 30,548	$ 15,426	$ 15,540
Common Stock	$ 4,236	$ -	$ 4,760	$ -
Warrants	$ 5,918	$ 4,890	$ 5,918	$ 783
Redeemable Preferred	$ -	$ -	$ 18,864	$ 15,968
Total	$ 40,416	$ 35,438	$ 44,968	$ 32,291

In **Table 1** above, you can see how Subordinated Debt with F/V of $30.5 million in 2002 was reduced to a F/V of $15.4 million in the following year. The other side of the transaction is the emergence of Redeemable Preferred stock (Non interest bearing) carrying a F/V of $16 million. In this case, it is quite evident that the fair value of Subordinated Debt had been swapped for a like-fair value of non-interest bearing preferred shares.

American Capital seems to be engaged very heavily in recapitalizations of big chunks of its non-performing loans in order to get them out of non-accrual status. Initially, at least until fair value catches up with them on the new instruments, they likely avoid having to record unrealized depreciation of these non-accrual loans.

The actual disclosure of all this is quite obfuscated. The Company's limited disclosure regarding recapitalizations and exchanges of debt security investments for equity shed little light on two key points, it seems to us. First, it is often not clear if the recapitalization has really strengthened and improved the prospects of the company in which the investments are held and secondly, the rationale for the valuation placed on equity securities received in the exchange is at best obscured. We find it interesting that American Capital values its convertible debt, equity and other securities based on their pro rata share of the residual equity value ***after*** deducting all debt from the estimated enterprise value. This may give them the opportunity to value the preferred shares, received in a recapitalization (where subordinated debt is swapped for preferred) at a fair value even higher than the debt exchanged for the preferred, this given the fact that there would be less debt, after the fact, to deduct from the preferred valuation.

Another piece of the valuation question becomes the quite apparent absence of an allowance for PIK dividends and interest. Given the fact that, $68.7 million of American Capital grade 1 and 2 loans (that are currently on non-accrual status) have PIK features, it would seem that lagging collections and the risk potential for non-collection would imply a valuation haircut of these at some time. It also would seem that a valuation allowance is in order, and this ***after*** the elimination of about $83 million in additional non-accrual loans from the list due to 2003 recapitalizations.

Questions regarding asset values emerge in other areas as well. For example, in 2003, in two loan securitizations totaling $556.2 million, American Capital contributed loans totaling $706 million to funding trusts, implying a 22% retained interest in the loans being sold. We are much more used to seeing 10% retained interests in similar securitizations. As if the high amount of retained interest was not enough, the Company was also required to post as collateral, relative to the securitizations, $687 million to secure the loans being sold in addition to the 20% retained interests. It is quite evident that valuation concerns run high with regards to the fair value of loans being securitized by American Capital.

<u>Accounting: Timing of sale, and booking of gains, is suspect</u>

American Capital’s cash needs, coupled with the need to show investment gains, may have caused it to cut at least one gain short recently. The late sale of California Pellet Mill, for a $6.2 million gain, came in just under the wire, on December 31, 2003. So under the wire was the transaction that the related press releases were not out until

January 22nd. At least one analyst posed repeated questions concerning the time lag at the Q4 earnings conference. American Capital management explained the delay by saying that the coordination of various clearances, from other related parties that they are contractually required to get approvals from, was a difficult matter and it "just takes time" to do such a thing. Odd that such a small transaction would require a three-week delay when details involving transactions involving billions are released concurrently with their closing.

Whatever the case, the 12/31 closing seems to have been serendipitously beneficial to American Capital's 2003 results as, without it, the Company's investment returns would have looked quite different for, without it, the $22 million in recognized gains would have been reduced to about $16 million. The Company entered into the California Pellet Mill investment in early 2003. By flipping California Pellet Mill after such a short holding period while, during the same period, restructuring so many of its non-performing loans for longer term, non-interest bearing preferred shares, it would seem that American Capital has fallen into the habit of cutting its profits short while letting its losses ride.

<u>Accounting: Disclosure provides some interest detail on deal structure</u>

Although American Capital provides little detail as to its individual dealings, we thought it advantageous to take a look at one of the deals as disclosed by the borrower. In this case the entity is Ace Capital Express, a public company. In F/Y 2003, ACE sold $40 million in principal value of senior subordinated notes to American Capital. The notes carried interest rates averaging LIBOR plus 11%. At the closing of the deal, American Capital received closing processing and structuring fees totaling $2.6 million and was required to pay the Company an administrative fee of $300,000 annually.

Clearly the deal was not one where ACE would be want to stay in the deal long, and indeed they are almost out of it. In March, ACE filed a registration statement for the sale of common stock in order to pay off the entire $40 million in notes bought by American Capital. When this happens, the Company will book a prepayment fee totaling $750,000.

This is probably a good example as to how American Capital structures its deals in order to maximize its up-front payback. The problem with this kind of deal comes when either the company, who needs the cash badly enough to agree to these terms either goes south (sticking American Capital with the paper) or moves to pay off the loan at the first available opportunity. Another example where it would seem the Company finds itself cutting its profits short while holding its losers for the long term.

<u>Governance: Various corporate disclosures, or lack thereof, are worrisome</u>

All that American Capital has to say about the recent SEC inquiry is that "the staff of the Securities and Exchange Commission has requested that we voluntarily provide certain documents and information as part of an informal, non-public inquiry. The staff has not indicated the subject of the inquiry. We have complied fully with the requests and expect to continue to do so should additional information be requested." When asked to shed some light on the SEC situation during the Q4 earnings conference call, the answer from COO Ira Wagner was tersely put "If we knew it, we would tell you." When asked if it had been resolved, CEO Malon Wilkus would only say "we will make the disclosures that are required and are necessary when things develop with respect to that informal inquiry."

We simply cannot believe that they do not know more than they are saying about the SEC inquiry. After all, the SEC does not just say they are making an informal inquiry; they ask for certain information, even if they characterize it as an informal, confidential inquiry. What they ask for is a good clue as to where they are headed. It would seem that the Company prefers to side step this issue for now.

Then there's the change in the Company's guidance philosophy. Where in the past, American Capital would provide, in its guidance disclosures, a wide variety of variables; the Company now provides guidance only with regards to its dividend payout. There were a number of questions, in the Q4 conference call, related to this. The Company was typically vague as management said things like "it just took a very large amount of internal time (to produce the previous guidance)", or "people seemed to have been misled by changes in some of those [guidance variables]", or, our favorite, "some of the metrics that we were giving guidance on had so much to do with the performance of the economy that we realized what we were ending up doing was acting like economists, and frankly we're not economists."

With regards to the Company's dividend guidance, American Capital says that they "have a lot of capability to work harder at one thing or adjust and do another thing to achieve our dividend guidance." An interesting statement, given the indicative accounting behavior we have observed. Our conclusion is simply that the decision to slim down the guidance elements was just a case of not wanting to disclose as much information as they had been in the past, some of which were generating an increasing number of questions. We also note that Kelley Gregory, who is head of Investor Relations and the point man on disclosing information to investors, recently announced his imminent departure from the Company.

Certainly, this reduced disclosure is just one more behavior that gives the recent insider trading and accounting behavior context.