CEFA's Closed-End Fund Research
An extension of *The Scott Letter: Closed-End Fund Report*
Volume 1, Issue 1
CEFadvisors.com
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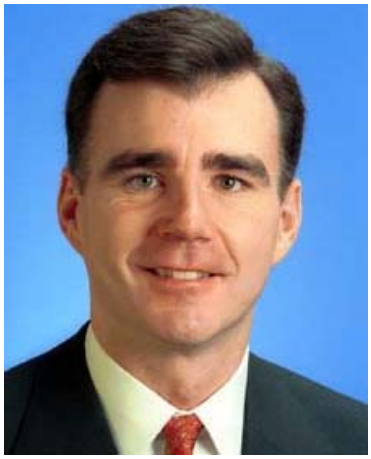
Keating Capital (KIPO): Late Stage Pre-IPO Investing with Permanent Capital & Investor Liquidity

Welcome to a new feature for Closed-End Fund Advisors where we will publish additional interviews with closed-end fund managers as an extension of The Scott Letter Closed-End Fund Report. In this issue, our interview will cover the business development company (BDC) closed-end fund, Keating Capital, Inc. (NASDAQ: KIPO).

While BDC CEFs are the *half sibling* of their traditional closed-end fund counterparts, we believe they, and as an example KIPO's concept and potential diversification benefits, offer a nice balance to the more traditional income focused closed-end fund portfolio.

However, it is important to note that this interview does not constitute a recommendation to purchase or sell shares in Keating Capital, and investors should do their own due diligence before deciding to invest.

Portfolio Manager & Investment Advisor



Timothy J. Keating is the President of Keating Investments, LLC, an SEC registered investment adviser, founded in 1997. Mr. Keating is also the Chairman and CEO of Keating Capital, a publicly traded business development company

Prior to founding Keating Investments, Mr. Keating was a proprietary arbitrage trader and head of the European Equity Trading Department at Bear Stearns Intl Ltd. (London) from 1994 to 1997.

Mr. Keating began his career at Kidder, Peabody & Co., Inc. where he was active in the Financial Futures Department in both New York and London. Mr. Keating is a 1985 cum laude graduate of Harvard College with an A.B. in economics.

Keating Investments is based in Denver and has 10 employees. At present, the exclusive focus of the firm is acting as the external investment adviser to Keating Capital, Inc.

Investment Objective

Equity Partners for Companies Primed to Become Public®

Keating Capital's investment objective is capital appreciation. They attempt to achieve this objective through investments in later stage, private, pre-initial public offering (IPO) companies with private enterprise values between $100 million and a $1 billion. They believe investors place a premium on liquidity or having the ability to sell stock quickly and efficiently through an established stock exchange. Their goal is to buy privately, sell publicly and capture the difference. Their primary investment criteria are:

- Revenue: $10 million+ in trailing 12 months
- IPO timing: within 18 months from date of investment
- Potential return: expectation of 2x return once the company is publicly traded over an anticipated 3-year holding period

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John Cole Scott interviewed **Tim Keating** via telephone on January 18, 2012.

Scott: When did you first conceive Keating Capital as a BDC closed-end fund?

Keating: It goes all the way back to 1997 and my last job on Wall Street with Bear Stearns when I came across the concept of "a discount for lack of marketability" or the "private / public valuation differential". After we closed our first private fund in 2007, with a great deal of success, we validated the concept.

Scott: Can you explain for our readers the differences between a traditional closed-end fund and a business development company ("BDC") closed-end fund?

Keating: Traditional closed-end funds ("CEFs") are investment companies under the Investment Company Act of 1940 and typically invest in the common equity of already public companies. Although strategies vary for traditional CEFs, they generally target their investments in specialized industry sectors, geographic areas or a niche strategy.

Keating Capital is a closed-end fund that has elected to be regulated as a business development company (BDC) under the 1940 Act. One primary distinguishing feature between BDCs and a traditional CEF is the types of investments that BDCs can make. Generally, at least 70% of a BDC's assets must consist of U.S.-based private companies or publicly listed companies with a market capitalization less than $250 million.

BDCs were a new corporate structure created by Congress to provide public investors access to private equity and debt returns, as well as addressing the private equity industry's reluctance to launch public funds.

Scott: Why did Congress create the new structure?

Keating: In 1980, banks were recovering from elevated commercial loan losses following the mid-1970s recession in addition to volatile interest rates and elevated inflation in the late 1970s. At that time, Congress believed there was a shortage of credit available to small and medium sized private businesses. The venture capital and private equity industries were much smaller and limited from raising capital from public shareholders because they would become subject to the 1940 Act if their securities were owned by over 100 shareholders.

To address these concerns, Congress created the BDC as a hybrid between a traditional 1940 Act investment company and a private investment fund. The amendments were part of The Small Business Investment Act of 1980.

In effect, Keating Capital is exactly what Congress intended to encourage, a publicly traded, later stage venture capital fund with over 4,000 individual stockholders.

Scott: What are the Fund's fees, and are fees generally different in a BDC CEF vs. a traditional CEF?

Keating: Keating Capital pays its investment adviser, Keating Investments, a base management fee of 2% of Keating Capital's gross assets annually.

Additionally, there is a 20% incentive fee payable at the end of each year. The incentive fee is calculated from Keating Capital's realized capital gains, on a cumulative basis from inception through the end of each calendar year, computed net of all realized capital losses and unrealized capital depreciation on a cumulative basis, less any previously paid incentive fees.

Finally, Keating Capital also reimburses Keating Investments on a monthly basis for a portion of overhead and other expenses incurred by performing administrative obligations.

Scott: What is the breakdown of the fund's fee structure?

Keating: Excluding incentive fees, Keating Capital projects its operating expenses for 2012 to be in the range of $3.5 – $4.0 million consisting of:

- Base management fees of about $1.5 million
- Direct operating expenses of about $1.5 – 2.0 million.
- Allocated administrative expenses of $0.5 million.

Traditional CEFs charge a management fee only. However, unlike BDCs, a traditional CEF is not allowed to receive an incentive fee. In creating BDCs, Congress allowed them to charge an incentive fee to generally mirror the traditional 20% carried interest charged by the managers of most private equity and venture capital firms.

Scott: Is an incentive fee normal for BDC funds?

Keating: There are two types of management arrangements with business development companies. Under one arrangement, the BDCs are internally managed. That means there is no incentive fee paid to the advisor. And equally, there's no base management fee. Instead of having an advisory agreement, the management team becomes employees of the Fund.

The other variety is externally managed, which is a conventional investment advisory agreement between fund and investment advisor. Of the 34 publicly traded BDCs, nine of those are internally managed and 25 are externally managed.

Scott: Do you ever find that shareholders who aren't familiar with BDC closed-end funds balk or spend too much time focusing on the incentive fee when evaluating the Fund?

Keating: There are always people who are deeply fee conscious, and rightfully and very understandably so. There are also people who are adverse to incentive fees in any way, shape or form. I can understand that perspective as well. I think the way we look at it is that we really think of the world as beta rather than alpha and that alpha is quite elusive requiring a very clearly identifiable and exploitable strategy.

In general, BDCs carry higher fee costs than closed-end funds because of the types of assets in which they invest. The purpose of a BDC is to invest in and provide managerial assistance to small companies. In our view, this specialized asset class requires a specialized set of investment professionals to manage.

Scott: When setting up KIPO, why did you select the CEF BDC fund structure vs. the alternatives?

Keating: Well, there are a couple of reasons. The first one is that the fundraising process in and of itself is arduous. So whether you're a private equity fund or a venture capital fund, every few years, it is a major undertaking to go out and raise capital. That is not necessarily off-putting if you're a larger organization, but if you're smaller, it can be quite distracting. We wanted to maintain our focus entirely on identifying these pre-IPO companies, analyze them, run the portfolio, and not worry about having to raise new capital every few years.

Because Keating Capital makes investments in private companies which we believe are committed to and capable of going public, there is effectively no liquidity in our underlying portfolio companies until they IPO. Even then, we typically have to wait 180 days for the expiration of an underwriter's lockup to become eligible to sell our stock. As a result, our typical holding period for a portfolio company position is about three years.

The BDC structure allowed us to raise permanent capital while focusing our time on identifying the companies and managing the portfolio. It allowed individual investors to have transparency through our SEC filings and to come and go as they please with the liquidity of an exchange listing.

Scott: What was the IPO process like for your fund? You IPOed at $10 and closed trading today at $7.35, was this anticipated?

Keating: Unlike a traditional initial public offering where there is a simultaneous capital raise and exchange listing, we purposely decoupled these two events. Keating Capital's initial public offering was an 18-month "continuous public offering" registered with the SEC that concluded on June 30, 2011, and raised $86.8 million. In a second, distinct step, we listed our shares December 12, 2011 on NASDAQ.

Keating Capital raised money in its offering at $10.00 per share. Based on our September 30 NAV of $8.27, we have incurred a reduction of $1.73 per share.

The breakdown of the $1.73 per share includes: (i) selling commissions ($1.05); (ii) cumulative operating expenses since inception ($0.65); (iii) distributions to stockholders ($0.05); (iv) an adjustment based on fee-waived sales ($0.04); and offset by (v) unrealized appreciation (+$0.06).

For additional financial information on Keating Capital, please refer to our Forms 10-K and 10-Q which have been previously filed with the SEC. http://www.sec.gov/edgar/searchedgar/webusers.htm

Scott: If you could go back, would you IPO your fund again in the same way?

Keating: Yes.

Scott: Would you change anything about the process?

Keating: No.

Scott: Who's the typical investor attracted to Keating Capital? Do you have a common investor personality?

Keating: We actually do. Our demographic is older than you might expect at 60 years old. Typically, they are buying through an IRA and have a three to five-year time horizon. What's attractive about Keating Capital to this audiences is the appalling performance of the broad equity markets over the last 10 years, and the need for continued growth in their portfolio.

They are very frustrated and feel if they're going to take the risk associated with equities, they may as well get into a strategy that affords them the potential for some alpha and not just market exposure.

Scott: You surprised me there when you said 60 years old. I expected a younger shareholder base.

How many US company IPOs are set for 2012?

Keating: Around 200 companies have already filed registration statements to complete an IPO.

Scott: How is this different than this time last year?

Keating: First, the 200 companies that are private but have filed to go public are almost double from the 125 that completed IPOs last year. Making 200 a very high number. In fact, I believe it's the highest number that we've had on file to go public since 2000.

Scott: In comparing the current IPO filings with 2007, (the highest year of completed IPOs in the last decade at 214), in January of that year did it look this strong?

Keating: That's correct. There are two factors to consider. A large number of companies in registration is a sign of a healthy IPO market, because there are many companies eager to go public. On the flip side, a large number can also be a negative sign, because it means that companies are stuck and the IPO window is shut.

The 200 number that you see today reflects a little bit of both. Specifically, during the August to October period of last year, there were a lot of companies that wanted to go public but simply were not able to get out because the IPO market was shut. The larger percentage includes companies eager to go public.

Scott: What do you see changing in the IPO market as we get into 2012 versus what you experienced as an investor in 2011?

Keating: The key takeaway from 2011 is that about two-thirds of the companies that went public last year were trading below their IPO prices at the end of the year. That is very bad. I think the biggest takeaway is going to be an adjustment in future IPO pricing. IPO Underwriters have two masters to serve.

On the one hand, they're representing the issuer of the new stock trying to obtain the highest price possible. On the other hand, it's important for investors to get a fair deal.

I would say the pendulum went in favor of the issuers recently, and I believe the pendulum will need to swing back in favor of investors in order to give them enticement to want to buy new issues in the IPO market post 2011.

Scott: When we talk about two-thirds of the 2011 IPOs ending the year below an IPO price was this a normal occurrence?

Keating: Normally, I believe a quarter to a third, in a typical vintage year, will be trading below the offer price. In 2011 the number was double the normal level.

2011 was really a tale of two halves. The first half was actually a very strong half. If you look at a graph of the number of IPOs, we hit rock bottom in 2008 and began a recovery in 2009.

That recovery continued in 2010 and in the first half of 2011. Q1 of 2011 was higher than Q1 of 2010, which was higher that Q1 of 2009, which was higher than Q1 of 2008. Similarly, Q2 of 2011 was higher than each of the three preceding years. The first half was a continued recovery; the second half was a brick wall.

Scott: Compared to last year this time, what type of footing do you feel you're on for potential investments? Did 2011 make you stronger?

Keating: 2011 was a sobering year for everyone involved. If you look at the S&P 500, it was close to a 0% year on a price basis, +2% on a total return basis.

The key issue for the IPO market is volatility. The big lesson learned is

that in a highly volatile environment, the IPO window is going to shut, and shut tight. Volatility is the enemy of the IPO market. Looking back, I don't believe 2011 was as scary as 2008.

In fact, I've been in the business for 26 years, including 1987, and nothing came close in my career to 2008-2009. 1987 was only a one day blip whereas 2008 felt like the world was coming to an end.

During 2011, we had two major events, Europe and the U.S. debt situation, which we thankfully managed to survive. As we look out at 2012, what we see is the equity market at what appears to be an attractive valuation. If you look at the S&P 500, it historically trades at 15 times earnings, currently it is around 13 times earnings. We are big believers in reversion to the mean. We think valuation is favorable for the equity markets, but volatility remains lurking behind a corner.

We dealt with the U.S. debt crisis temporarily. Europe is a weak situation, and, of course, we have an election coming up in November. If we had one or more of those issues resolved, we believe volatility would come down to a more normalized level.

Combining compelling equity market valuations and lower volatility would be the catalyst to really unleash the IPO market in a meaningful way. So, we're cautiously optimistic.

Scott: Thank you for your thoughts and insight on the current market and how it could potentially impact your fund.

According to Stifel Nicolaus research, it looks like you have 33 peer business development closed-ended funds. Who are your closest peer BDC funds for comparison?

Keating: GSV Capital Corp (GSVC) and Harris & Harris (TINY) are both BDCs that make equity investments in venture capital backed companies. However, to the best of our knowledge, Keating Capital is the first and only fund of its kind exclusively dedicated to pre-IPO investing in the U.S.

Scott: Is there an index for BDC CEFs for investors to track?

Keating: Yes. On February 24, 2011, Wells Fargo announced the launch of the Wells Fargo Business Development Company Index, a rules-based index measuring the performance of certain NYSE and NASDAQ listed Business Development Companies.

[Editor's Note] Seeking Alpha article about this index: http://seekingalpha.com/article/264797-reviewing-the-new-wells-fargo-business-development-company-index

In addition, there are now two tradable instruments that track this index: BDCS and BDCL.

Scott: In regard to IPO investing, besides GSVC and TINY, are there any similar or partial comparisons for investors that might compete with KIPO?

Keating: I believe there is one mutual fund and two ETF's that focus purely on what I'm going to call IPO investing, buying companies after they've completed their IPOs. For pre-IPO investing, Keating Capital is the only fund that is exclusively dedicated to pre-IPO investing, by which I mean that last private round of financing before an anticipated IPO.

The two BDC CEFs, the mutual fund and the two ETF's would be the closest animals to us.

[Editor's Note] Based on peer BDC fund's of approximately 40 basis points of market cap relative to market cap, KIPO's liquidity could be expected to increase over time to around $280K a day.

Scott: According to Stifel Nicolaus research, the current median price to NAV discount is -17% for BDC funds under $250M in assets, compared to -10% for all BDC funds. Is it better to compare your fund among its size peers or against all BDC funds?

Keating: Yes, I think the groupings are very relevant. Regarding the one month average daily volume vs. the market cap of the fund; larger BDCs (i.e., greater than $500 million market cap) have an average daily trading value of about 80 basis points of their market caps. For example, if you had a $1 billion fund, you'd expect to have $8 million in trading volume each day. For the midsized group, it's about 50 basis points and for the smaller BDCs, it's about 40 basis points.

[Editor's Note] Keating Capital (KIPO) is considered a smaller BDC fund.

Historically, size and discount often go hand in hand. We do think that we are properly lumped in with the smaller group of BDC funds.

Scott: What are your expectations for KIPO's 'normal' discount relationship knowing that you only report your net asset value (NAV) quarterly, like all BDC CEFs

Keating: As of September 30, 2011, KIPO had a NAV of $8.27. Based on the January 18, 2012 closing price of $7.35, Keating Capital traded at a price equivalent to 88.9% of NAV or an -11.1% discount vs. the average -17% peer average discount you mentioned before. The market price of our fund will trade at a price equal to, above or below our NAV per share, and as a matter of firm policy, we do not comment on our stock price.

Scott: How do you calculate, and when do you report your net asset value (NAV) for the Fund?

Keating: We value our investments in portfolio companies as of the end of each quarter. Our publicly listed equity investments for which market quotations are readily available are generally valued at the closing market prices as of quarter end. However, our publicly listed equity which are subject to lockup provisions restricting the resale of such investments for a specified period of time, are valued at a discount to the quarter end closing market prices.

The fair values of our private equity investments for which market quotations are not readily available (including investments in convertible preferred stock) are determined, in good faith, by our Board of Directors, based on various factors, including:

- The portfolio company's historical and projected financial results
- Industry valuation benchmarks
- Public market comparables
- Private mergers and acquisitions.

The fair values of these private portfolio company securities are generally discounted for lack of marketability since the securities are illiquid, there are restrictions on resale, or there is no established trading market.

In the absence of a readily ascertainable market value, the estimated value of our equity securities may differ significantly from the value that would be placed on the portfolio if a ready market for the equity securities existed. Changes in valuation of these equity securities from one period to another may be volatile.

Scott: Do you ever miss being in the hot IPO world, the Facebooks and the LinkedINs?

Keating: Yes we do, however, that's a self-imposed discipline for us as we typically focus on private companies with enterprise values of between $100 million and $1 billion. We avoid the quazi-public companies like Facebook. I have nothing but praise for Facebook, the company for all I know might be the best company on the planet.

The investment challenge is the following: at a $100 billion valuation is the differential between private and public valuation still there? Is there still an arbitrage opportunity?

We would argue no, there isn't. What happens with certain high profile social media companies is that valuation reflects almost a public valuation rather than a private valuation without a discount for lack of marketability.

Scott: I saw that GSVC has exposure to Facebook. It was mentioned in their recent N-2 filing.

Keating: Yes. I think GSVC's got a couple positions in social media companies. Michael Moe, who runs GSV Capital is a very bright and experienced manager.

He's written a great book called, *Finding the Next Starbucks* and is an extremely knowledgeable growth investor. I'm glad that our message and approach is resonating in the marketplace, and we're glad to have GSV join us in this space.

Scott: When can investors expect to see updated NAV & Financials?

Keating: Our Annual Report on Form 10-K is due on March 31, 2012, although we expect to file probably in mid-March.

Scott: What is the most important potentially unexpected risk for shareholders in your fund?

Keating: The biggest risk might be if the IPO window shuts down completely for a prolonged period of time.

Remember, there is a strong inverse relationship between volatility and IPO activity. IPO market expansion has historically taken place in modest volatility environments (i.e., those where the CBOE Volatility Index (VIX) is at ranges between 10% and 20%). Reduced volatility levels create an improved market for IPOs.

To the extent that the IPO window shuts for a quarter or two, we do not expect that there would be any impact in the long-term performance of Keating Capital because our success ultimately depends on our ability to capture the private/public valuation differential.

With perfect hindsight, the three questions that are relevant and ultimately will need to be asked to evaluate the performance of the strategy are:

1) Did each portfolio company go public within 18 months of Keating Capital's investment?
2) Once public, did each portfolio company trade at a similar valuation multiple to its public peer group?
3) Was Keating Capital able to exit its investment at its targeted 2x return potential over the anticipated three-year holding period?

If we can answer these questions affirmatively, then the strategy will be successful because we will have captured the valuation differential that we believe exists between comparable private and public companies.

Of course, a protracted period where the IPO window is shut (e.g., one lasting for four to eight quarters) would delay the time that it takes to generate our targeted return and would likely extend our anticipated three-year holding period.

Scott: The average annualized yield on your 14 peer BDC CEFs, (less than $250M in net assets) is 8.3%, according to Stifel Nicolaus research. Do you see any regular dividend for shareholders in the future? If so, would it be a return of capital?

Keating: We do not have a scheduled or planned distribution policy. Instead, net realized capital gains after reduction for any incentive fees, our annual operating expenses and any other retained amounts are expected to be distributed at least annually.

In the event we retain some or all of our realized net capital gains, we will likely designate the retained amount as a deemed distribution to stockholders. In this case, we will pay corporate-level tax on the retained amount, each U.S. stockholder will be required to include its share of the deemed distribution in income as if it had been actually distributed and they will be entitled to claim a credit or refund equal to its allocable share of the corporate-level tax we pay on the retained realized net capital gain.

Scott: What are your investor relations and shareholder communications plans for the Fund?

Keating: Margie Blackwell is the full-time Investor Relations Director for Keating Capital. She has worked for Keating Investments for 11 years and is intimately familiar with all aspects of our business. Additionally, Keating Capital has engaged JCPR to assist with public relations. We connect to shareholders and potential investors in the following ways:

- Send stockholders an email notification after each public filing
- Publish a quarterly newsletter
- Host conference calls for stockholders, representatives who sold shares in our public offering, analysts and other interested parties after each quarterly filing with the SEC
- Host periodic webinars to provide perspective on topical matters.
- Speak to the equity research analysts at investment banks who cover BDCs
- Conduct non-deal road shows during the year
- Actively give interviews to the national media, including such outlets as: The Wall Street Journal, Forbes, USA Today, Bloomberg, CNBC, The Street.com.

Scott: What's next for your firm, a secondary offering? A new fund?

Keating: We expect that Keating Capital will be fully invested by the end of Q2 2012. Our long-term goal for Keating Capital is to grow the fund to approximately $250 million in assets. This would allow us to hold 25 positions of $10 million each. We believe this is the optimal size for our pre-IPO strategy. Raising additional capital in the future, through some form of shelf registered public offering.

Scott: Why is $250 million and 25 investments the optimal size four your fund?

Keating: We are constrained in two very distinct ways in this strategy. Number one, there are a finite number of IPO's each and every year. For example, in 2011 there

were about 125 companies that went public. Because there is a fixed and finite number of companies going public, there is also a fixed and finite number of pre-IPO investment opportunities. It's not as if with an infinitely large pool of capital that the number of opportunities would increase.

Second, and very importantly, the kind of companies that we invest in typically have existing venture backers. Those existing backers often are participating in the final round of pre-IPO financing. Usually there's some left over for new investors like us. As an example, if a company is raising $50 million in a final pre-IPO round and there are three main existing venture backers who each decide to put $10 million each into that round, it accounts for $30 million. Now there's a need for $20 million.

With our current check size of $3 million to $5 million, we can be part of that $20 million. We believe based on our pipeline and the size of the deals we invest in, $10 million would be an optimal size, because it would make us a very important investor in these companies in these rounds, potentially accounting for up to half of the amount available to new money in a particular round, for example.

Scott: Are there any pending regulations that concern you for the IPO market from The SEC or FINRA?

Keating: Well actually quite the opposite, because what's happened now is widespread recognition in Congress that the public capital formation process is badly broken. There are a number of pending bills in Congress that are all designed to provide relief.

I think the one that I'll mention here is something called the IPO Taskforce, which is a group of venture capitalists, lawyers, accountants, investment bankers, consultants and others who put forth a series of recommendations and actually, to my pleasant surprise, many of these recommendations are not only being studied seriously, but in certain cases, the House has begun taking actions on them. I think the wind is in the sails for providing relief for things like Sarbanes Oxley and a number of other items for smaller companies that complete an IPO, they call it a ramping process giving time for these new public companies to meet certain regulations while still affording investor protection. The regulatory pendulum is getting ready to swing back toward neutral from a position of being extremely adverse to public companies.

Scott: Fascinating.

Keating: That can only help. And it can't happen soon enough.

Scott: Tim, we appreciate your time today in order to help our readers better understand your firm, fund and BDCs in general. Best wishes for a successful 2012.

For more information on Keating Capital please visit their website at: www.keatingcapital.com or call (720) 889-0139. Their Executive Summary on KIPO can be viewed using the following link http://keating.fruition.net/wp-content/uploads/2011/08/Keating-Capital-Executive-Summary1.pdf

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