StoneCastle Financial Corp.
Form N-CSR
March 06, 2014
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM N-CSR

CERTIFIED SHAREHOLDER REPORT OF REGISTERED MANAGEMENT INVESTMENT COMPANIES

Investment Company Act file number 811-22853

StoneCastle Financial Corp.

(Exact name of registrant as specified in charter)

152 West 57th Street, 35th Floor

New York, NY 10019

(Address of principal executive offices) (Zip code)

Joshua S. Siegel

StoneCastle Financial Corp.

152 West 57th Street, 35th Floor

New York, NY 10019

(Name and address of agent for service)

Copies of Communications to:

John P. Falco, Esq.

Pepper Hamilton LLP

3000 Two Logan Square

Eighteenth and Arch Streets

Philadelphia, PA 19103-2799

(215) 981-4659

Registrant's telephone number, including area code: (212) 354-6500

Date of fiscal year end: December 31

Date of reporting period: December 31, 2013

Item 1. Reports to Stockholders.

The Report to Shareholders is attached herewith.

Annual Report

December 31, 2013

www.stonecastle-financial.com

STONECASTLE FINANCIAL CORP.

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Certain statements in this report are forward-looking statements. Discussions of specific positions, strategies or investments are for illustration purposes only and are not intended as recommendations of a position, strategy or investment. The forward-looking statements and other views expressed herein are those of StoneCastle Asset Management LLC and StoneCastle Financial Corp. Actual future results or occurrences may differ significantly from those anticipated in any forward-looking statements and the views expressed herein are subject to change at any time, due to numerous market and other factors. StoneCastle Financial Corp. and Stone Castle Asset Management disclaims any obligation to update publicly or revise any forward-looking statements or views expressed herein.

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To Our Shareholders:

I am very proud to announce that 2013 marked a milestone as StoneCastle Financial Corp. ("StoneCastle Financial," or the "Company") broke new ground as the first publicly traded investment company dedicated to investing in community banks, an industry critical to the health of the U.S. economy. Embarking on this endeavor five years subsequent to the great recession, all of us at Stone Castle Asset Management LLC ("StoneCastle") are proud to expand upon our long history of support to community banks and their investors. For the first time, thousands of healthy community banks that were unable to tap into the capital markets in the way big banks can, have access to a new source of capital. That capital can enable banks to increase their capacity for local lending, bring liquidity to their shareholders (through share repurchases) or acquire other banking institutions as the industry continues to consolidate into fewer, stronger banks.

We are also proud that the American Banking Association's ("ABA's") subsidiary, the Corporation for American Banking, entered into an exclusive arrangement with the Company as a source of capital for their thousands of member banks. In its 100 year history, the ABA's commercial arm has only endorsed two businesses as capital providers to its members, one of which is StoneCastle Financial.

I am pleased to share the following thoughts on the community banking industry, as well as the success of the Company as we move into 2014.

StoneCastle's affiliated entities have been investing in community banks for more than a decade. At its core, community banking is a local business with local market relationships. This strong "local lender to local borrower" relationship has resulted in stable community bank performance, even throughout the recent financial crisis. Banks lend their customers' deposits to businesses such as the auto repair shop, the dry cleaner and the flower shop. They lend money to local consumers to fund a college education, acquire their first car or buy their first house. They contribute to communities by investing in Little League teams, the Boy and Girl Scouts and other local charities and non-profit groups. In fact, community banks, while representing only 18% of the banking industry's assets, provide almost 60% of the nation's total small business loans made by banks. Small businesses are the engine of job growth in America, so community banks are doing more than their fair share in job creation and economic growth.

Nearly one out of twenty counties (representing more than 150 counties across the U.S.) has no other bank than its local community bank. These banks help neighborhoods grow at the grass roots of our society. The people who work in these banks are interwoven into their community's fabric. StoneCastle Financial is excited to play a part in this local industry, as they work to re-kindle our country's economic development. By investing in StoneCastle Financial you are helping to support local businesses in your own town or city.

Investing in community banks has been historically difficult: difficult for investors to find investments and difficult to subsequently sell those investments (90% of banks are privately owned and are not traded). Community bank investing is a specialty business that requires specific skills and relationships;

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it is not easily or quickly penetrated by newly formed competitors. StoneCastle and its affiliates are known as a trusted source of funding for community banks. StoneCastle has developed long-term relationships over a decade and is proud to have earned the respect of multiple generations of bank executives and directors, as well as national and state regulators and financial agencies. This long history and depth of knowledge cannot easily be replicated and has allowed StoneCastle and its affiliates to emerge as a recognized leader in this space.

At StoneCastle, our employees have become a community of believers in the critical mission of community banks. Our core principals demand honesty, transparency and fair dealing in our endeavors to serve our shareholders and the banks in which StoneCastle Financial will invest.

I am excited to work with an extremely talented group of professionals at StoneCastle. Our team includes those who have invested in banks and the assets of banks, worked at and managed banks, served as regulators, analyzed risk at rating agencies or been service providers to banks. As a result, we have a very strong mix of talents and capabilities that result in a deep understanding in, and bring unique insights into, what can make a bank investment successful or unsuccessful. I believe that these industry specific skills combined with our people's integrity and our existing recognition as a leading voice in community banking sets us apart in the field.

I want to thank you for your trust and support and look forward to a healthy and prosperous 2014.

Yours Sincerely,

Joshua S. Siegel

Chairman & Chief Executive Officer

About StoneCastle Financial Corp.

StoneCastle Financial Corp., a registered investment company, (the "Company", "SCFC" or "StoneCastle Financial") commenced operations in November of 2013 to predominantly make investments in community banks located throughout the United States. The Company's investment objective is to provide stockholders with current income and, to a lesser extent, capital appreciation. The Company generally focuses its investments on preferred stock, subordinated debt, convertible securities and, to a lesser extent, common equity that will generally be expected to pay dividends or interest and generate capital gains over time. The Company may further enhance returns through the use of warrants, options or other equity conversion features.

Market Opportunity

The Company's adviser, StoneCastle Asset Management LLC ("StoneCastle", "we", "us" or "our"), believes that the community banking sector is attractive due to the strong long-term performance of community banks and the general lack of investment competition from institutional investors. The Company attempts to capitalize on the ongoing capital needs of community banks. StoneCastle believes that the environment for investing in community banks is attractive for the following reasons:

Long-term Stability of Community Banking Sector. The community banking industry has a long history of generating stable earnings and historically has exhibited a low rate of failure despite popular opinion to the contrary. Since 1934, FDIC insured banks have performed, in terms of their default rates, comparably with BBB and BB Moody's rated corporate bonds.

Large Fragmented Market. Community banks collectively control approximately $2.9 trillion of financial assets. Despite significant industry consolidation since 1980, there are still more than 6,700 FDIC-insured banks in the United States as of December 31, 2013. The majority (~98%) of these banks have less than $10 billion of assets and many only service their local communities. The highly fragmented nature of the industry poses significant challenges for potential investors seeking to implement a diversified investment strategy.

Constrained Supply of Capital. We believe that the supply of new capital available to community banks is extremely constrained and will remain so for many years. We also believe that there are many community banks with well-established franchises and cash flow characteristics that are not attracting capital from private equity or other institutional investors because: (i) they are perceived by such investors as risky due to their size; (ii) the companies are located in rural or niche markets that are unfamiliar to institutional investors, or (iii) the investments in these companies are too small given (a) the size of the target companies and (b) limitations on majority ownership dictated by certain banking regulations. We believe that these companies represent attractive investment candidates for us, and this lack of institutional investor interest and the inability of most community banks to access the capital markets will enable us to invest at attractive pricing levels.

Investment Summary

SCFC offers investors an opportunity to invest in a select group of what we believe to be well-run community banks (i.e., U.S. domiciled depository institutions with less than $10 billion of total assets) at historically low valuations, at a time when the industry appears to be poised for immense

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consolidation, a key historical driver of capital gains. SCFC has been exclusively endorsed by the American Bankers Association's Corporation for American Banking ("ABA") via its for-profit subsidiaries. According to the ABA, the American Bankers Association's subsidiaries members account for nearly 90% of the bank industry's total assets.

Investment Objectives

SCFC focuses on securities issued by community banks that have a history of stable earnings and profitability. In the case of investments with fixed dividends or interest, the continuity of these payments is paramount, and consequently SCFC seeks issuers that have business models that StoneCastle believes are stable over long periods of time. SCFC also seeks to generate capital gains by investing in banks using various equity strategies, including common equity, warrants, convertible securities and options. SCFC seeks to invest in equity-related instruments in circumstances where StoneCastle believes a company has the potential to generate above average growth or is undervalued. To a lesser extent, SCFC may also generate revenue in the form of commitment, origination, or structuring fees. In addition, SCFC focuses on community banks that StoneCastle believes will generate a steady stream of cash flow to pay dividends, as well as reinvest in their respective businesses. SCFC seeks to invest in community banks whose business models and expected future cash flows make them attractive M&A candidates, either as buyer or seller. These companies include candidates for strategic acquisition by other industry participants and companies that may conduct an initial public offering of common stock.

Investment Highlights

SCFC seeks to obtain investment income for our investors from various types of investments in the U.S. banking industry. In conjunction with a goal of earning income, SCFC also seeks to generate capital appreciation on our investments when practical and possible. Many of our investments will generate a tax-advantaged yield, due to a lower tax rate on qualified dividend income or capital gains, but other investments are taxed as ordinary income. Although SCFC is a public investment company, the company is structurally different than REITS and Business Development Companies (BDCs) in two important ways: we use less leverage and pay lower management fees to our advisor.

StoneCastle believes there are significant opportunities ahead, as banks are trading near historically low price to book multiples, currently at an average of 1.1x, down from 2.1x in 2004 which creates an environment more conducive to making investments that could generate capital gains. Larger public banks have historically traded at higher multiples than smaller banks; investments by SCFC can enable community banks to grow and potentially trade at the higher valuations of these larger banks. The health of banks has improved significantly, yet valuations still remain at or near historic lows. Further, many weaker banks have been closed or acquired, resulting in a healthier industry overall. Consolidation is expected to increase in 2014, with regulatory changes accelerating this trend.

Community Bank Market Commentary

Five years removed from the start of the financial crisis, community banks, defined as banks with less than $10 billion in assets, are demonstrating their resilience to economic cycles. They are posting solid profitability (91.4% of banks are profitable) with significantly lower credit costs due to losses on bad loans. StoneCastle carefully monitors industry trends and conditions in order to properly monitor the Company's investments and periodically reassess its investment strategy to adjust to market conditions.

Why do market conditions affect the health of banks?

Commercial banks and savings banks, in many ways, reflect the economic and demographic profile of the market or markets they serve. These depository institutions aggregate deposits from thousands of customers and then lend these funds back in their markets to finance real estate, businesses and consumers. Historically, these loans have been of relatively low risk because they are supported by either predictable cash flows or hard assets (real estate, automobiles, inventories, etc.) By definition, a bank is always taking some measure of risk, because there is always the chance the borrower will fail to repay 100% of their loan. A good bank balances the need to make loans, with taking acceptable levels of risk. Hence, to understand the health of a particular bank, and the industry at large, one must understand the health of the underlying markets.

While nearly every bank takes deposits and makes loans, the industry has several distinct types of banks. A key differentiator is size, which often dictates the business model of a bank and the risks it is willing to take to achieve its targeted return on equity:

Community Banks. With less than $10 billion in assets, these banks frequently serve a distinct geographic area, maybe one or two counties, focus on traditional business and real estate loans, and avoid higher risk and return businesses such as sub-prime lending, capital markets activities, derivatives, brokerage, forex, mortgage servicing or emerging markets. Their performance is correlated to their local market and its related industries.

Regional Banks. Generally defined as banks between $10 billion to $100 billion in assets, these banks share some of the attributes of the community banks as well as some of the attributes of larger money center banks (described below). They tend to take more risk than smaller community banks, serve a larger geographic area, have capital markets operations, asset management or insurance divisions and be involved in mortgage servicing. Regional bank's economic performance is correlated mostly to regional economic trends. However, these banks are also more susceptible to national economic trends.

Money Center Banks. Generally defined as banks with more than $100 billion, and in some cases over $300 billion in assets and up to $2 trillion in assets, money center banks are highly correlated to national and global economic trends, the performance of the capital markets and movements of the Federal Reserve and other central banks globally. They have diversified operations which brings diversification by geography, industry and product line.

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These three broad business models are quite different, as are the customers they serve. Community banks predominantly serve local businesses and consumers. Their customer relationships often run deep and can involve multiple generations. As such, community banks have intimate knowledge of their customers, which we believe has provided community banks with an advantage over many of their peers alongside of their core focus of traditional banking, limiting strategy drift.

Local market economics and demographics drive the risk of the bank's loan portfolio

A bank's risk is often driven by the markets in which it operates. Large global banks have a materially different risk profile than a bank that operates in ten distinct towns. However, the deep knowledge a community bank has of local borrowers can provide an advantage when underwriting loans. As we have emerged from the recent financial crisis, the proof of a management team's ability to underwrite local loans has played out on their balance sheets. Strong underwriting has been rewarded in the market place and the best management teams have been successful in creating significant shareholders value emerging from the crisis.

Credit quality continues to improve

Credit quality is important to a community bank, and to us, for several key reasons. First, when a bank has non-performing loans, its profitability is decreased because such loans do not pay interest. Second, these loans are required to be "written down" and reduced in value on the balance sheet, which in turn decreases a bank's regulatory capital because of the loss of value. Third, when the amount of non-performing loans increases, it can distract management from its focus on growth and earnings, to instead focus on resolving these distressed loans, which takes time and creates significant expense.

After several years of tough conditions, the non-performing assets (loans that that are not paying interest as required) on banks' balance sheets have decreased and banks continue to make progress in reducing credit costs. From a macro perspective, most metrics look positive. In addition, many institutions have moved past troubled assets either through successful restructurings, individual sales of other real estate owned ("OREO") or bulk sales of non-performing loans. As asset quality has improved, loan loss provision expenses have decreased and loan loss reserves have been released, helping to improve earnings.

Asset Quality and Earnings Continue to Improve. It is important to understand the difference between non-performing loans and charge offs for a bank. When a loan borrower ceases to make payments on a loan, or fails to comply with their loan agreement, the loan becomes "non-performing", and therefore is classified as a non-performing asset. When the bank sells the loan for a loss, writes the asset down on its balance sheet, or only receives a part of the loan balance when repaid, the bank takes a "charge-off" or loss on the loan. If a loan becomes non-performing but the bank does not suffer a loss, it does not have a long standing impact to the health of the bank.

Improving asset quality was a tailwind benefitting the industry's bottom line in 2013, and it appears to continue to move in a positive direction. As of third quarter 2013, the amount of non-performing assets at community banks as percentage of their total assets fell to 1.94% from 2.61% a year earlier. This is down from its 2010 historical peak of 3.50% and is the first sub-2% reading since third quarter 2008, the unofficial start of the financial crisis.

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Loan losses declined by almost one-half from the previous year, with net charge-offs totaling $11.7 billion in the quarter, down $10.5 billion (47.4%) from third quarter 2012. This is the lowest quarterly total for charge-offs since third quarter 2007. All major loan categories had year-over-year declines in charge-offs. These are noteworthy milestones on the industry's road to recovery. You will note in the table below that community banks continue to outperform their larger competitors by recognizing lower losses on their loans. We believe that the close connection between these smaller banks and their local customers along with good collateral and personal guarantees on most loans, contributed to the smaller amount of charge-offs.

Net-Charge Offs by Bank Size

	First 9 months of 2013	First 9 months of 2012
Community Banks (< $10 Billion in assets)	0.36 %	0.66 %
Regional Banks ($10B to $100 Billion in assets)	0.80 %	1.01 %
Money Center Banks (> $100 Billion in assets)	0.83 %	1.39 %
Source: FDIC		

Earnings Continue to Improve. Community banks posted an annualized return on assets (ROA) of 104 bps in the first nine months of 2013, improved from 99 bps in the prior period. The improvement was driven by a reduction in loan loss provisioning (18 bps of assets versus 37 bps) on less net charge-offs, as well as, reduced losses on other real estate owned (OREO) sales of 2 bps versus 6 bps. Across the industry, return on equity (ROE) recorded continued solid performance. Annualized ROE was 9.20% in the first nine months of 2013, improved from an annualized ROE of 8.83% in the same period during 2012. You will note in the table below that despite their smaller size, community banks' ROA continues to perform in line with their larger competitors.

Return on Assets by Bank Size

	First 9 months of 2013	First 9 months of 2012
Community Banks (< $10 Billion in assets)	1.04 %	0.99 %
Regional Banks ($10B to $100 Billion in assets)	1.01 %	1.17 %
Money Center Banks (> $100 Billion in assets)	1.07 %	0.97 %
Source: FDIC		

Improved sentiment from business owners is evidenced by increased demand for loans

With many markets experiencing modest local growth, there has been a continued battle for new loans given tepid demand. Community banks have reported that they have been successfully sourcing new loans often through loyal local customers. In addition, small business owners have reported they are becoming more comfortable with improving economic conditions. We hope to see this offset a reduction in demand from new home purchases and refinancings as mortgage rates have risen from their lows. However, in the financial recovery, certain local markets have benefitted more than others. The general trend is neutral to improving with real estate prices having stabilized and employment opportunities increasing.

Community Bank Loan balances rise by $27 billion. Banks are required to maintain a ratio of equity capital to their total assets sufficient to meet the definition of "well capitalized" as prescribed by federal banking rules and the FDIC. As loan balances grow, a bank's deposits must also grow and the bank must raise more capital to maintain its capital ratios. StoneCastle makes capital investments into community banks and as a result, this could result in more opportunities for SCFC to invest.

Loan growth continues, with signs of improvement beginning in third quarter 2013, with a 5.4% annualized increase for the total industry compared to a 2.8% increase in Q3 2012. Bank assets increased by $191.1 billion (1.3 percent) in Q3, while loan and lease balances rose for the eighth time in the last ten quarters, increasing by $69.7 billion (0.9%). Overall growth in commercial business loans, commercial real estate and farm lending were the primary drivers of loan growth in this latest quarterly report. In fact, community banking's industry loan to asset ratio is now 62.8%, its highest posting since fourth quarter 2010.

Commensurately, the banking industry's deposit growth also reached new heights. As of Q3, 2013 banks had a deposit to asset ratio of 80.6%, its highest point in over 20 years. Deposits increased by $247.8 billion (2.3%) in Q3 2013 but most of the growth—$235.6 billion—occurred in accounts with balances greater than $250,000.

Persistently low interest rate environment creates short term pressures

The interest rate environment is important to community banks, consumers and businesses alike. A majority of a community bank's income often comes from net interest margin (the difference between the interest earned on loans and investments, and the rate paid on deposits and other borrowings). As the rate environment has compressed, community banks have successfully retained deposits while simultaneously lowering rates on the accounts, thereby retaining their margin. If interest rates begin to move up, new loans may become more difficult to source as businesses may be less inclined to borrow at higher costs until offset by their growth in operations.

Industry data appears to show banks preparing more for rising rates by modifying their liabilities and shifting towards different loan products. Banks investment portfolios which are mostly fixed income securities may come under price pressure because fixed rate loans generally decrease in price when rates increase. However, with the oversight of their regulators, managing interest rate exposure is a core responsibility of any bank. Higher interest rates historically created higher bank net interest margins, which could improve their future profitability.

Net Interest Margins and Interest Rates. Financial results for banks in 2012 were buoyed by extremely low long-term rates, with the 10-year treasury yield below 2% for most of the year. This low interest rate environment drove gains on loan sales, mostly single family mortgages, to 28 bps and securities gains to 7 bps. In 2013, those same sources of profitability abated somewhat to 24 bps and 3 bps, respectively, as long-term rates rose to levels approaching 3%, post the Federal Reserve's announcement of its intent to taper quantitative easing.

The lagging effects of lower long-term rates and a flatter yield curve reduced net-interest margins to 3.71% for the first nine months of 2013. However, it is notable that the industry's rekindled focus on interest rates and the shape of the yield curve, rather than troubled assets, is a sign the industry continues to positively move beyond the financial crisis.

Many industry participants welcomed the rise in long-term interest rates. A steeper yield curve can generate higher spread-based income for community banks. We began to see this on a quarter over quarter basis in Q3 2013, when community bank net interest margins improved 8 bps to 3.78% from Q2 2013. We are particularly focused on the short-end of the interest rate curve, which will raise funding costs and may compress margins depending on the mix of floating rate or fixed rate loans held at a given bank. You will note in the table below that community banks continue to outperform their larger competitors in net interest margin.

Net Interest Margins by Bank Size

	First 9 months of 2013	First 9 months of 2012
Community Banks (< $10 Billion in assets)	3.71 %	3.78 %
Regional Banks ($10B to $100 Billion in assets)	3.64 %	3.73 %
Money Center Banks (> $100 Billion in assets)	2.98 %	3.24 %
Source: FDIC		

We note with particular concern that with low short-term rates, many community banks moved to the longer-end of the yield curve seeking higher returns (primarily fixed-rate residential mortgages and long dated securities). Should interest rates begin to trend higher, we will watch for banks having a 'drag' on their earnings from having purchase long dated fixed rate investments. Additionally, we will watch closely for banks that purchased longer dated investments and would have to recognize a fair value loss due to the inherent loss of value a fixed rate investment suffers when interest rates rise. However, longer term, higher interest rates should lead to higher net interest margins and higher returns on equity.

The bank regulatory environment is always changing, but banks adapt

As a bank investor, comfort is gained through a few important facts as it relates to regulation. The average age of a bank in America is more than 70 years. Therefore, most banks have been through many economic cycles and regulatory changes. As an industry, they have adapted well. Thoughtful and balanced regulations are critical to the industry and can help bring consistency and stability to earnings.

A significant focus on new financial regulatory changes has been evident in Washington and the numerous regulatory bodies that oversee banking. Implementation and interpretation of the Dodd-Frank Act along with the Volcker Rule, certain provisions from the Consumer Financial Protect Board and BASEL III, will continue to preoccupy many banks. These regulations are driving important changes and we believe that many of them have the potential to reduce risk in the banking system as well as provide a framework for delivering better products to consumers. The challenge banks face is that some of these regulatory changes may constrain their ability to operate flexibly, increase compliance costs and limit their ability to take on new lines of business.

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We are carefully watching the implementation of new regulations and have applauded the job done by regulators to recognize the differences between the largest banks and the community banks. Community banks have won some exceptions to new regulations that would have meaningfully increased their compliance expenses. However, we do expect higher overall compliance expenses from all banks and believe some of these expenses will be passed onto consumers to allow banks to maintain their level of profitability.

Community bank business model and consolidation

Community banks typically grow in a few ways: a) loan growth from local economic expansion, b) taking market share from their competitors, c) expanding into new markets or d) acquiring other banks or branches. Community bank consolidation has been expected over the last few years, but appears to have increased in pace only in the past few calendar quarters as valuations, of both the buyer and seller, have recovered. While a few years prior many banks were focused on bidding on distressed banks through the FDIC, attention has turned to unassisted transactions. Mergers of equals have been cheered by investors, as benefits from scale are being rewarded by the equity markets. We expect acquisitive activity to continue, however the acquiring management teams will be selective about their targets.

Industry M&A and Consolidation. Banks typically become more economically efficient as they grow in size. As a bank grows, its fixed costs are spread over a larger base of assets, increasing the return on equity and return on assets. Efficiency through scale, which does have diminishing benefits as the size becomes large, can also enable a bank to invest in new technology or new lines of business to improve customer experience.

Increased regulations have increased the fixed operating cost for a bank. Due to modest loan growth and low valuations, some banks will seek to merge to achieve scale. Consolidation is generally good for bank investors because it often leads to an increase in the value of the banks in which we invest. Community bank consolidation continued in the first nine months of 2013. During this period, 289 community banks ceased operations as independent companies (4.1% in absolute numbers). This is compared to 258 banks (3.4%) in the same period during 2012. As a point of reference, in 2010, approximately 50% of the bank consolidation was driven by regulatory action.

While banks under $10 billion in assets have significantly declined in numbers over the last 20 years, from 13,261 in 1993 to 6,792 as of Q3 2013, the assets under their control has not materially changed, from $2.91 trillion to $2.85 trillion, respectively.

Select Data on Community Banks (Under $10B in Assets)*

	Nine months ended	
	9/30/2013	9/30/2012
Structural		
# of Institutions	6,792	7,081
Failures	22	43
Condition Ratios		
Total Assets ($M)	$2,853,353	$2,860,779
Nonperforming Asset Ratio	1.94%	2.61%
Leverage Ratio	10.70%	10.50%
Total Risk-Based Capital Ratio	16.71%	16.86%
Loans to Assets	62.79%	61.67%
Deposit to Assets	80.62%	80.37%
Performance Ratios (all annualized)		
Return on Average Assets (AA)	1.04%	0.99%
Net interest Margin (ann.)	3.71%	3.79%
Return on Equity (ann.)	9.20%	8.83%
Loan Loss Provisions (LLP) to AA	0.18%	0.37%
LLP to Net Charge-offs	78.57%	88.55%

Source: FDIC, SNL Financial, StoneCastle Asset Management

* Information does not reflect the Company's performance or that of any of its holdings. Past performance is not indicative of future results.

Conclusion

We believe the health of community banks (over 6,000 companies) has returned. Bank valuations appear to be improving but have significant upside potential from these historically low levels. In addition we further believe stronger banks seeking growth to become more efficient through scale will create investment opportunities for us to help fund these mergers and generate capital gains over the long term for our investors.

Despite the apparent improvements in the economy and the banking industry, we continue to proceed with caution to find the best opportunities for our investors, while always seeking to minimize the risks inherent in investments. Our focus continues to be finding value in strong management teams operating in stable markets. We will use all the tools at our disposal in an attempt to achieve our target returns. Community banks across the country have a long-track record of dealing with volatile interest rates, ever changing regulatory policies and ever-changing market conditions. We believe the current market presents significant opportunities for community banks and patient investors alike.

Disclaimer

This letter contains and was prepared on the basis of information, statistics and other data obtained and compiled in part from third-parties and publicly available sources prior to the date hereof, including information from FDIC and SNL Financial LC. Such information has not been independently verified by StoneCastle or the Company. StoneCastle has relied on information provided by or from third party or public sources as complete, true, fair, accurate and not misleading. No warranty or representation, express or implied, is being made as to the accuracy, completeness or reasonableness of the information contained in this presentation whether obtained from or based upon third party or public sources or otherwise. Information in this letter is given as of the date hereof, may not be final, is based on information available to StoneCastle as of the date hereof, is subject to any assumptions set out herein and is subject to change without notice. It should be understood that subsequent developments may affect StoneCastle's views in this letter and StoneCastle does not undertake any obligation to provide any additional information or to update any of the information or the views contained herein or to correct any inaccuracies which may become apparent.

Dividends and Distributions

Dividends from net investment income are declared and paid on a quarterly basis. Distributions of net realized capital gains, if any, will be made at least annually. It is the Company's policy to comply with the requirements of the Internal Revenue Code of 1986, as amended, applicable to "regulated investment companies" or "RICs" and to distribute substantially all of its taxable income to its shareholders. In order to provide shareholders with a more stable level of dividend distributions, the Company may at times pay out more or less than distributable income earned in any particular quarter. The Company's current accumulated but undistributed net investment income, if any, is disclosed in the Statement of Assets and Liabilities, which comprises part of the financial information included in this report. The character and timing of dividends and distributions are determined in accordance with federal income tax regulations, which may differ from U.S. GAAP.

Summary of Current Dividend

	Distribution[a]	**Annualized[b]**
Dividend Distribution	$0.28	$2.02

(a) The dividend distribution covered the 50 day period from the launch of the Company on 11/13/2013 to the dividend payout date of 1/2/2014.

(b) The annualized figures do not provide a forecast of dividends or distributions, dividend yield, distribution rates or market value. The Company's quarterly distributions may be from net investment income, capital gains or return of capital. The dividend yield, distribution rate and income amounts reflect past amounts distributed and may not be indicative of future rates or income amounts. Distribution rates and amounts can change at any time.

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Dividend Reinvestment Plan

We have a common stock dividend reinvestment plan for our stockholders. Our plan is implemented as an “opt out” dividend reinvestment plan. As a result, if a stockholder participates in our Automatic Dividend Reinvestment Plan (“Plan”) all distributions will automatically be reinvested in additional common stock (unless a stockholder is ineligible or elects otherwise). If a stockholder opts out of the Plan, such stockholder will receive distributions in cash.

In the case that newly issued shares of our common stock are used to implement the Plan, the number of shares of common stock to be delivered to a participating stockholder shall be determined by (i) dividing the total dollar amount of the dividends payable to such stockholder by (ii) 97% of the average market prices per share of common stock at the close of regular trading on the NASDAQ Global Select Market for the five trading days immediately prior to the valuation date to be fixed by our board of directors.

In the case that shares repurchased on the open market are used to implement the Plan, the number of shares of common stock to be delivered to a participating stockholder shall be determined by dividing (i) the total dollar amount of the dividends payable to such stockholder by (ii) the weighted average purchase price of such shares.

We intend to use primarily newly issued shares to implement the dividend reinvestment plan (so long as we are trading at a premium to net asset value). If our shares are trading at a significant enough discount to net asset value and we are otherwise permitted under applicable law to purchase such shares, we intend to purchase shares in the open market in connection with our obligations under our dividend reinvestment plan. However, we reserve the right to issue new shares of our common stock in connection with our obligations under the dividend reinvestment plan even if our shares are trading below net asset value.

Portfolio Data

As of December 31, 2013

	Total Market Value	% of Total Investments		**# of Issuers**[(1)]
Total Long-Term Investments	$26,590,879	24.4	%	17
Primary Issuance	1,480,925	1.4	%	1
Secondary Issuance	25,109,954	23.0	%	16
Fixed Rate Securities	8,703,864	8.0	%	13
Step-up Rate Securities[(2)]	17,887,015	16.4	%	4
Floating Rate Issuance	—	0.0	%	—

(1) Issuers in which SCFC holds direct and indirect investments.
(2) Includes securities that are not indexed to market interest rates but will adjust upwards (step up) to a fixed rate in the future on predetermined dates.

Summary Characteristics of Bank Issuers[(1)]

	Weighted Average[(2)]
Assets (000s)[(3)]	$3,900,455
Capital (000s)	$442,688
Loans (000s)	$2,699,918
Loans to Deposits	83.3%
Equity/Assets	10.2%
Tier 1 Risk-Based Capital Ratio	14.2%
Loans/Assets	68.6%
ROA	0.8%
ROE	8.7%
NPAs/Assets	2.2%
NPAs/Equity Capital & Reserves	20.0%

(1) The term “Bank Issuers” as used herein refers to banks or holding companies thereof and includes issuers in which we have direct and indirect investments.
(2) For purposes of this table, the median and weighted average calculations are based on the Bank Issuers in which SCFC directly and indirectly holds investments; with respect to direct investments that are secured by obligations issued by Bank Issuers (each a “Secured Bond”), the weighted average is calculated by prorating the market value of the Secured Bond among the obligations issued by the underlying Bank Issuers that collateralize such Secured Bond. The calculations were prepared by the Company based on information obtained from FDIC and SNL Financial.
(3) Median Total Assets (000s) is $1,560,571.

Distribution by Size of Bank Issuer

Size of Bank Issuer	Number of Bank Issuers	Bank Issuers as a % of Long-Term Investments	
Assets > $10 Billion	1	0.4	%
$3 Billion < Assets ≤ $10 Billion	5	35.4	%
$1 Billion < Assets ≤ $3 Billion	5	55.0	%
$300 Million < Assets < $1 Billion	6	9.2	%
$150 Million < Assets < $300 Million	0	0.0	%
Assets < $150 Million	0	0.0	%
Total	17	100.0	%

STONECASTLE FINANCIAL CORP.

Schedule of Investments

As of December 31, 2013

Company	Industry	Investment	# of Shares/ Par Amount	Market Value
Long-Term Investments - 24.6%				
Preferred Securities - 17.9%				
Preferred Stock - 16.5%				
Farmers Capital Bank Corporation	Banking	Fixed Rate Cumulative Perpetual Preferred Stock Series A (5% through 2/14/2014, 9% thereafter)	5,494	$5,136,890
First Financial Holdings, Inc.	Banking	Fixed Rate Cumulative Perpetual Preferred Stock Series A (5% through 2/14/2014, 9% thereafter)	5,494	5,452,795