PROSPECT ENERGY CORP
Form N-2/A
August 01, 2006

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As filed with the Securities and Exchange Commission on August 1, 2006
Registration No. 333-132575

U.S. SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form N-2
þ **REGISTRATION STATEMENT UNDER THE SECURITIES ACT OF 1933**
þ **PRE-EFFECTIVE AMENDMENT NO. 2**
o **POST-EFFECTIVE AMENDMENT NO.**

PROSPECT ENERGY CORPORATION
(Exact Name of Registrant as Specified in Charter)
10 East 40th Street, 44th Floor
New York, NY 10016
(Address of Principal Executive Offices)
Registrant s Telephone Number, including Area Code: (212) 448-0702
John F. Barry III
M. Grier Eliasek
c/o Prospect Capital Management, LLC
10 East 40th Street, 44th Floor
New York, NY 10016
(212) 448-0702
(Name and Address of Agent for Service)
Copies of information to:
Leonard B. Mackey, Jr., Esq.
Clifford Chance US LLP
31 West 52nd Street
New York, NY 10019-6131
(212) 878-8000

Approximate Date of Proposed Public Offering: As soon as practicable after the effective date of this Registration Statement.

If any securities being registered on this form will be offered on a delayed or continuous basis in reliance on Rule 415 under the Securities Act of 1933, other than securities offered in connection with a distribution reinvestment plan, check the following box. þ

It is proposed that this filing will become effective (check appropriate box):

o when declared effective pursuant to section 8(c).

If appropriate, check the following box:

o This [post-effective] amendment designates a new effective date for a previously filed [post-effective amendment] [registration statement].

o This form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act and the Securities Act registration statement number of the earlier effective registration statement for the same offering is .

CALCULATION OF REGISTRATION FEE UNDER THE SECURITIES ACT OF 1933

	Proposed Maximum	Proposed Maximum	Amount of

Title of Securities Being Registered	Amount Being Registered(1)(2)	Offering Price Per Unit	Aggregate Offering Price	Registration Fee
Common Stock, $.001 par value per share(2)			300,000,000	
Preferred Stock(2)				
Warrants(3)				
Debt Securities(4)				
Total			$300,000,000(5)	$32,100.00(1)

(1) Estimated pursuant to Rule 457 solely for the purpose of determining the registration fee. All of such amount was previously paid. The proposed maximum offering price per Security will be determined, from time to time, by the Registrant in connection with the sale by the Registrant of the securities registered under this registration statement.

(2) Subject to Note 5 below, there is being registered hereunder an indeterminate principal amount of common stock or preferred stock as may be sold, from time to time.

(3) Subject to Note 5 below, there is being registered hereunder an indeterminate principal amount of warrants as may be sold, from time to time, representing rights to purchase common stock, preferred stock or debt securities.

(4) Subject to Note 5 below, there is being registered hereunder an indeterminate principal amount of debt securities as may be sold, from time to time. If any debt securities are issued at an original issue discount, then the offering price shall be in such greater principal amount as shall result in an aggregate price to investors not to exceed $300,000,000.

(5) In no event will the aggregate offering price of all securities issued from time to time pursuant to this registration statement exceed $300,000,000.

THE REGISTRANT HEREBY AMENDS THIS REGISTRATION STATEMENT ON SUCH DATE OR DATES AS MAY BE NECESSARY TO DELAY ITS EFFECTIVE DATE UNTIL THE REGISTRANT SHALL FILE A FURTHER AMENDMENT WHICH SPECIFICALLY STATES THAT THIS REGISTRATION STATEMENT SHALL THEREAFTER BECOME EFFECTIVE IN ACCORDANCE WITH SECTION 8(a) OF THE SECURITIES ACT OF 1933, AS AMENDED, OR UNTIL THIS REGISTRATION STATEMENT SHALL BECOME EFFECTIVE ON SUCH DATE AS THE COMMISSION, ACTING PURSUANT TO SECTION 8(a), MAY DETERMINE.

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The information in this prospectus supplement is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus supplement is not an offer to sell these securities and it is not soliciting an offer to buy these securities in any state where the offer and sale is not permitted.

SUBJECT TO COMPLETION DATED AUGUST 1, 2006

PROSPECTUS SUPPLEMENT
(To Prospectus dated August , 2006)

4,000,000 Shares

Common Stock

We are selling 4,000,000 shares of our common stock to repay debt and fund additional investments from our investment pipeline. Our common stock is quoted on the NASDAQ Global Market under the symbol PSEC. On July 31, 2006, the last sale price reported for our common stock on the NASDAQ Global Market was $16.21 per share.

Prospect Energy Corporation is a financial services company that lends to and invests in middle market, privately held or thinly traded public companies in the energy industry. We are organized as a non-diversified closed-end management investment company that has elected to be treated as a business development company under the Investment Company Act of 1940. Prospect Capital Management, LLC manages our investments, and Prospect Administration, LLC provides the administrative services necessary for us to operate.

Investing in our common stock involves risks. See Risk Factors beginning on page S-12 of this prospectus supplement and on page 10 of the accompanying prospectus.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus supplement is truthful or complete. Any representation to the contrary is a criminal offense.

	Per Share	Total
Public offering price	$	$
Underwriting discount (sales load)	$	$
Proceeds to us before expenses[1]	$	$

(1) Before deducting estimated expenses payable by us of $563,000.

The underwriters have the option to purchase up to an additional 600,000 shares of common stock at the public offering price, less the underwriting discount, within 30 days from the date of this prospectus supplement solely to cover over-allotments. If the over-allotment option is exercised in full, the total public offering price will be $, and the total underwriting discount (sales load) will be $. The proceeds to us would be $, before deducting estimated expenses payable by us of $563,000.

The underwriters expect to deliver the shares on or about , 2006.

Morgan Keegan & Company, Inc.
Sole Book Running Manager

Ferris, Baker Watts Incorporated

Oppenheimer & Co.

D.A. Davidson & Co.

Sterne, Agee & Leach, Inc.

The date of this prospectus supplement is , 2006.

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PROSPECTUS SUPPLEMENT

PROSPECTUS

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PROSPECTUS SUMMARY

This summary highlights some information from this prospectus supplement and the accompanying prospectus, and it may not contain all of the information that is important to you. To understand the terms of the common stock offered hereby, you should read this prospectus supplement and the accompanying prospectus carefully. Together, these documents describe the specific terms of the shares we are offering. You should carefully read the sections titled Risk Factors in this prospectus supplement and in the accompanying prospectus and the documents identified in the section Additional Information. Except as otherwise noted, all information in this prospectus supplement and the accompanying prospectus assumes no exercise of the underwriters over-allotment option.

The terms we, us, our, Company and Prospect Energy refer to Prospect Energy Corporation; Prospect Capital Management or the Investment Adviser refers to Prospect Capital Management, LLC; Prospect Administration or the Administrator refers to Prospect Administration, LLC.

The Company

We are a financial services company that lends to and invests in companies in the energy industry. We are organized as a non-diversified closed-end management investment company that has elected to be treated as a business development company under the Investment Company Act of 1940, or the 1940 Act.

We concentrate on making investments in energy companies having annual revenues of less than $250 million. Our typical investment involves a secured loan of less than $30 million with some form of equity participation. In most cases, companies in which we invest are privately held or have thinly traded public securities at the time we invest in them. We refer to these companies as middle market companies and these investments as middle market investments.

We seek to maximize returns to our investors by applying rigorous credit analysis and asset-based lending techniques to make and monitor our investments in asset intensive energy companies. We do not intend to invest directly in any energy company engaged exclusively in (1) oil and gas exploration, (2) speculative risks or (3) speculative trading in oil, gas and/or other commodities, although some of the energy companies in which we invest may be involved in some exploration or development activity.

As of March 31, 2006, we held investments having an aggregate value of $104.2 million in ten portfolio companies. For the quarter ended March 31, 2006, the weighted average yield on all of our outstanding investments in long-term debt securities issued by our portfolio companies was 14.5% (18% including dividend paying equity securities). As of July 28, 2006, we have executed non-binding letters of intent with four companies to make investments aggregating approximately $45 million. The proposed investments are subject to due diligence, approval of our investment committee and negotiation and execution of definitive investment agreements. We may consummate less than all or none of the investments that are subject to these non-binding letters of intent.

The Energy Industry

We invest primarily in the North American energy industry. We believe the energy industry is one of the largest, most dynamic and important industries in North America. The energy industry consists of companies in the direct energy value chain as well as companies that sell products and services to, or acquire products and services from, the direct energy value chain. In this prospectus, we refer to all of these companies as energy companies and assets in these companies as energy assets. The categories of energy companies in this value chain are described below. The direct energy value chain includes upstream businesses, midstream businesses and downstream businesses:

Upstream businesses find, develop and extract energy resources, including natural gas, crude oil and coal, which are typically found underground or offshore in geological reservoirs.

Midstream businesses gather, process, refine, store and transmit energy resources and their byproducts in a form that is usable by wholesale power generation, utility, petrochemical, industrial and gasoline customers.

Downstream businesses include the power and electricity segment as well as businesses that process, refine, market or distribute hydrocarbons or other energy resources, such as customer-ready natural gas, propane and gasoline, to end-user customers.

Our Competitive Advantages

We believe we have the following competitive advantages over others investing in middle market energy companies:

our team of investment professionals has more than 125 years of combined experience in the energy industry;

our focus on the energy industry distinguishes us from generalist private equity and mezzanine capital providers;

we avoid widely marketed auctions to achieve better pricing and terms;

we focus on transactions where we can obtain meaningful equity participation as additional consideration for our loans;

we believe we lower our risk by taking first or second lien security interests on strategic assets within the energy industry;

as a public company, our cost of capital is likely to be lower than the cost of capital of a private equity or private mezzanine fund;

our status as a business development company provides us with greater flexibility in customizing one-stop and other financing solutions for energy companies; and

our willingness to invest across all sub-sectors of the energy industry enhances portfolio diversification, decreasing risk and providing us a wider spectrum of investment opportunities.

Our Investment Objective and Policies

Our investment objective is to generate both current income and long-term capital appreciation through debt and equity investments. We focus on making investments in energy companies and will invest, under normal circumstances, at least 80% of our assets (including the amount of any borrowings for investment purposes) in these companies. Prospect Energy is a non-diversified company within the meaning of the 1940 Act, which means that from time to time a greater portion of our assets may consist of portfolio companies in which we have invested more than 5% of our net asset value and/or hold more than 10% of the outstanding voting securities than would be the case if we were a diversified company.

We seek to maximize returns to our investors by applying rigorous credit analysis and asset-based lending techniques, such as taking first or second priority security interests in energy assets. We do not invest directly in any energy company exclusively involved in (1) speculative oil and gas exploration, (2) speculative risks or (3) speculative trading in oil, gas and/or other commodities. Some of the energy companies in which we invest are involved in some exploration or development activity. While the structure of our investments varies, we invest primarily in secured senior and subordinated loans, generally referred to as mezzanine loans, which often include equity interests such as warrants or options received in connection with these loans, and dividend-paying equity securities, such as common and preferred stock and convertible securities, of middle market energy companies. Our investments typically range between $5 million and $30 million each, although this investment size may vary proportionately as the size of our capital base changes.

While we primarily seek current income through investment in the debt and/or dividend-paying equity securities of privately held or thinly traded public energy companies and long-term capital appreciation by

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acquiring accompanying warrants, options or other equity securities of such companies, we may invest up to 30% of our assets in opportunistic investments in order to seek enhanced returns for stockholders. Such investments may include debt and equity instruments of public companies that are not thinly traded. We expect that these public companies generally will have debt securities that are non-investment grade. Within this 30% basket, we may also invest in debt and equity securities of middle-market companies located outside of the United States.

Our investments typically include equity components that provide us with opportunities to share in the growth in value of portfolio companies. Equity components may include warrants or options to acquire common shares in a portfolio company, payment of a portion of the contractual interest on debt securities in common shares of the portfolio company, or contractual payment rights or rights to receive a proportional interest in the revenue, operating cash flow or net income of such company. When determined by the Investment Adviser to be in our best interest, we may acquire a controlling interest in a portfolio company. Any warrants or options we receive may require only a nominal cost to exercise, and thus, as a portfolio company appreciates in value, we may achieve additional investment return from this equity interest. In many cases, we have structured, and may seek to include, in all warrants provisions protecting our rights as a minority-interest or, if applicable, controlling-interest holder, as well as puts. We may also seek to include in all warrants rights to sell such securities back to the company, upon the occurrence of specified events. In many cases, we obtain registration rights in connection with these equity interests, which may include demand and piggyback registration rights.

We plan to hold most of our investments to maturity or repayment, but may sell our investments earlier if a liquidity event takes place, such as the sale or recapitalization of a portfolio company, or if the Investment Adviser deems such sale to be in our best interest.

We have qualified and elected to be treated for federal income tax purposes as a regulated investment company, or a RIC, under Subchapter M of the Internal Revenue Code of 1986, as amended (the Code). As a RIC, we generally do not pay corporate-level federal income taxes on any ordinary income or capital gains that we distribute to our stockholders as dividends. To continue to qualify as a RIC, we must, among other things, meet certain source-of-income and asset diversification requirements (as described below). In addition, to qualify for RIC tax treatment we must distribute to our stockholders, for each taxable year, at least 90% of our investment company taxable income, which is generally our ordinary income plus the excess of our realized net short-term capital gains over our realized net long-term capital losses.

The Investment Adviser

Prospect Capital Management manages our investment activities. John F. Barry III, our Chairman and Chief Executive Officer, is majority owner of Prospect Capital Management. Prospect Capital Management is an investment adviser registered under the Investment Advisers Act of 1940, or the Advisers Act. Under an investment advisory agreement between the Company and Prospect Capital Management (the Investment Advisory Agreement), we have agreed to pay Prospect Capital Management investment advisory fees, which will consist of an annual base management fee based on our gross assets including assets purchased with borrowed funds, as well as a two-part incentive fee based on our performance. On May 15, 2006, the Board of Directors of the Company voted unanimously to renew the Investment Advisory Agreement for the one year period beginning June 24, 2006. Our headquarters are located at 10 East 40th Street, 44th Floor, New York, NY 10016, and our telephone number is (212) 448-0702. Our web site is www.prospectenergy.com. The information on our web site is not part of this prospectus supplement.

Recent Developments

On July 31, 2006 our Board of Directors declared a quarterly dividend of $0.38 for the first fiscal quarter 2007, payable September 29, 2006 to stockholders of record on September 22, 2006. This represents a $0.04 or 12%

increase in the dividend paid for the last fiscal quarter in 2006.

On July 20, 2006, we entered into a $50 million senior revolving credit facility with HSH-Nordbank AG. The facility is for an initial term of one year, but our lender has the option to extend the facility for an

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additional two years. Interest on borrowings under the facility is charged at either (i) LIBOR plus the applicable spread at such time, ranging from 200 to 250 basis points, or (ii) the greater of the lender prime rate or the federal funds effective rate plus the applicable spread at such time, ranging from 50 to 100 basis points. Loans under our credit facility are collateralized by a security interest in all of our assets, including investments. Our credit facility will be used to supplement Prospect Energy s equity capital to make additional portfolio investments. Our credit facility, together with other borrowings (which may include reverse repurchase agreements and similar transactions), may be used in the future to leverage our capital. Our primary use of funds will be investments in portfolio companies and cash distributions to holders of our common stock.

On July 17, 2006, our Nominating and Corporate Governance Committee nominated Mr. William J. Gremp, Jr., and our Board of Directors accepted the nomination and elected Mr. Gremp as a director of the Company with a term expiring in 2007. Please see Management Board Of Directors And Executive Officers for more information.

On June 14, 2006, we declared a fourth fiscal quarter (for the fiscal year ending June 30, 2006) dividend of $0.34 per share, payable on June 30, 2006, to shareholders of record as of June 23, 2006. This dividend marks an increase of $0.04 or 13.3% from the prior quarter s dividend of $0.30 per share, an increase of $0.19 or 126.7% from the year-over-year prior quarter s dividend of $0.15 per share, and the seventh consecutive quarterly increase.

Since March 31, 2006, we have made investments totaling $39.8 million, including investments in Charlevoix Energy Trading, LLC; Iron Horse Coiled Tubing, Inc.; Central Illinois Energy, LLC; Conquest Cherokee LLC; and Advantage Oilfield Group, Ltd. We also received full payment on our loan to Natural Gas Systems, Inc. of $5.0 million. We have also received a prepayment premium of $375,000 and have realized $2.2 million in our equity position in Natural Gas Systems, Inc. Our realized annualized cash return on this investment is in excess of 60%, which does not include the value of shares we still hold.

The Offering

Common stock offered by us	4,000,000 shares.
Common stock outstanding prior to this offering	7,069,873 shares.
Common stock outstanding after this offering	11,069,873 shares.
Use of proceeds	We expect to use approximately $29.3 million of the net proceeds of this offering to repay amounts outstanding under our revolving credit facility. After such repayment, our revolving credit facility will be fully available to fund additional investments. We expect to use the remainder of the net proceeds to fund investments from our investment pipeline. See Use of Proceeds.
The NASDAQ Global Market symbol	PSEC
Risk factors	See Risk Factors in this prospectus supplement and other information in this prospectus supplement and the accompanying prospectus for a discussion of factors you should carefully consider before deciding to invest in shares of our common stock.
Current distribution rate	On July 31, 2006 our Board of Directors declared a quarterly dividend of $0.38 for the first fiscal quarter 2007, payable September 29, 2006 to stockholders of record on September 22, 2006. Our dividend is subject to change or discontinuance at any time in the discretion of our Board of Directors. Our future earnings and operating cash flow may not be sufficient to support a dividend.

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Fees and Expenses

The following tables are intended to assist you in understanding the costs and expenses that an investor in this offering will bear directly or indirectly. In these tables, we assume borrowings of $30 million, the approximate amount currently outstanding under our credit facility. Except where the context suggests otherwise, whenever this prospectus supplement contains a reference to fees or expenses paid by you, us or Prospect Energy, or that we will pay fees or expenses, Prospect Energy will pay such fees and expenses out of our net assets and, consequently, you will indirectly bear such fees or expenses as an investor in Prospect Energy. However, you will not be required to deliver any money or otherwise bear personal liability or responsibility for such fees or expenses.

Stockholder Transaction Expenses:

Sales load (as a percentage of offering price)(1)	5.50%
Offering expenses borne by us (as a percentage of offering price)(2)	0.87%
Dividend reinvestment plan expenses(3)	
Total stockholder transaction expenses (as a percentage of offering price)	6.37%

Annual Expenses (as a percentage of net assets attributable to common stock):(4)

Base management fee	2.38%(5)
Incentive fees payable under Investment Advisory Agreement (20% of realized capital gains and 20% of pre-incentive fee net investment income)	1.29%(6)
Interest payments on borrowed funds	1.45%(7)
Other expenses	1.24%(8)
Total annual expenses (estimated)	6.36%(6)(8)(9)

Example:

The following table demonstrates the projected dollar amount of cumulative expenses we would pay out of net assets and that you would indirectly bear over various periods with respect to a hypothetical investment in our common stock. In calculating the following expense amounts, we have assumed that our annual operating expenses would remain at the levels set forth in the table above and that we pay the stockholder transaction costs shown in the table above.

	1 Year	3 Years	5 Years	10 Years
You would pay the following expenses on a $1,000 investment, assuming a 5% annual return	$ 129	$ 256	$ 380	$ 673

While the table assumes, as required by the SEC, a 5% annual return, our performance will vary and may result in a return greater or less than 5%. The income incentive fee under the Investment Advisory Agreement would be zero at the 5% annual return assumption required by the SEC for this table, since no incentive fee is paid until the annual return exceeds 7%. However, we have reflected in the example the income incentive fee currently earned as if the annual return were at the level recently achieved, which is higher than 5%. Accordingly, the resulting calculations overstate expenses at the 5% annual return as these calculations do not reflect the provisions of the Investment

Advisory Agreement as it would actually be applied in the case of a 5% annual return. This table assumes that we will not realize any capital gains computed net of all realized capital losses and unrealized capital depreciation in any of the indicated time periods. If we achieve sufficient returns on our investments, including through the realization of capital gains, to trigger an incentive fee of a material amount, our expenses, and returns to our investors after such expenses, would be higher. In addition, while the example assumes reinvestment of all dividends and distributions at net asset value, participants in our dividend reinvestment plan will receive a number of shares of our common stock, determined by dividing the total dollar amount of the dividend payable to a participant by the market price per share of our common stock at the close of trading on the valuation date for the dividend. See Dividend Reinvestment Plan for additional information regarding our dividend reinvestment plan.

This example and the expenses in the table above should not be considered a representation of our future expenses. Actual expenses (including the cost of debt, if any, and other expenses) may be greater or less than those shown.

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(1) The underwriting discount with respect to our common stock sold in this offering, which is a one-time fee, is the only sales load paid in connection with this offering.

(2) The offering expenses of this offering are estimated to be approximately $563,000. If the underwriters exercise their over-allotment option in full, the offering expenses borne by us (as a percentage of the offering price) will be 0.76%.

(3) The expenses of the dividend reinvestment plan are included in other expenses.

(4) Net assets attributable to our common stock equal net assets (i.e., total assets less liabilities other than liabilities for money borrowed for investment purposes) at March 31, 2006 as adjusted for the net proceeds of this offering. See Capitalization .

(5) Our base management fee is 2.00% of our gross assets (which include any amount borrowed, i.e., total assets without deduction for any liabilities). Assuming that we have borrowed $30 million, the 2.00% management fee of gross assets equals 2.38% of net assets. See Management Investment Advisory Agreement in the accompanying prospectus and footnote 7 below.

(6) We expect to invest all of the net proceeds from this offering within 90 days of the date of the completion of the offering and may have capital gains and interest income that could result in the payment of an incentive fee to our Investment Adviser in the first year after completion of this offering. For a more detailed discussion of the calculation of the two-part incentive fee, see Management Investment Advisory Agreement in the accompanying prospectus.

(7) We may borrow additional money before and after the proceeds of this offering are substantially invested, but, in general, will utilize debt to the maximum extent reasonably possible before issuing equity. We currently have approximately $30 million outstanding under our credit facility, which has a one year term expiring July 19, 2007, subject to our lender s option to extend the credit facility for an additional two years. For more information, see Risk Factors Changes in interest rates may affect our cost of capital and net investment income below and Management s Discussion and Analysis of Financial Condition and Results of Operations Financial Condition, Liquidity and Capital Resources, Capital Raising Activities in the accompanying prospectus. The table above assumes that we have borrowed $30 million under our credit facility, which is the approximate amount currently outstanding. The table below shows our estimated annual expenses as a percentage of net assets attributable to common stock, assuming that we did not borrow any money.

Base management fee	2.02%
Incentive fees payable under Investment Advisory Agreement (20% of realized capital gains and 20% of pre-incentive fee net investment income)	1.29%
Interest payments on borrowed funds	
Other expense	1.24%
Total annual expense (estimated)	4.55%

(8) Other expense is based on an estimate of expenses during the current fiscal year representing all of our estimated recurring operating expenses (except fees and expenses reported in other items of this table) that are deducted from our operating income and reflected as expenses in our Statement of Operations. The estimate of our overhead expenses, including payments under the administration agreement, is based on our projected allocable portion of overhead and other expenses incurred by Prospect Administration in performing its obligations under

the administration agreement. Other expense does not include non-recurring expenses. See Management Administration Agreement in the accompanying prospectus.

(9) Total annual expense as a percentage of net assets attributable to our common stock are higher than the total annual expense percentage would be for a company that is not leveraged. We borrow money in order to leverage our net assets and increase our total assets with a view to increasing shareholder returns. The total annual expense percentage is required by the SEC to be calculated as a percentage of net assets, rather than the total assets, which includes assets that have been acquired with borrowed funds. If the total annual expense percentage were calculated as a percentage of total assets, our total annual expense ratio would be 5.34% of total assets.

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SELECTED CONDENSED FINANCIAL AND OTHER DATA

You should read the condensed financial and other data below with the Financial Statements and Notes thereto and Management s Discussion and Analysis of Financial Condition and Results of Operations included in the accompanying prospectus. Financial information for the twelve months ended June 30, 2005 has been derived from the audited financial statements for that period. Quarterly financial information is derived from unaudited financial data, which in the opinion of management reflect all adjustments (consisting only of normal recurring adjustments) that are necessary to present fairly the results of such interim periods. Interim results for the three and nine months ended March 31, 2006 are not necessarily indicative of the results that may be expected for the year ending June 30, 2006. See Management s Discussion and Analysis of Financial Condition and Results of Operations on page 25 of the accompanying prospectus for more information.

	Twelve Months Ended June 30, 2005	Nine Months Ended March 31,		Three Months Ended March 31,	
		2005	**2006**	**2005**	**2006**
		(Unaudited)	*(Unaudited)*	*(Unaudited)*	*(Unaudited)*
	(dollars in thousands, except per share data)				
Statement of operations data					
Investment income					
Interest income	$ 1,882	$ 887	$ 4,569	$ 437	$ 1,704
Interest income, controlled entities	2,704	1,876	3,316	828	1,309
Dividend income	284	24	450	10	90
Dividend income, controlled entities	3,151	2,200	2,249	500	850
Other income	72	13	487	13	73
Total investment income	8,093	5,000	11,071	1,788	4,026
Operating expenses					
Investment advisory fees					
Base management fee	1,808	1,317	1,554	485	521
Income incentive fee			1,041		533
Total investment advisory fees	1,808	1,317	2,595	485	1,054
Interest expense and credit facility costs			12		12
Administration costs	266	295	225	126	82
Legal fees	2,575	1,537	1,501	481	390
Valuation services	42	18	132	18	45
Other professional fees	230	163	313	75	85
Insurance expense	325	237	269	89	85
Directors fees	220	147	165	55	55
Organizational costs	25				
General and administrative expenses	191	48	277	15	92
Total operating expenses	5,682	3,762	5,489	1,344	1,900

Net investment income (loss)	2,411	1,238	5,582	444	2,126
Net realized loss	(2)		(18)		1
Net unrealized appreciation (depreciation)	6,342	414	1,392	414	828
Net income	$ 8,751	$ 1,652	$ 6,956	$ 858	$ 2,955
Earnings per share diluted and basic	$ 1.24	$ 0.23	$ 0.99	$ 0.12	$ 0.42
Balance sheet data and other information					
Cash	$	$ 12,848	$ 1,060	$ 12,848	$ 1,060
Total investments, net of unearned income	93,866	85,361	104,241	85,361	104,241
Total debt					
Net asset value	102,967	96,927	104,602	96,927	104,602
NAV per share	$ 14.59	$ 13.74	$ 14.81	$ 13.74	$ 14.81
Number of Portfolio Companies	6	3	10	3	10

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The following is a schedule of financial highlights for the periods indicated below:

	For the Twelve Months Ended June 30, 2005	For the Nine Months Ended March 31, 2005	For the Nine Months Ended March 31, 2006	For the Three Months Ended March 31, 2005	For the Three Months Ended March 31, 2006
Per share data[1]					
Net asset value at beginning of period	$ (0.01)	$ (0.01)	$ 14.59	$ 13.74	$ 14.69
Proceeds from initial public offering	13.95	13.95			
Costs related to the initial public offering	(0.21)	(0.21)	0.01		
Share issuance related to dividend reinvestment			0.02		0.02
Net investment income	0.34	0.17	0.79	0.06	0.30
Net unrealized appreciation	0.90	0.06	0.18	0.06	0.10
Dividends declared and paid	(0.38)	(0.22)	(0.78)	(0.12)	(0.30)
Net asset value at end of period	$ 14.59	$ 13.74	$ 14.81	$ 13.74	$ 14.81
Per share market value at end of period	$ 12.60	$ 12.90	$ 16.44	$ 12.90	$ 16.44
Total return based on market value[2]	(13.46)%	(12.46)%	37.35%	8.54%	11.08%
Total return based on net asset value[2]	7.40%	(6.88)%	7.13%	0.88%	3.00%
Shares outstanding at end of period	7,055,100	7,055,100	7,061,941	7,055,100	7,061,941
Other data					
Net assets at end of period (in thousands)	$ 102,967	$ 96,925	$ 104,602	$ 96,927	$ 104,602
Annualized ratio of operating expenses to average net assets	5.52%	5.11%	6.96%	5.51%	7.27%
Annualized ratio of operating income to average net assets	8.50%	1.68%	7.12%	1.82%	8.13%

(1) Financial highlights as of March 31, 2006 and June 30, 2005 are based on 7,061,941 shares and 7,055,100 shares outstanding, respectively. We issued 6,841 shares pursuant to our dividend reinvestment plan on March 31, 2006.

(2) Total return based on market value calculates the total return as a percentage for the period shown using the change in market price per share from the opening to the ending market price per share in each period assuming that dividends are reinvested in accordance with Prospect Energy s dividend reinvestment plan. Total return based on net asset value calculates the total return as a percentage for the period shown using the change in net asset value per share from the opening to the ending net asset value per share in each period assuming that dividends are reinvested in accordance with Prospect Energy s dividend reinvestment plan. The total return is not annualized.

RISK FACTORS

Investing in our common stock involves a high degree of risk. You should carefully consider the risks described below, together with all of the other information included in this prospectus supplement and in the accompanying prospectus, before you decide whether to make an investment in our common stock. The risks set forth below are not the only risks we face. If any of the adverse events or conditions described below occur, our business, financial condition and results of operations could be materially adversely affected, our net asset value and the trading price of our common stock could decline, and you could lose all or part of your investment.

Our portfolio investments have not been valued by our Board of Directors or independent valuation firm at June 30, 2006, and our net asset value may have changed significantly since our last independent valuation at March 31, 2006.

Our Board of Directors determines the fair value of our portfolio investments on a quarterly basis based on input from our Investment Adviser, the audit committee of our Board of Directors and a third party independent valuation firm. The last such determination of fair value was as of March 31, 2006, and, while the Board of Directors will review our net asset value per share in connection with this offering, it will not have the benefit of input from the independent valuation firm when it does so. Moreover, our financial statements have not been audited by our independent registered public accounting firm since the period ended June 30, 2005. In the period since the independent valuation firm last conducted an evaluation of our investment portfolio, the fair value of individual investments in our portfolio and the aggregate fair value of our investments may have changed significantly. Subsequent to completion of this offering, our audit committee and Board of Directors expect to receive from the independent valuation firm an analysis of the valuation of our investment portfolio at June 30, 2006. Based in part on that analysis, as well as the analysis performed by the Investment Adviser and the Audit Committee, our Board of Directors will determine the fair value of our investments at June 30, 2006. All of these steps will occur after completion of this offering. If our Board of Directors determines that the fair value of our investment portfolio at June 30, 2006 was less than such fair value at March 31, 2006, then we will record unrealized loss on our investment portfolio and report a lower net asset value per share than is reflected in the Selected Condensed Financial Data and the financial statements included elsewhere in this prospectus supplement and the accompanying prospectus. If our board of directors determines that the fair value of our investment portfolio at June 30, 2006 was greater than such fair value at March 31, 2006, we will record unrealized gain on our investment portfolio and report a greater net asset value per share than so reflected elsewhere in this prospectus supplement and the accompanying prospectus. Upon publication of this information in connection with our announcement of operating results for our fiscal year ended June 30, 2006, the market price of our common stock may fluctuate materially, and may be substantially less than the price per share you pay for our common stock in this offering.

Potential writedowns or losses with respect to three portfolio investments that are on our credit watch list, or on other portfolio investments, existing and to be made in the future could adversely affect our results of operations, cash flows, dividend level, net asset value and stock price.

As of the date of this prospectus supplement, loans we have made to Unity Virginia Holdings LLC (Unity), Whymore Coal Company (Whymore) and Worcester Energy Partners, Inc. (Worcester) are on our credit watch list due to existing or potential payment and existing or potential covenant defaults under the contracts governing such investments. Unity has filed a voluntary bankruptcy petition under Chapter 11 of the US Bankruptcy Code and is currently in default under the contract governing the investment. Unity is in the process of liquidating its assets. Our security interest in Unity s assets is a second priority lien, and the net proceeds from the sale or liquidation of Unity s assets may not satisfy in full the debt owed to the holder of the first priority lien on Unity s assets. Our lack of control over the liquidation of Unity s assets, our second lien security position in such assets and the prospect that Unity s assets have substantially decreased in value could result in our losing our entire investment in Unity. In addition, if the bankruptcy court were to set aside as preferential payments or we were otherwise deemed not to have recognized any amounts previously paid to us by Unity, our net investment income could be materially adversely affected. As of March 31, 2006, Unity was valued at $3.5 million, which represented 3.4% of the net asset value of the fund. Whymore and

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Worcester have experienced liquidity problems, and the Investment Adviser believes both portfolio companies could continue to experience covenant and/or payment defaults under the contracts governing our investments in those companies. We have provided, and may in the future provide, additional capital to Whymore and Worcester to provide liquidity to those portfolio companies, to enable them to pay operating expenses, including debt service, and for capital expenditures. While we have a first priority security interest in the assets of both Whymore and Worcester, the net realizable value of such collateral may be substantially less than the balances outstanding on the loans to those entities. Moreover, either of those portfolio companies may fail to pay principal and/or interest on their outstanding debts to us. Upon further analysis of the values of these investments, we could determine that the fair value of these investments should be reduced substantially, possibly to zero. If any of these events were to occur, our results of operations and cash flows could be materially adversely affected, our net asset value could be substantially reduced, our dividend could be reduced or limited and the market price for our stock could be substantially adversely affected.

Risks Relating To Our Business And Structure

We are dependent upon Prospect Capital Management s key management personnel for our future success.

We depend on the diligence, skill and network of business contacts of the senior management of Prospect Capital Management. We also depend, to a significant extent, on our Investment Adviser s access to the investment professionals and the information and deal flow generated by these investment professionals in the course of their investment and portfolio management activities. For a description of the senior management team, see Management. The senior management team evaluates, negotiates, structures, closes, monitors and services our investments. Our success depends to a significant extent on the continued service of the senior management team, particularly John F. Barry III and M. Grier Eliasek. The departure of any of the senior managers of Prospect Capital Management could have a material adverse effect on our ability to achieve our investment objective. In addition, we can offer no assurance that Prospect Capital Management will remain our Investment Adviser or that we will continue to have access to its investment professionals or its information and deal flow.

Our Investment Adviser and its senior management have limited experience managing a business development company under the 1940 Act.

The 1940 Act imposes numerous constraints on the operations of business development companies. For example, business development companies are required to invest at least 70% of their total assets primarily in securities of privately held or thinly traded U.S. public companies, cash, cash equivalents, U.S. government securities and other high quality debt investments that mature in one year or less. Our Investment Adviser s and its senior management s limited experience in managing a portfolio of assets under such constraints may hinder their ability to take advantage of attractive investment opportunities and, as a result, achieve our investment objective. In addition, our investment strategies differ in some ways from those of other investment funds that have been managed in the past by our Investment Adviser s investment professionals.

We are a relatively new company with limited operating history.

We were incorporated in April 2004 and have conducted investment operations since July 2004. We are subject to all of the business risks and uncertainties associated with any new business enterprise, including the risk that we may not achieve our investment objective and that the value of your investment in us could decline substantially or fall to zero. We completed our initial public offering on July 27, 2004. As of March 31, 2006, we continue to pursue our investment strategy and 89.5% of our net assets were then invested in energy companies, with the remainder invested in U.S. government and money market securities. If we do not realize yields in excess of our expenses, we may incur operating losses and the market price of our shares may decline.

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If our primary investments are deemed not to be qualifying assets, we could lose our status as a business development company or be precluded from investing according to our current business plan.

In order to maintain our status as a business development company, we must not acquire any assets other than qualifying assets unless, at the time of and after giving effect to such acquisition, at least 70% of our total assets are qualifying assets. If we acquire mezzanine loans or dividend-paying equity securities from an issuer that has outstanding marginable securities at the time we make an investment, these acquired assets cannot be treated as qualifying assets. See Regulation Qualifying Assets in the accompanying prospectus. This result follows the definition of eligible portfolio company under the 1940 Act, which in part looks to whether a company has outstanding marginable securities.

Amendments promulgated in 1998 by the Board of Governors of the Federal Reserve System to Regulation T under the Exchange Act expanded the definition of marginable security to include any non-equity security. These amendments have raised questions as to whether a private company that has outstanding debt securities would qualify as an eligible portfolio company.

We believe that the mezzanine loans and equity instruments that we have acquired and expect to continue to acquire should constitute qualifying assets because the privately held companies to which we lend do not, at the time of our investment, have outstanding marginable securities. Until the questions raised by the amendments to Regulation T have been clarified through SEC rulemaking or addressed by legislative, administrative or judicial action, we intend to treat as qualifying assets only those mezzanine loans that are not investment grade, do not have a public secondary market, and are issued by a private issuer that does not have outstanding a class of margin eligible securities at the time of our investment. Likewise, we treat equity securities issued by a portfolio company as qualifying assets only if such securities are issued by a private company that has no marginable securities outstanding at the time we purchase such securities.

To date, we do not believe that either the SEC or its staff has taken any position with respect to our analysis of the issues discussed above and neither the SEC or its staff has indicated that they concur with our analysis. We intend to adjust our investment focus as needed to comply with and/or take advantage of any future administrative position, judicial decision or legislative action.

If there were a court ruling or regulatory decision that conflicts with our interpretations, we could lose our status as a business development company or be precluded from investing in the manner described in this prospectus, either of which would have a material adverse effect on our business, financial condition and results of operations. See Regulations governing our operation as a business development company affect our ability to raise, and the way in which we raise, additional capital in the accompanying prospectus. Such a ruling or decision also may require that we dispose of investments that we made based on our interpretation of Regulation T. Such dispositions could have a material adverse effect on us and our stockholders. We may need to dispose of such investments quickly, which would make it difficult to dispose of such investments on favorable terms. In addition, because these types of investments will generally be illiquid, we may have difficulty in finding a buyer and, even if we do find a buyer, we may have to sell the investments at a substantial loss. See The lack of liquidity in our investments may adversely affect our business in the accompanying prospectus.

Our financial condition and results of operations will depend on our ability to manage our future growth effectively.

Prospect Capital Management has been registered as an investment adviser since March 31, 2004, and Prospect Energy has been organized as a closed-end investment company since April 13, 2004. As such, each entity is subject to the business risks and uncertainties associated with any young business enterprise, including the limited experience in managing or operating a business development company under the 1940 Act. Our ability to achieve our investment objective depends on our ability to grow, which depends, in turn, on our Investment Adviser s ability to continue to identify, analyze, invest in and monitor companies that meet our investment criteria. Accomplishing this result on a cost-effective basis is largely a function of our Investment Adviser s structuring of investments, its ability to provide competent, attentive and efficient services to us and our access to financing on acceptable terms. As we grow, we and Prospect Capital

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Management need to continue to hire, train, supervise and manage new employees. Failure to manage our future growth effectively could have a material adverse effect on our business, financial condition and results of operations.

We operate in a highly competitive market for investment opportunities.

A large number of entities compete with us to make the types of investments that we make in middle market energy companies. We compete with other business development companies, public and private funds, commercial and investment banks and commercial financing companies. Additionally, because competition for investment opportunities generally has increased among alternative investment vehicles, such as hedge funds, those entities have begun to invest in areas in which they have not traditionally invested, including investments in middle-market companies. As a result of these new entrants, competition for investment opportunities in middle-market companies has intensified, and we expect that trend to continue. Many of our existing and potential competitors are substantially larger and have considerably greater financial, technical and marketing resources than we do. For example, some competitors may have a lower cost of funds and access to funding sources that are not available to us. In addition, some of our competitors may have higher risk tolerances or different risk assessments, which could allow them to consider a wider variety of investments and establish more relationships than us. Furthermore, many of our competitors are not subject to the regulatory restrictions that the 1940 Act imposes on us as a business development company. We cannot assure you that the competitive pressures we face will not have a material adverse effect on our business, financial condition and results of operations. Also, as a result of existing and increasing competition, we may not be able to take advantage of attractive investment opportunities from time to time, and we can offer no assurance that we will be able to identify and make investments that are consistent with our investment objective.

We do not seek to compete primarily based on the interest rates that we offer. We believe that some of our competitors make loans with interest rates that are comparable to or lower than the rates we offer. We may lose investment opportunities if we do not match our competitors pricing, terms and structure. If we match our competitors pricing, terms and structure, we may experience decreased net interest income and increased risk of credit loss.

Regulations governing our operation as a business development company affect our ability to raise, and the way in which we raise, additional capital.

We may issue debt securities or preferred stock and/or borrow money from banks or other financial institutions, which we refer to collectively as senior securities, up to the maximum amount permitted by the 1940 Act. Under the provisions of the 1940 Act, we are permitted, as a business development company, to issue senior securities only in amounts such that our asset coverage, as defined in the 1940 Act, equals at least 200% after each issuance of senior securities. If the value of our assets declines, we may be unable to satisfy this test. If that happens, we may be required to sell a portion of our investments or sell additional shares of common stock and, depending on the nature of our leverage, to repay a portion of our indebtedness at a time when such sales may be disadvantageous. In addition, issuance of additional securities could dilute the percentage ownership of our current stockholders in us.

As a business development company regulated under provisions of the 1940 Act, we are not generally able to issue and sell our common stock at a price below the current net asset value per share. We may, however, sell our common stock, or warrants, options or rights to acquire our common stock, at a price below the current net asset value of our common stock in a rights offering to our stockholders or; if (1) our Board of Directors determines that such sale is in the Company s best interests and our stockholders, (2) our stockholders approve the sale of our common stock at a price that is less than the current net asset value, and (3) the price at which our common stock is to be issued and sold may not be less than a price which, in the determination of our Board of Directors, closely approximates the market value of such securities (less any sales load).

In addition, we may in the future seek to securitize our loans to generate cash for funding new investments. To securitize loans, we may create a wholly owned subsidiary and contribute a pool of loans to such subsidiary. This could include the sale of interests in the subsidiary on a non-recourse basis to purchasers who we would expect to be willing to accept a lower interest rate to invest in investment grade loan pools. We would retain a portion of the equity in the securitized pool of loans. An inability to successfully securitize our loan portfolio could limit our ability to grow our business and fully execute our business strategy, and could decrease our earnings, if any. Moreover, the successful securitization of our loan portfolio might expose us to losses because the residual loans in which we do not sell interests may tend to be those that are riskier and more likely to generate losses.

If we fail to qualify as a RIC, we will have to pay corporate-level taxes on our income and our income available for distribution would be reduced.

To maintain our qualification as a RIC under the Code, and obtain RIC tax treatment, we must meet certain source of income, asset diversification and annual distribution requirements. The annual distribution requirement for a RIC is satisfied if we distribute at least 90% of our ordinary income and realized net short-term capital gains in excess of realized net long-term capital losses, if any, to our stockholders on an annual basis. Because we expect to use debt financing in the future, we are subject to certain asset coverage ratio requirements under the 1940 Act and financial covenants that could, under certain circumstances, restrict us from making distributions necessary to qualify for RIC tax treatment. If we are unable to obtain cash from other sources, we may fail to qualify for RIC tax treatment and, thus, may be subject to corporate-level income tax. To maintain our qualification as a RIC, we must also meet certain asset diversification requirements at the end of each calendar quarter. Failure to meet these tests may result in our having to dispose of certain investments quickly in order to prevent the loss of RIC status. Because most of our investments are in private companies, any such dispositions could be made at disadvantageous prices and may result in substantial losses. If we fail to qualify as a RIC for any reason or become subject to corporate income tax, the resulting corporate taxes could substantially reduce our net assets, the amount of income available for distribution, and the actual amount of our distributions. Such a failure would have a material adverse effect on us and our shares. For additional information regarding asset coverage ratio and RIC requirements, see Regulation Senior securities and Material U.S. federal income tax considerations.

We may have difficulty paying our required distributions if we recognize income before or without receiving cash representing such income.

For federal income tax purposes, we include in income certain amounts that we have not yet received in cash, such as original issue discount, which may arise if we receive warrants in connection with the making of a loan or possibly in other circumstances, or payment-in-kind interest, which represents contractual interest added to the loan balance and due at the end of the loan term. Such original issue discount, which could be significant relative to our overall investment activities, or increases in loan balances as a result of payment-in-kind arrangements, are included in our income before we receive any corresponding cash payments. We also may be required to include in income certain other amounts that we do not receive in cash. While we focus primarily on investments that will generate a current cash return, our investment portfolio may also include securities that do not pay some or all of their return in periodic current cash distributions.

The income incentive fee payable by us is computed and paid on income that may include interest that has been accrued but not yet received in cash. If a portfolio company defaults on a loan that is structured to provide accrued interest, it is possible that accrued interest previously used in the calculation of the income incentive fee will become uncollectible.

Since in some cases we may recognize taxable income before or without receiving cash representing such income, we may have difficulty meeting the requirement to distribute at least 90% of our ordinary income and realized net short-term capital gains in excess of realized net long-term capital losses, if any, to maintain RIC tax treatment. Accordingly, we may have to sell some of our investments at times we would not consider advantageous, raise additional debt or equity capital or reduce new investment originations to meet these distribution requirements. If we are not able to obtain cash from other sources, we may fail to qualify for RIC treatment and thus become subject to corporate-level income tax. See Material U.S. federal income tax considerations Taxation as a RIC in the accompanying prospectus.

If we issue senior securities, including debt, you will be exposed to additional risks, including the typical risks associated with leverage.

You will be exposed to increased risk of loss if we incur debt to make investments. If we do incur debt, a decrease in the value of our investments or in our revenues would have a greater negative impact on the value of our common stock than if we did not use debt.

Our ability to pay dividends would be restricted if our asset coverage ratio were not at least 200% and any amounts that we use to service our indebtedness would not be available for dividends to our common stockholders.

It is likely that any debt we incur will be governed by an indenture or other instrument containing covenants restricting our operating flexibility.

We and you will bear the cost of issuing and servicing our senior securities.

Any convertible or exchangeable securities that we issue in the future may have rights, preferences and privileges more favorable than those of our common stock.

Changes in interest rates may affect our cost of capital and net investment income.

We expect that a significant portion of our debt investments will bear interest at fixed rates and the value of these investments could be negatively affected by increases in market interest rates. In addition, an increase in interest rates would make it more expensive to use debt to finance our investments. As a result, a significant increase in market interest rates could both reduce the value of our portfolio investments and increase our cost of capital, which would reduce our net investment income.

We need to raise additional capital to grow because we must distribute most of our income.

We need additional capital to repay borrowings under our revolving credit facility and to fund new investments. A reduction in the availability of new capital could limit our ability to grow. We must distribute at least 90% of our ordinary income and realized net short-term capital gains in excess of realized net long-term capital losses, if any, to our shareholders to maintain our RIC status. As a result, such earnings are not available to fund investment originations. We have sought additional capital by borrowing from financial institutions and may issue debt securities or additional equity securities. If we fail to obtain funds from such sources or from other sources to fund our investments, it could limit our ability to grow, which may have an adverse effect on the value of our common stock. In addition, as a business development company, we are generally required to maintain a ratio of at least 200% of total assets to total borrowings, which may restrict our ability to borrow in certain circumstances.

Most of our portfolio investments are recorded at fair value as determined in good faith by our Board of Directors and, as a result, there is uncertainty as to the value of our portfolio investments.

A large percentage of our portfolio investments consist of securities of privately held or thinly traded public companies. The fair value of these securities is often not readily determinable. The determination of fair value, and thus the amount of unrealized gains or losses we may incur in any year, is to a degree subjective, and the Investment Advisor has a conflict of interest in making the determination. We value these securities quarterly at fair value as determined in good faith by our Board of Directors based on input from our Investment Adviser, a third party independent valuation firm and our audit committee. Our Board of Directors utilizes the services of an independent valuation firm to assist in determining the fair value of any securities. Certain factors that may be considered in determining the fair value of our investments include the nature and realizable value of any collateral, the portfolio company s earnings, cash flows and ability to make payments, the markets in which the portfolio company does business, comparison to publicly traded companies, discounted cash flow and other relevant factors. Because such valuations, and particularly valuations of private securities and private companies, are inherently uncertain, the valuations may fluctuate over short periods of time and may be based on estimates the assumptions underlying which are erroneous. The determinations of fair value by our Board of Directors may differ materially from the values that would have been used if a ready market for these securities existed. Our net asset value could be adversely affected if the determinations regarding the fair value of our investments were materially higher than the values that we ultimately realize upon the disposal of such securities.

The lack of liquidity in our investments may adversely affect our business.

We generally make investments in private companies. Substantially all of these securities are subject to legal and other restrictions on resale or are otherwise less liquid than publicly traded securities. The illiquidity of our investments may make it difficult for us to sell such investments if the need arises. In addition, if we are required to liquidate all or a portion of our portfolio quickly, we may realize significantly less than the value at which we have previously recorded our investments. In addition, we may face other restrictions on our ability to liquidate