

BABSON CAPITAL PARTICIPATION INVESTORS

Form N-30D

May 27, 2016

Adviser

Babson Capital Management LLC
1500 Main Street, P.O. Box 15189
Springfield, Massachusetts 01115-5189

Independent Registered Public Accounting Firm

KPMG LLP
Boston, Massachusetts 02110

Counsel to the Trust

Ropes & Gray LLP
Boston, Massachusetts 02110

Custodian

State Street Bank and Trust Company
Boston, Massachusetts 02116
Transfer Agent & Registrar

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P.O. Box 219086
Kansas City, Missouri 64121-9086
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Internet Website

www.babsoncapital.com/funds/closed-end-funds/babson-capital-participation-investors

Babson Capital Participation Investors
c/o Babson Capital Management LLC
1500 Main Street, Suite 2200
Springfield, Massachusetts 01115
(413) 226-1516

Investment Objective and Policy

Babson Capital Participation Investors (the "Trust") is a closed-end management investment company, first offered to the public in 1988, whose shares are traded on the New York Stock Exchange under the trading symbol "MPV". The Trust's share price can be found in the financial section of most newspapers under either the New York Stock Exchange listings or Closed-End Fund Listings.

The Trust's investment objective is to maximize total return by providing a high level of current income, the potential for growth of income, and capital appreciation. The Trust's principal investments are privately placed,

below-investment grade, long-term debt obligations purchased directly from their issuers, which tend to be smaller companies. The Trust will also invest in publicly traded debt securities (including high yield securities) again with an emphasis on those with equity features, and in convertible preferred stocks and, subject to certain limitations, readily marketable equity securities. Below-investment grade or high yield securities have predominantly speculative characteristics with respect to the capacity of the issuer to pay interest and repay principal. The Trust is prohibited from purchasing below-investment grade securities if, after giving effect to the purchase, more than 75% of the Trust's total assets would be invested in below-investment grade securities, which are securities that are rated, at the time of purchase, BB or B by S&P or Ba or B by Moody's, or, if unrated, are believed by Babson Capital Management LLC ("Babson Capital") to be of an equivalent quality. In addition, the Trust will not invest in any debt security that is rated, at the time of acquisition, below B by S&P or Moody's, or if unrated, is believed by Babson Capital to be of an equivalent quality. In addition, the Trust may invest in high quality, readily marketable securities.

Babson Capital manages the Trust on a total return basis. The Trust distributes substantially all of its net income to shareholders each year. Accordingly, the Trust pays dividends to shareholders in January, May, August, and November. All registered shareholders are automatically enrolled in the Dividend Reinvestment and Cash Purchase Plan unless cash distributions are requested.

Form N-Q

The Trust files its complete schedule of portfolio holdings with the U.S. Securities and Exchange Commission ("SEC") for the first and third quarters of each fiscal year on Form N-Q. This information is available (i) on the SEC's website at <http://www.sec.gov>; and (ii) at the SEC's Public Reference Room in Washington, DC (which information on their operation may be obtained by calling 1-800-SEC-0330). A complete schedule of portfolio holdings as of each quarter-end is available upon request by calling, toll-free, 866-399-1516.

Proxy Voting Policies & Procedures; Proxy Voting Record

The Trustees of the Trust have delegated proxy voting responsibilities relating to the voting of securities held by the Trust to Babson Capital. A description of Babson Capital's proxy voting policies and procedures is available (1) without charge, upon request, by calling, toll-free 866-399-1516; (2) on the Trust's website:

<http://www.babsoncapital.com/funds/closed-end-funds/babson-capital-participation-investors>; and (3) on the SEC's website at <http://www.sec.gov>. Information regarding how the Trust voted proxies relating to portfolio securities during the most recent 12-month period ended June 30 is available (1) on the Trust's website:

<http://www.babsoncapital.com/funds/closed-end-funds/babson-capital-participation-investors>; and (2) on the SEC's website at <http://www.sec.gov>.

Legal Matters

The Trust has entered into contractual arrangements with an investment adviser, transfer agent and custodian (collectively "service providers") who each provide services to the Trust. Shareholders are not parties to, or intended beneficiaries of, these contractual arrangements, and these contractual arrangements are not intended to create any shareholder right to enforce them against the service providers or to seek any remedy under them against the service providers, either directly or on behalf of the Trust.

Under the Trust's Bylaws, any claims asserted against or on behalf of the Trust, including claims against Trustees and officers must be brought in courts located within the Commonwealth of Massachusetts.

The Trust's registration statement and this shareholder report are not contracts between the Trust and its shareholders and do not give rise to any contractual rights or obligations or any shareholder rights other than any rights conferred explicitly by federal or state securities laws that may not be waived.

Babson Capital Participation Investors
TO OUR SHAREHOLDERS
April 30, 2016

We are pleased to present the March 31, 2016 Quarterly Report of Babson Capital Participation Investors (the "Trust").

The Board of Trustees declared a quarterly dividend of \$0.27 per share, payable on May 13, 2016 to shareholders of record on May 2, 2016. The Trust paid a \$0.27 per share dividend for the preceding quarter. The Trust earned \$0.22 per share of net investment income, including \$0.02 per share of non-recurring charges, for the first quarter of 2016, compared to \$0.24 per share, including \$0.01 per share of non-recurring income, in the previous quarter.

During the first quarter, the net assets of the Trust increased to \$138,443,220 or \$13.39 per share compared to \$135,349,634 or \$13.10 per share on December 31, 2015. This translates into a 2.1% total return for the quarter, based on the change in the Trust's net assets assuming the reinvestment of all dividends. Longer term, the Trust returned 4.1%, 9.6%, 11.1%, 10.0% and 12.3% for the 1-, 3-, 5-, 10-, and 25-year periods ended March 31, 2016, respectively, based on the change in the Trust's net asset value (net of all fees and expenses) assuming the reinvestment of all dividends and distributions.

The Trust's share price increased 3.9% during the quarter, from \$13.75 per share as of December 31, 2015 to \$14.29 per share as of March 31, 2016. The Trust's market price of \$14.29 per share equates to a 6.7% premium over the March 31, 2016 net asset value per share of \$13.39. The Trust's average quarter-end premium for the 3-, 5- and 10-year periods was 7.2%, 11.6% and 8.9%, respectively. U.S. equity markets, as approximated by the Russell 2000 Index, decreased 1.5% for the quarter. U.S. fixed income markets, as approximated by the Barclays Capital U.S. Corporate High Yield Index, increased 3.4% for the quarter.

The Trust closed four new private placement investments, as well as one add-on investment in an existing portfolio company, during the first quarter. The four new investments were in Glynlyon Holding Companies, Inc., PANOS Brands LLC, Veritext Corporation and Wolf-Gordon, Inc., while the add-on investment was in PPC Event Services. A brief description of these investments can be found in the Consolidated Schedule of Investments. The total amount invested by the Trust in these transactions was \$6,942,000.

It was an active first quarter for the Trust in terms of new investments. Middle market merger and acquisition activity, a key driver of deal flow for the Trust, was steady during the quarter. We expect deal flow to remain steady for the rest of the year, assuming no significant external shocks to the market, so we are optimistic about the level of new investment activity for the Trust in 2016. The dark cloud on the horizon though, continues to be the high purchase prices and leverage levels that have been common in buyout transactions for the last couple of years. Average purchase price multiples for small companies continue to be at their highest levels in the past 15 years. Leverage multiples have also been worrisomely high for several years and are near their highs of the past 15 years as well. Though we are actively making new investments on behalf of the Trust in this market, we do so cautiously and with discipline, consistent with our longstanding investment philosophy of seeking to take prudent levels of risk and getting paid appropriately for the risk taken. We are not willing to provide financial leverage at levels that we believe are imprudent. This approach has served us well over the long term and through all kinds of market cycles.

The condition of the Trust's existing portfolio remained solid through the first quarter. The number of companies on our watch list and in default continues to be at or near the lowest level we have seen over the last five years. We successfully exited one investment during the quarter. We have a solid backlog of portfolio companies that are in the process of being sold, with three companies already having been sold so far in the second quarter. We had no companies pay their debt instruments held by the Trust during the quarter.

While the Trust was able to maintain its \$0.27 per share quarterly dividend for the first quarter, we must make note again, as we have for over two years now, that this dividend level may not be sustainable through 2016. The Trust's net investment income per share from recurring sources of \$0.24 for the first quarter was once again below the dividend rate. Net investment income per share from recurring sources has been below the dividend rate for every quarter since the second quarter of 2012. As we have discussed in prior reports, net investment income is down due principally to the considerable reduction in the number of private debt securities in the portfolio resulting from the high level of exit and prepayment activity that occurred in 2013 and 2014. With several strong recent quarters of new investment activity, we have made some progress in rebuilding the private portfolio, but it is still well below its former size. We have been able to maintain the \$0.27 per share quarterly dividend with current income, non-recurring income and earnings carried forward from prior quarters. Over time, however, the Trust's dividend-paying ability tends to be correlated with its recurring earnings capacity. This quarter, the Trust utilized \$0.05 per share of earnings carry-forwards to maintain the \$0.27 per share quarterly dividend. The Trust continues to have earnings carry-forwards which should be available to supplement recurring income for the next few quarters. But unless market conditions change dramatically, it is still

(Continued)

unlikely that we will be able to completely rebuild the portfolio back to its former size in the near term and grow net investment income. As a result, it is likely that in 2016 we will have to reduce the dividend from the current \$0.27 per share quarterly rate. As we move through 2016, we and the Board of Trustees will continue to evaluate the current and future earnings capacity of the Trust and formulate a dividend strategy that is consistent with that earnings level.

On behalf of the Trust's shareholders, the members of the Board of Trustees and the officers of the Trust, I would like to thank William J. Barrett for his many years of dedicated service to the Trust as a Trustee. Bill retired from the Board of Trustees effective as of the Trust's Annual Meeting of Shareholders which occurred on April 22, 2016. Bill had been a Trustee since 2006, and has provided the Trust with invaluable insight and guidance and has served our shareholders extremely well during his long tenure as a Trustee.

Lastly, as I announced at the Annual Meeting of Shareholders, I will be retiring from Babson Capital and as President of the Trust, effective June 1, 2016. At their April 22, 2016 meeting, the Board of Trustees elected Robert M. Shettle to succeed me as President of the Trust. Bob joined Babson Capital in 1998 and is currently a Vice President of the Trust and also head of Babson Capital's Mezzanine and Private Equity Group, where he oversees a team of investment professionals who originate, analyze, structure and document mezzanine and private equity investments.

Thank you for your continued interest in and support of Babson Capital Participation Investors.

Sincerely,

Michael L. Klofas

President

Portfolio Composition as of 03/31/16*

* Based on market value of total investments (including cash)

Cautionary Notice: Certain statements contained in this report may be "forward looking" statements. Investors are cautioned not to place undue reliance on forward-looking statements, which speak only as of the date on which they are made and which reflect management's current estimates, projections, expectations or beliefs, and which are subject to risks and uncertainties that may cause actual results to differ materially. These statements are subject to change at any time based upon economic, market or other conditions and may not be relied upon as investment advice or an indication of the Trust's trading intent. References to specific securities are not recommendations of such securities, and may not be representative of the Trust's current or future investments. We undertake no obligation to publicly update forward looking statements, whether as a result of new information, future events, or otherwise.

Babson Capital Participation Investors
CONSOLIDATED STATEMENT OF ASSETS AND LIABILITIES
March 31, 2016
(Unaudited)

Assets:

Investments

(See Consolidated Schedule of Investments)

Corporate restricted securities at fair value (Cost - \$96,708,386)	\$98,538,386
Corporate restricted securities at market value (Cost - \$19,908,885)	18,999,004
Corporate public securities at market value (Cost - \$24,233,254)	23,024,262
Short-term securities at amortized cost	1,999,867
Total investments (Cost - \$142,850,392)	142,561,519
Cash	10,607,379
Interest receivable	1,363,925
Receivable for investments sold	313,362
Other assets	28,355
Total assets	154,874,540
Liabilities:	
Note payable	15,000,000
Deferred tax liability	538,272
Investment advisory fee payable	311,497
Payable for investments purchased	305,304
Interest payable	27,267
Accrued expenses	248,980
Total liabilities	16,431,320
Total net assets	\$138,443,220

Net Assets:

Common shares, par value \$.01 per share	\$103,424
Additional paid-in capital	95,439,990
Retained net realized gain on investments, prior years	40,511,310
Undistributed net investment gain	3,657,424
Accumulated net realized loss on investments	(441,783)
Net unrealized depreciation of investments	(827,145)

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Total net assets	\$138,443,220
Common shares issued and outstanding (14,787,750 authorized)	10,342,412
Net asset value per share	\$13.39

See Notes to Consolidated Financial Statements

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CONSOLIDATED STATEMENT OF OPERATIONS

For the three months ended March 31, 2016

(Unaudited)

Investment Income:	
Interest	\$2,855,135
Dividends	41,909
Other	17,174
Total investment income	2,914,218
Expenses:	
Investment advisory fees	311,497
Interest	153,375
Trustees' fees and expenses	75,000
Professional fees	61,104
Reports to shareholders	24,000
Custodian fees	6,000
Other	30,206
Total expenses	661,182
Investment income - net	2,253,036
Net realized and unrealized gain on investments:	
Net realized loss on investments before taxes	(369,989)
Income tax expense	(160,104)
Net realized loss on investments after taxes	(530,093)
Net change in unrealized appreciation of investments before taxes	1,214,335
Net change in deferred income tax expense	(29,184)
Net change in unrealized appreciation of investments after taxes	1,185,151
Net gain on investments	655,058
Net increase in net assets resulting from operations	\$2,908,094

See Notes to Consolidated Financial Statements

Babson Capital Participation Investors
CONSOLIDATED STATEMENT OF CASH FLOWS
For the three months ended March 31, 2016
(Unaudited)

Net increase in cash:	
Cash flows from operating activities:	
Purchases/Proceeds/Maturities from short-term portfolio securities, net	\$2,008,704
Purchases of portfolio securities	(8,684,370)
Proceeds from disposition of portfolio securities	11,976,171
Interest, dividends and other income received	2,527,928
Interest expense paid	(153,375)
Operating expenses paid	(512,216)
Income taxes paid	(634,551)
Net cash provided by operating activities	6,528,291
Cash flows from financing activities:	
Cash dividends paid from net investment income	(2,788,666)
Receipts for shares issued on reinvestment of dividends	185,492
Net cash used for financing activities	(2,603,174)
Net increase in cash	3,925,117
Cash - beginning of year	6,682,262
Cash - end of period	\$10,607,379
Reconciliation of net increase in net assets to net cash provided by operating activities:	
Net increase in net assets resulting from operations	\$2,908,094
Decrease in investments	3,830,162
Decrease in interest receivable	249,337
Increase in receivable for investments sold	(313,362)
Increase in other assets	(1,572)
Increase in deferred tax liability	29,184
Increase in investment advisory fee payable	6,960
Increase in payable for investments purchased	305,304
Decrease in accrued expenses	(11,369)
Decrease in tax payable	(474,447)
Total adjustments to net assets from operations	3,620,197
Net cash provided by operating activities	\$6,528,291

See Notes to Consolidated Financial Statements

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CONSOLIDATED STATEMENTS OF CHANGES IN NET ASSETS

	For the three months ended 03/31/16 (Unaudited)	For the year ended 12/31/2015
Increase in net assets:		
Operations:		
Investment income - net	\$ 2,253,036	\$ 9,762,813
Net realized (loss)/gain on investments after taxes	(530,093)	161,395
Net change in unrealized appreciation/(depreciation) of investments after taxes	1,185,151	