

HERCULES TECHNOLOGY GROWTH CAPITAL INC
Form 10-K
March 09, 2007
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE
ACT OF 1934**
For the fiscal year ended December 31, 2006

OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE
ACT OF 1934**
For the transition period from _____ to _____

Commission File No. 814-00702

Hercules Technology Growth Capital, Inc.

(Exact name of Registrant as specified in its charter)

Maryland
(State or other jurisdiction of
incorporation or organization)

400 Hamilton Avenue, Suite 310

Palo Alto, California 94301

74-3113410
(I.R.S. Employer
Identification Number)

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(Address of principal executive offices)

(650) 289-3060

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12 (b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act:

Title of each class	Name of each exchange on which registered
Common Shares, par value \$0.001 per share	NASDAQ Global Market

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. Yes No

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days: YES NO

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes No

The aggregate market value of the voting and non-voting common stock held by non-affiliates of the registrant as of the last business day of the registrant's most recently completed second fiscal quarter was approximately \$117.5 million based upon a closing price of \$12.10 reported for such date by the NASDAQ Global Market. Common shares held by each executive officer and director and by each person who owns 5% or more of the outstanding common shares have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

The number of outstanding common shares of the registrant as of March 6, 2007 was 22,990,671.

DOCUMENTS INCORPORATED BY REFERENCE

Documents incorporated by reference: Portions of Hercules Technology Growth Capital, Inc.'s Proxy Statement for its 2007 Annual Meeting of Shareholders to be held on May 24, 2007 are incorporated by reference in the Annual Report on Form 10-K in response to Part III, Items 10, 11, 12, 13 and 14.

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FORM 10-K

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In this Annual Report on Form 10-K, or Annual Report, the Company, HTGC, we, us and our refer to Hercules Technology Growth Capital, Inc. and its wholly owned subsidiaries and its affiliated securitization trusts unless the context otherwise requires.

PART I

Item 1. Business

GENERAL

We are a specialty finance company that provides debt and equity growth capital to technology-related and life-sciences companies at all stages of development. Our investment objective is to maximize our portfolio's total return by generating current income from our debt investments and capital appreciation from our equity-related investments. We are an internally-managed, non-diversified closed-end investment company that has elected to be treated as a business development company under the Investment Company Act of 1940.

We primarily finance privately-held companies backed by leading venture capital and private equity firms and also may finance certain select publicly-traded companies that lack access to public capital or are sensitive to equity ownership dilution. Our principal executive office is located in the Silicon Valley and we have additional offices in the Boston, Boulder, Chicago and Columbus areas. Our goal is to be the leading structured mezzanine capital provider of choice for venture capital and private equity-backed technology-related and life sciences companies requiring sophisticated and customized financing solutions. Our strategy is to evaluate and invest in a broad range of ventures active in the technology and life science industries and to offer a full suite of growth capital products to complement a portfolio company's existing capital structure. We invest primarily in structured mezzanine debt and, to a lesser extent, in senior debt and equity. We use the term "structured mezzanine debt investment" to refer to any debt investment, such as a senior or subordinated secured loan, that is coupled with an equity component, including warrants, options or rights to purchase common or preferred stock. Our structured mezzanine debt investments will typically be secured by some or all of the assets of the portfolio company.

We focus our investments in companies active in the technology industry sub-sectors characterized by products or services that require advanced technologies, including computer software and hardware, networking systems, semiconductors, semiconductor capital equipment, information technology infrastructure or services, Internet consumer and business services, telecommunications, telecommunications equipment, renewable or alternative energy, media and life sciences. Within the life sciences sub-sector, we focus on medical devices, bio-pharmaceutical, health care services and information systems companies. We refer to all of these companies as "technology-related" companies and intend, under normal circumstances, to invest at least 80% of the value of our assets in such businesses.

Our primary business objectives are to increase our net income, net operating income and net asset value by investing in structured mezzanine debt and equity of venture capital and private equity backed technology-related companies with attractive current yields and the potential for equity appreciation and realized gains. Our structured debt investments typically include warrants or other equity interests, giving us the potential to realize equity-like returns on a portion of our investment. In some cases, we receive the right to make additional equity investments in our portfolio companies in connection with future equity financing rounds. Capital that we provide directly to venture capital and private equity backed technology-related companies is generally used for growth and in select cases for acquisitions or recapitalizations.

Our portfolio is comprised of, and we anticipate that our portfolio will continue to be comprised of, investments in technology-related companies at various stages of their development. Consistent with regulatory

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requirements, we invest primarily in United States based companies and to a lesser extent in foreign companies. To date, our emphasis has been primarily on private companies following or in connection with their first institutional round of equity financing, which we refer to as emerging-growth companies, and private companies in later rounds of financing, which we refer to as expansion-stage companies. In 2007, we expect to increase our investment activity in established companies, comprised of private companies in one of their final rounds of equity financing prior to a liquidity event or select publicly-traded companies that lack access to public capital or are sensitive to equity ownership dilution.

We commenced investment operations in September 2004 and have built our investment portfolio on disciplined underwriting, as well as on-going portfolio management. At December 31, 2006, we had outstanding structured mezzanine debt investments representing approximately \$266.7 million, warrant investments of \$8.4 million and equity investments of \$8.1 million for a total investment portfolio at fair value of \$283.2 million. In addition, at December 31, 2006, we had unfunded contractual commitments of \$55.5 million.

At December 31, 2006, the weighted average yield to maturity of our loan obligations was approximately 12.64%. Yields to maturity are computed using interest rates at inception of the loan and include amortization of loan facility fees, commitment fees and market premiums or discounts over the expected life of the debt investments, weighted by their respective costs when averaged and are based on the assumption that all contractual loan commitments have been fully funded.

CORPORATE HISTORY AND OFFICES

We are a Maryland corporation formed in December 2003 that began investment operations in September 2004. We are an internally managed, non-diversified, closed-end investment company that has elected to be treated as a business development company under the 1940 Act. As a business development company, we are required to meet various regulatory tests. A business development company is required to invest at least 70% of its total assets in private or thinly traded public U.S.-based companies. A business development company also must meet a coverage ratio of total net assets to total senior securities, which include all of our borrowings (including accrued interest payable) and any preferred stock we may issue in the future, of at least 200%.

From incorporation through December 31, 2005, we were taxed as a corporation under Subchapter C of the Internal Revenue Code. We will elect to be treated for federal income tax purposes as a RIC under the Internal Revenue Code with the filing of our federal corporate income tax return for 2006, which election, when actually made, will be effective as of January 1, 2006. To qualify as a RIC, we must, among other things, meet certain source-of-income and asset diversification requirements. Pursuant to these elections, we generally will not have to pay corporate-level taxes on any income that we distribute to our stockholders. To obtain and maintain the federal income tax benefits of RIC status, we must meet specified source-of-income and asset diversification requirements and distribute annually an amount equal to at least 90% of the sum of our net ordinary income and realized net short-term capital gains in excess of realized net long-term capital losses, if any, out of assets legally available for distribution.

Our principal executive offices are located at 400 Hamilton Avenue, Suite 310, Palo Alto, California 94301 and our telephone number is (650) 289-3060. We also have additional offices in the Boston, Boulder, Chicago and Columbus areas. We maintain a website on the Internet at www.herculestech.com. Information contained in our website is not incorporated by reference into this Annual Report, and you should not consider that information as part of this Annual Report. Our annual reports on Form 10-K, quarterly reports on Form 10-Q and our current reports on Form 8-K, as well as any amendments to those reports, are available free of charge through our website as soon as reasonably practicable after we file them with, or furnish them to, the Securities and Exchange Commission.

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Our Market Opportunity

We believe that technology-related companies compete in one of the largest and most rapidly growing sectors of the U.S. economy and that continued growth is supported by ongoing innovation and performance improvements in technology products as well as the adoption of technology across virtually all industries in response to competitive pressures. We believe that an attractive market opportunity exists for a specialty finance company focused primarily on structured mezzanine investments in technology-related companies for the following reasons:

Technology-related companies have generally been underserved by traditional lending sources;

Unfulfilled demand exists for structured debt financing to technology-related companies;

Structured mezzanine debt products are less dilutive and complement equity financing from venture capital and private equity funds; and

Valuations currently assigned to technology-related companies in private financing rounds, while increasing in recent years, still provide a good opportunity for attractive capital returns.

Technology-Related Companies Underserved by Traditional Lenders. We believe many viable technology-related companies backed by financial sponsors have been unable to obtain sufficient growth financing from traditional lenders, including financial services companies such as commercial banks and finance companies, in part because traditional lenders have continued to consolidate and have adopted a more risk-averse approach to lending that has resulted in tightened credit standards in recent years. More importantly, we believe traditional lenders are typically unable to underwrite the risk associated with financial sponsor-backed emerging-growth or expansion-stage companies effectively.

The unique cash flow characteristics of many technology-related companies include significant research and development expenditures and high projected revenue growth thus often making such companies difficult to evaluate from a credit perspective. In addition, the balance sheets of emerging-growth and expansion-stage companies often include a disproportionately large amount of intellectual property assets, which can be difficult to value. Finally, the speed of innovation in technology and rapid shifts in consumer demand and market share add to the difficulty in evaluating technology-related companies.

Due to the difficulties described above, we believe traditional lenders are generally refraining from entering the structured mezzanine debt marketplace for emerging-growth and expansion-stage companies, instead preferring the risk-reward profile of senior debt. Traditional lenders generally do not have flexible product offerings that meet the needs of technology-related companies. The financing products offered by traditional lenders typically impose on borrowers many restrictive covenants and conditions, including limiting cash outflows and requiring a significant depository relationship to facilitate rapid liquidation.

Unfulfilled Demand for Structured Debt Financing to Technology-Related Companies. Private debt capital in the form of structured debt financing from specialty finance companies continues to be an important source of funding for technology-related companies. We believe that the level of demand for structured debt financing to emerging-growth and expansion-stage companies is a function of the level of annual venture equity investment activity. In 2006, venture capital-backed companies received, in approximately 2,454 transactions, equity financing in an aggregate amount of approximately \$25.8 billion, representing an 8% increase over the preceding year, as reported by Dow Jones VentureOne. In addition, overall, the median round size in 2006 was \$7 million, up from \$6.5 million in 2005, and the highest annual median since 2000. For the second year in a row, equity investors are focusing more than a third of their investment activity on early-stage financings. Overall, seed- and first-round deals made up 36% of the deal flow in 2006, and about the same concentration of deal flow went to later-stage deals. As a result, we believe a range of \$20 billion to \$25 billion in annual equity investments to venture-backed companies will be sustainable for future years.

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We believe that demand for structured debt financing is currently unfulfilled, in part because historically the largest debt capital providers to technology-related companies exited the market during 2001 while at the same time lending requirements of traditional lenders have become more stringent. We therefore believe this is an opportune time to be active in the structured lending market for technology-related companies.

Structured Mezzanine Debt Products Complement Equity Financing From Venture Capital and Private Equity Funds. We believe that technology-related companies and their financial sponsors will continue to view structured debt securities as an attractive source of capital because it augments the capital provided by venture capital and private equity funds. We believe that our structured mezzanine debt products provide access to growth capital that otherwise may only be available through incremental investments by existing equity investors. As such, we provide portfolio companies and their financial sponsors with an opportunity to diversify their capital sources. Generally, we believe emerging-growth and expansion-stage companies target a portion of their capital to be debt in an attempt to achieve a higher valuation through internal growth. In addition, because financial sponsor-backed companies have recently been more mature prior to reaching a liquidity event, we believe our investments could provide the debt capital needed to grow or recapitalize during the extended period prior to liquidity events.

Lower Valuations for Private Technology-Related Companies. During the downturn in technology industries that began in 2000, the markets saw sharp and broad declines in valuations of venture capital and private equity-backed technology-related companies. According to Dow Jones VentureOne, median pre-money valuations for venture capital-backed companies in 2000 was \$25.0 million declining to a low of \$10.0 million in 2003. As of December 31, 2006 median pre-money valuations for venture capital-backed companies in 2006 was \$18.5 million compared to \$15.0 million in 2005. While pre-money valuations have been steadily increasing since 2003, we believe the valuations currently assigned to venture capital and private equity-backed technology-related companies in private financing rounds are still low and should allow us to continue to build a portfolio of equity-related securities at attractive valuation levels.

Our Business Strategy

Our strategy to achieve our investment objective includes the following key elements:

Leverage the Experience and Industry Relationships of Our Management Team and Investment Professionals. We have assembled a team of experienced investment professionals with extensive experience as venture capitalists, commercial lenders, and originators of structured debt and equity investments in technology-related companies. Our investment professionals have, on average, more than 15 years of experience as equity investors in, and/or lenders to, technology-related companies. In addition, our team members have originated structured mezzanine investments in over 200 technology-related companies, representing over \$1.0 billion in investments, and have developed a network of industry contacts with investors and other participants within the venture capital and private equity communities. In addition, members of our management team also have operational, research and development and finance experience with technology-related companies. We have established contacts with leading venture capital and private equity fund sponsors, public and private companies, research institutions and other industry participants, which should enable us to identify and attract well-positioned prospective portfolio companies.

We concentrate our investing activities in industries in which our investment professionals have investment experience. We believe that our focus on financing technology-related companies will enable us to leverage our expertise in structuring prospective investments, to assess the value of both tangible and intangible assets, to evaluate the business prospects and operating characteristics of technology-related companies and to identify and originate potentially attractive investments with these types of companies.

Mitigate Risk of Principal Loss and Build a Portfolio of Equity-Related Securities. We expect that our investments have the potential to produce attractive risk adjusted returns through current income, in the form of

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interest and fee income, as well as capital appreciation from equity-related securities. We believe that we can mitigate the risk of loss on our debt investments through the combination of loan principal amortization, cash interest payments, relatively short maturities, security interests in the assets of our portfolio companies, covenants requiring prospective portfolio companies to have certain amounts of available cash at the time of our investment and the continued support from a venture capital or private equity firm at the time we make our investment.

In addition, historically our structured debt investments typically include warrants or other equity interests, giving us the potential to realize equity-like returns on a portion of our investment. In addition, we expect, in some cases, to receive the right to make additional equity investments in our portfolio companies in connection with future equity financing rounds. We believe these equity interests will create the potential for meaningful long-term capital gains in connection with the future liquidity events of these technology-related companies.

Provide Customized Financing Complementary to Financial Sponsors' Capital. We offer a broad range of investment structures and possess expertise and experience to effectively structure and price investments in technology-related companies. Unlike many of our competitors that only invest in companies that fit a specific set of investment parameters, we have the flexibility to structure our investments to suit the particular needs of our portfolio companies. We offer customized financing solutions ranging from senior debt to equity capital, with a focus on structured mezzanine debt.

We use our relationships in the financial sponsor community to originate investment opportunities. Because venture capital and private equity funds typically invest solely in the equity securities of their portfolio companies, we believe that our debt investments will be viewed as an attractive source of capital, both by the portfolio company and by the portfolio company's financial sponsor. In addition, we believe that many venture capital and private equity fund sponsors encourage their portfolio companies to use debt financing for a portion of their capital needs as a means of potentially enhancing equity returns, minimizing equity dilution and increasing valuations prior to a subsequent equity financing round or a liquidity event.

Invest at Various Stages of Development. We provide growth capital to technology-related companies at all stages of development, from emerging-growth companies, to expansion-stage companies and established companies. We believe that this provides us with a broader range of potential investment opportunities than those available to many of our competitors, who generally focus their investments on a particular stage in a company's development. Because of the flexible structure of our investments and the extensive experience of our investment professionals, we believe we are well positioned to take advantage of these investment opportunities at all stages of prospective portfolio companies' development.

Benefit from Our Efficient Organizational Structure. We believe that the perpetual nature of our corporate structure enables us to be a long-term partner for our portfolio companies in contrast to traditional mezzanine and investment funds, which typically have a limited life. In addition, because of our access to the equity markets, we believe that we may benefit from a lower cost of capital than that available to private investment funds. We are not subject to requirements to return invested capital to investors nor do we have a finite investment horizon. Capital providers that are subject to such limitations are often required to seek a liquidity event more quickly than they otherwise might, which can result in a lower overall return on an investment.

Deal Sourcing Through Our Proprietary Database. We have developed a proprietary and comprehensive structured query language-based (SQL) database system to track various aspects of our investment process including sourcing, originations, transaction monitoring and post-investment performance. As of December 31, 2006, our proprietary SQL-based database system included over 10,900 technology-related companies and over 3,000 venture capital private equity sponsors/investors, as well as various other industry contacts. This proprietary SQL system allows us to maintain, cultivate and grow our industry relationships while providing us with comprehensive details on companies in the technology-related industries and their financial sponsors.

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Our Investments and Operations

We invest in debt securities and, to a lesser extent, equity securities, with a particular emphasis on structured mezzanine debt.

We generally seek to invest in companies that have been operating for at least six to 12 months prior to the date of our investment. We expect that such entities will, at the time of investment, be generating revenues or will have a business plan that anticipates generation of revenues within 24 to 36 months. Further, we anticipate that on the date of our investment we will obtain a lien on available assets, which may or may not include intellectual property, and these companies will have sufficient cash on their balance sheet to amortize their debt for at least six to 15 months following our investment. We generally require that a prospective portfolio company, in addition to having sufficient capital to support leverage, demonstrate an operating plan capable of generating cash flows or raising the additional capital necessary to cover its operating expenses and service its debt.

We expect that our investments will generally range from \$1.0 million to \$25.0 million. Our debt investments generally have an average initial principal balance of between \$3.0 million and \$7.0 million and have maturities of two to seven years, with an expected average term of three years. We typically structure our debt securities to provide for amortization of principal over the life of the loan, but may include an interest-only period, and our loans will be collateralized by a security interest in the borrower's assets, although we may not have the first claim on these assets and the assets may not include intellectual property. Our debt investments carry fixed or variable contractual interest rates typically ranging from 8% to 14%. In addition to the cash yields received on our loans, in some instances, certain loans may also include any of the following: end of term payments, exit fees, balloon payment fees or prepayment fees, which we may be required to include in income prior to receipt. We also generate revenue in the form of commitment and facility fees, and to a lesser extent, due diligence fees.

In addition, historically our structured mezzanine debt investments generally have equity enhancement features, typically in the form of warrants or other equity-related securities designed to provide us with an opportunity for capital appreciation. The warrants typically will be immediately exercisable upon issuance and generally will remain exercisable for the lesser of seven years or three years after an initial public offering. The exercise prices for the warrants varies from nominal exercise prices to exercise prices that are at or above the current fair market value of the equity for which we receive warrants. We may structure warrants to provide minority rights provisions and put rights upon the occurrence of certain events. We generally target a total annualized return (including interest, fees and value of warrants) of 12% to 25% for our debt investments.

Typically, our debt and equity investments take one of the following forms:

Structured Mezzanine Debt. We seek to invest a majority of our assets in structured mezzanine debt of prospective portfolio companies. Traditional mezzanine debt is a layer of high-coupon financing between debt and equity that most commonly takes the form of subordinated debt coupled with warrants, combining the cash flow and risk characteristics of both senior debt and equity. However, our structured mezzanine investments may be the only debt capital on the balance sheet of our portfolio companies, and in many cases we have a first priority security interest in all of our portfolio company's assets. Our structured mezzanine debt investments typically have maturities of between two and seven years, with full amortization for emerging-growth or expansion-stage companies and little or no amortization for select established companies. Our structured mezzanine debt investments carry a contractual interest rate between 8% and 14% and may include an additional end-of-term payment, are in an amount between \$3 million and \$25 million with an average initial principal balance of between \$3 million and \$7 million (although this investment size may vary proportionately as the size of our capital base changes) and have an average term of three years. In some cases we collateralize our investments by obtaining security interests in our portfolio companies' assets, which may include their intellectual property. In other cases we may prohibit a company from pledging or otherwise encumbering their intellectual property. We may structure our mezzanine debt investments with

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restrictive affirmative and negative covenants, default penalties, prepayment penalties, lien protection, equity calls, take control provisions and board observation rights.

Senior Debt. We seek to invest a limited portion of our assets in senior debt of prospective portfolio companies. Senior debt has a senior position with respect to a borrower's scheduled interest and principal payments and holds a first priority security interest in the assets pledged as collateral. Senior debt also may impose covenants on a borrower with regard to cash flows and changes in capital structure, among other items. Our senior debt investments carry a contractual interest rate between 8% and 12%, are in an amount between \$1 million and \$7 million with an average initial principal balance of \$3 million, and have an average term of under three years. We generally collateralize our investments by obtaining security interests in our portfolio companies' assets, which may include their intellectual property. In other cases we may obtain a negative pledge covering a company's intellectual property. Our senior loans, in certain instances, may be tied to the financing of specific assets. In connection with a senior debt investment, we may also provide the borrower with a working capital line-of-credit that will carry an interest rate ranging from the prime rate to 12%, generally maturing in one year, and will be secured by accounts receivable and / or inventory. In connection with a senior debt investment, we may also provide the borrower with a working capital line-of-credit at fixed rates or variable rates based on the prime rate or LIBOR plus a margin, generally maturing in one year, and will be secured by accounts receivable and / or inventory.

Equipment Loans. We intend to seek to invest a limited portion of our assets in equipment-based loans to early-stage prospective portfolio companies. Equipment-based loans are secured by a first priority security interest in the assets financed. We anticipate that these loans will generally be for amounts up to \$2.5 million, will carry a contractual interest rate between prime and prime plus 400 basis points, and have an average term between three and four years.

Equity-Related Securities. The equity-related securities we hold consist primarily of warrants or other equity interests generally obtained in connection with our structured mezzanine debt investments. In addition to the warrants received as a part of a structured mezzanine debt financing, we typically receive the right to make equity investments in a portfolio company in connection with the next equity financing round for that company. This right will provide us with the opportunity to further enhance our returns over time through opportunistic equity investments in our portfolio companies. Equity-related investments are typically in the form of preferred or common equity and may be structured with a dividend yield, providing us with a current return, and with customary anti-dilution protection and preemptive rights. In the future, we may achieve liquidity through a merger or acquisition of a portfolio company, a public offering of a portfolio company's stock or by exercising our right, if any, to require a portfolio company to buy back the equity-related securities we hold. We may also make direct equity investments into portfolio companies.

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A comparison of the typical features of our various investment alternatives is set forth in the chart below.

	Senior Debt	Structured Mezzanine Debt	Equipment Loans	Equity Securities
Typical Structure	Term or revolving debt	Term debt with warrants	Term debt with warrants	Preferred stock or common stock
Investment Horizon	Usually under 3 years	Long term, ranging from 2 to 7 years, with an average of 3 years	Ranging from 3 to 4 years	Long term
Ranking/Security	Senior/First lien	Senior or junior lien	Secured by underlying equipment	None/unsecured
Covenants	Generally comprehensive	Less restrictive; Mostly financial; Maintenance-based	None	None
Risk Tolerance	Low	Medium	High	High
Coupon/Dividend	Cash pay Floating or fixed rate	Cash Pay fixed rate; Payment-in-kind in limited cases	Cash pay-floating or fixed rate	Payment-in kind in limited cases
Customization or Flexibility	Standard	More flexible	Standard	Flexible
Equity Dilution Investment Criteria	None to low	Low	Low	High

We have identified several criteria that we believe are important in achieving our investment objective with respect to prospective portfolio companies. These criteria, while not inclusive, provide general guidelines for our investment decisions.

Portfolio Composition. While we generally focus our investments in venture capital and private equity backed technology-related companies, we seek to diversify across various financial sponsors as well as across various stages of companies - development and various technology industry sub-sectors and geographies.

Continuing Support from One or More Financial Sponsors. We generally invest in companies in which one or more established financial sponsors have previously invested and continue to make a contribution to the management of the business. We believe that having established financial sponsors with meaningful commitments to the business is a key characteristic of a prospective portfolio company. In addition, we look for representatives of one or more financial sponsors to maintain seats on the Board of Directors of a prospective portfolio company as an indication of such commitment.

Company Stage of Development. While we invest in companies at various stages of development, we generally require that prospective portfolio companies be beyond the seed stage of development and generally have received or have commitments for their first institutional round of equity financing. We expect a prospective portfolio company to demonstrate its ability to commence revenue generation or increase its revenues and operating cash flow over time. The anticipated growth rate of a prospective portfolio company is a key factor in determining the value that we ascribe to any warrants or other equity securities that we may acquire in connection with an investment in debt securities.

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Operating Plan. We generally require that a prospective portfolio company, in addition to having sufficient access to capital to support leverage, demonstrate an operating plan capable of generating cash flows or the ability to raise the additional capital necessary to cover its operating expenses and service its debt. Specifically, we require that a prospective portfolio company demonstrate at the time of our proposed investment that it has cash on its balance sheet, or is in the process of completing a financing so that it will have cash on its balance sheet, sufficient to support its operations for a minimum of 6 to 15 months.

Security Interest. In many instances we generally seek a first priority security interest in all of the portfolio company's tangible and intangible assets as collateral for our debt investment, subject in some cases to permitted exceptions. In other cases we may prohibit a company from pledging or otherwise encumbering their intellectual property. Although we do not intend to operate as an asset-based lender, the estimated liquidation value of the assets, if any, collateralizing the debt securities that we hold is an important factor in our credit analysis. We evaluate both tangible assets, such as accounts receivable, inventory and equipment, and intangible assets, such as intellectual property, customer lists, networks and databases.

Covenants. Our investments typically include one or more of the following covenants; cross-default and material adverse change provisions, require the portfolio company to provide periodic financial reports and operating metrics and will typically limit the portfolio company's ability to incur additional debt, sell assets, engage in transactions with affiliates and consummate an extraordinary transaction, such as a merger or recapitalization without our consent. In addition, we may require other performance or financial based covenants, as we deem appropriate.

Exit Strategy. Prior to making a debt investment that is accompanied by an equity-related security in a prospective portfolio company, we analyze the potential for that company to increase the liquidity of its equity through a future event that would enable us to realize appreciation in the value of our equity interest. Liquidity events may include an initial public offering, a private sale of our equity interest to a third party, a merger or an acquisition of the company or a purchase of our equity position by the company or one of its stockholders.

Investment Process

We have organized our management team around the four key elements of our investment process:

Origination;

Underwriting;

Documentation; and

Loan and Compliance Administration.

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Our investment process is summarized in the following chart:

Origination

The origination process for our investments includes sourcing, screening, preliminary due diligence and deal structuring and negotiation, all leading to an executed non-binding term sheet. Our investment origination team, which consists of 15 senior investment professionals is headed by our Chief Executive Officer, Mr. Henriquez, and is responsible for sourcing potential investment opportunities. The origination team uses their extensive relationships with various leading financial sponsors, management contacts within technology-related companies, trade sources, technology conferences and various publications to source prospective portfolio companies.

In addition, we have developed a proprietary and comprehensive SQL-based database system to track various aspects of our investment process including sourcing, originations, transaction monitoring and post-investment performance. As of December 31, 2006, our proprietary SQL-based database system included over 10,900 technology-related companies and over 3,000 venture capital private equity sponsors/investors, as well as various other industry contacts. This proprietary SQL system allows our origination team to maintain, cultivate and grow our industry relationships while providing our origination team with comprehensive details on companies in the technology-related industries and their financial sponsors.

If a prospective portfolio company generally meets certain underwriting criteria, we perform preliminary due diligence, which may include high level company and technology assessments, evaluation of its financial sponsors' support, market analysis, competitive analysis, evaluation of select management, risk analysis and transaction size, pricing, return analysis and structure analysis. If the preliminary due diligence is satisfactory, and the origination team recommends moving forward, we then structure, negotiate and execute a non-binding term sheet with the potential portfolio company. Upon execution of a term sheet, the investment opportunity moves to the underwriting process to complete formal due diligence review and approval.

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Underwriting

The underwriting review includes formal due diligence and approval of the proposed investment in the portfolio company.

Due Diligence. Our due diligence on a prospective investment is typically completed by two or more investment professionals which we define as the underwriting team. The underwriting team for a proposed investment consists of the deal sponsor who possesses specific industry knowledge and is responsible for originating and managing the transaction, other investment professional(s) who perform due diligence, credit and corporate financial analyses and, as needed, our Chief Legal Officer. To ensure consistent underwriting, we generally use our standardized due diligence methodologies, which include due diligence on financial performance and credit risk as well as an analysis of the operations, accounting policies and the legal and applicable regulatory framework of a prospective portfolio company. The members of the underwriting team work together to conduct due diligence and understand the relationships among the prospective portfolio company's business plan, operations and financial performance.

As part of our evaluation of a proposed investment, the underwriting team prepares an investment memorandum for presentation to the investment committee. In preparing the investment memorandum, the underwriting team typically meets with select key management of the company and select financial sponsors and assembles information necessary to the investment decision. If and when appropriate, the investment professionals may also contact industry experts and customers, vendors or, in some cases, competitors of the company.

Approval Process. The sponsoring managing director or principal presents the investment memorandum to our investment committee for consideration. The unanimous approval of our investment committee is required before we proceed with any investment. The members of our investment committee are our Chief Executive Officer, our Chief Legal Officer and our Chief Financial Officer. The investment committee generally meets weekly and more frequently on an as-needed basis.

Documentation

Our documentation group, headed by our Chief Legal Officer, administers the front-end documentation process for our loans. This group is responsible for documenting the term sheet approved by the investment committee to memorialize the transaction with a portfolio company. This group negotiates loan documentation and, subject to the approval of the Chief Legal Officer, final documents are prepared for execution by all parties. The documentation group generally uses the services of external law firms to complete the necessary documentation.

Loan and Compliance Administration

Our loan and compliance administration group, headed by our Chief Financial Officer, administers loans and tracks covenant compliance on our investments and oversees periodic reviews of our critical functions to ensure adherence with our internal policies and procedures. After funding of a loan in accordance with the investment committee's approval, the loan is recorded in our SQL-based database system. The loan and compliance administration group is also responsible for ensuring timely interest and principal payments and collateral management and advises the investment committee on the financial performance and trends of each portfolio company, including any covenant violations that occur, to aid us in assessing the appropriate course of action for each portfolio company and evaluating overall portfolio quality. In addition, the loan and compliance administration group advises the Valuation Committee of the board regarding the credit and investment grading for each portfolio company as well as changes in the value of collateral that may occur.

The loan and compliance administration group monitors our portfolio companies in order to determine whether the companies are meeting our financing criteria and their respective business plans and also monitors

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the financial trends of each portfolio company from its monthly or quarterly financial statements to assess the appropriate course of action for each company and to evaluate overall portfolio quality. In addition, our management team closely monitors the status and performance of each individual company through our SQL-based database system and periodic contact with our portfolio companies' management teams and their respective financial sponsors.

Credit and Investment Grading System. Our loan and compliance administration group uses an investment grading system to characterize and monitor our outstanding loans. Our loan and compliance administration group monitors and, when appropriate, recommends changes to investment grading. Our investment committee reviews the recommendations and/or changes to the investment grading, which are submitted on a quarterly basis to the Valuation Committee and our Board of Directors for approval. We use the following investment grading system as amended January 2006 and approved by our Board of Directors:

- Grade 1. Loans involve the least amount of risk in our portfolio. The borrower is performing above expectations, and the trends and risk profile is generally favorable.
- Grade 2. The borrower is performing as expected and the risk profile is neutral to favorable. All new loans are initially graded 2.
- Grade 3. The borrower may be performing below expectations, and the loan's risk has increased materially since origination. We increase procedures to monitor a borrower that may have limited amounts of cash remaining on the balance sheet, is approaching its next equity capital raise within the next three to year, or if the estimated fair value of the enterprise may be lower than when the loan was originated. We will generally lower the loan grade to a level 3 even if the company is performing in accordance to plan as it approaches the need to raise additional cash to fund its operations. Once the borrower closes its new equity capital raise, we may increase the loan grade back to grade 2.
- Grade 4. The borrower is performing materially below expectations, and the loan risk has substantially increased since origination. Loans graded 4 may experience some partial loss or full return of principal but are expected to realize some loss of interest which is not anticipated to be repaid in full, which, to the extent not already reflected, may require the fair value of the loan to be reduced to the amount we anticipate will be recovered. Grade 4 investments are closely monitored.
- Grade 5. The borrower is in workout, materially performing below expectations and a significant risk of principal loss is probable. Loans graded 5 will experience some partial principal loss or full loss of remaining principal outstanding is expected. Grade 5 loans will require the fair value of the loans be reduced to the amount, if any, we anticipate will be recovered.

At December 31, 2006, our investments had a weighted average investment grading of 2.14.

Managerial Assistance

As a business development company, we offer, and provide upon request, managerial assistance to our portfolio companies. This assistance could involve, among other things, monitoring the operations of our portfolio companies, participating in board and management meetings, consulting with and advising officers of portfolio companies and providing other organizational and financial guidance. We may receive fees for these services.

Asset Management

We may engage in the asset management business by providing investment advisory services to funds that may be formed in the future. Such funds may focus on our lower yielding assets, such as senior debt, equipment based only financing or equity only funding. We may contribute assets currently in our portfolio to the extent that our management and Board of Directors deems it appropriate. We may, from time to time, serve as the

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investment manager of such funds and may receive management and other fees for such services. Such funds may have overlapping investment objectives and may invest in asset classes similar to those targeted by us.

Competition

Our primary competitors provide financing to prospective portfolio companies and include non-bank financial institutions, federally or state chartered banks, venture debt funds, financial institutions, venture capital funds, private equity funds, investment funds and investment banks. Many of these entities have greater financial and managerial resources than we have, and the 1940 Act imposes certain regulatory restrictions on us as a business development company to which many of our competitors are not subject. However, we believe that few of our competitors possess the expertise to properly structure and price debt investments to venture capital and private equity backed technology-related companies. We believe that our specialization in financing technology-related companies will enable us to assess the value of intellectual property assets, evaluate the business prospects and operating characteristics of prospective portfolio companies and, as a result, identify investment opportunities that produce attractive risk-adjusted returns. For additional information concerning the competitive risks we face, see **Risk Factors** **Risks Related to our Business and Structure**. We operate in a highly competitive market for investment opportunities, and we may not be able to compete effectively.

Corporate Structure

We are a Maryland corporation and an internally-managed, non-diversified closed-end investment company that has elected to be regulated as a business development company under the 1940 Act. Hercules Technology II, L.P. (HTII), our wholly-owned subsidiary, is licensed under the Small Business Investment Act of 1958 as a Small Business Investment Company. Hercules Technology SBIC Management, LLC (HTM), another wholly-owned subsidiary, functions as the general partner of our subsidiary HTII. Hercules Funding I LLC, our wholly owned subsidiary, and Hercules Funding Trust I function as vehicles to collateralize loans under our securitized credit facility with Citigroup Global Markets Realty Corp. In December 2006, we established Hydra Management LLC and Hydra Management Co., Inc. an investment manager and an investment management company, respectively.

Our principal executive offices are located at 400 Hamilton Avenue, Suite 310, Palo Alto, California 94301. We also have offices in Boston, Massachusetts, Boulder, Colorado, Chicago, Illinois and Columbus, Ohio.

Brokerage Allocations and Other Practices

Because we generally acquire and dispose of our investments in privately negotiated transactions, we rarely use brokers in the normal course of business. In those cases where we do use a broker, we do not execute transactions through any particular broker or dealer, but will seek to obtain the best net results for Hercules, taking into account such factors as price (including the applicable brokerage commission or dealer spread), size of order, difficulty of execution, and operational facilities of the firm and the firm's risk and skill in positioning blocks of securities. While we generally seek reasonably competitive execution costs, we may not necessarily pay the lowest spread or commission available. Subject to applicable legal requirements, we may select a broker based partly upon brokerage or research services provided to us. In return for such services, we may pay a higher commission than other brokers would charge if we determine in good faith that such commission is reasonable in relation to the services provided. For the years ended December 31, 2006, 2005 and 2004 we paid \$12,100, \$4,000 and \$0 in brokerage commissions, respectively.

Employees

As of December 31, 2006, we had 26 employees, including 15 investment and portfolio management professionals all of whom have extensive prior experience working on financing transactions for technology-

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related companies. We intend to expand our management team, financial analyst group and operational personnel to support our growing portfolio of companies. We may also hire additional managing directors if our business indicates the need to expand the team to take advantage of growing market opportunities.

REGULATION AS A BUSINESS DEVELOPMENT COMPANY

The following discussion is a general summary of the material prohibitions and descriptions governing business development companies generally. It does not purport to be a complete description of all of the laws and regulations affecting business development companies.

A business development company is a unique kind of investment company that primarily focuses on investing in or lending to private companies and making managerial assistance available to them. A business development company provides stockholders with the ability to retain the liquidity of a publicly-traded stock, while sharing in the possible benefits of investing in emerging-growth or expansion-stage privately-owned companies. The 1940 Act contains prohibitions and restrictions relating to transactions between business development companies and their directors and officers and principal underwriters and certain other related persons and requires that a majority of the directors be persons other than interested persons, as that term is defined in the 1940 Act. In addition, the 1940 Act provides that we may not change the nature of our business so as to cease to be, or to withdraw our election as, a business development company unless approved by a majority of our outstanding voting securities. A majority of the outstanding voting securities of a company is defined under the 1940 Act as the lesser of: (i) 67% or more of such company's shares present at a meeting if more than 50% of the outstanding shares of such company are present or represented by proxy, or (ii) more than 50% of the outstanding shares of such company.

Qualifying Assets

Under the 1940 Act, a business development company may not acquire any asset other than assets of the type listed in Section 55(a) of the 1940 Act, which are referred to as qualifying assets, unless, at the time the acquisition is made, qualifying assets represent at least 70% of the company's total assets. The principal categories of qualifying assets relevant to our proposed business are the following:

- (1) Securities purchased in transactions not involving any public offering from the issuer of such securities, which issuer (subject to certain limited exceptions) is an eligible portfolio company, or from any person who is, or has been during the preceding 13 months, an affiliated person of an eligible portfolio company, or from any other person, subject to such rules as may be prescribed by the SEC. An eligible portfolio company is defined in the 1940 Act as any issuer which:
 - (a) is organized under the laws of, and has its principal place of business in, the United States;
 - (b) is not an investment company (other than a small business investment company wholly owned by the business development company) or a company that would be an investment company but for certain exclusions under the 1940 Act; and
 - (c) does not have any class of securities listed on a national securities exchange.
- (2) Securities of any eligible portfolio company which we control.
- (3) Securities purchased in a private transaction from a U.S. issuer that is not an investment company or from an affiliated person of the issuer, or in transactions incident thereto, if the issuer is in bankruptcy and subject to reorganization or if the issuer, immediately prior to the purchase of its securities was unable to meet its obligations as they came due without material assistance other than conventional lending or financing arrangements.
- (4)

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Securities of an eligible portfolio company purchased from any person in a private transaction if there is no ready market for such securities and we already own 60% of the outstanding equity of the eligible portfolio company.

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- (5) Securities received in exchange for or distributed on or with respect to securities described in (1) through (4) above, or pursuant to the exercise of warrants or rights relating to such securities.

- (6) Cash, cash equivalents, U.S. Government securities or high-quality debt securities maturing in one year or less from the time of investment.

Significant Managerial Assistance

In order to count portfolio securities as qualifying assets for the purpose of the 70% test, the business development company must either control the issuer of the securities or must offer to make available significant managerial assistance; except that, where the business development company purchases such securities in conjunction with one or more other persons acting together, one of the other persons in the group may make available such managerial assistance. Making available significant managerial assistance means, among other things, any arrangement whereby the business development company, through its directors, officers or employees, offers to provide and, if accepted, does so provide, significant guidance and counsel concerning the management, operations or business objectives and policies of a portfolio company through monitoring of portfolio company operations, selective participation in board and management meetings, consulting with and advising a portfolio company's officers or other organizational or financial guidance.

Temporary Investments

Pending investment in other types of qualifying assets, as described above, our investments may consist of cash, cash equivalents, U.S. government securities or high quality debt securities maturing in one year or less from the time of investment, which we refer to, collectively, as temporary investments, so that 70% of our assets are qualifying assets. Typically, we invest in U.S. treasury bills or in repurchase agreements, provided that such agreements are fully collateralized by cash or securities issued by the U.S. government or its agencies. A repurchase agreement involves the purchase by an investor, such as us, of a specified security and the simultaneous agreement by the seller to repurchase it at an agreed upon future date and at a price which is greater than the purchase price by an amount that reflects an agreed-upon interest rate. There is no percentage restriction on the proportion of our assets that may be invested in such repurchase agreements. However, if more than 25% of our total assets constitute repurchase agreements from a single counterparty, we would not meet the diversification tests imposed on us by the Code in order to qualify as a RIC for federal income tax purposes. Thus, we do not intend to enter into repurchase agreements with a single counterparty in excess of this limit. We will monitor the creditworthiness of the counterparties with which we enter into repurchase agreement transactions.

Warrants and Options

Under the 1940 Act, a business development company is subject to restrictions on the amount of warrants, options or rights to purchase shares of capital stock that it may have outstanding at any time. In particular, the amount of capital stock that would result from the conversion or exercise of all outstanding warrants, options or rights to purchase capital stock cannot exceed 25% of the business development company's total outstanding shares of capital stock. This amount is reduced to 20% of the business development company's total outstanding shares of capital stock if the amount of warrants, options or rights issued pursuant to an executive compensation plan would exceed 15% of the business development company's total outstanding shares of capital stock.

Senior Securities; Coverage Ratio

We will be permitted, under specified conditions, to issue multiple classes of indebtedness and one class of stock senior to our common stock if our asset coverage, as defined in the 1940 Act, is at least equal to 200% immediately after each such issuance. In addition, while any senior securities remain outstanding, we must make provisions to prohibit any dividend distribution to our stockholders or the repurchase of such securities or shares

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unless we meet the applicable asset coverage ratios at the time of the dividend distribution or repurchase. We may also borrow amounts up to 5% of the value of our total assets for temporary or emergency purposes. For a discussion of the risks associated with the resulting leverage, see Risk Factors. Because we borrow money, there could be increased risk in investing in our company.

Code of Ethics

We have adopted and will maintain a code of ethics pursuant to Rule 17j-1 under the 1940 Act that establishes procedures for personal investments and restricts certain personal securities transactions. Personnel subject to the code may invest in securities for their personal investment accounts, including securities that may be purchased or held by us, so long as such investments are made in accordance with the code's requirements. Our code of ethics will generally not permit investments by our employees in securities that may be purchased or held by us. We may be prohibited under the 1940 Act from conducting certain transactions with our affiliates without the prior approval of our directors who are not interested persons and, in some cases, the prior approval of the SEC.

Our code of ethics was filed with the SEC as an exhibit to the registration statement (Registration No. 333-126604) for our initial public offering. You may read and copy the code of ethics at the SEC's Public Reference Room in Washington, D.C. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-202-942-8090. In addition, the code of ethics is available on the EDGAR Database on the SEC's Internet site at <http://www.sec.gov>. You may obtain copies of the code of ethics, after paying a duplicating fee, by electronic request at the following email address: publicinfo@sec.gov, or by writing the SEC's Public Reference Section, Washington, D.C. 20549.

Privacy Principles

We are committed to maintaining the privacy of our stockholders and safeguarding their non-public personal information. The following information is provided to help you understand what personal information we collect, how we protect that information and why, in certain cases, we may share information with select other parties.

Generally, we do not receive any non-public personal information relating to our stockholders, although certain non-public personal information of our stockholders may become available to us. We do not disclose any non-public personal information about our stockholders or former stockholders to anyone, except as permitted by law or as is necessary in order to service stockholder accounts (for example, to a transfer agent).

We restrict access to non-public personal information about our stockholders to our employees with a legitimate business need for the information. We maintain physical, electronic and procedural safeguards designed to protect the non-public personal information of our stockholders.

Proxy Voting Policies and Procedures

We vote proxies relating to our portfolio securities in the best interest of our stockholders. We review on a case-by-case basis each proposal submitted to a stockholder vote to determine its impact on the portfolio securities held by us. Although we generally vote against proposals that may have a negative impact on our portfolio securities, we may vote for such a proposal if there exists compelling long-term reasons to do so.

Our proxy voting decisions are made by our investment committee, which is responsible for monitoring each of our investments. To ensure that our vote is not the product of a conflict of interest, we require that: (i) anyone involved in the decision making process disclose to our Chief Compliance Officer any potential conflict that he or she is aware of and any contact that he or she has had with any interested party regarding a

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proxy vote; and (ii) employees involved in the decision making process or vote administration are prohibited from revealing how we intend to vote on a proposal in order to reduce any attempted influence from interested parties.

Exemptive Relief

On June 21, 2005, we filed a request with the SEC for exemptive relief to allow us to take certain actions that would otherwise be prohibited by the 1940 Act, as applicable to business development companies. Specifically, we requested that the SEC permit us to issue stock options to our non-employee directors as contemplated by Section 61(a)(3)(B)(i)(II) of the 1940 Act. On February 15, 2007, we received approval from the SEC on this exemptive request.

On September 28, 2005, we filed an exemptive relief application requesting that the SEC permit us to exclude the indebtedness that our wholly-owned subsidiary, HTII, which is qualified as a small business investment company, issues to the Small Business Administration from the 200% asset coverage requirement applicable to us. We filed our final application on March 5, 2007 and are awaiting receipt. In addition, on July 7, 2006, we requested exemptive relief from the SEC to permit us to grant restricted stock and dividend equivalent rights on options to our officers, employees and directors. However, we cannot provide any assurance that we will receive any such exemptive relief.

Other

We will be periodically examined by the SEC for compliance with the 1934 Act and the 1940 Act.

We are required to provide and maintain a bond issued by a reputable fidelity insurance company to protect us against larceny and embezzlement. Furthermore, as a business development company, we are prohibited from protecting any director or officer against any liability to our stockholders arising from willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of such person's office.

We are required to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws, review these policies and procedures annually for their adequacy and the effectiveness of their implementation. We have designated Mr. Harvey, our Chief Legal Officer, as our Chief Compliance Officer who is responsible for administering these policies and procedures.

Small Business Administration Regulations

HTII, our wholly-owned subsidiary, is licensed by the Small Business Administration (SBA) as a small business investment company (SBIC) under Section 301(c) of the Small Business Investment Act of 1958. The Small Business Investment Company regulations currently limit the amount that is available to borrow by any SBIC to \$124.4 million, subject to periodic adjustments by the SBA. There is no assurance that we will draw up to the maximum limit available under the Small Business Investment Company program.

Small business investment companies are designed to stimulate the flow of private equity capital to eligible small businesses. Under present Small Business Administration regulations, eligible small businesses include businesses that have a tangible net worth not exceeding \$18 million and have average annual fully taxed net income not exceeding \$6 million for the two most recent fiscal years. In addition, a small business investment company must devote 20% of its investment activity to smaller concerns as defined by the Small Business Administration. A smaller concern is one that has a tangible net worth not exceeding \$6 million and has average annual fully taxed net income not exceeding \$2 million for the two most recent fiscal years. Small Business Administration regulations also provide alternative size standard criteria to determine eligibility, which depend on the industry in which the business is engaged and are based on such factors as the number of employees and

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gross sales. According to Small Business Administration regulations, small business investment companies may make long-term loans to small businesses, invest in the equity securities of such businesses and provide them with consulting and advisory services. Through our wholly-owned subsidiary HTII, we plan to provide long-term loans to qualifying small businesses, and in connection therewith, make equity investments.

HTII will be periodically examined and audited by the Small Business Administration's staff to determine its compliance with small business investment company regulations.

In January 2005, we formed HTII and HTM. On September 27, 2006, HTII received final approval to be licensed as a Small Business Investment Company (SBIC). HTII is able to borrow funds from the Small Business Administration against eligible pre-approved investments and additional deposits to regulatory capital. On January 30, 2007, HTII received notification that its initial application for leverage under its SBC license was approved allowing HTII to commence drawing up to \$50.0 million of leverage under its first tranche of capital from the SBA. On March 2, 2007, we filed our first draw request that would allow us to initially borrow up to \$12.0 million under the program.

CERTAIN UNITED STATES FEDERAL INCOME TAX CONSIDERATIONS

Conversion to Regulated Investment Company Status

Prior to 2006, we were taxed as a C Corporation under the Code. We operate to qualify as a regulated investment company, or RIC, under Subchapter M of the Code. If we qualify as a regulated investment company and annually distribute to our stockholders in a timely manner at least 90% of our investment company taxable income, we will not be subject to federal income tax on the portion of our taxable income and capital gains we distribute to our shareholders. Taxable income generally differs from net income as defined by generally accepted accounting principles due to temporary and permanent timing differences in the recognition of income and expenses, returns of capital and net unrealized appreciation or depreciation.

We have met the criteria specified below to qualify as a RIC, and will elect to be treated as a RIC under Subchapter M of the Code with the filing of our federal tax return for 2006. The election will be effective as of January 1, 2006. As a RIC, we generally will not have to pay corporate taxes on any income we distribute to our stockholders as dividends, which allows us to reduce or eliminate our corporate level tax. Prior to the effective date of our RIC election, we were taxed as a regular corporation under Subchapter C of the Code. On December 31, 2005, we held assets with built-in gain, which are assets whose fair market value as of the effective date of the election exceeds their tax basis. We elected to recognize all of our net built-in gains at the time of the conversion and paid tax on the built-in gain with the filing of our 2005 tax return. In making this election, we marked our portfolio to market at the time of our RIC election and paid approximately \$294,000 in tax on the resulting gains.

By December 31, 2006, we were required to distribute our earnings and profits while we were taxable as a C corporation. During 2006, we distributed \$1.20 per share to our shareholders of which approximately \$0.09 was deemed to be a distribution of these accumulated earnings and profits, \$0.97 was deemed to be a distribution of income and \$0.14 was a return of capital. The distribution of our income and our accumulated earnings and profits is considered ordinary income to our shareholders in 2006.

Taxation as a Regulated Investment Company

For any taxable year in which we:

qualify as a RIC; and

satisfy the Annual Distribution Requirement;

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we generally will not be subject to federal income tax on the portion of our investment company taxable income and net capital gain (*i.e.*, net realized long-term capital gains in excess of net realized short-term capital losses) we distribute to stockholders with respect to that year. (However, as described above, we will be subject to federal income taxes on certain dispositions of assets that had built-in gains as of the effective date of our conversion to RIC status (unless we elect to be taxed on such gains as of such date). In addition, if we subsequently acquire built-in gain assets from a C corporation in a carryover basis transaction, then we may be subject to tax on the gains recognized by us on dispositions of such assets unless we make a special election to pay corporate-level tax on such built-in gain at the time the assets are acquired.) We will be subject to United States federal income tax at the regular corporate rates on any income or capital gain not distributed (or deemed distributed) to our stockholders.

In order to qualify as a RIC for federal income tax purposes and obtain the tax benefits of RIC status, in addition to satisfying the Annual Distribution Requirement, we must, among other things:

have in effect at all times during each taxable year an election to be regulated as a business development company under the 1940 Act;

derive in each taxable year at least 90% of our gross income from (a) dividends, interest, payments with respect to certain securities loans, gains from the sale of stock or other securities, or other income derived with respect to our business of investing in such stock or securities and (b) net income derived from an interest in a qualified publicly traded limited partnership (the 90% Income Test); and

diversify our holdings so that at the end of each quarter of the taxable year:

at least 50% of the value of our assets consists of cash, cash equivalents, U.S. government securities, securities of other RICs, and other securities if such other securities of any one issuer do not represent more than 5% of the value of our assets or more than 10% of the outstanding voting securities of such issuer; and

no more than 25% of the value of our assets is invested in (i) securities (other than U.S. government securities or securities of other RICs) of one issuer, (ii) securities of two or more issuers that are controlled, as determined under applicable tax rules, by us and that are engaged in the same or similar or related trades or businesses or (iii) securities of one or more qualified publicly traded partnerships (the Diversification Tests).

Qualified earnings may exclude such income as management fees received in connection with our SBIC or other potential outside managed funds and certain other fees.

As a RIC, we will be subject to a 4% nondeductible federal excise tax on certain undistributed income unless we distribute in a timely manner an amount at least equal to the sum of (1) 98% of our ordinary income for each calendar year, (2) 98% of our capital gain net income for the 1-year period ending October 31 in that calendar year and (3) any income realized, but not distributed, in the preceding year (the Excise Tax Avoidance Requirement). We will not be subject to excise taxes on amounts on which we are required to pay corporate income tax (such as retained net capital gains). We currently intend to make sufficient distributions each taxable year to satisfy the Excise Tax Avoidance Requirement.

We may be required to recognize taxable income in circumstances in which we do not receive cash. For example, if we hold debt obligations that are treated under applicable tax rules as having original issue discount (such as debt instruments with payment-in-kind interest or, in certain cases, increasing interest rates or issued with warrants), we must include in income each year a portion of the original issue discount that accrues over the life of the obligation, regardless of whether cash representing such income is received by us in the same taxable year. Because any original issue discount accrued will be included in our investment company taxable income for the year of accrual, we may be required to make a distribution to our stockholders in order to satisfy the Annual Distribution Requirement, even though we will not have received any corresponding cash amount.

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Gain or loss realized by us from the sale or exchange of warrants acquired by us as well as any loss attributable to the lapse of such warrants generally will be treated as capital gain or loss. Such gain or loss generally will be long-term or short-term, depending on how long we held a particular warrant.

We are authorized to borrow funds and to sell assets in order to satisfy the Annual Distribution Requirement and the Excise Tax Avoidance Requirement (collectively, the Distribution Requirements). However, under the 1940 Act, we are not permitted to make distributions to our stockholders while our debt obligations and other senior securities are outstanding unless certain asset coverage tests are met. See Regulation Senior Securities; Coverage Ratio. Moreover, our ability to dispose of assets to meet the Distribution Requirements may be limited by (1) the illiquid nature of our portfolio, or (2) other requirements relating to our status as a RIC, including the Diversification Tests. If we dispose of assets in order to meet the Distribution Requirements, we may make such dispositions at times that, from an investment standpoint, are not advantageous.

Any transactions in options, futures contracts, hedging transactions, and forward contracts will be subject to special tax rules, the effect of which may be to accelerate income to us, defer losses, cause adjustments to the holding periods of our investments, convert long-term capital gains into short-term capital gains, convert short-term capital losses into long-term capital losses or have other tax consequences. These rules could affect the amount, timing and character of distributions to stockholders. We do not currently intend to engage in these types of transactions.

A RIC is limited in its ability to deduct expenses in excess of its investment company taxable income (which is, generally, ordinary income plus net realized short-term capital gains). If our expenses in a given year exceed gross taxable income (e.g., as the result of large amounts of equity-based compensation), we would experience a net operating loss for that year. However, a RIC is not permitted to carry forward net operating losses to subsequent years. In addition, expenses can be used only to offset investment company taxable income, not net capital gain. Due to these limits on the deductibility of expenses, we may for tax purposes have aggregate taxable income for several years that we are required to distribute and that is taxable to our stockholders even if such income is greater than the aggregate net income we actually earned during those years. Such required distributions may be made from our cash assets or by liquidation of investments, if necessary. We may realize gains or losses from such liquidations. In the event we realize net capital gains from such transactions, you may receive a larger capital gain distribution than you would have received in the absence of such transactions.

Failure to Qualify as a Regulated Investment Company

If we were unable to qualify for treatment as a RIC, we would be subject to tax on all of our taxable income at regular corporate rates. We would not be able to deduct distributions to stockholders, nor would they be required to be made. Such distributions (if made in a taxable year beginning on or before December 31, 2008) would be taxable to our stockholders and, provided certain holding period and other requirements were met, could qualify for treatment as qualified dividend income eligible for the 15% maximum rate to the extent of our current and accumulated earnings and profits. Subject to certain limitations under the Code, corporate distributees would be eligible for the dividends-received deduction. Distributions in excess of our current and accumulated earnings and profits would be treated first as a return of capital to the extent of the stockholder's tax basis, and any remaining distributions would be treated as a capital gain. To requalify as a RIC in a subsequent taxable year, we would be required to satisfy the RIC qualification requirements for that year and dispose of any earnings and profits from any year in which we failed to qualify as a RIC. Subject to a limited exception applicable to RICs that qualified as such under Subchapter M of the Code for at least one year prior to disqualification and that requalify as a RIC no later than the second year following the nonqualifying year, we could be subject to tax on any unrealized net built-in gains in the assets held by us during the period in which we failed to qualify as a RIC that are recognized within the subsequent 10 years, unless we made a special election to pay corporate-level tax on such built-in gain at the time of our requalification as a RIC.

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DETERMINATION OF NET ASSET VALUE

We determine the net asset value per share of our common stock quarterly. The net asset value per share is equal to the value of our total assets minus liabilities and any preferred stock outstanding divided by the total number of shares of common stock outstanding. As of the date of this report, we do not have any preferred stock outstanding.

At December 31, 2006, approximately 94% of our total assets represented investments in portfolio companies recorded at fair value. Value, as defined in Section 2(a) (41) of the 1940 Act, is (i) the market price for those securities for which a market quotation is readily available and (ii) for all other securities and assets, fair value is as determined in good faith by the Board of Directors in accordance with established valuation procedures and the recommendation of the Valuation Committee of the Board of Directors. Since there is typically no readily available market value for the investments in our portfolio, we value substantially all of our investments at fair value as determined in good faith by our management pursuant to a valuation policy and a consistent valuation process. Due to the inherent uncertainty in determining the fair value of investments that do not have a readily available market value, the fair value of our investments determined in good faith by our management may differ significantly from the value that would have been used had a ready market existed for such investments, and the differences could be material.

There is no single standard for determining fair value in good faith. As a result, determining fair value requires that judgment be applied to the specific facts and circumstances of each portfolio investment. Unlike banks, we are not permitted to provide a general reserve for anticipated loan losses. Instead, we must determine the fair value of each individual investment on a quarterly basis. We will record unrealized depreciation on investments when we believe that an investment has decreased in value, including where collection of a loan or realization of an equity security is doubtful. Conversely, we will record unrealized appreciation if we believe that the underlying portfolio company has appreciated in value and, therefore, our investment has also appreciated in value, where appropriate.

As a business development company, we invest primarily in illiquid securities including debt and equity-related securities of private companies. Our investments are generally subject to some restrictions on resale and generally have no established trading market. Because of the type of investments that we make and the nature of our business, our valuation process requires an analysis of various factors. Our valuation methodology includes the examination of, among other things, the underlying investment performance, financial condition and market changing events that impact valuation.

When a qualifying external event such as a significant purchase transaction, public offering, or subsequent debt or equity sale occurs, the pricing indicated by the external event will be used to corroborate our private debt or equity valuation. Securities that are traded in the over-the-counter market or on a stock exchange will be valued at the prevailing bid price on the valuation date.

Determinations in Connection with Offerings

In connection with each offering of shares of our common stock, our Board of Directors or a committee thereof is required to make the determination that we are not selling shares of our common stock at a price below the then current net asset value of our common stock at the time at which the sale is made. Our Board of Directors considers the following factors, among others, in making such determination:

the net asset value of our common stock disclosed in the most recent periodic report we filed with the SEC;

our management's assessment of whether any material change in the net asset value of our common stock has occurred (including through the realization of gains on the sale of our portfolio securities) from the period beginning on the date of the most recently disclosed net asset value of our common stock to the period ending two days prior to the date of the sale of our common stock; and

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the magnitude of the difference between the net asset value of our common stock disclosed in the most recent periodic report we filed with the SEC and our management's assessment of any material change in the net asset value of our common stock since the date of the most recently disclosed net asset value of our common stock, and the offering price of the shares of our common stock in the proposed offering.

Importantly, this determination does not require that we calculate the net asset value of our common stock in connection with each offering of shares of our common stock, but instead it involves the determination by our Board of Directors or a committee thereof that we are not selling shares of our common stock at a price below the then current net asset value of our common stock at the time at which the sale is made.

Moreover, to the extent that there is even a remote possibility that we may (i) issue shares of our common stock at a price below the then current net asset value of our common stock at the time at which the sale is made or (ii) trigger the undertaking (which we provide to the SEC in the registration statement relating to an offering of common stock) to suspend the offering of shares of our common stock if the net asset value of our common stock fluctuates by certain amounts in certain circumstances until the prospectus relating to such offering is amended, our Board of Directors will elect, in the case of clause (i) above, either to postpone the offering until such time that there is no longer the possibility of the occurrence of such event or to undertake to determine the net asset value of our common stock within two days prior to any such sale to ensure that such sale will not be below our then current net asset value, and, in the case of clause (ii) above, to comply with such undertaking or to undertake to determine the net asset value of our common stock to ensure that such undertaking has not been triggered.

These processes and procedures are part of our compliance policies and procedures. Records will be made contemporaneously with all determinations described in this section and these records will be maintained with other records we are required to maintain under the 1940 Act.

RISK FACTORS

Investing in our common stock involves a high degree of risk. You should consider carefully the risks described below and all other information contained in this Annual Report, including our financial statements and the related notes and the schedules and exhibits to this Annual Report.

Risks Related to our Business and Structure

We have a limited operating history as a business development company, which may affect our ability to manage our business and may impair your ability to assess our prospects.

We were incorporated in December 2003 and commenced investment operations in September 2004. We are subject to all of the business risks and uncertainties associated with any new business enterprise, including the risk that we will not achieve our investment objective and that the value of our common stock could decline substantially. We have a limited operating history as a business development company. As a result, we have limited operating results under these regulatory frameworks that can demonstrate to you either their effect on the business or our ability to manage the business within these frameworks. If we fail to maintain our status as a business development company or fail to qualify as a RIC, our operating flexibility and results of operations would be significantly affected.

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We are dependent upon key management personnel for our future success, particularly Manuel A. Henriquez, and if we are not able to hire and retain qualified personnel, or if we lose any member of our senior management team, our ability to implement our business strategy could be significantly harmed.

We depend upon the members of our senior management, particularly Mr. Henriquez, as well as other key personnel for the identification, final selection, structuring, closing and monitoring of our investments. These employees have critical industry experience and relationships on which we rely to implement our business plan. If we lose the services of Mr. Henriquez, or of any other senior management members, we may not be able to operate the business as we expect, and our ability to compete could be harmed, which could cause our operating results to suffer. We believe our future success will depend, in part, on our ability to identify, attract and retain sufficient numbers of highly skilled employees. If we do not succeed in identifying, attracting and retaining such personnel, we may not be able to operate our business as we expect.

Our business model depends to a significant extent upon strong referral relationships with venture capital and private equity fund sponsors, and our inability to develop or maintain these relationships, or the failure of these relationships to generate investment opportunities, could adversely affect our business.

We expect that members of our management team will maintain their relationships with venture capital and private equity firms, and we will rely to a significant extent upon these relationships to provide us with our deal flow. If we fail to maintain our existing relationships or to develop new relationships with other firms or sources of investment opportunities, then we will not be able to grow our investment portfolio. In addition, persons with whom members of our management team have relationships are not obligated to provide us with investment opportunities and, therefore, there is no assurance that such relationships will lead to the origination of debt or other investments.

We operate in a highly competitive market for investment opportunities, and we may not be able to compete effectively.

A large number of entities compete with us to make the types of investments that we plan to make in prospective portfolio companies. We compete with a large number of venture capital and private equity firms, as well as with other investment funds, investment banks and other sources of financing, including traditional financial services companies such as commercial banks and finance companies. Many of our competitors are substantially larger and have considerably greater financial, technical, marketing and other resources than we do. For example, some competitors may have a lower cost of funds and/or access to funding sources that are not available to us. This may enable some competitors to make commercial loans with interest rates that are comparable to or lower than the rates that we typically offer. We may lose prospective portfolio companies if we do not match competitors' pricing, terms and structure. If we do match competitors' pricing, terms or structure, we may experience decreased net interest income and increased risk of credit losses. 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, establish more relationships and build their market shares. Furthermore, many potential competitors are not subject to the regulatory restrictions that the 1940 Act imposes on us as a business development company or that the Code would impose on us as a RIC. If we are not able to compete effectively, our business, financial condition, and results of operations will be adversely affected. As a result of this competition, there can be no assurance that we will be able to identify and take advantage of attractive investment opportunities that we identify, or that we will be able to fully invest our available capital.

Because we intend to distribute substantially all of our income to our stockholders in order to qualify as a RIC, we will continue to need additional capital to finance our growth. If additional funds are unavailable or not available on favorable terms, our ability to grow will be impaired.

In order to satisfy the tax requirements applicable to a RIC, to avoid payment of excise taxes and to minimize or avoid payment of income taxes, we intend to distribute to our stockholders substantially all of our

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ordinary income and realized net capital gains except for certain realized net long-term capital gains, which we currently intend to retain, pay applicable income taxes with respect thereto and elect to treat as deemed distributions to our stockholders. As a business development company, we generally are required to meet a coverage ratio of total assets to total borrowings and other senior securities, which includes all of our borrowings and any preferred stock that we may issue in the future, of at least 200%. This requirement limits the amount that we may borrow. Because we will continue to need capital to grow our loan and investment portfolio, this limitation may prevent us from incurring debt and require us to raise additional equity at a time when it may be disadvantageous to do so. While we expect to be able to borrow and to issue additional debt and equity securities, we cannot assure you that debt and equity financing will be available to us on favorable terms, or at all, and debt financings may be restricted by the terms of any of our outstanding borrowings. In addition, as a business development company, we generally are not permitted to issue equity securities priced below net asset value without stockholder approval and approval of our independent directors. If additional funds are not available to us, we could be forced to curtail or cease new lending and investment activities, and our net asset value could decline.

Because we borrow money, there could be increased risk in investing in our company.

Lenders have fixed dollar claims on our assets that are superior to the claims of stockholders, and we have granted, and may in the future grant, lenders a security interest in our assets in connection with borrowings. In the case of a liquidation event, those lenders would receive proceeds before our stockholders. In addition, borrowings, also known as leverage, magnify the potential for gain or loss on amounts invested and, therefore, increase the risks associated with investing in our securities. Leverage is generally considered a speculative investment technique. If the value of our assets increases, then leveraging would cause the net asset value attributable to our common stock to increase more than it otherwise would have had we not leveraged. Conversely, if the value of our assets decreases, leveraging would cause the net asset value attributable to our common stock to decline more than it otherwise would have had we not leveraged. Similarly, any increase in our revenue in excess of interest expense on our borrowed funds would cause our net income to increase more than it would without the leverage. Any decrease in our revenue would cause our net income to decline more than it would have had we not borrowed funds and could negatively affect our ability to make distributions on common stock. Our ability to service any debt that we incur will depend largely on our financial performance and will be subject to prevailing economic conditions and competitive pressures. We and, indirectly our stockholders will bear the cost associated with our leverage activity. Our securitized credit facility with Citigroup Global Markets Realty Corp. which we refer to as the Citigroup Facility contains financial and operating covenants that could restrict our business activities, including our ability to declare dividends if we default under certain provisions.

As of December 31, 2006, we had outstanding indebtedness of \$41 million pursuant to our securitized credit facility with Citigroup Global Market Realty Corp., which we refer to as the Citigroup Facility. We expect, in the future, to borrow from, and issue senior debt securities to, banks, insurance companies and other lenders, including additional borrowings pursuant to the Citigroup Facility. See Management's Discussion and Analysis of Financial Condition Borrowings. In addition, we expect to continue to pursue financing from the Small Business Administration under its Small Business Investment Company program. See Regulation Small Business Administration Regulations.

As a business development company, we generally are required to meet a coverage ratio of total assets to total borrowings and other senior securities, which include all of our borrowings and any preferred stock that we may issue in the future, of at least 200%. If this ratio declines below 200%, we may not be able to incur additional debt and may need to sell a portion of our investments to repay some debt when it is disadvantageous to do so, and we may not be able to make distributions.

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Because most of our investments typically are not in publicly-traded securities, there is uncertainty regarding the value of our investments, which could adversely affect the determination of our net asset value.

At December 31, 2006, portfolio investments, 99% of which are valued at fair value by the Board of Directors were approximately 94% of our total assets. We expect our investments to continue to consist primarily of securities issued by privately-held companies, the fair value of which is not readily determinable. In addition, we are not permitted to maintain a general reserve for anticipated loan losses. Instead, we are required by the 1940 Act to specifically value each investment and record an unrealized gain or loss for any asset that we believe has increased or decreased in value. There is no single standard for determining fair value in good faith. We value these securities at fair value as determined in good faith by our Board of Directors, based on the recommendations of our Valuation Committee. The Valuation Committee uses its best judgment in arriving at the fair value of these securities. As a result, determining fair value requires that judgment be applied to the specific facts and circumstances of each portfolio investment while employing a consistently applied valuation process for the types of investments we make. However, the Board of Directors retains ultimate authority as to the appropriate valuation of each investment. Because such valuations are inherently uncertain and may be based on estimates, our determinations of fair value may differ materially from the values that would be assessed if a ready market for these securities existed. We adjust quarterly the valuation of our portfolio to reflect the Board of Directors determination of the fair value of each investment in our portfolio. Any changes in fair value are recorded in our statement of operations as net change in unrealized appreciation or depreciation. Our net asset value could be adversely affected if our determinations regarding the fair value of our investments were materially higher than the values that we ultimately realize upon the disposal of such securities.

Our financial results could be negatively affected if a significant portfolio investment fails to perform as expected.

Our total investment in companies may be significant individually or in the aggregate. As a result, if a significant investment in one or more companies fails to perform as expected, our financial results could be more negatively affected and the magnitude of the loss could be more significant than if we had made smaller investments in more companies. The following table shows the fair value of investments held at December 31, 2006 that are greater than 5% of net assets:

	December 31, 2006	
	Fair Value	Percentage of Net Assets
QuatRx Pharmaceuticals Company	\$ 18,014,443	7.1%
Aveo Pharmaceuticals, Inc.	15,008,082	5.9%
Luminus Devices, Inc.	15,010,086	5.9%
Wageworks, Inc.	15,295,434	6.0%

QuatRx Pharmaceuticals Company is a pharmaceutical company focused on discovering, licensing, developing and commercializing compounds in the endocrine, metabolic and cardiovascular therapeutic areas.

AVEO is a biopharmaceutical company focused on the discovery and development of novel cancer therapeutics.

Luminus Devices, Inc. develops and manufactures high performance solid state light emitting devices, leading the industry in designing and manufacturing new, powerful light source for a variety of applications.

WageWorks provides employer-sponsored, tax-advantaged spending solutions, including medical and family-care reimbursement and transit passes.

Our financial results could be negatively affected if these portfolio companies or any of our other significant portfolio companies encounter financial difficulty and fail to repay their obligations or to perform as expected.

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Regulations governing our operations as a business development company affect our ability to, and the manner in which, we raise additional capital, which may expose us to risks.

Our business will require a substantial amount of capital. We may acquire additional capital from the issuance of senior securities, including borrowings, securitization transactions or other indebtedness, or the issuance of additional shares of our common stock. However, we may not be able to raise additional capital in the future on favorable terms or at all. We may issue debt securities, other evidences of indebtedness or preferred stock, and we may 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. The 1940 Act permits us to issue senior securities in amounts such that our asset coverage, as defined in the 1940 Act, equals at least 200% after each issuance of senior securities. Our ability to pay dividends or issue additional senior securities would be restricted if our asset coverage ratio were not at least 200%. If the value of our assets declines, we may be unable to satisfy this test. If that happens, we may be required to liquidate a portion of our investments and repay a portion of our indebtedness at a time when such sales may be disadvantageous. As a result of issuing senior securities, we would also be exposed to typical risks associated with leverage, including an increased risk of loss. If we issue preferred stock, the preferred stock would rank senior to common stock in our capital structure, preferred stockholders would have separate voting rights and might have rights, preferences, or privileges more favorable than those of our common stockholders and the issuance of preferred stock could have the effect of delaying, deferring, or preventing a transaction or a change of control that might involve a premium price for holders of our common stock or otherwise be in your best interest.

To the extent that we are constrained in our ability to issue debt or other senior securities, we will depend on issuances of common stock to finance operations. Other than in certain limited situations such as rights offerings, as a business development company, we are generally not able to issue our common stock at a price below net asset value without first obtaining required approvals from our stockholders and our independent directors. If we raise additional funds by issuing more common stock or senior securities convertible into, or exchangeable for, our common stock, then the percentage ownership of our stockholders at that time will decrease, and you might experience dilution. In addition to issuing securities to raise capital as described above, we anticipate that, in the future, we may securitize our loans to generate cash for funding new investments. An inability to successfully securitize our loan portfolio could limit our ability to grow our business and fully execute our business strategy.

When we are a debt or minority equity investor in a portfolio company, we may not be in a position to control the entity, and management of the company may make decisions that could decrease the value of our portfolio holdings.

We make both debt and minority equity investments; therefore, we are subject to the risk that a portfolio company may make business decisions with which we disagree, and the stockholders and management of such company may take risks or otherwise act in ways that do not serve our interests. As a result, a portfolio company may make decisions that could decrease the value of our portfolio holdings.

If we do not invest a sufficient portion of our assets in qualifying assets, we could fail to qualify as a business development company or be precluded from investing according to our current business strategy.

As a business development company, we may 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. See Regulation.

We believe that most of the senior and mezzanine loans investments will constitute qualifying assets. However, we may be precluded from investing in what we believe are attractive investments if such investments are not qualifying assets for purposes of the 1940 Act. If we do not invest a sufficient portion of our assets in qualifying assets, we could lose our status as a business development company, which would have a material adverse effect on our business, financial condition and results of operations. Similarly, these rules could prevent us from making follow-on investments in existing portfolio companies (which could result in the dilution of our

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position) or could require us to dispose of investments at inappropriate times in order to comply with the 1940 Act. If we need to dispose of such investments quickly, it would be difficult to dispose of such investments on favorable terms. For example, 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.

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

In accordance with generally accepted accounting principles and tax requirements, we include in income certain amounts that we have not yet received in cash, such as contracted payment-in-kind interest, which represents contractual interest added to a loan balance and due at the end of such loan's term. In addition to the cash yields received on our loans, in some instances, certain loans may also include any of the following: end-of-term payments, exit fees, balloon payment fees or prepayment fees. The increases in loan balances as a result of contracted payment-in-kind arrangements are included in income for the period in which such payment-in-kind interest was accrued, which is often in advance of receiving cash payment, and are separately identified on our statements of cash flows. We also may be required to include in income certain other amounts that we will not receive in cash.

Any warrants that we receive in connection with our debt investments will generally be valued as part of the negotiation process with the particular portfolio company. As a result, a portion of the aggregate purchase price for the debt investments and warrants will be allocated to the warrants that we receive. This will generally result in original issue discount for tax purposes, which we must recognize as ordinary income, increasing the amount that we are required to distribute to qualify for the federal income tax benefits applicable to RICs. Because these warrants would not produce distributable cash for us at the same time as we are required to make distributions in respect of the related original issue discount, we would need to obtain cash from other sources to satisfy such distribution requirements. If we are unable to obtain cash from other sources to satisfy such distribution requirements, we may fail to qualify for the federal income tax benefits allowable to RICs and, thus, become subject to a corporate-level income tax on all our income.

Other features of the debt instruments that we hold may also cause such instruments to generate an original issue discount, resulting in a dividend distribution requirement in excess of current cash interest received. Since in certain cases we may recognize income before or without receiving cash representing such income, we may have difficulty meeting the RIC tax requirement to distribute at least 90% of our net ordinary income and realized net short-term capital gains in excess of realized net long-term capital losses, if any. If we are unable to meet these distribution requirements, we will not qualify for the federal income tax benefits allowable to a RIC. Accordingly, we may have to sell some of our assets, raise additional debt or equity capital or reduce new investment originations to meet these distribution requirements.

There is a risk that you may not receive distributions or that our distributions may not grow over time.

We intend to make distributions on a quarterly basis to our stockholders. We cannot assure you that we will achieve investment results that will allow us to make a specified level of cash distributions or year-to-year increases in cash distributions. In addition, due to the asset coverage test applicable to us as a business development company, we may be limited in our ability to make distributions. Also, our credit facility limits our ability to declare dividends if we default under certain provisions.

If we are unable to manage our future growth effectively, we may be unable to achieve our investment objective, which could adversely affect our financial condition and results of operations and cause the value of your investment to decline.

Our ability to achieve our investment objective will depend on our ability to sustain growth. Sustaining growth will depend, in turn, on our senior management team's ability to identify, evaluate, finance and invest in suitable companies that meet our investment criteria. Accomplishing this result on a cost-effective basis is

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largely a function of our marketing capabilities, our management of the investment process, our ability to provide efficient services and our access to financing sources on acceptable terms. Failure to manage our future growth effectively could have a material adverse effect on our business, financial condition and results of operations.

Our quarterly and annual operating results are subject to fluctuation as a result of the nature of our business, and if we fail to achieve our investment objective, the net asset value of our common stock may decline.

We could experience fluctuations in our quarterly and annual operating results due to a number of factors, some of which are beyond our control, including, but not limited to, the interest rate payable on the debt securities that we acquire, the default rate on such securities, the level of our expenses, variations in and the timing of the recognition of realized and unrealized gains or losses, the degree to which we encounter competition in our markets and general economic conditions. As a result of these factors, results for any period should not be relied upon as being indicative of performance in future periods.

In addition, any of these factors could negatively impact our ability to achieve our investment objectives, which may cause our net asset value of our common stock to decline.

Fluctuations in interest rates may adversely affect our profitability.

A portion of our income will depend upon the difference between the rate at which we borrow funds and the interest rate on the debt securities in which we invest. Because we will borrow money to make investments, our net investment income is dependent upon the difference between the rate at which we borrow funds and the rate at which we invest these funds. Typically, we anticipate that our interest-earning investments will accrue and pay interest at fixed rates, and that our interest-bearing liabilities will accrue interest at variable rates. As a result, there can be no assurance that a significant change in market interest rates will not have a material adverse effect on our net investment income. We anticipate using a combination of equity and long-term and short-term borrowings to finance our investment activities.

A significant increase in market interest rates could harm our ability to attract new portfolio companies and originate new loans and investments. We expect that most of our initial investments in debt securities will be at fixed rates. However, in the event that we make investments in debt securities at variable rates, a significant increase in market interest rates could also result in an increase in our non-performing assets and a decrease in the value of our portfolio because our floating-rate loan portfolio companies may be unable to meet higher payment obligations. In periods of rising interest rates, our cost of funds would increase, resulting in a decrease in our net investment income. In addition, a decrease in interest rates may reduce net income, because new investments may be made at lower rates despite the increased demand for our capital that the decrease in interest rates may produce. We may, but will not be required to, hedge against the risk of adverse movement in interest rates in our short-term and long-term borrowings relative to our portfolio of assets. If we engage in hedging activities, it may limit our ability to participate in the benefits of lower interest rates with respect to the hedged portfolio. Adverse developments resulting from changes in interest rates or hedging transactions could have a material adverse effect on our business, financial condition, and results of operations.

If we are unable to continue to borrow money in order to leverage our equity capital, then our ability to make new investments and to execute our business plan will be impaired.

As of December 31, 2006, we had outstanding borrowings of \$41.0 million pursuant to the Citigroup Facility. We expect to incur additional indebtedness under our subsidiary's small business investment company license from the Small Business Administration. There can be no assurance that we will be successful in obtaining any additional debt capital on terms acceptable to us or at all. If we are unable to obtain debt capital, then our equity investors will not benefit from the potential for increased returns on equity resulting from leverage to the extent that our investment strategy is successful.

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In addition, the terms of available financing may place limits on our financial and operating flexibility. If we are unable to obtain sufficient capital in the future, we may:

be forced to reduce our operations;

not be able to expand or acquire complementary businesses; and

not be able to develop new services or otherwise respond to changing business conditions or competitive pressures.

It is likely that the terms of any long-term or revolving credit or warehouse facility we may enter into in the future could constrain our ability to grow our business.

As of December 31, 2006, the Company, through Hercules Funding Trust I, an affiliated statutory trust, has a \$150 million securitized credit facility with Citigroup. We expect to enter into additional revolving credit or warehouse facilities in the future. While there can be no assurance that we will be able to borrow from banks or other financial institutions, we expect that we will, at some time in the future, obtain a long-term or revolving credit facility or a warehouse facility. The current lenders have, and any future lender or lenders will have fixed dollar claims on our assets that are senior to the claims of our stockholders and, thus, will have a preference over our stockholders with respect to our assets. In addition, we may grant a security interest in our assets in connection with any such borrowing. We expect such a facility to contain customary default provisions such as a minimum net worth amount, a profitability test, and a restriction on changing our business and loan quality standards. An event of default under any credit facility would likely result, among other things, in termination of the availability of further funds under that facility and an accelerated maturity date for all amounts outstanding under the facility, which would likely disrupt our business and, potentially, the business of the portfolio companies whose loans that we financed through the facility. This could reduce our revenues and, by delaying any cash payment allowed to us under our facility until the lender has been paid in full, reduce our liquidity and cash flow and impair our ability to grow our business and maintain our status as a RIC.

Our cost of borrowing is increased by the warrant participation agreement we have with one of our lenders. In addition, our realized gains are reduced by amounts paid pursuant to the warrant participation agreement.

Citigroup has an equity participation right through a warrant participation agreement on the pool of loans and warrants collateralized under the Citigroup Facility. Pursuant to the warrant participation agreement, we granted to Citigroup a 10% participation in all warrants held as collateral. As a result, Citigroup is entitled to 10% of the realized gains on the warrants until the realized gains paid to Citigroup pursuant to the agreement equals \$3,750,000 (the Maximum Participation Limit). The obligations under the warrant participation agreement continue even after the Citigroup Facility is terminated until the Maximum Participation Limit has been reached.

During the year ended December 31, 2006, the Company reduced its realized gain by approximately \$221,000 for Citigroup's participation in the gain on sale of an equity security and recorded an additional liability and reduced its unrealized gains by a net amount of approximately \$35,000 for Citigroup's participation. Since inception of the agreement, we have paid Citigroup approximately \$281,000 under the warrant participation agreement thereby reducing our realized gains. In addition, our realized gains will be reduced by the amounts owed to Citigroup under the warrant participation agreement. The value of Citigroup's participation right on unrealized gains in the related equity investments since inception of the agreement was approximately \$377,000 at December 31, 2006 and is included in accrued liabilities and reduces the unrealized gain recognized by us at December 31, 2006. Citigroup's rights under the warrant participation agreement increase our cost of borrowing and reduce our realized gains.

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One of our wholly-owned subsidiaries is licensed by the U.S. Small Business Administration, and as a result, we will be subject to SBA regulations.

Our wholly-owned subsidiary HTII, is licensed to operate as a SBIC and is regulated by the U.S. Small Business Administration (SBA). The SBA regulations require that a licensed SBIC be periodically examined and audited by the SBA to determine its compliance with the relevant SBA regulations. If HTII fails to comply with applicable SBA regulations, the SBA could, depending on the severity of the violation, limit or prohibit the HTII s use of debentures, declare outstanding debentures immediately due and payable, and/or limit the HTII from making new investments. The SBA also imposes a limit on the maximum amount that may be borrowed by any single SBIC. The SBA prohibits, without prior SBA approval, a change of control of a SBIC or transfers that would result in any person (or a group of persons acting in concert) owning 10% or more of a class of capital stock of a licensed SBIC.

If we are unable to satisfy Code requirements for qualification as a RIC, then we will be subject to corporate-level income tax, which would adversely affect our results of operations and financial condition.

We will elect to be treated as a RIC for federal income tax purposes with the filing of our federal corporate income tax return for 2006, which election will be effective as of January 1, 2006. We will not qualify for the tax treatment allowable to RICs if we are unable to comply with the source of income, diversification and distribution requirements contained in Subchapter M of the Code, or if we fail to maintain our election to be regulated as a business development company under the 1940 Act. If we fail to qualify for the federal income tax benefits allowable to RICs for any reason and remain or become subject to a corporate-level income tax, the resulting taxes could substantially reduce our net assets, the amount of income available for distribution to our stockholders and the actual amount of our distributions. Such a failure would have a material adverse effect on us, the net asset value of our common stock and the total return, if any, obtainable from your investment in our common stock. Any net operating losses that we incur in periods during which we qualify as a RIC will not offset net capital gains (i.e., net realized long-term capital gains in excess of net realized short-term capital losses) that we are otherwise required to distribute, and we cannot pass such net operating losses through to our stockholders. In addition, net operating losses that we carry over to a taxable year in which we qualify as a RIC normally cannot offset ordinary income or capital gains.

Interpretations of the staff of the Securities and Exchange Commission regarding the appropriateness of the consolidation of certain of our subsidiaries may have an impact on our financial statements.

The staff of the Securities and Exchange Commission (the Staff) is reviewing the appropriateness of the consolidation of certain types of subsidiaries on an industry-wide basis under generally accepted accounting principles (GAAP) and Rule 6-03 of Regulation S-X. In connection with such review, the Staff is in the process of reviewing the appropriateness of our consolidation of certain of our subsidiaries (the Subsidiaries). In the event that the Staff disagrees with our position with respect to the appropriateness of consolidation of any of the Subsidiaries, then we will make such additional disclosures and prospective changes in accounting methods as the Staff requires on a prospective basis which will be discussed and reviewed with us.

Although we believe that our consolidation of the Subsidiaries conforms with GAAP, there can be no assurance that the Staff will ultimately concur with our position. Such events could have a material impact on our future reported results.

Changes in laws or regulations governing our business could negatively affect the profitability of our operations.

Changes in the laws or regulations, or the interpretations of the laws and regulations, which govern business development companies, small business investment companies, RICs or non-depository commercial lenders could significantly affect our operations and our cost of doing business. We are subject to federal, state and local laws and regulations and are subject to judicial and administrative decisions that affect our operations, including

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our loan originations, maximum interest rates, fees and other charges, disclosures to portfolio companies, the terms of secured transactions, collection and foreclosure procedures, and other trade practices. If these laws, regulations or decisions change, or if we expand our business into jurisdictions that have adopted more stringent requirements than those in which we currently conduct business, then we may have to incur significant expenses in order to comply or we may have to restrict our operations. In addition, if we do not comply with applicable laws, regulations and decisions, then we may lose licenses needed for the conduct of our business and be subject to civil fines and criminal penalties, any of which could have a material adverse effect upon our business results of operations or financial condition.

Risks Related to Our Investments

Our investments are concentrated in a limited number of technology-related companies, which subjects us to the risk of significant loss if any of these companies default on their obligations under any of their debt securities that we hold, or if any of the technology-related industry sectors experience a downturn.

We have invested and intend to continue investing in a limited number of technology-related companies. A consequence of this limited number of investments is that the aggregate returns we realize may be significantly adversely affected if a small number of investments perform poorly or if we need to write down the value of any one investment. Beyond the asset diversification requirements to which we will be subject as a RIC, we do not have fixed guidelines for diversification or limitations on the size of our investments in any one portfolio company and our investments could be concentrated in relatively few issuers. In addition, we have invested in and intend to continue investing, under normal circumstances, at least 80% of the value of our total assets (including the amount of any borrowings for investment purposes) in technology-related and life-science companies. As a result, a downturn in technology-related and life-science industry sectors could materially adversely affect us.

Our investments may be concentrated in emerging-growth or expansion-stage portfolio companies, which may have limited operating histories and financial resources.

We expect that our portfolio will continue to consist primarily of investments in emerging-growth and expansion-stage privately-owned businesses, which may have relatively limited operating histories. Compared to larger established or publicly-owned firms, these companies may be particularly vulnerable to economic downturns, may have more limited access to capital and higher funding costs, may have a weaker financial position and may need more capital to expand or compete. These businesses also may experience substantial variations in operating results. They may face intense competition, including from companies with greater financial, technical and marketing resources. Furthermore, some of these companies do business in regulated industries and could be affected by changes in government regulation. Accordingly, these factors could impair their cash flow or result in other events, such as bankruptcy, which could limit their ability to repay their obligations to us, and may adversely affect the return on, or the recovery of, our investment in these companies. We cannot assure you that any of our investments in our portfolio companies will be successful. Our portfolio companies compete with larger, established companies with greater access to, and resources for, further development in these new technologies. We may lose our entire investment in any or all of our portfolio companies.

Our investment strategy focuses on technology-related and life-science companies, which are subject to many risks, including volatility, intense competition, shortened product life cycles and periodic downturns, and you could lose all or part of your investment.

We have invested and will continue investing primarily in technology-related and life-science companies, many of which may have narrow product lines and small market shares, which tend to render them more vulnerable to competitors' actions and market conditions, as well as to general economic downturns. The revenues, income (or losses), and valuations of technology-related and life-science companies can and often do fluctuate suddenly and dramatically. In addition, technology-related markets are generally characterized by abrupt business cycles and intense competition. Beginning in mid-2000, there was substantial excess production

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capacity and a significant slowdown in many technology-related industries. This overcapacity, together with a cyclical economic downturn, resulted in substantial decreases in the market capitalization of many technology-related and life-science companies. While such valuations have recovered to some extent, such decreases in market capitalization may occur again, and any future decreases in technology-related and life-science company valuations may be substantial and may not be temporary in nature. Therefore, our portfolio companies may face considerably more risk of loss than do companies in other industry sectors.

Because of rapid technological change, the average selling prices of products and some services provided by technology-related and life-science companies have historically decreased over their productive lives. As a result, the average selling prices of products and services offered by technology-related and life-science companies may decrease over time, which could adversely affect their operating results, their ability to meet obligations under their debt securities and the value of their equity securities. This could, in turn, materially adversely affect our business, financial condition and results of operations.

We have invested in and may continue investing in technology-related and life-science companies that do not have venture capital or private equity firms as equity investors, and these companies may entail a higher risk of loss than do companies with institutional equity investors, which could increase the risk of loss of your investment.

Our portfolio companies will often require substantial additional equity financing to satisfy their continuing working capital and other cash requirements and, in most instances, to service the interest and principal payments on our investment. Portfolio companies that do not have venture capital or private equity investors may be unable to raise any additional capital to satisfy their obligations or to raise sufficient additional capital to reach the next stage of development. Portfolio companies that do not have venture capital or private equity investors may be less financially sophisticated and may not have access to independent members to serve on their boards, which means that they may be less successful than portfolio companies sponsored by venture capital or private equity firms. Accordingly, financing these types of companies may entail a higher risk of loss than would financing companies that are sponsored by venture capital or private equity firms.

Economic recessions or downturns could impair the ability of our portfolio companies to repay loans, which, in turn, could increase our non-performing assets, decrease the value of our portfolio, reduce our volume of new loans and harm our operating results, which might have an adverse effect on our results of operations.

Many of our portfolio companies may be susceptible to economic slowdowns or recessions and may be unable to repay our loans during such periods. Therefore, our non-performing assets are likely to increase and the value of our portfolio is likely to decrease during such periods. Adverse economic conditions also may decrease the value of collateral securing some of our loans and the value of our equity investments. Economic slowdowns or recessions could lead to financial losses in our portfolio and a decrease in revenues, net income and assets. Unfavorable economic conditions also could increase our funding costs, limit our access to the capital markets or result in a decision by lenders not to extend credit to us.

A portfolio company's failure to satisfy financial or operating covenants imposed by us or other lenders could lead to defaults and, potentially, termination of the portfolio company's loans and foreclosure on its secured assets, which could trigger cross-defaults under other agreements and jeopardize the portfolio company's ability to meet its obligations under the debt securities that we hold. We may incur expenses to the extent necessary to seek recovery upon default or to negotiate new terms with a defaulting portfolio company. In addition, if a portfolio company goes bankrupt, even though we may have structured our investment as senior debt or secured debt, depending on the facts and circumstances, including the extent to which we actually provided significant managerial assistance, if any, to that portfolio company, a bankruptcy court might re-characterize our debt holding and subordinate all or a portion of our claim to that of other creditors. These events could harm our financial condition and operating results.

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We do not control our portfolio companies. These portfolio companies may face intense competition, including competition from companies with greater financial resources, more extensive research and development, manufacturing, marketing and service capabilities and greater number of qualified and experienced managerial and technical personnel. They may need additional financing which they are unable to secure and which we are unable or unwilling to provide, or they may be subject to adverse developments unrelated to the technologies they acquire.

The inability of our portfolio companies to commercialize their technologies or create or develop commercially viable products or businesses would have a negative impact on our investment returns.

The possibility that our portfolio companies will not be able to commercialize their technology, products or business concepts presents significant risks to the value of our investment. Additionally, although some of our portfolio companies may already have a commercially successful product or product line when we invest, technology-related and life-science products and services often have a more limited market- or life -span than have products in other industries. Thus, the ultimate success of these companies often depends on their ability to continually innovate, or raise additional capital, in increasingly competitive markets. Their inability to do so could affect our investment return. In addition, the intellectual property held by our portfolio companies often represents a substantial portion of the collateral, if any, securing our investments. We cannot assure you that any of our portfolio companies will successfully acquire or develop any new technologies, or that the intellectual property the companies currently hold will remain viable. Even if our portfolio companies are able to develop commercially viable products, the market for new products and services is highly competitive and rapidly changing. Neither our portfolio companies nor we have any control over the pace of technology development. Commercial success is difficult to predict, and the marketing efforts of our portfolio companies may not be successful.

An investment strategy focused primarily on privately-held companies presents certain challenges, including the lack of available information about these companies, a dependence on the talents and efforts of only a few key portfolio company personnel and a greater vulnerability to economic downturns.

We invest primarily in privately-held companies. Generally, very little public information exists about these companies, and we are required to rely on the ability of our management team to obtain adequate information to evaluate the potential returns from investing in these companies. If we are unable to uncover all material information about these companies, then we may not make a fully informed investment decision, and we may not receive the expected return on our investment or lose some or all of the money invested in these companies. Also, privately-held companies frequently have less diverse product lines and a smaller market presence than do larger competitors. Privately-held companies are, thus, generally more vulnerable to economic downturns and may experience more substantial variations in operating results than do larger competitors. These factors could affect our investment returns.

In addition, our success depends, in large part, upon the abilities of the key management personnel of our portfolio companies, who are responsible for the day-to-day operations of our portfolio companies. Competition for qualified personnel is intense at any stage of a company's development, and high turnover of personnel is common in technology-related companies. The loss of one or more key managers can hinder or delay a company's implementation of its business plan and harm its financial condition. Our portfolio companies may not be able to attract and retain qualified managers and personnel. Any inability to do so may negatively impact our investment returns.

If our portfolio companies are unable to protect their intellectual property rights, then our business and prospects could be harmed. If our portfolio companies are required to devote significant resources to protecting their intellectual property rights, then the value of our investment could be reduced.

Our future success and competitive position depend in part upon the ability of our portfolio companies to obtain and maintain proprietary technology used in their products and services, which will often represent a significant portion of the collateral, if any, securing our investment. The portfolio companies will rely, in part, on

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patent, trade secret and trademark law to protect that technology, but competitors may misappropriate their intellectual property, and disputes as to ownership of intellectual property may arise. Portfolio companies may, from time to time, be required to institute litigation in order to enforce their patents, copyrights or other intellectual property rights, to protect their trade secrets, to determine the validity and scope of the proprietary rights of others or to defend against claims of infringement. Such litigation could result in substantial costs and diversion of resources. Similarly, if a portfolio company is found to infringe upon or misappropriate a third party's patent or other proprietary rights, that portfolio company could be required to pay damages to such third party, alter its own products or processes, obtain a license from the third party and/or cease activities utilizing such proprietary rights, including making or selling products utilizing such proprietary rights. Any of the foregoing events could negatively affect both the portfolio company's ability to service our debt investment and the value of any related debt and equity securities that we own, as well as any collateral securing our investment.

We may not be able to realize our entire investment on equipment-based loans in the case of default.

We may from time-to-time provide loans that will be collateralized only by equipment of the portfolio company. If the portfolio company defaults on the loan we would take possession of the underlying equipment to satisfy the outstanding debt. The residual value of the equipment at the time we would take possession may not be sufficient to satisfy the outstanding debt and we could experience a loss on the disposition of the equipment.

Some of our portfolio companies may need additional capital, which may not be readily available.

Our portfolio companies will often require substantial additional equity financing to satisfy their continuing working capital and other requirements, and in most instances to service the interest and principal payments on our investment. Each round of venture financing is typically intended to provide a company with only enough capital to reach the next stage of development. We cannot predict the circumstances or market conditions under which our portfolio companies will seek additional capital. It is possible that one or more of our portfolio companies will not be able to raise additional financing or may be able to do so only at a price or on terms unfavorable to us, either of which would negatively impact our investment returns. Some of these companies may be unable to obtain sufficient financing from private investors, public capital markets or traditional lenders. Accordingly, financing these types of companies may entail a higher risk of loss than would financing companies that are able to utilize traditional credit sources.

We may be unable or decide not to make additional cash investments in our portfolio companies which could result in our losing our initial investment if the portfolio company fails.

We may have to make additional cash investments in our portfolio companies to protect our overall investment value in the particular company. We retain the discretion to make any additional investments as our management determines. The failure to make such additional investments may jeopardize the continued viability of a portfolio company, and our initial (and subsequent) investments. Moreover, additional investments may limit the number of companies in which we can make initial investments. In determining whether to make an additional investment our management will exercise its business judgment and apply criteria similar to those used when making the initial investment. We cannot assure you that we will have sufficient funds to make any necessary additional investments, which could adversely affect our success and result in the loss of a substantial portion or all of our investment in a portfolio company.

If our investments do not meet our performance expectations, you may not receive distributions.

We intend to make distributions on a quarterly basis to our stockholders. We may not be able to achieve operating results that will allow us to make distributions at a specific level or to increase the amount of these distributions from time to time. In addition, due to the asset coverage test applicable to us as a business development company, we may be limited in our ability to make distributions. See Regulation. Also, restrictions and provisions in any future credit facilities may limit our ability to make distributions. As a RIC, if we do not distribute a certain percentage of our income annually, we will suffer adverse tax consequences, including failure to obtain, or possible loss of, the federal income tax benefits allowable to RICs. See Certain United States Federal Income Tax Considerations Taxation as a Regulated Investment Company. We cannot assure you that you will receive distributions at a particular level or at all.

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Any unrealized depreciation that we experience on our loan portfolio may be an indication of future realized losses, which could reduce our income available for distribution.

As a business development company, we are required to carry our investments at market value or, if no market value is ascertainable, at the fair value as determined in good faith by our Board of Directors in accordance with procedures approved by our Board of Directors. Decreases in the market values or fair values of our investments will be recorded as unrealized depreciation. Any unrealized depreciation in our loan portfolio could be an indication of a portfolio company's inability to meet its repayment obligations to us with respect to the affected loans. This could result in realized losses in the future and ultimately in reductions of our income available for distribution in future periods.

The lack of liquidity in our investments may adversely affect our business and, if we need to sell any of our investments, we may not be able to do so at a favorable price. As a result, we may suffer losses.

We generally invest in debt securities with terms of up to seven years and hold such investments until maturity, and we do not expect that our related holdings of equity securities will provide us with liquidity opportunities in the near-term. We invest and expect to continue investing in companies whose securities have no established trading market and whose securities are and will be subject to legal and other restrictions on resale or whose securities are and will be less liquid than are publicly-traded securities. The illiquidity of these investments may make it difficult for us to sell these investments when desired. 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 had previously recorded these investments. As a result, we do not expect to achieve liquidity in our investments in the near-term. However, to maintain our qualification as a business development company and as a RIC, we may have to dispose of investments if we do not satisfy one or more of the applicable criteria under the respective regulatory frameworks. Our investments are usually subject to contractual or legal restrictions on resale, or are otherwise illiquid, because there is usually no established trading market for such investments. The illiquidity of most of our investments may make it difficult for us to dispose of the investments at a favorable price and, as a result, we may suffer losses.

If the assets securing the loans that we make decrease in value, then we may lack sufficient collateral to cover losses.

We believe that our portfolio companies generally will be able to repay our loans from their available capital, from future capital-raising transactions, or from cash flow from operations. However, to attempt to mitigate credit risks, we will typically take a security interest in the available assets of these portfolio companies, including the equity interests of their subsidiaries and, in some cases, the equity interests of our portfolio companies held by their stockholders. In many cases, our loans will include a period of interest-only payments. There is a risk that the collateral securing our loans may decrease in value over time, may be difficult to sell in a timely manner, may be difficult to appraise and may fluctuate in value based upon the success of the business and market conditions, including as a result of the inability of a portfolio company to raise additional capital. In some circumstances, our lien could be subordinated to claims of other creditors. Additionally, deterioration in a portfolio company's financial condition and prospects, including its inability to raise additional capital, may be accompanied by deterioration in the value of the collateral for the loan. Moreover, in the case of some of our structured mezzanine debt, we may not have a first lien position on the collateral. Consequently, the fact that a loan is secured does not guarantee that we will receive principal and interest payments according to the loan's terms, or that we will be able to collect on the loan should we be forced to enforce our remedies. In addition, because we invest in technology-related companies, a substantial portion of the assets securing our investment may be in the form of intellectual property, if any, inventory and equipment and, to a lesser extent, cash and accounts receivable. Intellectual property, if any, that is securing our loan could lose value if, among other things, the company's rights to the intellectual property are challenged or if the company's license to the intellectual property is revoked or expires. Inventory may not be adequate to secure our loan if our valuation of the inventory at the time that we made the loan was not accurate or if there is a reduction in the demand for the inventory.

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Similarly, any equipment securing our loan may not provide us with the anticipated security if there are changes in technology or advances in new equipment that render the particular equipment obsolete or of limited value, or if the company fails to adequately maintain or repair the equipment. Any one or more of the preceding factors could materially impair our ability to recover principal in a foreclosure.

Our portfolio companies may incur debt that ranks equally with, or senior to, our investments in such companies.

We invest primarily in debt securities issued by our portfolio companies. In some cases, portfolio companies will be permitted to have other debt that ranks equally with, or senior to, the debt securities in which we invest. Such debt instruments may provide that the holders thereof are entitled to receive payment of interest or principal on or before the dates on which we are entitled to receive payments in respect of the debt securities in which we invest. Also, in the event of insolvency, liquidation, dissolution, reorganization or bankruptcy of a portfolio company, holders of debt instruments ranking senior to our investment in that portfolio company would typically be entitled to receive payment in full before we receive any distribution in respect of our investment. After repaying such senior creditors, such portfolio company might not have any remaining assets to use for repaying its obligation to us. In the case of debt ranking equally with debt securities in which we invest, we would have to share on a pari passu basis any distributions with other creditors holding such debt in the event of an insolvency, liquidation, dissolution, reorganization or bankruptcy. In addition, we would not be in a position to control any portfolio company by investing in its debt securities. As a result, we are subject to the risk that a portfolio company in which we invest may make business decisions with which we disagree and the management of such companies, as representatives of the holders of their common equity, may take risks or otherwise act in ways that do not best serve our interests as debt investors.

Our equity investments are highly speculative, and we may not realize gains from these investments. If our equity investments do not generate gains, then the return on our invested capital will be lower than it would otherwise be, which could result in a decline in the value of shares of our common stock.

When we invest in debt securities, we generally expect to acquire warrants or other equity securities as well. Our goal is ultimately to dispose of these equity interests and realize gains upon disposition of such interests. Over time, the gains that we realize on these equity interests may offset, to some extent, losses that we experience on defaults under debt securities that we hold. However, the equity interests that we receive may not appreciate in value and, in fact, may decline in value. Accordingly, we may not be able to realize gains from our equity interests, and any gains that we do realize on the disposition of any equity interests may not be sufficient to offset any other losses that we experience.

We do not control any of our portfolio companies and therefore our portfolio companies may make decisions with which we disagree.

We do not control any of our portfolio companies, even though we may have board observation rights and our debt agreements may contain certain restrictive covenants. As a result, we are subject to the risk that a portfolio company in which we invest may make business decisions with which we disagree and the management of such company, as representatives of the holders of their common equity, may take risks or otherwise act in ways that do not serve our interests as debt investors.

Prepayments of our debt investments by our portfolio companies could adversely impact our results of operations and reduce our return on equity.

We are subject to the risk that the investments we make in our portfolio companies may be repaid prior to maturity. When this occurs, we will generally reinvest these proceeds in temporary investments, pending their future investment in new portfolio companies. These temporary investments will typically have substantially lower yields than the debt being prepaid and we could experience significant delays in reinvesting these amounts.

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Any future investment in a new portfolio company may also be at lower yields than the debt that was repaid. As a result, our results of operations could be materially adversely affected if one or more of our portfolio companies elects to prepay amounts owed to us. Additionally, prepayments could negatively impact our return on equity, which could result in a decline in the market price of our common stock.

We may not realize gains from our equity investments.

When we invest in debt securities, we generally expect to acquire warrants or other equity securities as well. However, the equity interests we receive may not appreciate in value and, in fact, may decline in value. Accordingly, we may not be able to realize gains from our equity interests, and any gains that we do realize on the disposition of any equity interests may not be sufficient to offset any other losses we experience.

Risks Related to Our Common Stock

Our common stock price may be volatile and may decrease substantially.

The trading price of our common stock following an offering may fluctuate substantially. The price of the common stock that will prevail in the market after an offering may be higher or lower than the price you paid and the liquidity of our common stock may be limited, in each case depending on many factors, some of which are beyond our control and may not be directly related to our operating performance. These factors include, but are not limited to, the following:

price and volume fluctuations in the overall stock market from time to time;

3,021 26,769

Total comprehensive income (loss) for the year

23,748	(42,359)	717,400	698,789	1,182	699,971
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Acquisition of non-controlling interest (4)

183	183	(379)	(196)
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Balance at December 31, 2009

2,004,743 (23,295) 1,726,216 (2,324,866) (570,844) 4,484,388 5,296,342 964,897 6,261,239

- (1) Shareholders' equity determined in accordance with accounting principles generally accepted in Luxembourg is disclosed in Note 25 (iii).
- (2) The Company has an authorized share capital of a single class of 3.5 billion shares having a nominal value of USD1.00 per share. As of December 31, 2009, there were 2,004,743,442 shares issued. All issued shares are fully paid.

(3) Represents the difference between book value of non-monetary contributions received from shareholders under Luxembourg GAAP and IFRS.

(4) On February 5, 2009, Ternium Internacional España S.L.U. acquired from its related company Siderca S.A.I.C., 53,452 shares of Siderar S.A.I.C., representing 0.015% of that company's share capital, for an aggregate purchase price of USD 196 thousand. After this acquisition, Ternium increased its ownership in Siderar to 60.94%.

As permitted by IFRS 3, the Company accounted for this acquisition under the economic entity model, which requires that the acquisition of an additional equity interest in a controlled subsidiary be accounted for at its carrying amount, with the difference arising on purchase price allocation being recorded directly in equity.

Dividends may be paid by Ternium to the extent distributable retained earnings calculated in accordance with Luxembourg law and regulations exist. Therefore, retained earnings included in these consolidated financial statements may not be wholly distributable. See Note 25 (iii). The accompanying notes are an integral part of these consolidated financial statements

TERNIUM S.A.

Consolidated financial statements

as of December 31, 2011 and 2010 and

for the years ended December 31, 2011, 2010 and 2009

(All amounts in USD thousands)

CONSOLIDATED STATEMENT OF CASH FLOWS

	Notes	Year ended December 31,		
		2011	2010	2009
Cash flows from operating activities				
Income from continuing operations:		649,908	779,470	339,101
Adjustments for:				
Depreciation and amortization	12 & 13	405,842	383,300	385,105
Income tax accruals less payments	31 (b)	(255,945)	226,820	(49,342)
Equity in earnings of associated companies	14	(1,293)	(1,688)	(1,110)
Interest accruals less payments	31 (b)	43,047	(59)	10,706
Impairment charge	25 (ii)			27,022
Changes in provisions	20	29,932	5,543	4,614
Changes in working capital	31 (b)	(397,806)	(447,973)	635,179
Interest income Sidor financial asset	27 (i)	(11,390)	(61,012)	(135,952)
Net foreign exchange results and others		184,840	(77,576)	(53,565)
Net cash provided by operating activities		647,135	806,825	1,161,758
Cash flows from investing activities				
Capital expenditures	12 & 13	(601,343)	(350,124)	(208,590)
Acquisition of business:				
Purchase consideration	3		(75,000)	(196)
Cash acquired	3		6,593	
Decrease (Increase) in other investments	15 & 19	588,212	(820,672)	43,163
Proceeds from the sale of property, plant and equipment		1,696	1,693	3,245
Proceeds from Sidor financial asset	27	133,084	767,382	953,611
Dividends received from associated companies	14		302	
Contributions in associated companies	14		(302)	
Net cash provided by (used in) investing activities		121,649	(470,128)	791,233
Cash flows from financing activities				
Dividends paid in cash to company's shareholders		(147,231)	(100,237)	
Dividends paid in cash by subsidiary companies		(140,579)	(38,304)	
Contributions from non-controlling shareholders in consolidated subsidiaries		39,200	4,900	
Repurchase of treasury shares	30	(150,000)		
Proceeds from borrowings		666,180	35,441	219,037
Repayments of borrowings		(632,140)	(555,918)	(1,141,625)
Net cash used in financing activities		(364,570)	(654,118)	(922,588)

Increase (Decrease) in cash and cash equivalents	404,214	(317,421)	1,030,403
Movement in cash and cash equivalents			
At January 1,	1,779,416	2,095,798	1,065,552
Effect of exchange rate changes	(25,039)	1,039	(157)
Increase (Decrease) in cash and cash equivalents	404,214	(317,421)	1,030,403
Cash and cash equivalents at December 31, (1)	19	2,158,591	1,779,416
			2,095,798

(1) In addition, the Company had restricted cash for USD 248 and USD 12,343 as of December 31, 2011 and 2010, respectively. As of December 31, 2009, there were no restricted cash. Additionally, the Company had other investments with a maturity of more than three months for USD 281,676 and USD 848,400 at December 31, 2011 and 2010, respectively. The accompanying notes are an integral part of these consolidated financial statements.

TERNIUM S.A.

Notes to the Consolidated Financial Statements

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TERNIUM S.A.

Notes to the Consolidated Financial Statements (Contd.)

1 General information

Ternium S.A. (the Company or Ternium), was incorporated on December 22, 2003 to hold investments in flat and long steel manufacturing and distributing companies. The Company has an authorized share capital of a single class of 3.5 billion shares having a nominal value of USD1.00 per share. As of December 31, 2011, there were 2,004,743,442 shares issued. All issued shares are fully paid.

Following a corporate reorganization carried out during fiscal year 2005, in January 2006 the Company successfully completed its registration process with the United States Securities and Exchange Commission (SEC). Ternium s ADSs began trading on the New York Stock Exchange under the symbol TX on February 1, 2006. The Company s initial public offering was settled on February 6, 2006. On January 31, 2011, the Company filed with the SEC a registration statement on form F-3 relating to sales of equity and debt securities.

The Company was initially established as a public limited liability company (société anonyme) under Luxembourg s 1929 holding company regime. Until termination of such regime on December 31, 2010, holding companies incorporated under the 1929 regime (including the Company) were exempt from Luxembourg corporate and withholding tax over dividends distributed to shareholders.

On January 1, 2011, the Company became an ordinary public limited liability company (société anonyme) and, effective as from that date, the Company is subject to all applicable Luxembourg taxes (including, among others, corporate income tax on its worldwide income) and its dividend distributions will generally be subject to Luxembourg withholding tax. However, dividends received by the Company from subsidiaries in high income tax jurisdictions, as defined under Luxembourg law, will continue to be exempt from corporate income tax in Luxembourg under Luxembourg s participation exemption.

As part of the Company s corporate reorganization in connection with the termination of Luxembourg s 1929 holding company regime, on December 6, 2010, the Company contributed its equity holdings in all its subsidiaries and all its financial assets to its Luxembourg wholly-owned subsidiary Ternium Investments S.à.r.l., or Ternium Investments, in exchange for newly issued corporate units of Ternium Investments. As the assets contributed were recorded at their historical carrying amount in accordance with Luxembourg GAAP, the Company s December 2010 contribution of such assets to Ternium Investments resulted in a non-taxable revaluation of the accounting value of the Company s assets under Luxembourg GAAP. The amount of the December 2010 revaluation was equal to the difference between the historical carrying amounts of the assets contributed and the value at which such assets were contributed and amounted to USD4.0 billion. However, for the purpose of these consolidated financial statements, the assets contributed by Ternium to its wholly-owned subsidiary Ternium Investments were recorded based on their historical carrying amounts in accordance with IFRS, with no impact on the financial statements.

Following the completion of the corporate reorganization, and upon its conversion into an ordinary Luxembourg holding company, the Company voluntarily recorded a special reserve exclusively for tax-basis purposes. As of December 31, 2011 and 2010, this special tax reserve amounted to USD 7.7 billion and USD 7.9 billion, respectively. The Company expects that, as a result of its corporate reorganization, its current overall tax burden will not increase, as all or substantially all of its dividend income will come from high income tax jurisdictions. In addition, the Company expects that dividend distributions for the foreseeable future will be imputed to the special reserve and therefore should be exempt from Luxembourg withholding tax under current Luxembourg law.

2 Basis of presentation

These consolidated financial statements have been prepared in accordance with IFRS (International Financial Reporting Standards) issued and effective or issued and early adopted as at the time of preparing these statements (February 2012), as issued by the International Accounting Standards Board, and adopted by the European Union. These consolidated financial statements are presented in thousands of United States dollars (USD), except otherwise indicated.

Elimination of all material intercompany transactions and balances between the Company and their respective subsidiaries have been made in consolidation.

The consolidated financial statements have been prepared under the historical cost convention, as modified by the revaluation of available-for-sale financial assets, and financial assets and financial liabilities (including derivative instruments) at fair value through profit or loss.

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Certain comparative amounts have been reclassified to conform to changes in presentation in the current period. These reclassifications do not have a material effect on the Company's consolidated financial statements.

These consolidated financial statements have been approved for issue by the Board of Directors on February 22, 2012.

TERNIUM S.A.

Notes to the Consolidated Financial Statements (Contd.)

2 Basis of presentation (continued)

Detailed below are the companies whose financial statements have been included in these consolidated financial statements.

Company	Country of Organization	Main activity	Percentage of ownership at December 31,		
			2011	2010	2009
Ternium S.A.	Luxembourg	Holding	100.00%	100.00%	100.00%
Ternium Investments S.à.r.l. (1)	Luxembourg	Holding	100.00%	100.00%	
Ternium Solutions A.G. (2)	Switzerland	Services	100.00%		
Ternium Brasil S.A. (3)	Brazil	Holding	100.00%	100.00%	100.00%
Siderúrgica do Norte Fluminense S.A. (4)	Brazil	Manufacturing and selling of steel products	100.00%	100.00%	
Ylopa Servicios de Consultoria Lda. (5)	Portugal	Holding		94.38%	94.38%
Consorcio Siderurgia Amazonia S.L.U. (6)	Spain	Holding	94.38%	94.38%	94.38%
Secor Servicios Corporativos S.A. (6)	Venezuela	Holding	94.38%	94.38%	94.38%
Ternium Internacional España S.L.U. (3)	Spain	Marketing of steel products	100.00%	100.00%	100.00%
Siderar S.A.I.C. (7)	Argentina	Manufacturing and selling of flat steel products	60.94%	60.94%	60.94%
Impeco S.A. (8)	Argentina	Manufacturing of pipe products	60.97%	60.97%	60.97%
Prosid Investments S.C.A. (8)	Uruguay	Holding	60.94%	60.94%	60.94%
Inversiones Basilea S.A. (9)	Chile	Purchase and sale of real estate and other	60.94%	60.94%	60.94%
Ternium Mexico S.A. de C.V. (10)	Mexico	Holding	88.72%	88.72%	88.71%
Hylsa S.A. de C.V. (11)	Mexico	Manufacturing and selling of steel products	88.72%	88.72%	88.71%
Las Encinas S.A. de C.V. (11)	Mexico	Exploration, exploitation and pelletizing of iron ore	88.72%	88.72%	88.71%
Ferropak Comercial S.A. de C.V. (11)	Mexico	Scrap services company	88.72%	88.72%	88.71%
Ferropak Servicios S.A. de C.V. (11)	Mexico	Services	88.72%	88.72%	88.71%
Galvacer America Inc (11)	USA	Distributing company	88.72%	88.72%	88.71%
Galvamet America Corp (11)	USA	Manufacturing and selling of insulated panel products	88.72%	88.72%	88.71%
Transamerica E. & I. Trading Corp (11)	USA	Scrap services company	88.72%	88.72%	88.71%
Técnica Industrial S.A. de C.V. (11)	Mexico	Services	88.72%	88.72%	88.71%
Sefimsa S.A. de C.V. (11)	Mexico	Financial Services	88.72%	88.72%	88.71%
Ecore Holding S. de R.L. de C.V. (11)	Mexico	Holding	88.72%	88.72%	88.71%
Neotec L.L.C. (11)	USA	Holding	88.72%	88.72%	88.71%
Treasury Services S.A. de C.V. (11)	Mexico	Financial Services	88.72%	88.72%	88.71%
APM, S.A. de C.V. (11)	Mexico	Manufacturing and selling of steel products	88.72%	88.72%	88.71%
Acedor, S.A. de C.V. (11)	Mexico	Holding	88.72%	88.72%	88.71%

TERNIUM S.A.

Notes to the Consolidated Financial Statements (Contd.)

2 Basis of presentation (continued)

Company	Country of Organization	Main activity	Percentage of ownership at December 31,		
			2011	2010	2009
Empresas Stabilit S.A. de C.V. (12)	Mexico	Holding		88.72%	88.71%
Acerus S.A. de C.V. (11)	Mexico	Manufacturing and selling of steel products	88.72%	88.72%	88.71%
Imsa Monclova S.A. de C.V. (11)	Mexico	Services	88.72%	88.72%	88.71%
Ternium Internacional Guatemala S.A. (13)	Guatemala	Selling of steel products	99.98%	88.72%	88.71%
Corporativo Grupo Imsa S.A. de C.V. (11)	Mexico	Services	88.72%	88.72%	88.71%
Ternium USA Inc. (11)	USA	Manufacturing and selling of steel products	88.72%	88.72%	88.71%
Consortio Minero Benito Juarez Peña Colorada S.A. de C.V. (14)	Mexico	Exploration, exploitation and pelletizing of iron ore	44.36%	44.36%	44.36%
Peña Colorada Servicios S.A. de C.V. (14)	Mexico	Services	44.36%	44.36%	44.36%
Servicios Integrales Nova de Monterrey S.A. de C.V. (15)	Mexico	Medical and Social Services	66.09%	66.09%	66.09%
Ternium Guatemala S.A. (16)	Guatemala	Manufacturing and selling of steel products		88.72%	88.71%
Ternium Internacional Nicaragua S.A.	Nicaragua	Manufacturing and selling of steel products	99.38%	88.18%	88.18%
Ternium Internacional Honduras S.A. de C.V.	Honduras	Manufacturing and selling of steel products	99.18%	88.01%	88.00%
Ternium Internacional El Salvador, S.A. de C.V.	El Salvador	Manufacturing and selling of steel products	99.91%	88.66%	88.65%
Ternium Internacional Costa Rica S.A.	Costa Rica	Manufacturing and selling of steel products	99.98%	88.72%	88.71%
Ferrasa S.A.S. (17)	Colombia	Manufacturing and selling of steel products	54.00%	54.00%	
Perfilamos del Cauca S.A.S. (17)	Colombia	Manufacturing and selling of steel products	54.00%	54.00%	
Figuraciones S.A.S. (17)	Colombia	Manufacturing and selling of steel products	54.00%	54.00%	
Siderúrgica de Caldas S.A.S. (17)	Colombia	Manufacturing and selling of steel products	54.00%	54.00%	

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Procesadora de Materiales Industriales S.A.	Colombia	Scrap services company	32.40%	32.40%	
Recolectora Industrial de Colombia S.A. (18)	Colombia	Scrap services company		28.70%	
Desechos Industriales de Colombia S.A. (18)	Colombia	Scrap services company		29.70%	
Tenigal S. de R.L. de C.V. (19)	Mexico	Manufacturing and selling of steel products	51.00%	51.00%	
Ternium Investments Switzerland AG (3)	Switzerland	Holding	100.00%	100.00%	
Ternium Internacional S.A. (20)	Uruguay	Holding and marketing of steel products	100.00%	100.00%	100.00%
Ternium International Ecuador S.A. (21)	Ecuador	Marketing of steel products	100.00%	100.00%	100.00%

TERNIUM S.A.

Notes to the Consolidated Financial Statements (Contd.)

2 Basis of presentation (continued)

Company	Country of Organization	Main activity	Percentage of ownership at December 31,		
			2011	2010	2009
Ternium International USA Corporation (21)	USA	Marketing of steel products	100.00%	100.00%	100.00%
Ternium Internationaal B.V. (21)	Netherlands	Marketing of steel products	100.00%	100.00%	100.00%
Ternium Internacional Perú S.A. (21)	Peru	Marketing of steel products	100.00%	100.00%	100.00%
Ternium Internacional de Colombia S.A.S. (formerly Ternium Internacional de Colombia S.A.) (21)	Colombia	Marketing of steel products	100.00%	100.00%	100.00%
Ternium Procurement S.A. (20)	Uruguay	Procurement services	100.00%	100.00%	100.00%
Ternium International Inc. (20)	Panama	Marketing of steel products	100.00%	100.00%	100.00%
Ternium Engineering & Services S.A. (22)	Uruguay	Engineering and other services	100.00%	100.00%	100.00%
Ternium Ingeniería y Servicios de Argentina S.A.	Argentina	Engineering and other services	100.00%	100.00%	100.00%
Ternium Ingeniería y Servicios de Mexico S.A. de C.V.	Mexico	Engineering and other services	100.00%	100.00%	100.00%
Ternium Treasury Services S.A. (20)	Uruguay	Financial Services	100.00%	100.00%	100.00%
Ternium Treasury Services B.V. (20)	Netherlands	Financial Services	100.00%	100.00%	100.00%
Ferrasa Panamá, S.A. (23)	Panama	Manufacturing and selling of steel products	54.00%	54.00%	
Aceros Transformados de Panamá, S.A. (23)	Panama	Manufacturing and selling of steel products	54.00%	54.00%	
Ternium Investments S.A. (formerly Dirken Company S.A.) (24)	Uruguay	Holding			100.00%

- (1) Incorporated in the fourth quarter of 2010.
- (2) Indirectly through Ternium Investments S.à.r.l. Total voting rights held: 100.00%. Incorporated in the first quarter of 2011.
- (3) Indirectly through Ternium Investments S.à.r.l. Total voting rights held: 100.00%.
- (4) Indirectly through Ternium Brasil S.A. Total voting rights held: 100.00%. Incorporated during 2010.
- (5) This company was dissolved as of December 27, 2011.
- (6) Since December 27, 2011, indirectly through Ternium Investments S.à.r.l. (85.62%) and Prosid Investments S.C.A. (8.76%). Total voting rights held: 100.00%. Before that, indirectly through Ylopa Servicios de Consultoría Lda.
- (7) Indirectly through Ternium Internacional España S.L.U. Total voting rights held: 60.94%.
- (8) Indirectly through Siderar S.A.I.C and Ternium Internacional S.A. Total voting rights held 100.00%.
- (9) Indirectly through Siderar S.A.I.C. Total voting rights held 100.00%.
- (10) Indirectly through Siderar S.A.I.C., Inversiones Basilea S.A. and Ternium Internacional España S.L.U. Total voting rights held 99.93%.
- (11) Indirectly through Ternium Mexico S.A. de C.V. Total voting rights held: 100.00%.
- (12) Merged with Ternium Mexico S.A. de C.V. during the fourth quarter of 2011.
- (13) Indirectly through Ternium Internacional España S.L.U. Total voting rights held: 100%.
- (14) Indirectly through Ternium Mexico S.A. de C.V. Total voting rights held: 50.00%. Consolidated under the proportionate consolidation method.
- (15) Indirectly through Ternium Mexico S.A. de C.V. Total voting rights held: 74.50%.
- (16) This company was merged with Ternium Internacional Guatemala, S.A. during the first quarter of 2011.
- (17) Indirectly through Ternium Internacional España S.L.U. Total voting rights held: 54.00%. Incorporated during 2010. (See note 3).
- (18) These companies were sold during the second quarter of 2011.
- (19) Indirectly through Ternium Internacional España S.L.U. Total voting rights held: 51.00%. Incorporated during 2010. (See note 29).

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- (20) Indirectly through Ternium Investments Switzerland AG. Total voting rights held: 100.00%.
- (21) Indirectly through Ternium Internacional S.A. Total voting rights held 100.00%.
- (22) Indirectly through Ternium Internacional Inc. Total voting rights held 100.00%.
- (23) Indirectly through Ternium Treasury Services S.A. Total voting rights held: 54.00%. Incorporated during 2010. (See note 3).
- (24) This company was dissolved as of December 6, 2010.

TERNIUM S.A.**Notes to the Consolidated Financial Statements (Contd.)****3 Acquisition of business*****Ferrasa S.A.S and Ferrasa Panamá S.A.***

On August 25, 2010, Ternium completed the acquisition of a 54% ownership interest in Ferrasa S.A.S., a company organized under the laws of Colombia (Ferrasa) through a capital contribution in the amount of USD 74.5 million. Ferrasa has a 100% ownership interest in Sidecaldas S.A.S. (Sidecaldas), Figuraciones S.A.S. (Figuraciones) and Perfilamos del Cauca S.A.S. (Perfilamos), all of which are also Colombian companies. Ternium has also completed the acquisition of a 54% ownership interest in Ferrasa Panamá S.A. (Ferrasa Panamá) and its subsidiary Aceros Transformados de Panamá S.A. (Aceros) for USD 0.5 million. On the mentioned date the Company obtained control over the assets and liabilities of the acquired companies.

Ferrasa is a long and flat steel products processor and distributor. Sidecaldas is a scrap-based long steel making and rolling facility, with an annual production capacity of approximately 140,000 tons. Figuraciones and Perfilamos manufacture welded steel tubes, profiles and beams. These companies have combined annual sales of approximately 300,000 tons, of which approximately 70% are long products and 30% are flat and tubular products, used mainly in the construction sector. Ferrasa Panamá is a long steel products processor and distributor based in Panama, with annual sales of approximately 8,000 tons.

The former controlling shareholders have an option to sell to Ternium, at any time, all or part of their remaining 46% interest in each of Ferrasa and Ferrasa Panamá, and Ternium has an option to purchase all or part of that remaining interest from the former controlling shareholders, at any time after the second anniversary of the closing.

Ferrasa and Ferrasa Panamá contributed revenues of USD 128.0 million and a net loss of USD 1.5 million (net of USD 1.3 million corresponding to non-controlling interests) in the period from August 25, 2010 to December 31, 2010. The fair value and book value of assets and liabilities arising from the transaction are as follows:

	September 30, Fair value
Property, plant and equipment	140,118
Previously recognized goodwill	
Customer relationships	15,403
Trademarks	4,407
Other contractual rights	4,064
Other intangible assets	42
Inventories	76,771
Cash and cash equivalents	6,593
Deferred tax assets	7,832
Borrowings	(134,120)
Other assets and liabilities, net	15,141
Non-controlling interest in subsidiaries	(236)
Net	136,015
Non-controlling interest	(62,572)
Goodwill	1,557

Total Purchase Consideration**75,000**

The Company accounts for the acquired businesses using the purchase method of accounting which requires that the assets acquired and liabilities assumed be recorded at the date of acquisition at their respective fair values.

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The application of the purchase method requires certain estimates and assumptions especially concerning the determination of the fair values of the acquired intangible assets and property, plant and equipment as well as the liabilities assumed at the date of the acquisition. Moreover the useful lives of the acquired intangible assets, property, plant and equipment have to be determined. The judgments made in the context of the purchase price allocation can materially impact the Company's future results of operations. The valuations are based on information available at the acquisition date.

TERNIUM S.A.

Notes to the Consolidated Financial Statements (Contd.)

3 Acquisition of business (continued)

Significant judgments and assumptions made regarding the purchase price allocation in the course of the acquisition of Ferrasa and Ferrasa Panamá, included the following:

For valuation of customer relationship the excess earnings method was used, which is based on calculating the present value of the future cash flows of the future economic benefits during the remaining useful life attributable to the customer base. Customer relationships are being amortized over an estimated useful life of 10 years.

For the valuation of brands, the relief-from-royalty method was applied, both with the value that a third party would have paid for these trademarks. The expected amortization of these assets is determined on the basis of the expected benefit the asset provides the entity (e.g. expected decline in value). For valuation of the other contractual rights, the postulated loss of income method was used. Both intangible assets are being amortized over an estimated useful life of 10 years.

The valuation of acquired intangible assets is to a great extent based on anticipated cash flows. Nevertheless it is possible that actual outcomes could vary significantly from such estimated future cash flows.

For property, plant and equipment, fair values were derived from expert appraisals.

The valuation of inventories at the date of acquisition was based on the corresponding selling price less estimated costs of completion or estimated costs to make the sale.

The excess of the purchase price for Ferrasa and Ferrasa Panamá over the estimated fair values of the net assets acquired is recorded as goodwill amounting to USD 1.6 million as of August 25, 2010. Goodwill derives mainly from the fair value of the going concern element of the acquiree.

The Company has chosen to recognize the non-controlling interest at its proportionate share in net identifiable assets acquired.

Acquisition related costs are included in the income statement.

Pro forma data for the acquisitions

Had the Ferrasa transaction been consummated on January 1, 2010, unaudited pro forma net sales and net loss totaling USD 336 million and USD 4 million, respectively, would have been included in Ternium's financial statements for the year ended December 31, 2010. These pro forma results were prepared based on unaudited accounting records maintained prior to such transaction and adjusted by depreciation and amortization of tangible and intangible assets and interest expense of the borrowing incurred for the transaction as described above.

4 Accounting policies

These Consolidated Financial Statements have been prepared following the same accounting policies used in the preparation of the audited Consolidated Financial Statements for the year ended December 31, 2010.

The following is a summary of the principal accounting policies followed in the preparation of these consolidated financial statements:

(a) Group accounting

(1) Subsidiary companies and transactions with non-controlling interests

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Subsidiaries are all entities over which the Company has the power to govern the financial and operating policies generally accompanying a shareholding of more than one half of the voting rights. Subsidiaries are fully consolidated from the date on which control is transferred to the Company. They are deconsolidated from the date that control ceases.

The Company uses the acquisition method of accounting to account for business combinations. The consideration transferred for the acquisition of a subsidiary is the fair values of the assets transferred, the liabilities incurred and the equity interests issued by the Company. The consideration transferred includes the fair value of any asset or liability resulting from a contingent consideration arrangement. Acquisition-related costs are expensed as incurred. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured initially at the fair values at the acquisition date. Indemnification assets are recognized at the same time that the Company recognizes the indemnified item and measures them on the same basis as the indemnified item, subject to the need for a valuation allowance for uncollectible amounts. The Company measures the value of a reacquired right recognized as an intangible asset on the basis of the remaining contractual term of the related contract regardless of whether market participants would consider potential contractual renewals in determining its fair value.

TERNIUM S.A.

Notes to the Consolidated Financial Statements (Contd.)

4 Accounting policies (continued)

On an acquisition-by-acquisition basis, the Company recognizes any non-controlling interest in the acquiree at the non-controlling interest's proportionate share of the acquiree's net assets.

The excess of the consideration transferred, the amount of any non-controlling interest in the acquiree and the acquisition-date fair value of any previous equity interest in the acquiree over the fair value of the Company's share of the identifiable net assets acquired is recorded as goodwill. If this is less than the fair value of the net assets of the subsidiary acquired in the case of a bargain purchase, the difference is recognized directly in the income statement.

The measurement period is the earlier of the date that the acquirer receives the information that it is looking for or cannot obtain the information and one year after the acquisition date. Where the accounting for a business combination is not complete by the end of the reporting period in which the business combination occurred provisional amounts are reported.

The Company treats transactions with non-controlling interests as transactions with equity owners of the Company. For purchases from non-controlling interests, the difference between any consideration paid and the relevant share acquired of the carrying value of net assets of the subsidiary is recorded in equity. Gains or losses on disposals to non-controlling interests are also recorded in equity.

When the Company ceases to have control or significant influence, any retained interest in the entity is remeasured to its fair value, with the change in carrying amount recognized in profit or loss. The fair value is the initial carrying amount for the purposes of subsequently accounting for the retained interest as an associate, joint venture or financial asset. In addition, any amounts previously recognized in other comprehensive income in respect of that entity are accounted for as if the group had directly disposed of the related assets or liabilities. This may mean that amounts previously recognized in other comprehensive income are reclassified to profit or loss.

Inter-company transactions, balances and unrealized gains on transactions between group companies are eliminated. Unrealized losses are also eliminated. Accounting policies of subsidiaries have been changed where necessary to ensure consistency with the policies adopted by the group. However, the fact that the functional currency of some subsidiaries is their respective local currency, generates some financial gains (losses) arising from intercompany transactions, that are included in the consolidated income statement under Other financial expenses, net.

(2) Joint ventures

The Company reports its interests in jointly controlled entities using proportionate consolidation. The Company's share of the assets, liabilities, income, expenses and cash flows of jointly controlled entities are combined on a line-by-line basis with similar items in the Company's financial statements.

Where the Company transacts with its jointly controlled entities, unrealized profits and losses are eliminated to the extent of the Company's interest in the joint venture.

(3) Associated companies

Associated companies are entities in which Ternium generally has between 20% and 50% of the voting rights, or over which Ternium has significant influence, but which it does not control. Investments in associated companies are accounted for using the equity method of accounting. Under this method the Company's share of the post-acquisition profits or losses of an associated company is recognized in the income statement and its share of post-acquisition changes in reserves is recognized in reserves. The cumulative post-acquisition changes are adjusted against the cost of the investment. Unrealized gains on transactions among the Company and its associated companies are eliminated to the extent of the Company's interest in such associated company; unrealized losses are also eliminated unless the transaction provides evidence of an impairment of the transferred asset. When the Company's share of losses in an associated company equals or exceeds its interest in such associate, the Company does not recognize further losses unless it has incurred obligations or made payments on behalf of such associated company.

If the ownership interest in an associate is reduced but significant influence is retained, only a proportionate share of the amounts previously recognized in other comprehensive income are reclassified to profit or loss where appropriate.

(b) Foreign currency translation

(1) Functional and presentation currency

Items included in the financial statements of each of the Company's subsidiaries and associated companies are measured using the currency of the primary economic environment in which the entity operates (the functional currency). The functional and presentation currency of the Company is the U.S. dollar. Although Ternium is located in Luxembourg, it operates in several countries with different currencies. The USD is the currency that best reflects the economic substance of the underlying events and circumstances relevant to Ternium as a whole.

TERNIUM S.A.

Notes to the Consolidated Financial Statements (Contd.)

4 Accounting policies (continued)

(2) Subsidiary companies

The results and financial position of all the group entities (none of which operates in a hyperinflationary economy) that have a functional currency different from the presentation currency, are translated into the presentation currency as follows:

- (i) assets and liabilities are translated at the closing rate of each statement of financial position;
- (ii) income and expenses for each income statement are translated at average exchange rates; and
- (iii) all resulting translation differences are recognized within other comprehensive income.

In the case of a sale or other disposition of any such subsidiary, any accumulated translation differences would be recognized in the income statement as part of the gain or loss on sale.

(3) Transactions in currencies other than the functional currency

Transactions in currencies other than the functional currency are translated into the functional currency using the exchange rates prevailing at the date of the transactions or valuation where items are re-measured.

At the end of each reporting period: (i) monetary items denominated in currencies other than the functional currency are translated using the closing rates, (ii) non-monetary items that are measured in terms of historical cost in a currency other than the functional currency are translated using the exchange rates prevailing at the date of the transactions; and (iii) non-monetary items that are measured at fair value in a currency other than the functional currency are translated using the exchange rates prevailing at the date when the fair value was determined.

Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at year-end exchange rates of monetary assets and liabilities denominated in currencies other than the functional currency are recorded as gains and losses from foreign exchange and included in Other financial income (expenses), net in the consolidated income statement, except when deferred in equity as qualifying cash flow hedges and qualifying net investment hedges. Translation differences on non-monetary financial assets and liabilities such as equities held at fair value through profit or loss are recognized in profit or loss as part of the fair value gain or loss, while translation differences on non-monetary financial assets such as equities classified as available for sale are included in the available for sale reserve in equity. Ternium had no such assets or liabilities for any of the periods presented.

(c) Financial instruments

Non derivative financial instruments

Non derivative financial instruments comprise investments in equity and debt securities, trade and other receivables, cash and cash equivalents, loans and borrowings, and trade and other payables. Ternium non derivative financial instruments are classified into the following categories:

Financial instruments at fair value through profit or loss: comprises mainly cash and cash equivalents and investments in debt securities held for trading;

Held-to-maturity instruments: measured at amortized cost using the effective interest method less impairment losses. As of December 31, 2011 and 2010, there are no instruments classified under this category;

Loans and receivables: measured at amortized cost using the effective interest method less impairment losses;

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Available-for-sale (AFS) financial assets: gains and losses arising from changes in fair value are recognized within other comprehensive income (OCI) with the exception of impairment losses, interest calculated using the effective interest method and foreign exchange gains and losses on monetary assets, which are recognized directly in profit or loss. Where the investment is disposed of or is determined to be impaired, the cumulative gain or loss previously recognized in OCI is included in the income statement for the period. As of December 31, 2011 and 2010, there are no instruments classified under this category;

Other financial liabilities: measured at amortized cost using the effective interest method.

The classification depends on the nature and purpose of the financial assets and is determined at the time of initial recognition.

Financial assets and liabilities are recognized and derecognized on the settlement date.

Financial assets are initially measured at fair value, net of transaction costs, except for those financial assets classified as financial assets at fair value through profit or loss.

Financial liabilities, including borrowings, are initially measured at fair value, net of transaction costs and subsequently measured at amortized cost using the effective interest method, with interest expense recognized on an effective yield basis.

TERNIUM S.A.**Notes to the Consolidated Financial Statements (Contd.)****4 Accounting policies (continued)***Impairment of financial assets*

The Company assesses at the end of each reporting period whether there is objective evidence that a financial asset or group of financial assets is impaired. A financial asset or a group of financial assets is impaired and impairment losses are incurred only if there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a loss event) and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated. The Company first assesses whether objective evidence of impairment exists.

For loans and receivables category and for held-to-maturity investments, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate. The carrying amount of the asset is reduced and the amount of the loss is recognized in the consolidated income statement.

If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognized, the reversal of the previously recognized impairment loss is recognized in the consolidated income statement.

Derivative financial instruments

Information about accounting for derivative financial instruments and hedging activities is included in Note 33 Financial Risk management.

(d) Property, plant and equipment

Land and buildings comprise mainly factories and offices. All property, plant and equipment are recognized at historical acquisition or construction cost less accumulated depreciation and accumulated impairment (if applicable), except for land, which is carried at acquisition cost less accumulated impairment (if applicable). There are no material residual values for property, plant and equipment items.

Major overhaul and rebuilding expenditures are recognized as a separate asset when future economic benefits are expected from the item, and the cost can be measured reliably.

Ordinary maintenance expenses on manufacturing properties are recorded as cost of products sold in the period in which they are incurred.

Where a tangible fixed asset comprises major components having different useful lives, these components are accounted for as separate items.

Leases where the lessor retains a significant portion of the risks and rewards of ownership are classified as operating leases. Payments made under operating leases (net of any incentives received from the lessor) are charged to the income statement on a straight-line basis over the period of the lease.

Depreciation method is reviewed at each year end. Depreciation is calculated using the straight-line method to amortize the cost of each asset to its residual value over its estimated useful life as follows:

	September 30,
Land	No Depreciation
Buildings and improvements	10-45 years
Production equipment	5-20 years

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Vehicles, furniture and fixtures and other equipment

5-10 years

Property, plant and equipment used in mining activities are depreciated over its useful life or over the remaining life of the mine if shorter and there is no alternative use possible.

The assets' useful lives are reviewed, and adjusted if appropriate, at each year end.

Gains and losses on disposals are determined by comparing the proceeds with the corresponding carrying amounts and are included in the income statement.

If the carrying amount of an asset were greater than its estimated recoverable amount, it would be written down to its recoverable amount. (see Note 4 (f) Impairment).

TERNIUM S.A.

Notes to the Consolidated Financial Statements (Contd.)

4 Accounting policies (continued)

(e) Intangible assets

(1) Information system projects

Generally, costs associated with developing or maintaining computer software programs are recognized as an expense as incurred. However, costs directly related to the acquisition and implementation of information systems are recognized as intangible assets if they have a probable economic benefit exceeding the cost beyond one year and comply with the recognition criteria of IAS 38.

Information system projects recognized as assets are amortized using the straight-line method over their useful lives, not exceeding a period of 3 years. Amortization charges are included in cost of sales, selling, general and administrative expenses.

(2) Mining concessions

Mining license was recognized as a separate intangible asset upon the acquisition of the investment in Mexico and comprises the right to exploit the mines and is recognized at its fair value at acquisition date less accumulated amortization.

These mining concessions were granted for a 50-year period; following the expiration of the initial concession term, the concessions are renewable for an additional 50- year term in accordance with, and subject to the procedures set forth in, applicable Mexican mining law.

Amortization charge is calculated by using the unit-of-production method, on the basis of actual mineral extracted in each period compared to the estimated mineral reserves, and is included in cost of sales. Any change in the estimation of reserves is accounted for prospectively. The resulting amortization rate for the years ended December 31, 2011 and 2010, is approximately 9% per year.

(3) Exploration costs

Exploration and evaluation costs are measured at cost. Costs directly associated with exploration activities and leasehold acquisition costs are capitalized until the determination of reserves is evaluated. If it is determined that commercial discovery has not been achieved, these costs are charged to expense. If it is determined that commercial discovery has been achieved, costs incurred are reclassified into Property, Plant and Equipment or Intangible Assets according to the nature of the expenditure and amortization starts. Exploration costs are tested for impairment annually. No impairment losses have been recorded for any of the years presented.

(4) Goodwill

Goodwill represents the excess of the acquisition cost over the fair value of Ternium's participation in acquired companies' net assets at the acquisition date. Under IFRS 3 (revised), goodwill is considered to have an indefinite life and not amortized, but is subject to annual impairment testing.

Goodwill is allocated to Cash-generating units (CGU) for the purpose of impairment testing. The allocation is made to those cash-generating units expected to benefit from the business combination which generated the goodwill being tested.

As of December 31, 2011, the carrying amount of goodwill allocated to the Mexico CGU was USD 662.3 million, while the carrying amount of goodwill allocated to other CGUs totaled USD 1.5 million.

(5) Research and development

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Research expenditures are recognized as expenses as incurred. Development costs are recorded as cost of sales in the income statement as incurred because they do not fulfill the criteria for capitalization. Research and development expenditures for the years ended December 31, 2011, 2010 and 2009 totaled USD 8.8 million, USD 5.7 million and USD 6.0 million, respectively.

(6) Customer relationships acquired in a business combination

In accordance with IFRS 3 (revised) and IAS 38, Ternium has recognized the value of customer relationships separately from goodwill in connection with the acquisitions of Grupo Imsa and Ferrasa S.A.S.

Customer relationships are amortized using the straight-line method over a useful life of approximately 10 years.

(7) Trademarks acquired in a business combination

In accordance with IFRS 3 and IAS 38, Ternium has recognized the value of trademarks separately from goodwill in connection with the acquisitions of Grupo Imsa and Ferrasa S.A.S.

Trademarks are amortized using the straight-line method over a useful life of between 5 to 10 years.

TERNIUM S.A.

Notes to the Consolidated Financial Statements (Contd.)

4 Accounting policies (continued)

(f) Impairment

Assets that have an indefinite useful life (including goodwill) are not subject to amortization and are tested annually for impairment or whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. Assets that are subject to amortization and investments in affiliates are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment loss is recognized for the amount by which the asset's carrying amount exceeds its recoverable amount. The recoverable amount is the higher of an asset's fair value less cost to sell and the value in use.

To carry out these tests, assets are grouped at the lowest levels for which there are separately identifiable cash flows (each, a CGU). When evaluating long-lived assets for potential impairment, the Company estimates the recoverable amount based on the value in use of the corresponding CGU. The value in use of each CGU is determined on the basis of the present value of net future cash flows which will be generated by the assets tested.

Determining the present value of future cash flows involves highly sensitive estimates and assumptions specific to the nature of each CGU's activities, including estimates and assumptions relating to amount and timing of projected future cash flows, expected changes in market prices, expected changes in the demand of Ternium products and services, selected discount rate and selected tax rate.

Ternium uses cash flow projections for the next five years based on past performance and expectations of market development; thereafter, it uses a perpetuity rate with no growth increase. Application of the discounted cash flow (DCF) method to determine the value in use of a CGU begins with a forecast of all expected future net cash flows. Variables considered in forecasts include the gross domestic product (GDP) growth rates of the country under study and their correlation with steel demand, level of steel prices and estimated raw material costs as observed in industry reports.

Cash flows are discounted at post-tax rates that reflect specific country and currency risks associated with the cash flow projections. The discount rates used are based on Ternium's weighted average cost of capital (WACC), which is considered to be a good indicator of cost of capital. As of December 31, 2011, the discount rate used to test goodwill allocated to Mexico CGU for impairment was 11.4%.

As a result of the above factors, actual cash flows and values could vary significantly from the forecasted future cash flows and related values derived using discounting techniques. Based on the information currently available, however, Ternium believes that it is not reasonably possible that the variation would cause the carrying amount to exceed the recoverable amount of the CGUs.

At December 31, 2009, an impairment provision over the agreement with Corus recognized as intangible assets, was recorded for the amount of USD 27.0 million. See note 25 (ii). At December 31, 2011 and 2010, no impairment provisions were recorded.

(g) Other investments

Other investments consist primarily of investments in financial debt instruments and equity investments where the Company holds less than 20% of the outstanding equity and does not exert significant influence.

All purchases and sales of investments are recognized on the settlement date, which is not significantly different from the trade date, which is the date that Ternium commits to purchase or sell the investment.

Income from financial instruments is recognized in Other financial income (expenses), net in the income statement. The fair value of quoted investments are based on current bid prices. If the market for a financial investment is not active or the securities are not listed, the Company estimates the fair value by using standard valuation techniques. Dividends from investments in equity instruments are recognized in the income statement when the Company's right to receive payments is established.

(h) Inventories

Inventories are stated at the lower of cost (calculated using the first-in-first-out FIFO method) or net realizable value. The cost of finished goods and goods in process comprises raw materials, direct labor, depreciation, other direct costs and related production overhead costs. It excludes borrowing costs. Goods acquired in transit at year end are valued at supplier's invoice cost.

The cost of iron ore produced in our mines comprises all direct costs necessary to extract and convert stockpiled inventories into raw materials, including stripping costs, depreciation of fixed assets related to the mining activity and amortization of mine exploration costs for those under-production mines.

The Company assesses the recoverability of its inventories considering their selling prices, if the inventories are damaged, or if they have become wholly or partially obsolete (see note 4 (x) (4)).

TERNIUM S.A.

Notes to the Consolidated Financial Statements (Contd.)

4 Accounting policies (continued)

(i) Trade receivables and other receivables

Trade and other receivables are carried at face value less an allowance for doubtful accounts, if applicable. This amount does not differ significantly from fair value.

A provision for impairment is established when there is objective evidence that a financial asset or group of assets is impaired. Objective evidence that a financial asset or group of assets is impaired includes observable data that comes to the attention of the Company about a loss event, such as a significant financial difficulty of the obligor or a breach of contract. The amount of the impairment is determined as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the asset's original effective interest rate. The amount of the loss is recognized in the income statement.

(j) Cash and cash equivalents

Cash and cash equivalents and highly liquid short-term securities are carried at fair market value or at a historical cost which approximates fair market value.

For purposes of the cash flow statement, cash and cash equivalents comprise cash, bank current accounts and short-term highly liquid investments (original maturity of three months or less at date of acquisition) and overdrafts.

In the consolidated statement of financial position, bank overdrafts are included in borrowings within current liabilities.

(k) Non current assets (disposal groups) classified as held for sale

Non-current assets (disposal groups) are classified as assets held for sale, complying with the recognition criteria of IFRS 5, and stated at the lower of carrying amount and fair value less cost to sell if their carrying amount is recovered principally through a sale transaction rather than through continuing use.

The carrying value of non-current assets classified as held for sale, at December 31, 2011 and 2010 totals USD 10.4 million and USD 10.0 million, respectively, which corresponds principally to land and other real estate items. Sale is expected to be completed within a one-year period.

(l) Borrowings

Borrowings are recognized initially for an amount equal to the proceeds received. In subsequent periods, borrowings are stated at amortized cost; any difference between proceeds and the redemption value is recognized in the income statement over the period of the borrowings.

Capitalized costs for issue of debt are amortized over the life of their respective debt.

(m) Income taxes – current and deferred

The current income tax charge is calculated on the basis of the tax laws in force in the countries in which Ternium and its subsidiaries operate. Management evaluates positions taken in tax returns with respect to situations in which applicable tax regulation could be subject to interpretation. A liability is recorded for tax benefits that were taken in the applicable tax return but have not been recognized for financial reporting.

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Deferred income taxes are calculated using the liability method on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the financial statements. Deferred income tax is not accounted for if it arises from initial recognition of an asset or liability in a transaction other than a business combination that at the time of the transaction affects neither accounting nor taxable profit or loss. The principal temporary differences arise on fixed assets, intangible assets, inventories valuation and provisions for pensions. Deferred tax assets and liabilities are measured at the tax rates that are expected to apply in the period when the asset is realized or the liability is settled, based on tax rates and tax laws that have been enacted or substantially enacted at year end. Under IFRS, deferred income tax assets (liabilities) are classified as non-current assets (liabilities).

Deferred tax assets are recognized to the extent it is probable that future taxable income will be available to offset temporary differences.

Deferred income tax is provided on temporary differences arising on investments in subsidiaries and associated companies, except where the timing of the reversal of the temporary difference is controlled by the Company and it is probable that the temporary difference will not reverse in the foreseeable future.

Under Mexican law, Ternium's subsidiaries are required to pay their employees an annual benefit which is determined as a percentage of taxable profit for the year.

TERNIUM S.A.

Notes to the Consolidated Financial Statements (Contd.)

4 Accounting policies (continued)

(n) Employee liabilities

(1) Pension obligations

The Company has defined benefit and defined contribution plans. A defined benefit plan is a pension plan that defines an amount of pension benefit that an employee will receive on retirement, usually dependent on one or more factors such as age, years of service and compensation.

The liability recognized in the statement of financial position in respect of defined benefit pension plans is the present value of the defined benefit obligation at year end, together with adjustments for unrecognized actuarial gains or losses and past service costs. The defined benefit obligation is calculated annually (at year end) by independent actuaries using the projected unit credit method.

Actuarial gains and losses arising from experience adjustments and changes in actuarial assumptions are charged or credited to income over the employees' expected average remaining working lives.

Past-service costs are recognized immediately in income, unless the changes to the pension plan are conditional on the employees remaining in service for a specified period of time (the vesting period). In this case, the past-service costs are amortized on a straight-line basis over the vesting period.

Mexico

Ternium Mexico has defined benefit and defined contribution plans.

The valuation of the liabilities for the defined benefit employee retirement plans (pensions and seniority premiums) covers all employees and is based primarily on their years of service, their present age and their remuneration at the date of retirement. The cost of the employee retirement plans (pension, health-care expenses and seniority premiums) is recognized as an expense in the year in which services are rendered in accordance with actuarial studies made by independent actuaries. The formal retirement plans are congruent with and complementary to the retirement benefits established by the Mexican Institute of Social Security. Additionally, the Company has established a plan to cover health-care expenses of retired employees. The Company has established irrevocable trust funds for the payment of pensions and seniority premiums, as well as for health-care expenses.

The defined contribution plans provide a benefit equivalent to the capital accumulated with the company's contributions, which are provided as a match of employees' contributions to the plan. The plan provides vested rights according to the years of service and the cause of retirement.

Argentina

Siderar implemented an unfunded defined benefit employee retirement plan for certain senior officers. The plan is designed to provide certain benefits to those officers (additional to those contemplated under applicable Argentine labor laws) in case of terminations of the employment relationship due to certain specified events, including retirement. Benefits provided by the plan are denominated in U.S. Dollars and are calculated based on a seven-year salary average.

(2) Termination benefits

Termination benefits are payable when employment is terminated before the normal retirement date, or whenever an employee accepts voluntary redundancy in exchange for these benefits. The Company recognizes termination benefits when it is demonstrably committed to either: (i) terminating the employment of current employees according to a detailed formal plan without possibility of withdrawal or (ii) providing termination benefits as a result of an offer made to encourage voluntary redundancy.

(3) Other compensation obligations

Employee entitlements to annual leave and long-service leave are accrued as earned.

During 2007, Ternium launched an incentive retention program (the Program) applicable to certain senior officers and employees of the Company, who will be granted a number of Units throughout the duration of the Program. The value of each of these Units is based on Ternium's shareholders' equity (excluding non-controlling interest). Also, the beneficiaries of the Program are entitled to receive cash amounts based on (i) the amount of dividend payments made by Ternium to its shareholders, and (ii) the number of Units held by each beneficiary to the Program. Units vest ratably over a period of four years and will be redeemed by the Company ten years after grant date, with the option of an early redemption at seven years after grant date. As the cash payment of the benefit is tied to the book value of the shares, and not to their market value, Ternium valued this long-term incentive program as a long term benefit plan as classified in IAS 19.

TERNIUM S.A.

Notes to the Consolidated Financial Statements (Contd.)

4 Accounting policies (continued)

As of December 31, 2011 and 2010, the outstanding liability corresponding to the Program amounts to USD 12.5 million and USD 10.8 million, respectively. The total value of the units granted to date under the program, considering the number of units and the book value per share as of December 31, 2011 and 2010, is USD 15.1 million and USD 12.6 million, respectively.

(4) Social security contributions

Social security laws in force in the countries in which the Company operates provide for pension benefits to be paid to retired employees from government pension plans and/or private fund managed plans to which employees may elect to contribute. As stipulated by the respective laws, Siderar and Ternium Mexico make monthly contributions calculated based on each employee's salary to fund such plans. The related amounts are expensed as incurred. No additional liabilities exist once the contributions are paid.

(o) Provisions and other liabilities

Ternium has certain contingencies with respect to existing or potential claims, lawsuits and other proceedings. Unless otherwise specified, Ternium accrues a provision for a present legal or constructive obligation as a result of a past event, when it is probable that future cost could be incurred and that cost can be reasonably estimated. Generally, accruals are based on developments to date, Ternium's estimates of the outcomes of these matters and the advice of Ternium's legal advisors.

(p) Trade payables

Trade payables are recognized initially at fair value and subsequently measured at amortized cost using the effective interest method.

(q) Revenue recognition

Revenues are recognized as sales when revenue is earned and is realized or realizable. This includes satisfying all of the following criteria: the arrangement with the customer is evident, usually through the receipt of a purchase order; the sales price is fixed or determinable; delivery as defined by the risk transfer provision of the sales contracts has occurred, and collectibility is reasonably assured.

Interest income is recognized on an effective yield basis.

(r) Borrowing Costs

Beginning on January 1, 2009, and as required by IAS 23 revised, Ternium capitalizes the borrowing costs incurred to finance construction, acquisition or production of qualifying assets. In the case of specific borrowings, Ternium determines the amount of borrowing costs eligible for capitalization as the actual borrowing costs incurred on that borrowing during the period less any investment income on the temporary investment of those borrowings. For general borrowings, Ternium determines the amount of borrowing costs eligible for capitalization by applying a capitalization rate to the expenditures on that asset. The capitalization rate is the weighted average of the borrowing costs applicable to the borrowings that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset. The amount of borrowing costs that Ternium capitalizes during a period will not exceed the amount of borrowing costs incurred during that period. At December 31, 2011, the capitalized borrowing costs are not material.

(s) Cost of sales, selling, general and administrative expenses

Cost of sales and expenses are recognized in the income statement on the accrual basis of accounting.

Commissions, freight and other selling expenses, including shipping and handling costs, are recorded in Selling, general and administrative expenses in the Consolidated Income Statement.

(t) Removal of waste materials to access mineral deposits

Stripping costs (the costs associated with the removal of overburden and other waste materials) that are incurred during the development of a mine (pre-production stripping costs) are expensed when incurred, while post-production stripping costs are included in the cost of the inventory produced (that is extracted) at each mine individually during the period they are incurred.

(u) Earnings per share

Earnings per share are calculated by dividing the net income attributable to shareholders by the daily weighted average number of ordinary shares issued during the year (see Note 26).

TERNIUM S.A.

Notes to the Consolidated Financial Statements (Contd.)

4 Accounting policies (continued)

(v) Derivative financial instruments and hedging activities

Ternium designates certain derivatives as hedges of a particular risk associated with a recognized asset or liability or a highly probable forecast transaction. These transactions are classified as cash flow hedges (mainly interest rate swaps, collars, currency forward contracts on highly probable forecast transactions and commodities contracts). The effective portion of the fair value of derivatives that are designated and qualify as cash flow hedges is recognized in OCI. Amounts accumulated in OCI are recognized in the income statement in the same period as any offsetting losses and gains on the hedged item. The gain or loss relating to the ineffective portion is recognized immediately in the income statement. The fair value of Ternium derivative financial instruments (asset or liability) continues to be reflected in the statement of financial position.

For transactions designated and qualifying for hedge accounting, Ternium documents the relationship between hedging instruments and hedged items, as well as its risk management objectives and strategy for undertaking various hedge transactions. At December 31, 2011, the effective portion of designated cash flow hedges amounts to USD 14.9 million (net of taxes for USD 2.9 million) and is included under changes in the fair value of derivatives classified as cash flow hedges line item in the statement of comprehensive income (see Note 32 (a)).

More information about accounting for derivative financial instruments and hedging activities is included in Note 34 Financial risk management .

(w) Segment information

Reportable operating segments: for management purposes, the Company is organized on a worldwide basis into the following segments: flat steel products, long steel products and others. The Company is not aggregating any operating segments in order to arrive at its reportable segments.

The flat steel products segment comprises the manufacturing and marketing of hot rolled coils and sheets, cold rolled coils and sheets, tin plate, welded pipes, hot dipped galvanized and electro-galvanized sheets, pre-painted sheets and other tailor-made products to serve its customers requirements.

The long steel products segment comprises the manufacturing and marketing of billets (steel in its basic, semi-finished state), wire rod and bars.

The other products segment includes products other than flat and long steel, mainly pig iron, pellets and pre-engineered metal buildings.

(x) Critical Accounting Estimates

The preparation of financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and the related disclosure of contingent assets and liabilities. Estimates and judgments are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. Management makes estimates and assumptions concerning the future. Actual results may differ significantly from these estimates under different assumptions or conditions.

The principal estimates and assumptions that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year are addressed below.

(1) Goodwill impairment test

Assessment of the recoverability of the carrying value of goodwill requires significant judgment. Management evaluates goodwill allocated to the operating units for impairment on an annual basis or whenever there is an impairment indicator.

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Goodwill is tested at the level of the CGU. Impairment testing of the CGU is carried out and the value in use determined in accordance with the accounting policy stated in Note 4(f). The discount rates used for these tests are based on Ternium's weighted average cost of capital adjusted for specific country and currency risks associated with the cash flow projections. The discount rate used at December 31, 2011 was 11.4% and no impairment charge resulted from the impairment test performed.

(2) Income taxes

Management calculates current and deferred income taxes according to the tax laws applicable to each subsidiary in the countries in which such subsidiaries operate. However, certain adjustments necessary to determine the income tax provision are finalized only after the balance sheet is issued. In cases in which the final tax outcome is different from the amounts that were initially recorded, such differences will impact the income tax and deferred tax provisions in the period in which such determination is made.

TERNIUM S.A.

Notes to the Consolidated Financial Statements (Contd.)

4 Accounting policies (continued)

Also, when assessing the recoverability of tax assets, management considers the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies.

(3) Loss contingencies

Ternium is subject to various claims, lawsuits and other legal proceedings that arise in the ordinary course of business, including customer claims in which a third party is seeking reimbursement or indemnity. The Company's liability with respect to such claims, lawsuits and other legal proceedings cannot be estimated with certainty. Periodically, management reviews the status of each significant matter and assesses potential financial exposure. If the potential loss from the claim or proceeding is considered probable and the amount can be reasonably estimated, a liability is recorded. Management estimates the amount of such liability based on the information available and the assumptions and methods it has concluded are appropriate, in accordance with the provisions of IFRS. Accruals for such contingencies reflect a reasonable estimate of the losses to be incurred based on information available, including the relevant litigation or settlement strategy, as of the date of preparation of these financial statements. As additional information becomes available, management will reassess its evaluation of the pending claims, lawsuits and other proceedings and revise its estimates. The loss contingencies provision amounts to USD 15.3 million and USD 16.1 million as of December 31, 2011 and 2010, respectively.

(4) Allowance for obsolescence of supplies and spare parts and slow-moving inventory

Management assesses the recoverability of its inventories considering their selling prices or whether they are damaged or have become wholly or partly obsolete.

Net realizable value is the estimated selling price in the ordinary course of business, less the costs of completion and selling expenses.

The Company establishes an allowance for obsolete or slow-moving inventory in connection with finished goods and goods in process. The allowance for slow-moving inventory is recognized for finished goods and goods in process based on management's analysis of their aging. In connection with supplies and spare parts, the calculation is based on management's analysis of their aging, the capacity of such materials to be used based on their levels of preservation and maintenance, and their potential obsolescence due to technological change.

As of December 31, 2011 and 2010, the Company recorded no allowance for net realizable value and USD 60.5 million and USD 68.2 million, respectively, as allowance for obsolescence.

During 2011 and 2010, no charges were recorded in connection with net realizable value allowance. Charges to mark the inventory to net realizable value in 2009 were USD 127.6 million. Of this amount, USD 82.8 million in 2009 corresponded to inventories for shipments to the North America region, while USD 44.8 million in 2009 corresponded to inventories for exports within the South and Central America region.

The additions to the allowance for net realizable value recorded during 2009 responded to the steep fall of steel prices as a result of the global financial crisis that began in 2008. Beginning in the second half of 2008 up to the first half of 2009 average prices of flat steel products decreased 41%. Accordingly, inventory values were compared to their estimated net selling prices and written down when the selling prices were lower than historical costs. This was the case of inventories produced from third-party slabs in Mexico and certain raw materials in Argentina that had been acquired at market prices in force prior to the beginning of the global financial crisis.

(5) Valuation of the Sidor financial asset

The Sidor financial asset recorded as a result of the nationalization of Sidor was treated as a receivable and valued at its amortized cost using the applicable effective interest rate. The discount rate used to measure this receivable at amortized cost was estimated on the basis of management's best estimate of market rates adjusted to reflect specific risks.

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The initial measurement of the receivable and its subsequent measurements until November 8, 2010, were performed on the basis of its discounted amount using an annual discount rate of 14.36%. This discount rate was estimated on the basis of the yield (13.3%) of Venezuelan sovereign debt with maturities similar to that of the receivable held by Ternium against CVG; however, as the Venezuelan sovereign debt with similar maturities was governed by New York law, while the receivable with CVG was governed by Venezuelan law, the discount rate was further adjusted to adequately reflect the specific risk of Ternium's receivable. After the rescheduling of the last unpaid installment agreed on December 18, 2010, the annual discount rate used to measure the receivable was estimated at 6.28%, on the basis of the specific risks associated to the third-party promissory notes received as guarantee for full payment of CVG obligations.

For further information on the Sidor nationalization and the rescheduling of the related receivable, refer to Note 27.

TERNIUM S.A.**Notes to the Consolidated Financial Statements (Contd.)****4 Accounting policies (continued)***(6) Useful Lives and Impairment of Property, Plant and Equipment and Other Long-lived Assets*

In determining useful lives, management considered, among others, the following factors: age, operating condition and level of usage and maintenance. Management conducted visual inspections for the purpose of (i) determining whether the current conditions of such assets are consistent with normal conditions of assets of similar age; (ii) confirming that the operating conditions and levels of usage of such assets are adequate and consistent with their design; (iii) establishing obsolescence levels and (iv) estimating life expectancy, all of which were used in determining useful lives. Management believes, however, that it is possible that the periods of economic utilization of property, plant and equipment may be different than the useful lives so determined. Furthermore, management believes that this accounting policy involves a critical accounting estimate because it is subject to change from period to period as a result of variations in economic conditions and business performance.

When assessing whether an impairment indicator may exist, the Company evaluates both internal and external sources of information, such as the following:

- whether significant changes with an adverse effect on the entity have taken place during the period, or will take place in the near future, in the technological, market, economic or legal environment in which the entity operates or in the market to which an asset is dedicated;
- whether market interest rates or other market rates of return on investments have increased during the period, and those increases are likely to affect the discount rate used in calculating an asset's value in use and decrease the asset's recoverable amount materially;
- whether the carrying amount of the net assets of the entity is more than its market capitalization;
- whether evidence is available of obsolescence or physical damage of an asset.
- whether significant changes with an adverse effect on the entity have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, an asset is used or is expected to be used. These changes include the asset becoming idle, plans to discontinue or restructure the operation to which an asset belongs, plans to dispose of an asset before the previously expected date, and reassessing the useful life of an asset as finite rather than indefinite; and
- whether evidence is available from internal reporting that indicates that the economic performance of an asset is, or will be, worse than expected.

None of the Company's CGUs were tested for impairment, other than for goodwill test (see note 4 (x) (1)), in 2011 and 2010, as no impairment indicators were identified. Furthermore, based on information currently available, management believes that the recognition of a future impairment charge is not reasonably possible.

(7) Allowances for doubtful accounts

Management makes estimates of the uncollectibility of our accounts receivable. Management analyses the trade accounts receivable on a regular basis and, when aware of a third party's inability to meet its financial commitments to the Company, management impairs the amount due by means of a charge to the allowance for doubtful accounts. Management specifically analyses accounts receivable and historical bad debts, customer creditworthiness, current economic trends and changes in customer payment terms when evaluating the adequacy of the allowance for doubtful accounts.

Allowances for doubtful accounts are adjusted periodically in accordance with the aging of overdue accounts. For this purpose, trade accounts receivable overdue by more than 90 days, and which are not covered by a credit collateral, guarantee or similar surety, are fully provisioned. As of December 31, 2011 and 2010, allowance for doubtful accounts totals USD 16.1 million and USD 17.2 million, respectively.

TERNIUM S.A.

Notes to the Consolidated Financial Statements (Contd.)

5 Segment information

Reportable operating segments

	September 30,	September 30,	September 30,	September 30,	September 30,
	Flat steel products	Long steel products	Other	Unallocated	Total
	Year ended December 31, 2011				
Net sales	7,792,045	1,217,877	147,276		9,157,198
Cost of sales	(6,138,685)	(864,522)	(91,045)		(7,094,252)
Gross profit	1,653,360	353,355	56,231		2,062,946
Selling, general and administrative expenses	(673,363)	(96,832)	(15,966)		(786,161)
Other operating income (expenses), net	(14,912)	3,247	99		(11,566)
Operating income	965,085	259,770	40,364		1,265,219
Capital expenditures PP&E	470,641	70,181	12,528		553,350
Depreciation PP&E	300,795	31,468	6,284		338,547
Segment assets					
Inventories, net	1,870,523	239,060	27,441		2,137,024
Trade receivables, net	588,371	143,255	10,902		742,528
Property, plant and equipment, net	3,591,733	389,820	51,122		4,032,675
Intangible assets, net	868,978	72,629	44,465		986,072
Assets discontinued operations				136,294	136,294
Other assets				2,711,981	2,711,981
	Year ended December 31, 2010				
	September 30,	September 30,	September 30,	September 30,	September 30,
	Flat steel products	Long steel products	Other	Unallocated	Total
Net sales	6,376,380	833,137	172,487		7,382,004
Cost of sales	(4,932,551)	(633,958)	(98,745)		(5,665,254)
Gross profit	1,443,829	199,179	73,742		1,716,750
Selling, general and administrative expenses	(585,746)	(62,419)	(17,141)		(665,306)
Other operating income (expenses), net	2,887	(506)	112		2,493
Operating income	860,970	136,254	56,713		1,053,937
Capital expenditures PP&E	272,623	38,123	6,172		316,918

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Depreciation PP&E	285,755	20,851	6,214	312,820
Segment assets				
Inventories, net	1,804,896	117,721	30,773	1,953,390
Trade receivables, net	514,521	121,872	27,109	663,502
Property, plant and equipment, net	3,831,181	378,212	53,503	4,262,896
Intangible assets, net	1,004,680	75,504	49,164	1,129,348
Assets discontinued operations			257,988	257,988
Other assets			2,845,207	2,845,207

TERNIUM S.A.

Notes to the Consolidated Financial Statements (Contd.)

5 Segment information (continued)

	September 30, Flat steel products	September 30, Long steel products	September 30, Other	September 30, Unallocated	September 30, Total
	Year ended December 31, 2009				
Net sales	4,249,979	572,900	136,104		4,958,983
Cost of sales	(3,634,854)	(392,983)	(82,533)		(4,110,370)
Gross profit	615,125	179,917	53,571		848,613
Selling, general and administrative expenses	(477,067)	(40,739)	(13,724)		(531,530)
Other operating income (expenses), net	(21,303)	414	189		(20,700)
Operating income	116,755	139,592	40,036		296,383
Capital expenditures PP&E	178,425	10,270	1,983		190,678
Depreciation PP&E	287,177	19,017	6,786		312,980
Segment assets					
Inventories, net	1,219,347	102,423	28,798		1,350,568
Trade receivables, net	349,230	60,825	27,780		437,835
Property, plant and equipment, net	3,724,825	263,461	52,129		4,040,415
Intangible assets, net	977,552	60,795	47,065		1,085,412
Assets discontinued operations				964,359	964,359
Other assets				2,414,084	2,414,084

Geographical information

There are no revenues from external customers attributable to the Company's country of incorporation (Luxembourg). Ternium sells its products to three main geographical areas: South and Central America, North America, and Europe and others. The North American area comprises principally United States and Mexico. The South and Central American area comprises principally Argentina, Colombia, Paraguay, Guatemala, Costa Rica, Uruguay, Dominican Republic and Honduras.

	September 30, South and Central America	September 30, North America	September 30, Europe and other	September 30, Total
	Year ended December 31, 2011			
Net sales	4,015,858	5,085,227	56,113	9,157,198
Segment assets				
Trade receivables, net	237,910	496,506	8,112	742,528
Property, plant and equipment, net	1,392,065	2,639,229	1,381	4,032,675
Intangible assets, net	50,438	935,634		986,072
Capital expenditures PP&E	201,849	350,524	977	553,350

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Depreciation PP&E	141,352	197,067	128	338,547
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	September 30, South and Central America	September 30, Year ended December 31, 2010 North America	September 30, Year ended December 31, 2010 Europe and other	September 30, Year ended December 31, 2010 Total
Net sales	3,057,676	4,208,617	115,711	7,382,004
Segment assets				
Trade receivables, net	192,723	456,433	14,346	633,502
Property, plant and equipment , net	1,437,417	2,825,370	109	4,262,896
Intangible assets, net	54,443	1,074,905		1,129,348
Capital expenditures PP&E	182,845	134,027	46	316,918
Depreciation PP&E	118,774	194,029	17	312,820

TERNIUM S.A.

Notes to the Consolidated Financial Statements (Contd.)

5 Segment information (continued)

	September 30, South and Central America	September 30, Year ended December 31, 2009 North America	September 30, Year ended December 31, 2009 Europe and other	September 30, Year ended December 31, 2009 Total
Net sales	1,782,446	2,976,938	199,599	4,958,983
Segment assets				
Trade receivables, net	116,231	318,466	3,138	437,835
Property, plant and equipment, net	1,297,289	2,743,045	81	4,040,415
Intangible assets, net	36,188	1,049,224		1,085,412
Capital expenditures PP&E	117,583	73,044	51	190,678
Depreciation PP&E	111,895	201,071	14	312,980

Revenues by product

	September 30, 2011	September 30, Year ended December 31, 2010	September 30, Year ended December 31, 2009
Semi-finished (1)		29	11,389
Hot rolled		2,749,607	1,214,349
Cold rolled		1,458,875	837,798
Coated (2)		2,926,291	1,846,967
Roll-formed and tubular (3)		657,272	339,476
Flat steel products		7,792,045	6,376,380
			4,249,979
Semi-finished (4)		91,955	30,835
Hot rolled (5)		1,125,922	542,065
Long steel products		1,217,877	833,137
			572,900
TOTAL STEEL PRODUCTS		9,009,922	7,209,517
			4,822,879
Other products		147,276	172,487
			136,104
TOTAL SALES		9,157,198	7,382,004
			4,958,983

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- (1) Semi-finished includes slabs.
- (2) Coated includes hot-dipped galvanized, electrogalvanized, pre-painted, tin plate and tin-free steel.
- (3) Roll-formed and tubular includes steel pipes, tubular products, beams, insulated panels, roofing and cladding, roof tiles and steel decks.
- (4) Semi-finished includes billets and round bars.
- (5) Hot rolled includes wire rod, bars and stirrups.

TERNIUM S.A.

Notes to the Consolidated Financial Statements (Contd.)

6 Cost of sales

	September 30, 2011	September 30, Year ended December 31, 2010	September 30, 2009
Inventories at the beginning of the year	1,953,390	1,350,568	1,826,547
Acquisition of business (Note 3)		76,771	
Translation differences	(229,685)	28,621	(46,857)
Plus: Charges for the year			
Raw materials and consumables used and other movements	5,933,893	4,763,000	2,473,327
Services and fees	246,364	197,873	126,325
Labor cost	577,101	496,961	378,558
Depreciation of property, plant and equipment	323,210	295,504	308,156
Amortization of intangible assets	16,557	19,453	14,462
Maintenance expenses	348,721	342,529	221,175
Office expenses	6,678	6,662	4,997
Freight and transportation	56,035	36,892	32,846
Insurance	7,032	7,530	9,256
Charge (Recovery) of obsolescence allowance	6,121	11,710	(7,556)
Valuation allowance			127,553
Recovery from sales of scrap and by-products	(40,532)	(40,654)	(27,326)
Others	26,391	25,224	19,475
Less: Inventories at the end of the year	(2,137,024)	(1,953,390)	(1,350,568)
Cost of Sales	7,094,252	5,665,254	4,110,370

7 Selling, general and administrative expenses

	September 30, 2011	September 30, Year ended December 31, 2010	September 30, 2009
Services and fees (1)	71,091	60,874	46,923
Labor cost	180,650	153,807	150,914
Depreciation of property plant and equipment	15,337	17,316	4,824
Amortization of intangible assets	50,738	51,027	57,663
Maintenance expenses	17,730	11,113	6,858
Taxes	120,264	89,412	65,889
Office expenses	32,973	29,567	26,134
Freight and transportation	269,630	232,184	156,520
Increase (Decrease) of allowance for doubtful accounts	322	(393)	(1,635)
Others	27,426	20,399	17,440
Selling, general and administrative expenses	786,161	665,306	531,530

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(1) Includes fees accrued for professional services rendered by PwC to Ternium S.A. and its subsidiaries during the year ended December 31, 2011 that amounted to USD 3,776, including USD 3,281 for audit services, USD 447 for audit-related services, USD 24 for tax services and USD 24 for all other services.

8 Labor costs (included in cost of sales, selling, general and administrative expenses)

	September 30, 2011	September 30, Year ended December 31, 2010	September 30, 2009
Wages, salaries and social security costs	687,877	594,909	450,828
Termination benefits	38,786	27,872	55,358
Pension benefits (Note 22 (i))	31,088	27,987	23,286
Labor costs	757,751	650,768	529,472

TERNIUM S.A.

Notes to the Consolidated Financial Statements (Contd.)

9 Other operating (expenses) income, net

	September 30, 2011	September 30, Year ended December 31, 2010	September 30, 2009
Results from the sale of sundry assets	(4,169)	(4,681)	(2,121)
Provision for legal claims and other matters (Note 20 and 25 (ii))	(29,932)	(5,543)	(4,614)
Fees related to the repurchase of shares from Usiminas (Note 30)	10,200		
Impairment charge (Note 25 (ii))			(27,022)
Others	12,335	12,717	13,057
Other operating (expenses) income, net	(11,566)	2,493	(20,700)

10 Other financial (expenses) income, net

	September 30, 2011	September 30, Year ended December 31, 2010	September 30, 2009
Net foreign exchange (loss) gain	(236,362)	123,690	83,057
Change in fair value of financial instruments	7,968	1,545	10,607
Debt issue costs	(5,078)	(4,562)	(5,149)
Others	(6,525)	(5,561)	(6,876)
Other financial (expenses) income, net	(239,997)	115,112	81,639

11 Income tax expense**Income tax**

Income tax expense for each of the years presented is as follows:

	September 30, 2011	September 30, Year ended December 31, 2010	September 30, 2009
Current tax	(368,378)	(410,041)	(124,647)
Deferred tax (Note 21)	41,285	(1,035)	(24,812)
Deferred tax effect of changes in tax rates			(11,216)
Effect of change in fair value of cash flow hedge	6,701	4,419	9,112
Recovery of income tax (1)	4,417		60,249
Income tax expense	(315,974)	(406,657)	(91,314)

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(1) Represents gains recorded in 2011 and 2009 for several income tax claims filed against the tax authorities for which definitive favorable rulings were obtained in such years.

Income tax expense for the years ended December 31, 2011, 2010 and 2009 differed from the amount computed by applying the statutory income tax rate in force in each country in which the company operates to pre-tax income as a result of the following:

	September 30, 2011	September 30, Year ended December 31, 2010	September 30, 2009
Income before income tax	965,882	1,186,127	430,415
Income tax expense at statutory tax rate	(292,300)	(366,992)	(92,662)
Non taxable income	5,929	2,797	1,940
Non deductible expenses	(28,568)	(38,132)	(41,085)
Unrecognized tax losses	(5,452)	(4,330)	(8,540)
Recovery of income tax	4,417		60,249
Effect of changes in tax rate			(11,216)
Income tax expense	(315,974)	(406,657)	(91,314)

Tax rates used to perform the reconciliation between tax expense (income) and accounting profit are those in effect at each relevant date or period in each applicable jurisdiction.

TERNIUM S.A.

Notes to the Consolidated Financial Statements (Contd.)

12 Property, plant and equipment, net

	September 30,	September 30,	September 30,	September 30,	September 30,	September 30,	September 30,
			Year ended	Year ended	Year ended	Year ended	Year ended
			December 31,	December 31,	December 31,	December 31,	December 31,
			2011	2010	2010	2010	2010
	Land	Buildings and improvements	Production equipment	Vehicles, furniture and fixtures	Work in progress	Spare parts	Total
Cost							
Values at the beginning of the year	489,750	1,799,404	4,181,696	152,280	318,330	37,148	6,978,608
Translation differences	(59,328)	(158,079)	(409,796)	(12,920)	(51,784)	(2,955)	(694,862)
Additions	46,565	2,514	13,760	4,359	482,981	3,171	553,350
Disposals / Consumptions		(10,412)	(10,563)	(3,942)	(1,315)	(133)	(26,365)
Transfers		86,869	106,692	6,749	(200,310)		
Values at the end of the year	476,987	1,720,296	3,881,789	146,526	547,902	37,231	6,810,731
Depreciation							
Accumulated at the beginning of the year		(611,089)	(1,975,650)	(127,363)		(1,610)	(2,715,712)
Translation differences		53,672	195,284	10,570		129	259,655
Depreciation charge		(96,190)	(232,395)	(9,393)		(569)	(338,547)
Disposals / Consumptions		4,787	9,474	2,250		37	16,548
Accumulated at the end of the year		(648,820)	(2,003,287)	(123,936)		(2,013)	(2,778,056)
At December 31, 2011	476,987	1,071,476	1,878,502	22,590	547,902	35,218	4,032,675
	September 30,	September 30,	September 30,	September 30,	September 30,	September 30,	September 30,
			Year ended	Year ended	Year ended	Year ended	Year ended
			December 31,	December 31,	December 31,	December 31,	December 31,
			2010	2010	2010	2010	2010
	Land	Buildings and improvements	Production equipment	Vehicles, furniture and fixtures	Work in progress	Spare parts	Total

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Cost							
Values at the beginning of the year	424,722	1,511,825	4,024,494	149,214	387,721	32,590	6,530,566
Translation differences	20,717	(18,926)	43,439	(4,097)	(7,566)	(1,522)	32,045
Acquisition of business	26,041	41,217	67,280	4,070	1,510		140,118
Additions	18,270	5,575	2,730	1,955	282,139	6,249	316,918
Disposals / Consumptions		(3,616)	(34,111)	(2,381)	(762)	(169)	(41,039)
Transfers		263,329	77,864	3,519	(344,712)		
Values at the end of the year	489,750	1,799,404	4,181,696	152,280	318,330	37,148	6,978,608
Depreciation							
Accumulated at the beginning of the year		(554,581)	(1,809,902)	(124,455)		(1,213)	(2,490,151)
Translation differences		20,341	29,192	4,128		54	53,715
Depreciation charge		(78,000)	(225,866)	(8,464)		(490)	(312,820)
Disposals / Consumptions		1,151	30,926	1,428		39	33,544
Accumulated at the end of the year		(611,089)	(1,975,650)	(127,363)		(1,610)	(2,715,712)
At December 31, 2010							
	489,750	1,188,315	2,206,046	24,917	318,330	35,538	4,262,896

TERNIUM S.A.

Notes to the Consolidated Financial Statements (Contd.)

13 Intangible assets, net

	September 30,	September 30,	September 30,	September 30,	September 30,	September 30,	September 30,
			Year ended	Year ended	Year ended	Year ended	Year ended
			December 31,	December 31,	December 31,	December 31,	December 31,
			2011	2011	2011	2011	2011
	Information	Mining	Exploration	Customer	Trademarks	Goodwill	Total
	system	concessions	costs	relationships			
	projects			and other			
				contractual			
				rights			
Cost							
Values at the beginning of the year	118,784	109,809	31,688	324,670	81,023	750,127	1,416,101
Translation differences	(14,399)	(14,981)	(3,019)	(34,349)	(7,358)	(86,321)	(160,427)
Additions	34,345		13,648				47,993
Transfers		16,493	(16,493)				
Values at the end of the year	138,730	111,321	25,824	290,321	73,665	663,806	1,303,667
Depreciation							
Accumulated at the beginning of the year	(82,741)	(47,600)		(108,711)	(47,701)		(286,753)
Translation differences	8,437	6,635		15,032	6,349		36,453
Depreciation charge	(11,455)	(9,884)		(31,625)	(14,331)		(67,295)
Accumulated at the end of the year	(85,759)	(50,849)		(125,304)	(55,683)		(317,595)
At December 31, 2011	52,971	60,472	25,824	165,017	17,982	663,806	986,072

	September 30,	September 30,	September 30,	September 30,	September 30,	September 30,	September 30,
			Year ended	Year ended	Year ended	Year ended	Year ended
			December 31,	December 31,	December 31,	December 31,	December 31,
			2010	2010	2010	2010	2010
	Information	Mining	Exploration	Customer	Trademarks	Goodwill	Total
	system	concessions	costs	relationships			
	projects			and other			
				contractual			
				rights			
Cost							
Values at the beginning of the year	98,736	103,909	20,812	288,414	73,358	708,643	1,293,872
Translation differences	(363)	5,900	1,412	14,795	3,258	39,927	64,929

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Acquisition of business	42			19,467	4,407	1,557	25,473
Additions	20,369		10,843	1,994			33,206
Disposals / Consumptions			(1,379)				(1,379)
Values at the end of the year	118,784	109,809	31,688	324,670	81,023	750,127	1,416,101
Depreciation							
Accumulated at the beginning of the year	(66,363)	(35,568)		(74,474)	(32,055)		(208,460)
Translation differences	690	(2,215)		(4,390)	(1,898)		(7,813)
Depreciation charge	(17,068)	(9,817)		(29,847)	(13,748)		(70,480)
Accumulated at the end of the year	(82,741)	(47,600)		(108,711)	(47,701)		(286,753)
At December 31, 2010	36,043	62,209	31,688	215,959	33,322	750,127	1,129,348

TERNIUM S.A.

Notes to the Consolidated Financial Statements (Contd.)

14 Investments in associated companies

	September 30, As of December 31, 2011	September 30, As of December 31, 2010
At the beginning of the year	8,212	6,577
Translation adjustment	(124)	(53)
(Disposals)/Acquisitions	(70)	302
Dividends received from associated companies		(302)
Equity in earnings of associated companies	1,293	1,688
At the end of the year	9,311	8,212

The principal associated companies, all of which are unlisted, are:

Company	September 30, Country of incorporation	September 30, Voting rights at December 31, 2011	September 30, 2010	September 30, Value at December 31, 2011	September 30, 2010
Lomond Holdings BV. (1)	Netherlands	50.00%	50.00%	7,299	6,635
Finma S.A.I.F. (2)	Argentina	33.33%	33.33%	1,429	1,200
Arhsa S.A. (2)	Argentina	33.33%	33.33%	379	176
Techinst S.A. (3)	Argentina	33.33%	33.33%	204	126
Compañía Afianzadora de Empresas Siderúrgicas S.G.R. (4)	Argentina		38.89%		75
				9,311	8,212

- (1) Holding Company. Indirectly through the participation in Ternium Investments Switzerland A.G. since December 7, 2011. Prior to this date and since August 9, 2010, the participation was held by Ternium Treasury Services S.A. and prior to August 9, 2010, it was held by Ternium Procurement S.A.
- (2) Consulting and financial services. Indirectly through the participation in Siderar.
- (3) Consulting and financial services. Indirectly through the participation in Ternium Treasury Services S.A.
- (4) Granting of guarantees to participating partners to facilitate or permit access to credits for purchase of national raw material. Indirectly through the participation in Siderar.

15 Other investments, net Non-current

	September 30, As of December 31, 2011	September 30, As of December 31, 2010
Time deposits with related parties (i) (Note 28)		18,086

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Investments in debt instruments	13,900	17,227
Others	187	262
Other investments, net Non-current	14,087	35,575

- (i) The Company held a savings fund denominated in U.S. dollars until the fourth quarter of 2011.

TERNIUM S.A.

Notes to the Consolidated Financial Statements (Contd.)

16 Receivables, net Non-current and Current

	September 30, As of December 31, 2011	September 30, As of December 31, 2010
Receivables with related parties (Note 28)	197	285
Employee advances and loans	8,163	8,821
Advances to suppliers for the purchase of property, plant and equipment	98,455	21,125
Advances to suppliers for the purchase of property, plant and equipment with related parties (Note 28)	290	1,548
Tax credits	12,582	18,369
Others	4,514	6,323
Receivables, net Non-current	124,201	56,471

	As of December 31, 2011	As of December 31, 2010
Value added tax	14,455	26,169
Tax credits	46,059	26,806
Employee advances and loans	9,128	10,465
Advances to suppliers	8,289	4,815
Advances to suppliers with related parties (Note 28)	955	552
Expenses paid in advance	7,145	3,695
Government tax refunds on exports	3,092	9,263
Receivables with related parties (Note 28)	286	548
Others	16,182	12,260
Receivables, net Current	105,591	94,573

17 Trade receivables, net Non-current and Current

	September 30, As of December 31, 2011	September 30, As of December 31, 2010
Trade receivables	7,672	354
Allowance for doubtful accounts (Note 20)	(146)	(354)
Trade receivables, net Non-current	7,526	

	As of December 31, 2011	As of December 31, 2010
Current accounts	720,667	669,403
Trade receivables with related parties (Note 28)	30,337	10,959
Allowance for doubtful accounts (Note 20)	(16,002)	(16,860)
Trade receivables, net Current	735,002	663,502

18 Inventories, net

	September 30, As of December 31, 2011	September 30, 2010
Raw materials, materials and spare parts	593,903	523,832
Goods in process	1,055,934	998,552
Finished goods	414,614	415,985
Goods in transit	133,033	83,214
Obsolescence allowance (Note 20)	(60,460)	(68,193)
Inventories, net	2,137,024	1,953,390

TERNIUM S.A.

Notes to the Consolidated Financial Statements (Contd.)

19 Cash, cash equivalents and other investments

	September 30, As of December 31, 2011	September 30, 2010
(i) Other investments		
Deposits with maturity of more than three months	281,676	848,400
(ii) Cash and cash equivalents		
Cash and banks	115,585	98,811
Restricted cash	248	12,343
Deposits with maturity of less than three months	2,042,758	1,668,262
Cash and cash equivalents	2,158,591	1,779,416

20 Allowances and Provisions Non-current and Current

Provisions and allowances Non-current	September 30, Deducted from assets Allowance for doubtful accounts	September 30, Liabilities Legal claims and other matters
Year ended December 31, 2011		
Values at the beginning of the year	354	16,144
Translation differences	(23)	(2,228)
Additions		31,289
Reversals	(185)	(1,357)
Uses		(28,508)
At December 31, 2011	146	15,340
Year ended December 31, 2010		
Values at the beginning of the year	416	18,913
Translation differences	(18)	(290)
Additions		6,721
Reversals	(44)	(1,178)
Uses		(8,022)
At December 31, 2010	354	16,144

Provisions and allowances - Current	September 30, Deducted from assets	September 30, Deducted from assets
	Allowance for doubtful accounts	Obsolescence allowance
Year ended December 31, 2011		
Values at the beginning of the year	16,860	68,193
Translation differences	(1,103)	(7,385)
Acquisition of business		
Reversals	(2,133)	(26,261)
Additions	2,640	32,382
Uses	(262)	(6,469)
At December 31, 2011	16,002	60,460
Year ended December 31, 2010		
Values at the beginning of the year	16,310	58,153
Translation differences	(460)	1,911
Acquisition of business	4,168	1,290
Reversals	(3,885)	(17,719)
Additions	3,536	29,429
Uses	(2,809)	(4,871)
At December 31, 2010	16,860	68,193

TERNIUM S.A.

Notes to the Consolidated Financial Statements (Contd.)

21 Deferred income tax

Deferred income taxes are calculated in full on temporary differences under the liability method using the tax rate of the applicable country.

Changes in deferred income tax are as follows:

	September 30, Year ended December 31, 2011	September 30, December 31, 2010
At beginning of the year	(865,355)	(857,297)
Translation differences	83,172	(14,855)
Acquisition of business		7,832
Deferred tax credit (charge)	41,285	(1,035)
At end of the year	(740,898)	(865,355)

The changes in deferred tax assets and liabilities (prior to offsetting the balances within the same tax jurisdiction) during the year are as follow:

	September 30, Fixed assets	September 30, Inventories	September 30, Intangible assets	September 30, Other	September 30, Total at December 31, 2011
Deferred tax liabilities					
At beginning of year	(682,027)	(70,498)	(81,161)	(169,373)	(1,003,059)
Translation differences	67,654	7,975	8,832	12,430	96,891
Income statement credit (charge)	27,936	10,718	10,596	(12,965)	36,285
At end of year	(586,437)	(51,805)	(61,733)	(169,908)	(869,883)
	Provisions	Trade Receivables	Tax losses (1)	Other	Total at December 31, 2011
Deferred tax assets					
At beginning of year	66,626	7,971	22,210	40,897	137,704
Translation differences	(6,037)	(1,531)	(3)	(6,148)	(13,719)
Income statement credit (charge)	409	2,363	(6,328)	8,556	5,000
At end of year	60,998	8,803	15,879	43,305	128,985

(1) As of December 31, 2011, the recognized tax losses amount to USD 15,879 and the net unrecognized deferred tax assets amount to USD 17,885. According to the tax law in force in the jurisdictions in which the tax losses are generated, these amounts do not have a certain expiration date.

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Deferred tax assets and liabilities are offset when the entity a) has a legally enforceable right to set off the recognized amounts; and b) intends to settle the tax on a net basis or to realize the asset and settle the liability simultaneously.

The amounts shown in the statement of financial position include the following:

	September 30, As of December 31, 2011	September 30, 2010
Deferred tax assets to be recovered after more than 12 months	74,202	82,980
Deferred tax liabilities to be settled after more than 12 months	(807,914)	(922,136)
	(733,712)	(839,156)

TERNIUM S.A.

Notes to the Consolidated Financial Statements (Contd.)

22 Other liabilities Non-current and Current

	September 30, As of December 31, 2011	September 30, 2010
(i) Other liabilities Non-current		
Termination benefits	4,238	4,877
Pension benefits	155,625	166,812
Related parties (Note 28)		507
Other	40,982	29,116
Other liabilities Non-current	200,845	201,312

Pension benefits

The amounts recognized in the consolidated statement of financial position are determined as follows:

	September 30, Year ended December 31, 2011	September 30, Year ended December 31, 2010
Present value of unfunded obligations	251,354	262,366
Unrecognized prior service costs	(3,578)	(3,694)
Unrecognized actuarial losses	(72,253)	(72,946)
Fair value of plan assets	(19,898)	(18,914)
Liability in the statement of financial position	155,625	166,812

The amounts recognized in the consolidated income statement are as follows:

	September 30, Year ended December 31, 2011	September 30, Year ended December 31, 2010
Current service cost	6,150	4,697
Interest cost	22,030	20,000
Amortization of prior service costs	818	634
Net actuarial losses recognized in the year	2,090	2,656
Total included in labor costs	31,088	27,987

Changes in the liability recognized in the consolidated statement of financial position are as follows:

September 30, Year ended December 31,	September 30, Year ended December 31,
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	2011	2010
At the beginning of the year	166,812	151,562
Transfers, new participants and funding of the plan	(19,321)	(20,412)
Total expense	31,088	27,987
Translation differences	(21,261)	8,473
Contributions paid	(1,693)	(798)
At the end of the year	155,625	166,812

The principal actuarial assumptions used were as follows:

	September 30, Year ended December 31, 2011	September 30, Year ended December 31, 2010
Mexico		
Discount rate	8.75%	8.75%
Rate of compensation increase	4.00%	4.00%

	September 30, Year ended December 31, 2011	September 30, Year ended December 31, 2010
Argentina		
Discount rate	7.00%	7.00%
Rate of compensation increase	2.00%	2.00%

TERNIUM S.A.

Notes to the Consolidated Financial Statements (Contd.)

22 Other liabilities (continued)

	September 30, As of December 31, 2011	September 30, 2010
(ii) Other liabilities Current		
Payroll and social security payable	97,536	88,727
Termination benefits	8,547	6,693
Related Parties (Note 28)	4,052	22,017
Others	4,641	6,173
Other liabilities Current	114,776	123,610

23 Derivative financial instruments

Net fair values of derivative financial instruments

The net fair values of derivative financial instruments at December 31, 2011 and 2010 were as follows:

	September 30, Year ended December 31, 2011	September 30, 2010
Contracts with positive fair values:		
Foreign exchange contracts	50	212
	50	212
Contracts with negative fair values:		
Interest rate swap contracts	(19,264)	(54,675)
Foreign exchange contracts	(10,638)	(102)
	(29,902)	(54,777)

Derivative financial instruments breakdown is as follows:

a) Interest rate contracts

Fluctuations in market interest rates create a degree of risk by affecting the amount of the Company's interest payments and the value of its floating-rate debt. As of December 31, 2011, most of the Company's long-term borrowings were at variable rates.

Ternium Mexico entered into derivative instruments to manage the impact of the floating interest rate changes on its financial debt. The notional amount represents 42% of its total exposure as of December 31, 2011.

On February 23, 2007, Ternium Mexico entered into several interest rate collar agreements that fix the interest rate to be paid over an aggregate notional amount of USD 140 million, in an average range of 4.19% to 6.00%. These agreements are due in March 2012.

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On June 18, 2008, Ternium Mexico entered into several knock-in swap agreements in an average swap level of 5.22% and a knock-in level of 2.5%. As of December 31, 2011, the notional amount outstanding is USD 396 million. These agreements are due in July 2012 and have been accounted for as cash flow hedges. Changes in fair value of derivative instruments designated as cash flow hedges for each of the years presented are included below:

	September 30, Gross amount	September 30, Cash flow hedges Income Tax	September 30, Total
At December 31, 2009	(46,693)	14,009	(32,684)
(Decrease) / Increase	(19,334)	5,800	(13,534)
Reclassification to income statement	34,063	(10,219)	23,844
At December 31, 2010	(31,964)	9,590	(22,374)
(Decrease) / Increase	(658)	197	(460)
Reclassification to income statement	22,994	(6,898)	16,096
At December 31, 2011	(9,628)	2,889	(6,738)

The gross amount of the pre-tax reserve recorded in other comprehensive income at December 31, 2011 (amounting to a loss of USD 9.6 million) is expected to be reclassified to the income statements in 2012.

TERNIUM S.A.

Notes to the Consolidated Financial Statements (Contd.)

23 Derivative financial instruments (continued)

b) Foreign exchange contracts

From time to time, Ternium's subsidiaries enter into derivative agreements to manage their exposure to currencies other than the USD.

During 2011, Prosid Investments entered into several forward agreements to manage the exchange rate exposure generated by Siderar's debt in ARS against USD. The notional amount hedged as of December 31, 2011 was ARS 2.1 billion with an average forward price of 4.67 ARS per USD.

Furthermore, during 2011, Ferrasa Colombia S.A.S. has been hedging the exposure of certain trade receivables denominated in its local currency through non-deliverable forward agreements. As of December 31, 2011, the agreements aggregate notional amount were COP 34.4 billion at an exchange rate of 1,923 COP per USD.

On December 14, 2011, Ternium Mexico S.A. de C.V. entered into a forward agreement over an aggregate notional amount of MXN 627.5 million, at an exchange rate of 13.94 MXN per USD, to manage its operating exposure in MXN. This agreement is due in January 19, 2012.

During December 2011 and in connection with the purchase of the investment in Usiminas (see note 35), both Ternium Investments S.a.r.l., through its Zug branch, and Prosid Investments entered into several non-deliverable forward and forward exchange collar agreements to manage the exchange rate exposure generated by the share purchase agreement in BRL against USD. The notional amount hedged as of December 31, 2011 by Ternium Investments S.a.r.l. and Prosid Investments was BRL 2.9 billion and BRL 1.0 billion, respectively. These agreements are due in January 2012 and have been accounted for as cash flow hedges. As of December 31, 2011, the after-tax cash flow hedge reserve related to these agreements amounted to USD 8.2 million.

The net fair values of the exchange rate derivative contracts as of December 31, 2011 and December 31, 2010 were as follows:

Currencies	September 30, Contract	September 30, Notional amount	September 30, Fair Value at December 31, 2011	September 30, 2010
BRL/USD	ND Forward (1)	3.9 billion BRL	(8,902)	
ARS/USD	Forward	2.1 billion ARS	(1,653)	
MXN/USD	Forward	0.6 billion MXN	(83)	
COP/USD	ND Forward	34.4 billion COP	50	
USD/EUR	Forward			212
USD/EUR	Cross Currency Swap			(52)
CRC/USD	ND Forward			8
GTQ/USD	ND Forward			(57)
			(10,588)	111

(1) These foreign exchange contracts were accounted for as cash flow hedges.

USD: US dollars; ARS: Argentine pesos; BRL: Brazilian reals; MXN: Mexican pesos; COP: Colombian pesos; GTQ: Guatemalan quetzales; CRC: Costa Rican colon.

24 Borrowings

	September 30, Year ended December 31, 2011	September 30, December 31, 2010
(i) Non-current		
Bank borrowings	951,469	1,429,278
Less: debt issue costs	(2,974)	(2,704)
	948,495	1,426,574
(ii) Current		
Bank borrowings	1,043,977	517,718
Less: debt issue costs	(2,427)	(4,635)
	1,041,550	513,083
Total Borrowings	1,990,045	1,939,657

TERNIUM S.A.

Notes to the Consolidated Financial Statements (Contd.)

24 Borrowings (continued)

The maturity of borrowings is as follows:

	September 30, 2012	September 30, 2013	September 30, Expected Maturity Date 2014 and thereafter	September 30, At December 31, (1) 2011	September 30, 2010
Fixed Rate	484,996			484,996	14,206
Floating Rate	556,554	401,791	546,704	1,505,049	1,925,451
Total	1,041,550	401,791	546,704	1,990,045	1,939,657

(1) As most borrowings incorporate floating rates that approximate market rates and the contractual repricing occurs every 3 to 6 months, the fair value of the borrowings approximates their carrying amount and it is not disclosed separately.

The weighted average interest rates which incorporate instruments denominated mainly in US dollars and Argentina pesos and which also include the effect of derivative financial instruments- at year end were as follows:

	September 30, December 31, 2011	September 30, 2010
Bank borrowings	3.42%	3.29%

The nominal average interest rates shown above were calculated using the rates set for each instrument in its corresponding currency and weighted using the dollar-equivalent outstanding principal amount of said instruments at December 31, 2011 and 2010, respectively.

Breakdown of borrowings by currency is as follows:

Currency	Interest rates	December 31,	
		2011	2010
USD	Floating	1,357,795	1,786,928
USD	Fixed	1,690	
ARS	Floating	467	
ARS	Fixed	460,946	312
BRL	Floating	17,177	12,725
COP	Floating	125,300	125,798
COP	Fixed		3,746
CRC	Fixed	6,475	
GTQ	Fixed	15,885	10,148
MXN	Floating	4,310	
Total Borrowings		1,990,045	1,939,657

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USD: US dollars; ARS: Argentine pesos; BRL: Brazilian reales; COP: Colombian pesos; CRC: Costa Rican colon; GTQ: Guatemalan quetzales; MXN: Mexican pesos.

On April 6, 2011, the Company's subsidiary Ternium Mexico, S.A. de C.V. (Ternium Mexico), Crédit Agricole Corporate and Investment Bank, acting as Administrative Agent, and certain banks parties to a loan agreement dated as of July 12, 2007, partially refinanced a syndicated loan facility that had been incurred to finance Ternium's 2007 acquisition of Grupo Imsa, a company subsequently merged into Ternium Mexico.

The outstanding balance of the facility refinanced amounted to USD 1.0 billion. As part of the refinancing, the final maturity date of bank loans in a principal amount of USD 0.8 billion was extended to July 23, 2014 (with the extended loans being payable in four consecutive and equal semi-annual installments commencing on January 26, 2013), and the applicable margin structure for the extended loans was amended. On July 26, 2012, Ternium Mexico will repay the remaining USD 0.2 billion principal amount of the loans that was not refinanced.

TERNIUM S.A.**Notes to the Consolidated Financial Statements (Contd.)****25 Contingencies, commitments and restrictions on the distribution of profits**

Ternium is involved in litigation arising from time to time in the ordinary course of business. The Company recorded a provision for those cases in which there is a probable cash outflow and the outcome can be reliably estimated. Based on management's assessment and the advice of legal counsel, it is not anticipated that the ultimate resolution of existing litigation would be material to Ternium's consolidated financial position, results of operations or liquidity.

*(i) Tax claims**(a) Siderar. AFIP Income tax claim for fiscal years 1995 to 1999*

The *Administración Federal de Ingresos Públicos* (AFIP - the Argentine tax authority) has challenged the charge to income of certain disbursements that Siderar has treated as expenses necessary to maintain industrial installations, which as such should be deducted in the year in which they take place. The AFIP asserts that these are investments or improvements that must be capitalized and, therefore, it made a jeopardy assessment of income tax due on a nominal tax basis plus fines and interest in fiscal years 1995 to 1999 amounting to approximately USD 18.7 million as of December 31, 2011.

The Company appealed these assessments before the National Tax Court, as in the view of its legal and tax advisors, there are reasons that would likely result in a favorable ruling for the Company.

On April 13, 2005 the Company was notified of a ruling issued by the National Tax Court reducing the assessments made by the AFIP for fiscal years 1995 and 1996. The ruling was appealed both by the Company and the AFIP.

On June 10, 2010 the Company was notified of a ruling issued by the Court of Appeals in federal administrative law which mainly resulted in favor of the Company. The ruling was appealed both by the Company and the AFIP.

Based on the above, the Company recognized a provision amounting to USD 2.0 million as of December 31, 2011 as management considers there could be a potential cash outflow.

(b) Ternium Mexico. SAT Income tax claim for fiscal year 2004

On January 26, 2012, the Mexican tax authorities notified Ternium Mexico and its subsidiary Acerus S.A. de C.V. of a tax assessment that challenges the value attributed by a predecessor of Acerus to a capital reduction made in 2004 (i.e., prior to the Company's investment in Ternium Mexico's predecessor Grupo Imsa in 2007) and assesses an income tax deficiency. The tax authorities assert that the capital reduction should have been valued at a price significantly higher than the value attributed at the time by the shareholder. The proposed assessment represents an estimated contingency of MXN 4,092 Million (approximately USD 293 million) at December 31, 2011, in taxes and penalties. The Company will appeal this assessment before the Mexican tax authorities and ultimately the tax courts and believes that it is not probable that the ultimate resolution of the matter will result in an obligation. Accordingly, no provision was recorded in these Consolidated Financial Statements.

(ii) Commitments

The following are Ternium's main off-balance sheet commitments:

(a) Siderar entered into a contract with Tenaris, a related company of Ternium, for the supply of steam generated at the power generation facility that Tenaris owns in the compound of the Ramallo facility of Siderar. Under this contract, Tenaris has to provide 250 tn/hour of steam, and Siderar has the obligation to take or pay this volume. The amount of this outsourcing agreement totals USD 93.6 million and is due to terminate in 2018.

(b) Siderar, within the investment plan to increase its production capacity, has entered into several commitments to acquire new production equipment for a total consideration of USD 117.3 million.

(c) Siderar is a party to a long-term contract with Air Liquide Argentina S.A. for the supply of oxygen, nitrogen and argon. The agreement requires Siderar to take or pay minimum daily amounts of these gases for an aggregate amount of USD 59.0 million to satisfy Siderar's current production needs through 2021, and to make incremental purchases of these gases for an aggregate amount of USD 116.1 million to satisfy the requirements through 2025 of a new separation facility to be constructed as part of Siderar's expansion plan. As a result of the several global crisis that began in 2008 and the uncertainties surrounding the evolution of steel demand in the domestic and global markets, the parties engaged in discussions for the renegotiation of the contract. In February 2011, Siderar and Air Liquide Argentina reached agreement on the terms of the renegotiation; the obligations of the parties under the agreement related to the new separation facility were suspended through March 31, 2012, and Siderar agreed to purchase from Air Liquide Argentina certain equipment for an aggregate amount of approximately USD 21.4 million (as of December 31, 2011, Siderar paid advances in an amount of USD 12.6 million). If Siderar were to resume its expansion plan on or prior to March 31, 2012, Air Liquide Argentina would be required to repurchase that equipment, and all of the parties' obligations under the contract would be reinstated; otherwise, all rights and obligations relating to the new separation plant and the related supply of gases would terminate automatically on March 31, 2012, and Siderar would be required to pay to Air Liquide Argentina an aggregate amount currently estimated at USD 12.0 million.

TERNIUM S.A.**Notes to the Consolidated Financial Statements (Contd.)****25 Contingencies, commitments and restrictions on the distribution of profits (continued)**

(d) Siderar assumed fixed commitments for the purchase of raw materials for a total amount of USD 948.4 million to be expended during the next 3 years.

(e) The production process of Ternium Mexico's (former Hylsa's plants) requires a large amount of electricity. On December 20, 2000, Hylsa entered into a 25-year contract with Iberdrola Energía Monterrey, S.A. de C.V. (Iberdrola), a Mexican subsidiary of the Spanish Company Iberdrola Energía, S.A., for the supply to four of Mexico's plants of a contracted electrical demand of 111.2 MW, for a contracted amount of USD 0.9 billion, which is due to terminate in 2027. There are no penalties if consumption is lower in 30 MW per year. This contract effectively started on April 30, 2002, and currently supplies approximately 26% of Ternium Mexico's electricity needs.

(f) Several Ternium Mexico's subsidiaries which have facilities throughout the Mexican territory are parties to a long term energy purchase agreement for approximately 90 MW of electricity as purchased capacity with Tractebel Energía de Monterrey, S. de R.L. de C.V., distributed among each plant defined as a capacity user. Each capacity user is committed to pay Tractebel for the purchased capacity and for the net energy delivered. Ternium Mexico is required to provide its best estimate of its expected nomination for capacity and energy under the specific limits and timelines. The monthly payments are calculated considering the capacity charges, energy charges, back-up power charges, and transmission charges, less any steam credits. The contracted amount is of USD 221 million and the contract will terminate in 2018.

(g) Grupo Imsa (now Ternium Mexico), together with Grupo Marcegaglia, Duferco International Investment Holding and Donkuk Steel Mill Co., were parties to a ten-year steel slab off-take framework agreement with Corus UK Limited (now Tata Steel UK Limited) dated as of December 16, 2004, which was supplemented by bilateral off-take agreements. Under the agreements, the off-takers could be required to purchase, in the aggregate, approximately 78% of the steel slab production of Corus' former Teesside facility in the North East of England, of which Grupo Imsa's share was 15.38%, or approximately 0.5 million tons per year, of the total production.

In addition, the off-takers were required to make, in the aggregate and according to their respective pro rata shares, significant payments to Corus to finance capital expenditures. In December 2007, all of Grupo Imsa's rights and obligations under this contract were assigned to Ternium Procurement S.A. (formerly known as Alvory S.A.).

On April 7, 2009, Ternium Procurement S.A., together with the other off-takers, declared the early termination of the off-take framework agreement and their respective off-take agreements with Corus pursuant to a provision allowing the off-takers to terminate the agreements upon the occurrence of certain events specified in the off-take framework agreement. Corus initially denied the occurrence of the alleged termination event, stated that it would pursue specific performance and initiated an arbitration proceeding against the off-takers and Ternium Mexico (as guarantor of Ternium Procurement's obligations) seeking damages arising out of the alleged wrongful termination of the off-take agreements, which damages Corus did not quantify but stated that would exceed USD 150 million (approximately USD 29.7 million in the case of Ternium Procurement), the maximum aggregate cap on liability that the off-takers would have under the off-take framework agreement (a limitation that Corus disputed). In addition, Corus threatened to submit to arbitration further claims in tort against the off-takers, and also threatened to submit such claims against certain third-parties to such agreements, including the Company. The off-takers and Ternium Mexico, in turn, denied Corus claims and brought counterclaims against Corus which, in the aggregate, would also be greater than USD 150 million.

On May 12, 2009, Corus, by a letter from its lawyers, alleged that the off-takers's termination notice amounted to a repudiatory breach of the agreements and stated that it accepted that the agreements had come to an end and that it would no longer pursue a claim for specific performance in the arbitration; the claim for damages, for all losses caused by the alleged off-takers' wrongful repudiation of the agreements, however, would be maintained. On July 9, 2009, Corus submitted an amended request for arbitration adding tortious claims against the off-takers and adding to its claims the payment of punitive or exemplary damages.

On December 21, 2010, the arbitration tribunal issued a partial final award where it held that the off-takers had invalidly terminated the off-take agreements. The tribunal also held that the maximum aggregate USD 150 million liability cap (out of which approximately USD 29.7 million corresponds to Ternium Procurement) provided in the off-take framework agreement applied to all of Corus's claims against the off-takers, including tort as well as contract claims. The tribunal formally admitted new claims and counterclaims into the arbitration proceedings on April 10, 2011.

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On April 15, 2011, the arbitration tribunal issued a second partial final award where it held that the off-takers should pay to the claimant GBP 1.6 million for its reasonable legal and other costs incurred before the first partial final award. The off-takers paid that amount around mid May. In addition, on May 27, 2011, the off-takers paid to Tata an aggregate amount of USD 16.3 million (of which Ternium Procurement paid USD 3.2 million) as indemnification for one of its claims under the arbitration proceedings.

On June 16, 2011, Tata, the off-takers and Ternium Mexico settled the dispute, and the off-takers, in exchange for a full release and discharge of each of them and their respective representatives and affiliates, from all claims and disputes that Tata may have against any of them in relation to the off-take framework agreement and its related agreements, agreed to pay to Tata an aggregate amount of USD 124 million (including the USD16.3 million previously paid) and authorized their agent under the off-take agreements to transfer to Tata UK£1.8 million and EUR 0.5 million which had been received by the agent from the off-takers under the off-take framework agreement before the early termination of such agreement. Ternium Procurement paid to Tata its share of the settlement amount (i.e., USD21.3 million) on June 17, 2011.

TERNIUM S.A.**Notes to the Consolidated Financial Statements (Contd.)****25 Contingencies, commitments and restrictions on the distribution of profits (continued)**

On June 21, 2011, Tata notified the arbitration tribunal that the arbitration proceedings were withdrawn. On July 8, 2011 and as a consequence of the settlement reached among the parties, the tribunal declared the termination of the arbitration proceedings.

(iii) Restrictions on the distribution of profits

Under Luxembourg law, at least 5% of net income per year calculated in accordance with Luxembourg law and regulations must be allocated to a reserve until such reserve has reached an amount equal to 10% of the share capital. At December 31, 2011, this reserve reached the above-mentioned threshold.

As of December 31, 2011, Ternium may pay dividends up to USD 6.1 billion in accordance with Luxembourg law and regulations.

Shareholders' equity under Luxembourg law and regulations comprises the following captions:

	September 30, At December 31, 2011
Share capital	2,004,743
Legal reserve	200,474
Non distributable reserves	1,414,122
Accumulated profit at January 1, 2011 (1)	6,153,015
Loss for the year	(20,029)
Total shareholders' equity under Luxembourg GAAP	9,752,325

(1) As a result of the repurchase of its own shares from Usiminas on February 15, 2011 (see Note 30), the Company is required under applicable Luxembourg law to create a new non-distributable reserve in the amount of USD 150 million.

26 Earnings per share

As of December 31, 2011, the capital was USD 2,004,743,442 represented by 2,004,743,442 shares, each having a nominal value of USD 1.00 each.

For fiscal years 2011, 2010 and 2009, the weighted average of shares outstanding totaled 1,968,327,917, 2,004,743,442 and 2,004,743,442 shares, respectively. See note 30.

Earnings per share are calculated by dividing the net income attributable to equity holders of the Company by the daily weighted average number of ordinary shares outstanding during the year.

September 30, 2011	September 30, 2010	September 30, 2009
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Profit from continuing operations attributable to equity holders of the Company	513,541	622,076	305,830
Profit from discontinued operations attributable to equity holders of the Company			411,570
Weighted average number of ordinary shares in issue	1,968,327,917	2,004,743,442	2,004,743,442
Basic and diluted earnings per share from continuing operations attributable to equity holders of the Company (USD per share)	0.26	0.31	0.15
Basic and diluted earnings per share from discontinued operations attributable to equity holders of the Company (USD per share)			0.21

TERNIUM S.A.**Notes to the Consolidated Financial Statements (Contd.)****27 Discontinued operations Nationalization of Sidor**

On March 31, 2008, Ternium S.A. (the Company) controlled approximately 59.7% of Sidor, while Corporación Venezolana de Guayana, or CVG (a Venezuelan governmental entity), and Banco de Desarrollo Económico y Social de Venezuela, or BANDES (a bank owned by the Venezuelan government), held approximately 20.4% of Sidor and certain Sidor employees and former employees held the remaining 19.9% interest.

Further to several threats of nationalization and various adverse interferences with management in preceding years, on April 8, 2008, the Venezuelan government announced its intention to take control over Sidor. On April 29, 2008, the National Assembly of Venezuela passed a resolution declaring that the shares of Sidor, together with all of its assets, were of public and social interest, and authorizing the Venezuelan government to take any action it deemed appropriate in connection with any such assets, including expropriation. Subsequently, Decree Law 6058 of the President of Venezuela dated April 30, 2008, ordered that Sidor and its subsidiaries and associated companies be transformed into state-owned enterprises (empresas del Estado), with the government owning not less than 60% of their share capital. On July 12, 2008, Venezuela, acting through CVG, assumed operational control and complete responsibility for Sidor's operations, and Sidor's Board of Directors ceased to function. However, negotiations between the Venezuelan government and the Company regarding the terms of the compensation continued over several months, and the Company retained formal title over the Sidor shares during that period.

On May 7, 2009, the Company completed the transfer of its entire 59.7% interest in Sidor to CVG. The Company agreed to receive an aggregate amount of USD 1.97 billion as compensation for its Sidor shares. Of that amount, CVG paid USD 400 million in cash at closing. The balance was divided in two tranches: the first tranche of USD 945 million was scheduled to be paid in six equal quarterly installments beginning in August 2009 until November 2010, while the second tranche would be due in November 2010, subject to quarterly mandatory prepayment events based on the increase of the WTI crude oil price over its May 6, 2009 level. Under the agreements with CVG and Venezuela, in the event of non-compliance by CVG with its payment obligations, the Company reserved the rights and remedies that it had prior to the transfer of the Sidor shares in relation to any claim against Venezuela, subject to certain limitations, including that the Company may not claim an amount exceeding the outstanding balance due from CVG.

CVG made all payments required to be made under the agreements governing the transfer of Sidor to Venezuela except for the payment due on November 8, 2010. On December 18, 2010, Ternium reached an agreement with CVG, on the rescheduling of the unpaid balance, which amounted to USD 257.4 million. As provided in the refinancing agreement, CVG paid USD 7.0 million to Ternium in January 2011, and CVG is required to pay the remainder in five quarterly installments, beginning on February 15, 2011 and ending on February 15, 2012. As security for the payment of the outstanding balance, Ternium received, duly endorsed in its favor, promissory notes issued by Energía Argentina S.A. (Enarsa) and Compañía Administradora del Mercado Mayorista Eléctrico S.A. (Cammesa) (both companies owned by the Argentine government) to PDVSA Petróleo S.A. (a company owned by the Venezuelan government). While the first three installments were paid, the final two installments were not paid when due, and, as of the date of these financial statements, a total principal amount of USD 130.3 million remains outstanding. Ternium is pursuing the payment of the outstanding amounts and has reserved all of its rights under contracts, investment treaties and Venezuelan and international law with respect to such amounts.

In the years ended December 31, 2011, 2010 and 2009, the Company recorded gains in the amount of USD 11.4 million, USD 61.0 million and USD 136.0 million, respectively. These gains are included in Interest income - Sidor financial asset in the Income Statement and represent the accretion income over the receivable held against CVG. In addition, the Company recorded a gain related to the disposal of Sidor of USD 428,023, net of income tax, during the year ended December 31, 2009.

28 Related party transactions

As of December 31, 2011, Techint owned 62.02% of the Company's share capital, Tenaris held 11.46% and Inverban S.A. owned 0.33%, of the Company's share capital. Each of Techint, Tenaris and Inverban were controlled by San Faustin S.A., a Luxembourg company (San Faustin). Rocca & Partners Stichting Administratiekantoor Aandelen San Faustin (RP STAK), a Dutch private foundation (Stichting), held shares in San Faustin sufficient in number to control San Faustin. No person or group of persons controls RP STAK.

For commitments with Related Parties see Note 25.

TERNIUM S.A.

Notes to the Consolidated Financial Statements (Contd.)

28 Related party transactions (continued)

The following transactions were carried out with related parties:

	September 30, 2011	September 30, Year ended December 31, 2010	September 30, 2009
(i) Transactions			
(a) Sales of goods and services			
Sales of goods to other related parties	167,786	172,337	40,915
Sales of services to associated parties	109	65	76
Sales of services to other related parties	1,682	1,763	562
	169,577	174,165	41,553
(b) Purchases of goods and services			
Purchases of goods from other related parties	58,219	49,735	34,834
Purchases of services from associated parties	42,762	38,939	31,403
Purchases of services from other related parties	129,844	114,377	91,404
	230,825	203,051	157,641
(c) Financial results			
Income with associated parties	95	78	581
Income with other related parties			118
Expenses with other related parties			(29)
	95	78	670
(d) Dividends			
Dividends received from associated parties		302	
(ii) Year-end balances			
		September 30, At December 31, 2011	September 30, 2010
a) Arising from sales/purchases of goods/services and other transactions			
Receivables from associated parties		97	368
Receivables from other related parties		30,723	11,424
Advances to suppliers with other related parties		1,245	2,101
Payables to associated parties		(2,576)	(1,953)
Payables to other related parties		(50,265)	(42,048)

(20,776) (30,108)

(b) Other investments

Time deposit	18,086
	18,086

(iii) Officers and Directors compensation

During the year ended December 31, 2011 the cash compensation of Officers and Directors amounted to USD 12,853. In addition, Officers received 824,000 Units for a total amount of USD 2,366 in connection with the incentive retention program mentioned in note 4 (n) (3).

29 Investments in Mexico

On October 4, 2010, Ternium and Nippon Steel Corporation signed a definitive agreement to form an operation in Mexico for the manufacturing and sale of hot-dip galvanized and galvanized steel sheets to serve the Mexican automobile market. The company was established in November 2010 and operates under the name of Tenigal, S.R.L. de C.V. Ternium and Nippon Steel hold 51% and 49% participations in Tenigal, respectively.

Tenigal plans to build a hot-dip galvanizing plant in the vicinity of Monterrey City (equivalent to the state-of-the-art equipment now in operation at Nippon Steel's steelworks in Japan) with a production capacity of 400,000 metric tons per year. Ternium expects that construction of the facility would require a total investment of approximately USD 350 million. The plant is currently expected to commence production of high-grade and high-quality galvanized and galvanized automotive steel sheets, including outer-panel and high-strength qualities, in 2013. Tenigal is expected to serve the requirements of the growing automotive industry in Mexico, including those of the Japanese car makers.

In addition, Ternium Mexico plans to construct new pickling, cold-rolling, annealing and tempering lines at the same site. Part of the output from these lines will be used to supply the Tenigal plant. Ternium expects that construction of these lines would require a total investment of approximately USD 700 million. As of December 31, 2011, the amount invested in property, plant and equipment totaled USD 40.5 million.

TERNIUM S.A.

Notes to the Consolidated Financial Statements (Contd.)

30 Repurchase of Shares from Usiminas concurrently with secondary public offering

On January 31, 2011, Ternium entered into a transaction and registration rights agreement with its 14.3% shareholder Usinas Siderúrgicas de Minas Gerais S.A. Usiminas (Usiminas) and Techint Holdings S.à.r.l. (Techint). The transaction and registration rights agreement provided, among other things, for a SEC-registered underwritten public offering of up to all of Ternium shares held by Usiminas (less the number of shares that Ternium and Techint agreed to purchase as discussed below) in the form of ADSs listed on the New York Stock Exchange. Neither Ternium nor Techint offered to sell any Ternium shares or ADSs in the public offering.

On February 9, 2011, Ternium and Techint, following the pricing of the underwritten public offering mentioned above, entered into purchase agreements with Usiminas relating to their concurrent purchase transactions of Ternium shares. Under these agreements, on February 15, 2011, Ternium and Techint purchased from Usiminas 41,666,666 and 27,777,780 Ternium shares for a total consideration of USD 150 million and USD 100 million, respectively. In connection with the sale of Ternium s shares by Usiminas, Ternium collected a USD 10.2 million fee, included in Other operating income (expenses), net and was reimbursed of all expenses relating to the offering and concurrent purchase.

Following consummation of these transactions, Techint owns directly 62.02% of the Company s share capital and Tenaris holds directly 11.46% of the Company s share capital (both including treasury shares) and Usiminas will no longer own any Ternium shares. In addition, the two members of Ternium s Board of Directors nominated by Usiminas resigned from the Ternium board.

Related to the dividends distributed on June 9, 2011, and as these treasury shares are held by one of Ternium s subsidiaries, the dividends attributable to these treasury shares amounting to USD 3.1 million were included in equity as less dividend paid.

31 Other required disclosures

(a) Statement of comprehensive income

	September 30, Gross amount	September 30, Cash flow hedges Income Tax	September 30, Total	September 30, Currency translation adjustment
At December 31, 2009	(46,693)	14,009	(32,684)	(715,372)
(Decrease) / Increase	(19,334)	5,800	(13,534)	35,915
Reclassification to income statement	34,063	(10,219)	23,844	
At December 31, 2010	(31,964)	9,590	(22,374)	(679,457)
(Decrease) / Increase	(8,861)	197	(8,663)	(433,633)
Reclassification to income statement	22,994	(6,898)	16,096	
At December 31, 2011	(17,831)	2,889	(14,941)	(1,113,090)

(b) Statement of cash flows

September 30, 2011	September 30, At December 31, 2010	September 30, 2009
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(i) Changes in working capital (1)			
Inventories	(413,321)	(497,430)	429,122
Receivables and others	(12,113)	30,052	115,252
Trade receivables	(116,856)	(179,308)	193,677
Other liabilities	25,332	63,062	(67,778)
Trade payables	119,152	135,651	(35,094)
	(397,806)	(447,973)	635,179
(ii) Income tax accrual less payments			
Tax accrued (Note 11)	315,974	406,657	91,314
Taxes paid	(571,919)	(179,837)	(140,656)
	(255,945)	226,820	(49,342)
(iii) Interest accruals less payments			
Interest accrued	105,570	70,771	105,655
Interest paid	(62,523)	(70,830)	(94,949)
	43,047	(59)	10,706

(1) Changes in working capital are shown net of the effect of exchange rate changes.

TERNIUM S.A.

Notes to the Consolidated Financial Statements (Contd.)

32 Recently issued accounting pronouncements

(i) International Accounting Standard 19 (amended 2011), Employee benefits

In June 2011, the IASB issued IAS 19 (amended 2011), *Employee benefits*, which makes significant changes to the recognition and measurement of defined benefit pension expense and termination benefits, and to the disclosures for all employee benefits. IAS 19 (amended 2011) must be applied for annual periods beginning on or after 1 January 2013.

(ii) International Accounting Standard 1 (amended 2011), Presentation of financial statements

In June 2011, the IASB issued IAS 1 (amended 2011), *Presentation of financial statements*. The amendment requires entities to separate items presented in Other Comprehensive Income into two groups, based on whether or not they may be recycled to profit or loss in the future. IAS 1 (amended 2011) must be applied for annual periods beginning on or after 1 July 2012.

(iii) International Financial Reporting Standard 9 (amended 2011), Financial Instruments

In November 2009, the IASB issued IFRS 9 *Financial Instruments* which establishes principles for the financial reporting of financial assets by simplifying their classification and measurement. This interpretation is applicable for annual periods beginning on or after 1 January 2015. Earlier application is not permitted for entities that prepare financial statements in accordance with IFRS as adopted by the EU, since the interpretation is not yet adopted by the EU.

(iv) International Financial Reporting Standard 10, Consolidated financial statements

In May 2011, the IASB issued IFRS 10, *Consolidated financial statements*. IFRS 10 replaces all of the guidance on control and consolidation in IAS 27 and SIC-12. IFRS 10 must be applied for annual periods beginning on or after 1 January 2013.

(v) International Financial Reporting Standard 11, Joint arrangements

In May 2011, the IASB issued IFRS 11, *Joint arrangements*. IFRS 11 sets out the core principle that a party to a joint arrangement determines the type of joint arrangement in which it is involved by assessing its rights and obligations and accounts for those rights and obligations in accordance with that defined type of joint arrangement. IFRS 11 must be applied for annual periods beginning on or after 1 January 2013.

(vi) International Financial Reporting Standard 12, Disclosures of interest in other entities

In May 2011, the IASB issued IFRS 12, *Disclosures of interest in other entities*. This standard includes the disclosure requirements for all forms of interest in other entities. IFRS 12 must be applied for annual periods beginning on or after 1 January 2013.

(vii) International Financial Reporting Standard 13, Fair value measurement

In May 2011, the IASB issued IFRS 13, *Fair value measurement*. IFRS 13 explains how to measure fair value and aims to enhance fair value disclosures. IFRS 13 must be applied for annual periods beginning on or after 1 January 2013.

(viii) IFRIC Interpretation 20, Stripping costs in the production phase of a surface mine

In October 2011, the IFRIC issued IFRIC Interpretation 20, *Stripping costs in the production phase of a surface mine*. IFRIC addresses the recognition of production stripping costs as an asset and the measurement of the stripping activity asset. IFRIC 20 must be applied for annual periods beginning on or after 1 January 2013.

These standards, amendments to standards and interpretations are not effective for the financial year beginning January 1, 2011 and have not been early adopted.

The Company's management is currently assessing the potential impact that the application of these standards may have on the Company's financial condition or results of operations.

33 Financial risk management

1) Financial risk factors

Ternium's activities expose the Company to a variety of risks: market risk (including the effects of changes in foreign currency exchange rates, interest rates and commodities prices), credit risk and liquidity risk.

Ternium's overall risk management program focuses on the unpredictability of financial markets and seeks to minimize potential adverse effects on the financial performance. Ternium's subsidiaries may use derivative financial instruments to hedge certain risk exposures.

TERNIUM S.A.

Notes to the Consolidated Financial Statements (Contd.)

33 Financial risk management (continued)

1.1) Market Risk

(i) Foreign exchange rate risk

Ternium operates and sells its products in different countries, and as a result is exposed to foreign exchange rate volatility. In addition, the Company entered into several borrowings that contain covenants providing for the compliance with certain financial ratios, including ratios measured in currencies other than the U.S. dollar. This situation exposes Ternium to a risk of non-compliance derived from volatility in foreign exchange rates. Ternium's subsidiaries may use derivative contracts in order to hedge their exposure to exchange rate risk derived from their trade and financial operations.

Ternium general policy is to minimize the negative impact of fluctuations in the value of other currencies with respect to the U.S. dollar. Ternium's subsidiaries monitor their net operating cash flows in currencies other than the U.S. dollar, and analyze potential hedging according to market conditions. This hedging can be carried out by netting operational positions or by financial derivatives. However, regulatory or legal restrictions in the countries in which Ternium's subsidiaries operate, could limit the possibility of the Company carrying out its hedging policy.

Ternium has foreign operations, whose net assets are exposed to foreign currency translation risk, some of which may impact net income. The fact that some subsidiaries have measurement currencies other than the U.S. dollar may, at times, distort the results of the hedging efforts as reported under IFRS.

The following table shows a breakdown of Ternium's assessed financial position exposure to currency risk as of December 31, 2011. These balances include intercompany positions where the intervening parties have different functional currencies.

USD million Exposure to	September 30,	September 30,	September 30,	September 30,
	USD	Functional Currency MXN	ARS	COP
US dollar (USD)	(n/a)	(1,708.2)	214.0	(93.1)
EU euro (EUR)	6.3	(3.5)	13.5	
Other currencies	(0.1)			

We estimate that if the Argentine peso, Mexican peso and Colombian peso had weakened by 1% against the US dollar with all other variables held constant, total pre-tax income for the year would have been USD 16.3 million lower (USD 17.2 million lower as of December 31, 2010), as a result of foreign exchange gains/losses on translation of US dollar-denominated financial position, mainly trade receivables, borrowings and trade payables. This effect would have been offset by the change in the currency translation adjustment recorded in equity.

Considering the same variation of the currencies against the US dollar of all net investments in foreign operations amounting to USD 3.8 billion, the currency translation adjustment included in total equity would have been USD 37.2 million lower (USD 38.8 million lower as of December 31, 2010), arising from the adjustment on translation of the equity related to the Mexican peso, the Argentine peso and the Colombian peso.

(ii) Interest rate risk

Ternium manages its exposure to interest rate volatility through its financing alternatives and hedging instruments. Borrowings issued at variable rates expose the Company to the risk of increased interest expense in the event of a raise in market interest rates, while borrowings issued at fixed rates expose the Company to a variation in its fair value. The Company's interest-rate risk mainly arises from long-term borrowings that bear variable-rate interest that is partially fixed through different derivative transactions, such as swaps and structures with options. The Company's general policy is to maintain a balance between instruments exposed to fixed and variable rates; which can be modified according to long term market conditions.

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Ternium's nominal weighted average interest rate for its debt instruments, which also includes the effect of derivative financial instruments, was 3.42% and 3.29% for 2011 and 2010, respectively. These rates were calculated using the rates set for each instrument in its corresponding currency and weighted using the dollar-equivalent outstanding principal amount of each instrument as of December 31, 2011 and 2010, respectively.

Ternium's total variable interest rate debt amounted to USD 1,505 million (75.6% of total borrowings) at December 31, 2011 and USD 1,925 million (99.3 % of total borrowings) at December 31, 2010.

If interest rates on the aggregate average notional of US dollar denominated borrowings held during 2011, excluding borrowings with derivatives contracts mentioned in Note 23(a), had been 100 basis points higher with all other variables held constant, total pre-tax income for the year ended December 31, 2011 would have been USD 12.1 million lower (USD 10.3 million lower as of December 31, 2010).

TERNIUM S.A.

Notes to the Consolidated Financial Statements (Contd.)

33 Financial risk management (continued)

(iii) Commodity price risk

In the ordinary course of its operations, Ternium purchases raw materials (such as iron ore, coal and slabs) and other commodities (including electricity and gas). Commodity prices are generally volatile as a result of several factors, including those affecting supply and demand, political, social and economic conditions, and other circumstances. Ternium monitors its exposure to commodity price volatility on a regular basis and applies customary commodity price risk management strategies. For further information on long-term commitments, see note 25(ii).

1.2) Credit risk

Credit risk arises from cash and cash equivalents, deposits with banks and financial institutions, as well as credit exposures to customers, including outstanding receivables and committed transactions. Ternium's subsidiaries have credit guidelines in place to ensure that derivative and treasury counterparties are limited to high credit quality financial institutions.

Ternium has no significant concentrations of credit risk from customers. No single customer accounts for more than five percent of Ternium's sales. Ternium's subsidiaries have policies in place to ensure that sales are made to customers with an appropriate credit history, and that credit insurances, letters of credit or other instruments are requested to reduce credit risk whenever deemed necessary. The subsidiaries maintain allowances for potential credit losses. The utilization of credit limits is regularly monitored.

Trade and other receivables are carried at face value less allowance for doubtful accounts, if applicable. This amount does not differ significantly from fair value. The other receivables do not contain significant impaired assets.

As of December 31, 2011, trade receivables total USD 742.5 million. These trade receivables are collateralized by guarantees under letter of credit and other bank guarantees of USD 7.1 million, credit insurance of USD 471.6 million and other guarantees of USD 19.3 million.

As of December 31, 2011, trade receivables of USD 667.0 million were fully performing.

As of December 31, 2011, trade receivables of USD 58.9 million were past due. These trade receivables as of December 31, 2011, are past due less than 3 months.

The amount of the allowance for doubtful accounts was USD 16.1 million as of December 31, 2011.

The carrying amounts of the Company's trade and other receivables as of December 31, 2011, are denominated in the following currencies:

Currency	September 30, USD million
US dollar (USD)	553.1
EU euro (EUR)	28.7
Argentine peso (ARS)	22.2
Mexican peso (MXN)	263.4
Colombian peso (COP)	104.2
Other currencies	0.7
	972.3

1.3) Liquidity risk

Management maintains sufficient cash and marketable securities and credit facilities to finance normal operations. Management monitors rolling forecasts of the group's liquidity reserve on the basis of expected cash flow.

The Company has negotiated additional credit facilities in its Argentine subsidiaries and renegotiated a part of an existing credit facility in Mexico (see note 24).

The table below analyses financial liabilities into relevant maturity groups based on the remaining period at the date of the statement of financial position to the contractual maturity date. The amounts disclosed in the table are the contractual undiscounted cash flows.

USD million	September 30, 2012	September 30, 2013	September 30, 2014	September 30, 2015	September 30, Thereafter
Borrowings	1,041.5	401.8	422.6	24.5	99.6
Interests to be accrued (1)	91.3	47.1	29.5	18.0	8.9
Trade payables and other liabilities	653.3	5.0	3.1	3.1	11.5
Derivatives financial instruments	29.9				
Total	1,816.1	453.9	455.2	45.6	120.1

(1) These amounts do not include the effect of derivative financial instruments.

TERNIUM S.A.

Notes to the Consolidated Financial Statements (Contd.)

33 Financial risk management (continued)

As of December 31, 2011 total cash and cash equivalents and other current investments less borrowings amounted to USD 450.2 million.

1.4) Capital risk

Ternium seeks to maintain an adequate debt/equity ratio considering the industry and the markets where it operates. The year-end ratio debt over debt plus equity is 0.23 and 0.22 as of December 31, 2011 and 2010, respectively. The Company does not have to comply with regulatory capital adequacy requirements as known in the financial services industry.

2) Financial instruments by category and fair value hierarchy level

The accounting policies for financial instruments have been applied to the line items below. According to the scope and definitions set out in IFRS 7 and IAS 32, employers' rights and obligations under employee benefit plans, and non financial assets and liabilities such as advanced payments and income tax payables, are not included.

At December 31, 2011 (in USD thousands)	September 30, Loans and receivables	September 30, Assets at fair value through profit and loss	September 30, Total
(i) Assets as per statement of financial position			
Receivables	38,467		38,467
Derivative financial instruments		50	50
Trade receivables	742,528		742,528
Other investments	46,535	249,041	295,576
Cash and cash equivalents	26,345	2,132,246	2,158,591
Total	853,875	2,381,337	3,235,212

At December 31, 2011 (in USD thousands)	Derivatives	Other financial liabilities	Total
(ii) Liabilities as per statement of financial position			
Other liabilities		31,418	31,418
Trade payables		644,641	644,641
Derivative financial instruments	29,902		29,902
Borrowings		1,990,045	1,990,045
Total	29,902	2,666,104	2,696,006

At December 31, 2010 (in USD thousands)	Loans and receivables	Assets at fair value through profit and loss	Total
(i) Assets as per statement of financial position			
Receivables	38,693		38,693
Derivative financial instruments		212	212

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Trade receivables	663,502		663,502
Other investments	23,864	859,849	883,713
Cash and cash equivalents	113,342	1,666,073	1,779,416
Total	839,401	2,526,134	3,365,536

At December 31, 2010 (in USD thousands)	Derivatives	Other financial liabilities	Total
(ii) Liabilities as per statement of financial position			
Other liabilities		28,682	28,682
Trade payables		541,709	541,709
Derivative financial instruments	54,777		54,777
Borrowings		1,939,657	1,939,657
Total	54,777	2,510,048	2,564,825

TERNIUM S.A.

Notes to the Consolidated Financial Statements (Contd.)

33 Financial risk management (continued)

Fair Value by Hierarchy

Following the requirements contained in paragraph 27B of IFRS 7, Ternium categorizes each class of financial instrument measured at fair value in the statement of financial position into three levels, depending on the significance of the judgment associated with the inputs used in making the fair value measurements. Level 1 comprises financial assets and financial liabilities whose fair values have been determined on the basis of quoted prices (unadjusted) in active markets for identical assets or liabilities. Level 2 includes financial assets and financial liabilities for which fair values have been estimated using inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices). Level 3 comprises financial instruments for which inputs to estimate fair value of the assets or liabilities are not based on observable market data (unobservable inputs).

Description	September 30, Fair value measurement at December 31, 2011 (in USD thousand):		
	Total	Level 1	Level 2
Financial assets at fair value through profit or loss			
Cash and cash equivalents	2,132,246	1,971,564	160,682
Other investments	249,041	213,655	35,386
Derivatives financial instruments	50		50
Total assets	2,381,338	2,185,219	196,118

Financial liabilities at fair value through profit or loss			
Derivatives financial instruments	29,902		29,902
Total liabilities	29,902		29,902

Description	Fair value measurement at December 31, 2010 (in USD thousand):		
	Total	Level 1	Level 2
Financial assets at fair value through profit or loss			
Cash and cash equivalents	1,666,073	1,531,082	134,991
Other investments	859,849	811,824	48,025
Derivatives financial instruments	212		212
Total assets	2,526,134	2,342,906	183,228

Financial liabilities at fair value through profit or loss			
Derivatives financial instruments	54,777		54,777
Total liabilities	54,777		54,777

There were no significant transfers between Level 1 and Level 2 of the fair value hierarchy and there were no financial assets and liabilities considered as Level 3.

3) Accounting for derivative financial instruments and hedging activities

Derivative financial instruments are initially recognized in the statement of financial position at cost and subsequently measured at fair value. Changes in fair value are disclosed under Other financial income (expenses), net line item in the income statement. Ternium does not hedge its net investments in foreign entities.

Ternium designates certain derivatives as hedges of a particular risk associated with a recognized asset or liability or a highly probable forecast transaction. These transactions are classified as cash flow hedges (mainly interest rate swaps, collars and commodities contracts). The effective portion of the fair value of derivatives that are designated and qualify as cash flow hedges is recognized within other comprehensive income. Amounts accumulated in other comprehensive income are recognized in the income statement in the same period than any offsetting losses and gains on the hedged item. The gain or loss relating to the ineffective portion is recognized immediately in the income statement. The fair value of Ternium derivative financial instruments (asset or liability) continues to be reflected on the statement of financial position.

For transactions designated and qualifying for hedge accounting, Ternium documents at inception the relationship between hedging instruments and hedged items, as well as its risk management objectives and strategy for undertaking various hedge transactions. The Company also documents its assessment, both at hedge inception and on an ongoing basis, of whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in fair values or cash flows of hedged items. At December 31, 2011, the effective portion of designated cash flow hedges amounts to USD 14.9 million (net of taxes for USD 2.9 million) and is included as Cash flow hedges line item in the statement of comprehensive income.

TERNIUM S.A.**Notes to the Consolidated Financial Statements (Contd.)****33 Financial risk management (continued)**

The fair values of various derivative instruments used for hedging purposes are disclosed in Note 23. The full fair value of a hedging derivative is classified as a non-current asset or liability when the remaining maturity of the hedged item is more than 12 months and as a current asset or liability when the remaining maturity of the hedged item is less than 12 months.

Changes in the fair value of any derivative instruments that do not qualify for hedge accounting under IAS 39 are recognized immediately in the income statement.

4) Fair value estimation

The estimated fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

For the purpose of estimating the fair value of financial assets and liabilities with maturities of less than one year, the Company uses the market value less any estimated credit adjustments. For other investments, the Company uses quoted market prices.

As most borrowings include variable rates or fixed rates that approximate market rates and the contractual re-pricing occurs every 3 to 6 months, the fair value of the borrowings approximates its carrying amount and is not disclosed separately.

In assessing the fair value of derivatives and other financial instruments, Ternium uses a variety of methods, including, but not limited to, estimated discounted value of future cash flows using assumptions based on market conditions existing at each year end.

34 Subsequent events Share purchase agreement of Usiminas

On November 27, 2011, the Company's wholly-owned Luxembourg subsidiary Ternium Investments S.à.r.l., together with the Company's Argentine majority-owned subsidiary Siderar S.A.I.C. (and Siderar's wholly-owned Uruguayan subsidiary Prosid Investments S.C.A.), and Confab Industrial S.A., a majority-owned Brazilian subsidiary of Tenaris S.A. (TenarisConfab), entered into share purchase agreements with Camargo Corrêa, Votorantim and Caixa dos Empregados da Usiminas (Usiminas employee pension fund, or CEU) for the acquisition of 139.7 million ordinary shares of Usinas Siderúrgicas de Minas Gerais S.A. USIMINAS (Usiminas), representing 27.7% (out of which 22.7% corresponds to Ternium) of Usiminas' voting capital, at a price of BRL 36.0 (approximately USD 19.0) per ordinary share. Ternium Investments and Siderar financed their BRL 4.1 billion share (approximately USD 2.2 billion) with cash on hand and, in the case of Ternium Investments, a USD 700 million syndicated term loan.

Upon closing of the transaction on January 16, 2012, Ternium Investments, Siderar and TenarisConfab joined Usiminas' existing control group through the acquisition of 84.7, 30.0, and 25.0 million ordinary shares, respectively. In addition, Nippon Steel acquired from CEU 8.5 million ordinary shares. In addition, Ternium Investments, Siderar and Prosid entered into an amended and restated Usiminas shareholders' agreement with Nippon Steel, Mitsubishi, Metal One and CEU, governing Ternium Investments, Siderar (and Prosid) and TenarisConfab's rights within the Usiminas control group; most decisions in that control group are subject for its approval to a 65% majority of the control group shares. As a result of these transactions, the control group, which holds 322.7 million ordinary shares representing the majority of Usiminas' voting rights, is now formed as follows: Nippon Group 46.1%, Ternium/Tenaris Group 43.3% (out of which 35.6% corresponds to Ternium), and CEU 10.6%. The rights of Ternium Investments, Siderar (and Prosid) and TenarisConfab within the Ternium/Tenaris Group are governed under a separate shareholders agreement.

Following the closing of the transaction, Messrs. Daniel Novegil, Roberto Vidigal and Alcides Morgante were appointed as members of Usiminas' Board of Directors, together with their alternates, to replace the Board members nominated by Camargo Correa and Votorantim. In addition, Usiminas' Board of Directors appointed Julián Eguren, previously a senior executive with Ternium, as Chief Executive Officer (Diretor-Presidente) of Usiminas.

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With strategically located facilities near the main consumers of steel in Brazil and iron ore mines in the Serra Azul region, Usiminas is organized under four main business units: Mining, Steel, Steel Processing and Capital Goods. In 2010, Usiminas had net sales of BRL 13.0 billion (approximately USD 7.4 billion).

Pablo Brizzio

Chief Financial Officer

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