



Prospect Capital Corporation (PSEC)

Updated May 28th, 2019 by Josh Arnold

Key Metrics

Current Price:	\$6.76	5 Year CAGR Estimate:	8.1%	Volatility Percentile:	45.7%
Fair Value Price:	\$5.95	5 Year Growth Estimate:	0.0%	Momentum Percentile:	60.8%
% Fair Value:	114%	5 Year Valuation Multiple Estimate:	-2.6%	Growth Percentile:	1.2%
Dividend Yield:	10.7%	5 Year Price Target	\$5.95	Valuation Percentile:	29.4%
Dividend Risk Score:	D	Retirement Suitability Score:	B	Total Return Percentile:	39.0%

Overview & Current Events

Prospect Capital Corporation is a business development company, or BDC. It provides private debt and private equity to middle-market companies in the US. The company focuses on direct lending to owner-operated companies, as well as sponsor-backed transactions. Prospect invests primarily in first and second lien senior loans and mezzanine debt, with occasional equity investments. Prospect's investment objective is to generate current income and long-term capital appreciation. The company went public in 2004 and currently has a market capitalization of \$2.5 billion.

Prospect reported its fiscal Q3 results on 5/8/19 and results were slightly better than expected. Net investment income, the company's equivalent to earnings-per-share for a traditional company, came in at 21 cents. This was better than the consensus of 20 cents by a penny. In addition, it represented a \$0.02 increase against last year's Q3, but was a \$0.01 decrease against Q2.

Prospect produced only \$36 million in new originations during the quarter, but received \$195 million in repayments. This implies the company has some available capital for new investments in the near-term. Net asset value per share rose slightly from Q2 to \$9.08, which compares very favorably to the current share price under \$7. In addition, its net-of-cash-to-debt ratio was steady at 69%.

After the Q3 report, our estimate for this year is \$0.85 in net investment income. Separately, Prospect maintained its monthly dividend at six cents, good for an annual payout of \$0.72.

Growth on a Per-Share Basis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
NII	\$1.11	\$0.33	\$1.38	\$1.67	\$1.57	\$1.19	\$1.03	\$1.04	\$0.85	\$0.79	\$0.85	\$0.85
DPS	\$1.62	\$1.33	\$1.21	\$1.22	\$1.28	\$1.32	\$1.19	\$1.00	\$1.00	\$0.77	\$0.72	\$0.72
Shares	32	59	86	114	207	343	359	357	360	364	367	400

Growth has been tough to come by for Prospect for the past decade. The company weathered the financial crisis quite well – 2010 results excluded – but since 2012, net investment income has struggled. Indeed, last year's results marked the lowest net investment income since 2010. Part of this is due to Prospect's prodigious share count, which is nearly 12 times higher today than it was a decade ago. While it is typical for a BDC to issue shares to fund acquisitions, Prospect's dilution has been fairly extreme. To be fair, dilution has slowed materially since 2014, but it is still a headwind. Given this history of dilution and very weak net investment income performance, our estimated growth rate for Prospect is 0%.

Prospect has had additional trouble growing net investment income because its balance sheet has slowly grown smaller over time. The company's total assets are under \$6 billion today while total assets were \$6.4 billion five years ago. The company's investment opportunities have slowly dwindled over time, although total assets appear to have stabilized near \$5.8 billion.

The company's dividend has also shrunk over time as this year's payout of \$0.72 is less than half the value of the dividend from a decade ago. Shrinking net investment income has taken its toll on the company's ability to finance the dividend. We see the dividend as remaining at \$0.72 for the foreseeable future given Prospect can cover its dividend today, and that we don't see any meaningful net investment income growth.

Disclosure: This analyst has no position in the security discussed in this research report, and no plans to initiate one in the next 72 hours.



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Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
Avg. P/NII	9.7	33.0	7.8	6.0	7.1	9.2	8.8	6.9	9.9	8.7	8.0	7.0
Avg. Yld.	15.1%	12.2%	11.3%	12.3%	11.5%	12.1%	13.1%	13.8%	11.8%	11.3%	10.7%	12.1%

Prospect's average price to net investment income has averaged 8.2 in the past decade excluding 2010's outlier. We see fair value is lower than that at 7 times net investment income given that the company's growth outlook has deteriorated. We therefore see a 2.6% headwind to total annual returns from the valuation drifting lower over time.

Likewise, the company's current dividend yield at 10.7% is quite low by historical standards, implying that the stock could be a bit overvalued. We see the yield rising back to 12.1%, which is more in line with the company's history.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
Payout	146%	403%	88%	73%	82%	111%	116%	96%	118%	97%	85%	85%

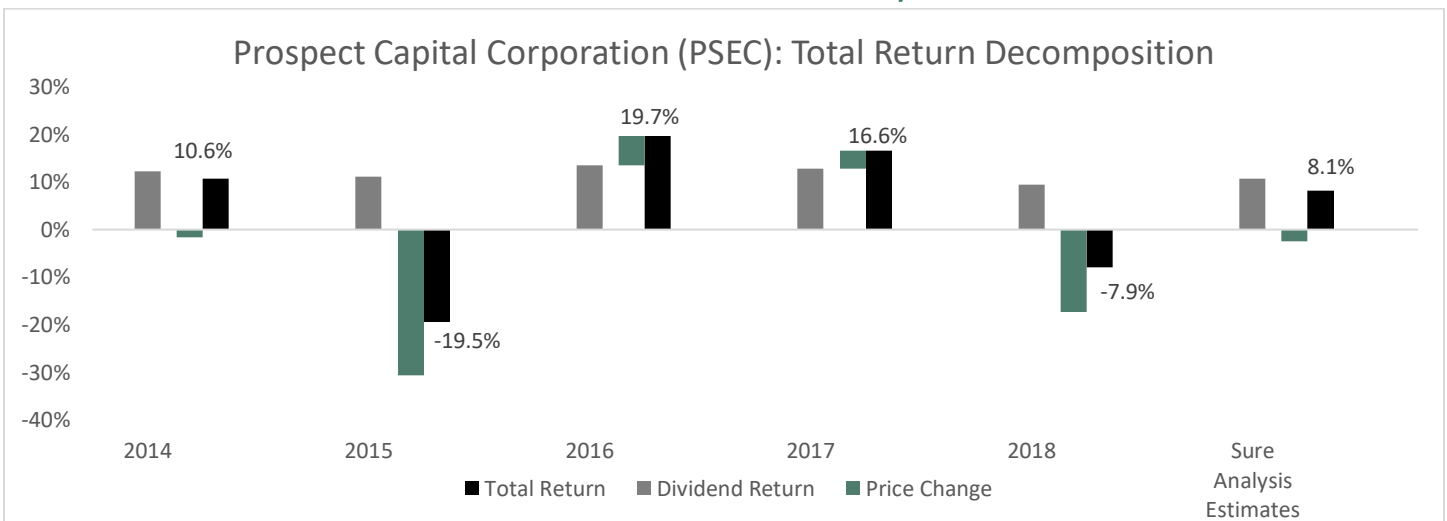
One of the issues with the business development companies is that competitive advantages are very difficult to come by, and Prospect is certainly no exception. Scale is the name of the game for BDCs and with a shrinking balance sheet, Prospect has lost some of its scale over time.

The company's payout ratio was over 100% for several years in the past decade, but current net investment income covers the dividend. While we cannot say no further cuts are coming, the dividend is certainly in much better shape than it was a couple of years ago. We think Prospect can maintain its monthly payout of six cents for the foreseeable future after the payout was cut several times in recent years.

Final Thoughts & Recommendation

Prospect Capital offers investors a huge yield, but it is not without its risks. The valuation appears to be a bit high today, particularly in light of the company's growth outlook. The yield is also low by historical standards, so we think investors that are interested in owning Prospect could wait for a better price. We are forecasting 8.1% in total returns in the coming years, consisting of the 10.7% yield, no growth, and a 2.6% headwind from the valuation. With this in mind, we rate Prospect a hold.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Revenue	100	28	130	204	245	346	379	137	284	326
SG&A Exp.	35	7	12	13	18	31	30	32	32	26
Net Profit	35	20	118	191	221	319	346	103	253	300
Net Margin	34.9%	70.4%	91.1%	93.5%	90.2%	92.3%	91.4%	75.3%	89.2%	92.0%
Free Cash Flow	-74	55	-582	-229	-1786	-1725	45	862	376	369

Balance Sheet Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Total Assets	667	833	1549	2255	4448	6477	6798	6236	6173	5839
Cash & Equivalents	10	1	1	3	203	134	110	318	318	84
Accounts Receivable	1	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Total Liabilities	134	121	435	743	1792	2859	3095	2800	2818	2432
Accounts Payable	N/A	N/A	11	21	52	75	70	71	69	56
Long-Term Debt	125	100	407	664	1683	2773	2984	2667	2642	2312
Shareholder's Equity	533	711	1114	1512	2656	3618	3703	3436	3355	3407
D/E Ratio	0.23	0.14	0.37	0.44	0.63	0.77	0.81	0.78	0.79	0.68

Profitability & Per Share Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Return on Assets	5.8%	2.6%	9.9%	10.0%	6.6%	5.8%	5.2%	1.6%	4.1%	5.0%
Return on Equity	7.3%	3.2%	13.0%	14.5%	10.6%	10.2%	9.5%	2.9%	7.4%	8.9%
ROIC	6.0%	2.7%	10.1%	10.3%	6.8%	5.9%	5.3%	1.6%	4.2%	5.1%
Shares Out.	32	59	86	114	207	343	359	357	360	364
Revenue/Share	3.18	0.47	1.51	1.78	1.18	1.15	1.07	0.39	0.79	0.90
FCF/Share	-2.34	0.92	-6.76	-2.01	-8.63	-5.75	0.13	2.42	1.05	1.02

Note: All figures in millions of U.S. Dollars unless per share or indicated otherwise.

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