Capitala Finance Corp. (CPTA)

Updated July 21st, 2019 by Josh Arnold

Key Metrics

Current Price:	$10	**5 Year CAGR Estimate:**	8.4%	**Volatility Percentile:**	79.5%
Fair Value Price:	$9	**5 Year Growth Estimate:**	0.0%	**Momentum Percentile:**	84.4%
% Fair Value:	91%	**5 Year Valuation Multiple Estimate:**	-1.8%	**Growth Percentile:**	2.0%
Dividend Yield:	10.2%	**5 Year Price Target**	$9	**Valuation Percentile:**	47.6%
Dividend Risk Score:	D	**Retirement Suitability Score:**	B	**Total Return Percentile:**	56.4%

Overview & Current Events

Capitala Finance Corp. is part of Capitala Group, a $2.7 billion asset manager that provides a variety of financing options. Capitala Finance, specifically, provides financial solutions for lower middle market companies, making debt and equity investments that are typically between $10 million and $50 million. Capitala operates in the US and Canada, generally with first lien debt, but also through equity and warrants where capital appreciation is a more attractive goal. The company produces about $50 million in revenue annually and trades with a $158 million market capitalization.

Capitala provided Q1 earnings on 5/6/19 and results narrowly beat expectations. The company originated $21.1 million of new investments and generated $11.5 million in repayments. Debt investments were $20 million while equity investments were the balance of $1.1 million.

Total investment income was $12.7 million in Q1, up fractionally from the $12.6 million in last year's Q1. Capitala also received $1.3 million in dividend income in Q1 from its equity positions.

Total expenses were $8.5 million, compared to $8.1 million in the year-ago period. There was an increase in incentive fees of $0.8 million that was offset by $0.2 million declines in base management fees and general expenses, respectively.

Net investment income per share, which is akin to earnings-per-share for a company like Capitala, came to $0.26 in Q1 compared to $0.28 in the year-ago period. Expenses rose more quickly than net investment income, causing the decline. In addition, the share count rises over time as Capitala issues shares.

We see Capitala producing $1.00 in NII per share this year, which is the same amount the company produced in the past two years and is a level supported by Q1 results as well.

Growth on a Per-Share Basis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
NII	---	---	---	---	$1.50	$1.54	$1.67	$1.84	$0.98	$1.00	***$1.00***	***$1.00***
DPS	---	---	---	---	$0.47	$1.88	$2.38	$1.80	$1.47	$1.00	***$1.00***	***$1.00***
Shares	---	---	---	---	13.0	13.0	15.2	15.8	15.9	16.0	***16.2***	***17.0***

Capitala's NII has declined rather sharply since it came public in late 2013. It used to earn $1.50+ per share in NII, but since cresting at $1.84 in 2016, Capitala hasn't earned more than $1.00. The company struggles to raise funds that are significantly cheaper than the yields on its loans and the capital appreciation on its equity portfolio. For this reason, we think Capitala will continue to earn ~$1.00 in NII per share annually, for a growth rate of 0%.

Apart from the cost of funds becoming an issue, despite portfolio growth, Capitala's portfolio is setup to take advantage of rising rates. Its investment portfolio is comprised of ~60% variable rate notes with the balance of ~40% in fixed rate instruments. Conversely, its funding is almost entirely fixed rate, with only ~5% of its funding in variable rate instruments. In practice, this means that as rates move up, Capitala benefits greatly as interest income rises, but funding costs are stable. When rates fall, however, interest income declines while funding costs are stable. In addition, Capitala's operating costs are essentially flat over time, meaning the leverage from rates moving up and down is even more pronounced. Given that long-term rates have moved down so sharply of late, we see Capitala's balance sheet as a significant headwind to near-term earnings growth.

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Capitala is required to pay out nearly all of its earnings in distributions to shareholders, and we see the current dividend of $1.00 per share annually, paid monthly, as the ceiling. Capitala has cut its distribution before and that is a distinct possibility again, but $1.00 is sustainable for now given where NII is.

Valuation Analysis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	Now	2024
Avg. P/NII	---	---	---	---	12.8	12.2	9.6	7.1	11.9	8.1	***9.8***	***9.0***
Avg. Yld.	---	---	---	---	2.4%	10.0%	14.9%	13.8%	12.6%	12.3%	***10.2%***	***11.1%***

The stock has traded with an average price-to-NII ratio of 10.5 in its relatively short trading history. However, that includes much more favorable rate environments than the current one, and we see 9 times NII as closer to fair value. As such, we're projecting a 1.8% headwind to total returns moving forward. The slight decline in the share price should see the yield move up to 11%, which is closer to its historical yields than the current 10.2%.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
Payout	---	---	---	---	31%	122%	143%	98%	150%	100%	***100%***	***100%***

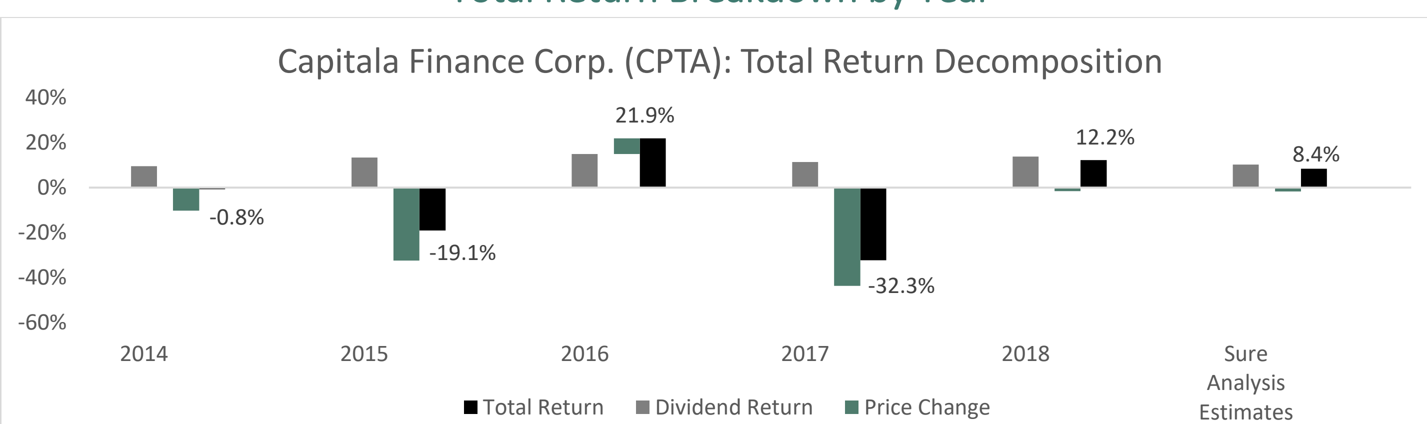
Capitala doesn't have any competitive advantages as it offers the same financing products as any other company in the sector. Its small scale doesn't help either, and this contributes to slim margins. Capitala didn't exist during the Great Recession but middle market lenders suffer immensely due to bankruptcies from borrowers during economic downturns. Capitala is a long way from being a defensive stock and we see it as a risky way to achieve monthly income.

The dividend payout ratio will always be very high as Capitala is required to pay essentially all of its earnings to shareholders. The current dividend is sustainable because NII is around $1 per share annually and because Capitala has shown it is willing and able to issue additional common shares to fill any funding gap with the dividend. This does not make the payout safe over the long term, but we don't see any imminent threat to it today.

Final Thoughts & Recommendation

Capitala is trading in excess of our fair value estimate and looks quite risky. Total returns should be in the high single digits, comprised of a small decline in the valuation and the double-digit current yield. However, we rate Capitala a sell given its balance sheet composition, poor earnings growth outlook, and its exposure to downside interest rate risk. Capitala's monthly payments and 10%+ yield are enticing, but not enough to warrant owning this risky stock today. Sure Dividend rates Capitala a sell and would reevaluate at a price closer to – or preferably below – fair value.

Total Return Breakdown by Year



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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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Income Statement Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Revenue					30	1	17	11	0	-13
SG&A Exp.					1	4	4	4	7	5
Net Profit					29	-3	14	9	-7	-16
Net Margin					96.7%	-555%	82.2%	81.1 %	16242 %	121%
Free Cash Flow					-39	-119	-96	69	44	27
Income Tax							0	0	1	-2

Balance Sheet Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Total Assets					476	540	633	584	535	493
Cash & Equivalents					102	55	34	36	31	39
Total Liabilities					208	299	364	334	313	303
Accounts Payable					3	3	3	3	3	3
Long-Term Debt					202	296	359	321	299	297
Shareholder's Equity					269	241	269	251	222	191
D/E Ratio					0.75	1.23	1.34	1.28	1.35	1.56

Profitability & Per Share Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Return on Assets					7.2%	-0.7%	2.4%	1.5%	-1.2%	-3.1%
Return on Equity					14.0%	-1.4%	5.4%	3.5%	-3.0%	-7.8%
ROIC					7.3%	-0.7%	2.4%	1.5%	-1.3%	-3.2%
Shares Out.					13.0	13.0	15.2	15.8	15.9	15.99
Revenue/Share					2.30	0.05	1.11	0.71	0.00	-0.83
FCF/Share					-2.99	-9.20	-6.34	4.37	2.75	1.71

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