



Gladstone Capital (GLAD)

Updated July 13th, 2019 by Josh Arnold

Key Metrics

Current Price:	\$9.51	5 Year CAGR Estimate:	6.6%	Volatility Percentile:	35.8%
Fair Value Price:	\$8.50	5 Year Growth Estimate:	0.0%	Momentum Percentile:	63.7%
% Fair Value:	112%	5 Year Valuation Multiple Estimate:	-2.2%	Growth Percentile:	2.0%
Dividend Yield:	8.8%	5 Year Price Target	\$8.50	Valuation Percentile:	38.7%
Dividend Risk Score:	B	Retirement Suitability Score:	A	Total Return Percentile:	36.5%

Overview & Current Events

Gladstone Capital is a business development company, or BDC, that primarily invests in small and medium businesses. These investments are made via a variety of equity (10% of portfolio) and debt instruments (90% of portfolio), generally with very high yields. Loan size is typically in the \$7 to \$30 million range, and has terms up to seven years. The BDC's stated purpose is to generate income it can distribute to its shareholders. It trades today with a market capitalization of \$280 million and for income investors, it pays distributions monthly, instead of quarterly.

Gladstone reported second quarter results on 5/1/19 and results were in line with expectations. Net investment income, or NII, came to 21 cents per share, which was flat to last year's Q2. Total investment income rose 5.1% to \$12.5 million, but total expenses rose 9.8%, rising \$5.8 million to \$6.5 million. This offset gains in investment income, leading to the flat NII result in Q2.

During the quarter, Gladstone invested \$3.9 million, and also received \$48.5 million in repayment proceeds. The company issued 460,658 new shares during Q2 to fund general corporate expenses and new investments, which is consistent with past behavior. Net asset value per share rose 1.6% year-over-year to \$8.11. Finally, the company's weighted-average yield on its debt portfolio fell slightly from 12.3% to 12.0%.

Our estimate for 2019 NII-per-share is \$0.85 given that the company continues to earn around 21 cents per quarter. Gladstone's growth rate has been very close to zero for many years, and we see no catalysts for that to improve.

Growth on a Per-Share Basis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
NII	\$1.00	\$0.84	\$0.88	\$0.91	\$0.88	\$0.87	\$0.84	\$0.84	\$0.84	\$0.85	\$0.85	\$0.85
DPS	\$1.26	\$0.84	\$0.84	\$0.84	\$0.84	\$0.84	\$0.84	\$0.84	\$0.84	\$0.84	\$0.84	\$0.84
Shares	21.1	21.1	21.0	21.0	21.0	21.0	21.1	23.2	25.5	27.1	29.0	35.0

Gladstone reports net investment income per share, or NII, instead of earnings-per-share, which is consistent with other BDCs. On that measure, the company's results have been fairly lackluster in terms of growth in the past decade. Our estimate of 85 cents for this year is essentially flat with 2010, and every year since then. Gladstone's share issuances have funded higher NII in dollar terms, but haven't earned enough above its cost of capital to move the needle on NII-per-share. Given this history, we estimate Gladstone's long-term growth at 0%.

The yields on the company's portfolio influence its ability to earn income and therefore, cover its expenses and pay distributions to shareholders. Over time, the company's portfolio yield has drifted higher to the 12% it is today. However, higher expenses have offset that growth recently, which is why NII-per-share continues to be flat over time. Gladstone's portfolio continues to grow in dollar terms, but given its offsetting rising expenses, and loan non-accruals, NII hasn't grown. We see this cycle of new investments being offset by losses and higher expenses.

Gladstone's dividend has been at \$0.07 monthly, or \$0.84 annually, since 2010. Prior to that, the distribution was \$1.26 per share, and unsustainable. However, after the cut, Gladstone has been able to pay the dividend reliably and we see the distribution as remaining at \$0.84 annually for the foreseeable future.

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	7.8	13.1	10.7	9.2	10.1	10.9	10.0	9.1	11.4	10.7	11.2	10.0
Avg. Yld.	16.1%	7.6%	8.9%	10.1%	9.5%	8.8%	10.0%	11.0%	8.8%	9.3%	8.8%	9.9%

Gladstone has traded at a price-to-NII ratios of between 7.8 and 13.1 in the past decade, both of which occurred at the beginning of the period. More recently, the stock has traded near 10 times NII, which is where we assess fair value. At 11.2 times NII, the stock appears to be somewhat overvalued. Should it revert to 10 times NII, shareholders would see a 2.2% annual headwind to total returns.

The yield is also lower than it typically is at 8.8%; Gladstone's average yield in the past decade has been 10%, and we see the yield rising back to that level over time. Both metrics suggest the stock is modestly overvalued at present.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
Payout	126%	100%	95%	92%	95%	97%	100%	100%	100%	99%	99%	99%

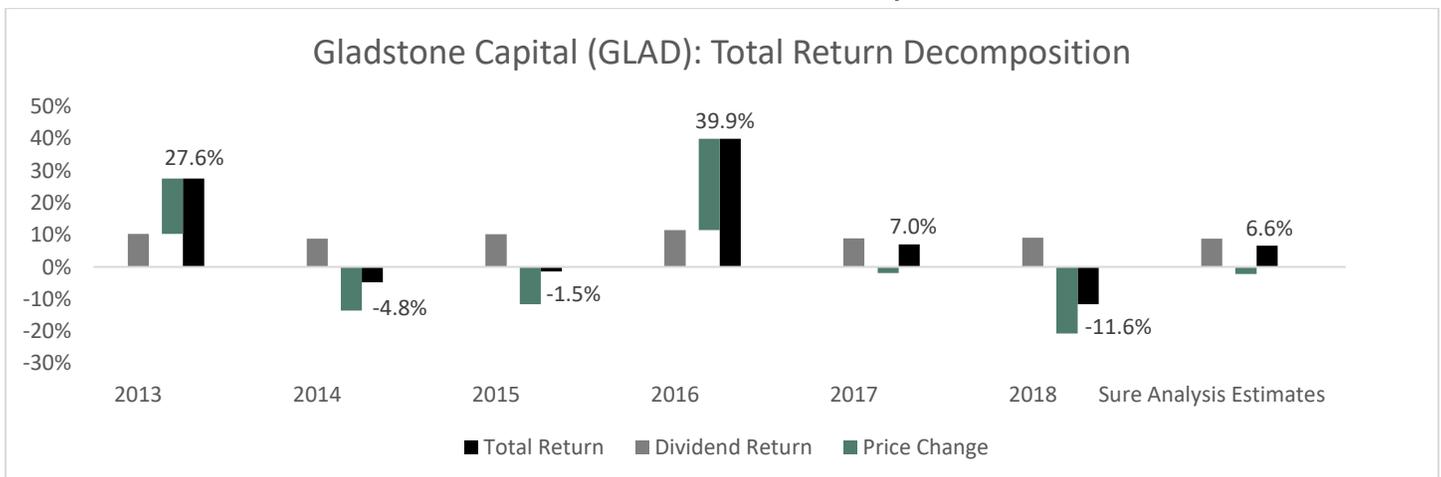
Gladstone doesn't have any competitive advantages as it operates in much the same way as any other BDC. It is also dependent upon funding costs and the spreads it can earn on its debt and equity investments, so it has no competitive advantages. During recessions, Gladstone will likely struggle as repayments may become a problem for its debt investments. Indeed, this caused the company to cut its dividend during the Great Recession, and it hasn't recovered.

On the plus side, we don't see further distribution cuts at this point in the absence of a recession given that Gladstone has reliably earned ~\$0.84 for the past several years. We don't rate the dividend as particularly safe, but BDCs are required to distribute essentially all of their income to shareholders, so the payout ratio will always be high.

Final Thoughts & Recommendation

We see 6.6% total annual returns in the coming years as Gladstone's 2.2% headwind from a lower valuation is more than offset by the generous yield. However, as noted above, we see the stock as slightly overvalued today and we think investors can initiate a position at a lower price and better yield. Given this, we rate the stock a sell and note that we'd likely upgrade it to hold on a lower valuation. Gladstone is far from a safe investment, so we don't believe 6.6% annual returns fully compensate for the risk one takes on by owning it.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Revenue	35	29	-12	4	43	24	21	25	30	31
SG&A Exp.	12	4	6	7	6	6	6	7	7	8
Net Profit	4	16	-21	-8	32	11	8	11	17	19
Net Margin	10.9%	57.3%	174.9%	-211.9%	75.4%	46.1%	40.4%	46.0%	56.8%	59.5%
Free Cash Flow	96	87	-68	26	32	0	-74	60	-13	-18

Balance Sheet Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Total Assets	336	271	318	293	295	301	382	336	366	400
Cash & Equivalents	5	8	7	10	14	6	4	6	5	2
Accounts Receivable	6	3	3	3	2	3	6	2	2	3
Total Liabilities	87	21	104	105	89	102	191	134	146	162
Accounts Payable	0	1	0	1	1	1	1	1	1	1
Long-Term Debt	83	18	100	62	47	38	127	71	93	110
Shareholder's Equity	249	249	214	189	206	200	191	201	220	237
D/E Ratio	0.33	0.07	0.47	0.33	0.23	0.19	0.66	0.35	0.42	0.46

Profitability & Per Share Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Return on Assets	1.0%	5.4%	-7.2%	-2.6%	10.9%	3.8%	2.5%	3.2%	4.9%	4.9%
Return on Equity	1.5%	6.6%	-9.1%	-4.0%	16.3%	5.5%	4.3%	5.8%	8.2%	8.2%
ROIC	1.0%	5.5%	-7.3%	-2.8%	12.8%	4.6%	3.0%	3.8%	5.9%	5.7%
Shares Out.	21.09	21.06	21.04	21.01	21.00	21.00	21.07	23.20	25.50	27.10
Revenue/Share	1.64	1.36	-0.57	0.18	2.03	1.16	1.00	1.07	1.19	1.16
FCF/Share	4.53	4.11	-3.25	1.25	1.53	0.02	-3.54	2.59	-0.51	-0.65

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

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