



Stellus Capital Management (SCM)

Updated July 22nd, 2019 by Josh Arnold

Key Metrics

Current Price:	\$14	5 Year CAGR Estimate:	8.0%	Volatility Percentile:	22.9%
Fair Value Price:	\$12	5 Year Growth Estimate:	2.0%	Momentum Percentile:	74.2%
% Fair Value:	120%	5 Year Valuation Multiple Estimate:	-3.6%	Growth Percentile:	7.6%
Dividend Yield:	9.6%	5 Year Price Target	\$13	Valuation Percentile:	29.4%
Dividend Risk Score:	D	Retirement Suitability Score:	B	Total Return Percentile:	45.9%

Overview & Current Events

Stellus Capital Management is a business development company, or BDC, that bills itself as a flexible source of capital for the middle market. The company provides capital solutions to companies with \$5 million to \$50 million of EBITDA and does so with a variety of instruments, the majority of which are debt. Stellus provides first lien, second lien, mezzanine, convertible debt, and equity investments to a diverse group of customers, generally at high yields, in the US and Canada. The company was formed in 2012, produces \$58 million in annual revenue, and has a \$270 million market capitalization.

Stellus reported Q1 earnings on 5/10/2019 and results slightly missed expectations. Stellus made just one investment in Q1 of \$29 million, which was mostly offset by \$21.8 million of repayment proceeds. Q1's activity meant that Stellus had 55 portfolio companies at the end of the quarter, up from 52 in the year-ago period.

Total investment income, which is how BDC's report revenue, came in at \$13.8 million in Q1, up 27% from last year's Q1 showing of \$10.9 million. Total investment income is volatile given the way BDCs generate revenue, so one quarter's movement isn't necessarily indicative of a trend, but Q1 was strong nonetheless.

Higher expenses, however, led to net investment income, or NII, declining from \$4.5 million to \$4.3 million year-over-year. On a core basis, NII came to \$0.34 per share, up from \$0.28 in the year-ago period. Core NII excludes capital gains incentive fees, making it a truer measure of operating performance.

Stellus' weighted average yield on its debt portfolio came to 10.7%, which is slightly lower than it has been in recent years. Indeed, its debt portfolio yield has slowly but steadily declined for the past several quarters.

Net asset value, or NAV, is up to \$14.32 per share, so Stellus is trading right at NAV today. Stellus also produced \$0.63 in realized gains per share on its portfolio, a very strong showing as it produced just \$0.08 in the year-ago period. That helped drive the significant increase in NAV year-over-year.

Stellus managed to cover its distribution with core NII in Q1, which did not occur last year. Still, we see falling portfolio yields and deleveraging of expenses as pushing NII down to \$1.25 this year; that is our initial estimate.

Growth on a Per-Share Basis

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
NII	---	---	---	\$0.11	\$1.33	\$1.34	\$1.33	\$1.39	\$1.21	\$1.42	\$1.25	\$1.38
DPS	---	---	---	\$0.18	\$1.43	\$1.36	\$1.36	\$1.36	\$1.36	\$1.36	\$1.36	\$1.36
Shares	---	---	---	12.0	12.1	12.3	12.5	12.5	14.9	16.0	16.4	20.0

Stellus, like most BDCs, has a difficult time growing NII. The combination of high funding costs, which is generally done with debt and/or preferred stock, as well as varying yields on the company's debt portfolio, make it difficult to offset a rising share count over time. We see Stellus as having to manage these issues over the long term, but we do see 2% NII growth annually in the coming years.

We think the company's lower debt portfolio yield will bottom sometime soon and as Stellus is able to reset with new investments, its spreads should reflate back to prior levels. The company's net assets continue to grow over time, but these gains have been somewhat offset by a rising share count. We think the share count will continue to be a headwind moving forward, but that the company will be able to slowly rebuild NII-per-share with better lending spreads.

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	---	---	---	N/A	11.2	10.5	8.5	7.5	11.3	9.0	11.4	9.5
Avg. Yld.	---	---	---	1.2%	9.6%	9.7%	12.0%	13.0%	9.9%	10.6%	9.6%	10.4%

Stellus has traded with an average price-to-NII ratio of 9.7 in its relatively short history as a public company, and that is around where we assess fair value. We note, however, that Stellus' valuation has moved somewhat erratically, trading for 7.5 times NII in 2016 and then 11.3 times the next year, for instance. We see the stock as significantly overvalued today given it trades for 11.4 times NII, which is on the higher end of its historical range. We see a 3.6% headwind to total annual returns as a result.

The dividend yield shows a similar story as it is 9.6% today, which is on the lower end of where it has been historically. We see the relatively low yield as another indication the stock is overpriced today.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2024
Payout	---	---	---	164%	108%	101%	102%	98%	112%	96%	109%	99%

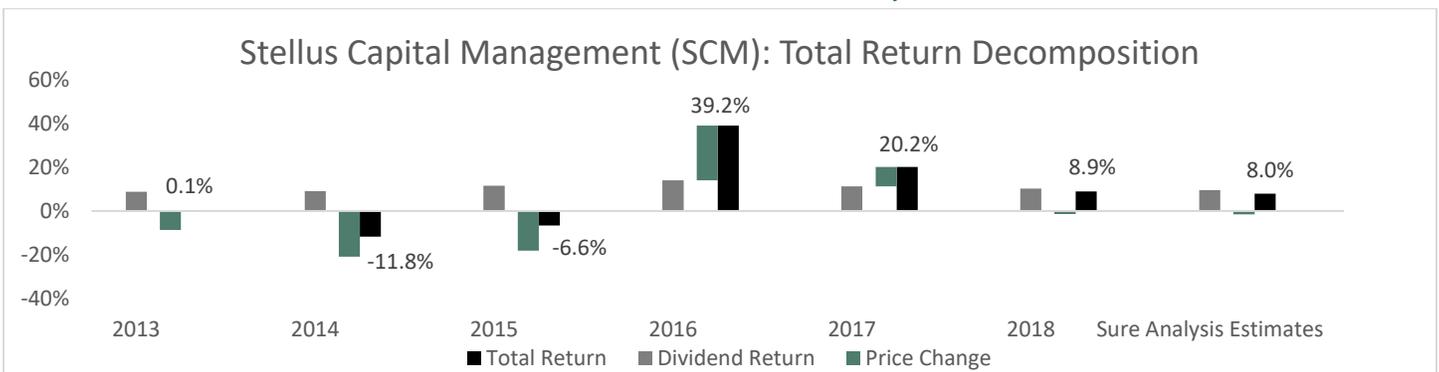
Stellus, like other BDCs, has no competitive advantages. It offers the same products as any other BDC to the same set of customers, so advantages are virtually impossible to achieve. In addition, BDCs suffer mightily during recessions because borrowers have a more difficult time meeting repayment timelines. Stellus wasn't around during the last recession but we see it as having significant issues with NII generation when the next recession strikes.

Stellus is required to pay virtually all of its NII in distributions as a BDC, so the payout ratio will always be high. Even though the payout ratio is in excess of 100% today, we don't see an imminent cut to the distribution on the horizon. The reason is because Stellus is able to cover the vast majority of the payout with core NII, and it is also willing and able to issue new common shares to cover any deficit. While we wouldn't characterize the payout as safe, we also don't see any catalyst for an immediate cut at this point.

Final Thoughts & Recommendation

Stellus' sizable yield and monthly dividend payments are certainly attractive. However, we see declining portfolio yields and immense risk to NII during a recession as key reasons to be cautious. We are forecasting solid total returns in the coming years of 8%, consisting of 2% NII growth, the 9.6% dividend yield, and a 3.6% headwind from a declining valuation. However, given the valuation of the stock, the dividend in excess of core NII, and the risky nature of BDCs in general (especially during recessions), we rate Stellus a sell.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Revenue					29	32	35	26	27	31
Gross Profit					25	27	29			
Gross Margin					85.6%	83.9%	83.4%	0.0%	0.0%	0.0%
SG&A Exp.					7	7	7	4	5	4
Operating Profit					18	20	22			
Operating Margin					61.8%	63.2%	62.8%	0.0%	0.0%	0.0%
Net Profit					18	10	8	23	23	26
Net Margin					59.7%	31.5%	21.8%	87.7%	83.0%	84.3%
Free Cash Flow					29	32	35	26	27	31
Income Tax					25	27	29			

Balance Sheet Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Total Assets				263	298	327	365	380	400	526
Cash & Equivalents				62	14	2	11	9	25	17
Accounts Receivable					0	0	0			
Total Liabilities				89	122	153	201	209	180	301
Accounts Payable				5	3	3	3	3	3	4
Long-Term Debt					119	148	196	203	174	292
Shareholder's Equity				174	176	174	165	171	220	225
D/E Ratio					0.68	0.85	1.19	1.19	0.79	1.30

Profitability & Per Share Metrics

Year	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Return on Assets						3.3%	2.2%	6.2%	5.8%	5.7%
Return on Equity					10.0%	5.8%	4.5%	13.8%	11.6%	11.8%
ROIC						3.3%	2.2%	6.3%	5.9%	5.7%
Shares Out.				12.0	12.1	12.3	12.5	12.5	14.9	16.0
Revenue/Share					2.44	2.63	2.82	2.12	1.83	1.95
FCF/Share					-5.67	-2.21	-1.96	0.71	1.27	-6.42

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

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