



Prospect Capital Corporation (PSEC)

Updated September 9th, 2019 by Josh Arnold

Key Metrics

Current Price:	\$6.52	5 Year CAGR Estimate:	7.5%	Volatility Percentile:	43.4%
Fair Value Price:	\$5.74	5 Year Growth Estimate:	0.0%	Momentum Percentile:	39.0%
% Fair Value:	114%	5 Year Valuation Multiple Estimate:	-2.5%	Growth Percentile:	2.0%
Dividend Yield:	11.0%	5 Year Price Target	\$5.74	Valuation Percentile:	39.9%
Dividend Risk Score:	F	Retirement Suitability Score:	C	Total Return Percentile:	48.8%

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 \$2.4 billion.

Prospect reported Q4 and full-year earnings on 8/27/19, and results were largely as expected. The company ended the year with \$312 million in net investment income, up substantially from the \$287 million produced in the prior year. On a per-share basis, NII was essentially flat as the share count rose at about the same rate as NII.

Total investments as of the end of the fiscal year were \$5.6 billion, down fractionally from the year-ago period. Prospect has 135 different companies in its portfolio, with 44% of its investments in secured first liens, 24% in secured second liens, 15% in subordinated notes, and 16% in equity investments. This structure has been quite stable over time as Prospect appears to favor a small amount of equity investments and a diversified debt portfolio of all risk types.

Average leverage ended the year at 4.7x EBITDA, while its average portfolio yield including equity investments was 10.6%. This was up fractionally year-over-year, as was the debt portfolio yield of 13.1%.

We're out with an initial estimate for fiscal 2020 of 82 cents in NII as we see prepayments as a risk for Prospect and other BDCs given the significant move down in yields in recent months.

Growth on a Per-Share Basis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
NII	\$0.33	\$1.38	\$1.67	\$1.57	\$1.19	\$1.03	\$1.04	\$0.85	\$0.79	\$0.79	\$0.82	\$0.82
DPS	\$1.33	\$1.21	\$1.22	\$1.28	\$1.32	\$1.19	\$1.00	\$1.00	\$0.77	\$0.72	\$0.72	\$0.72
Shares¹	59	86	114	207	343	359	357	360	364	367	370	385

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. Part of this is due to Prospect's prodigious share count, which is about six 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 excessive. Given this history of dilution and weak net investment income performance, we don't expect growth on a per share basis.

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 well under \$6 billion today while total assets were \$6.4 billion five years ago.

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.

¹ Share count in millions

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.



Prospect Capital Corporation (PSEC)

Updated September 9th, 2019 by Josh Arnold

Valuation Analysis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Now	2025
Avg. P/NII	33.0	7.8	6.0	7.1	9.2	8.8	6.9	9.9	8.7	8.0	8.0	7.0
Avg. Yld.	12.2%	11.3%	12.3%	11.5%	12.1%	13.1%	13.8%	11.8%	11.3%	10.6%	11.0%	12.5%

Prospect's average price to net investment income has averaged 8.2 in the past decade excluding 2010's outlier. We see fair value as lower than that at 7 times net investment income given that the company's growth outlook has deteriorated. We therefore see a 2.5% headwind to total annual returns from the valuation drifting lower over time.

Likewise, the company's current dividend yield at 11% is relatively low by historical standards, implying that the stock could be a bit overvalued. We see the yield rising back to 12.5%, which is more in line with the company's history.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
Payout	403%	88%	73%	82%	111%	116%	96%	118%	97%	85%	88%	88%

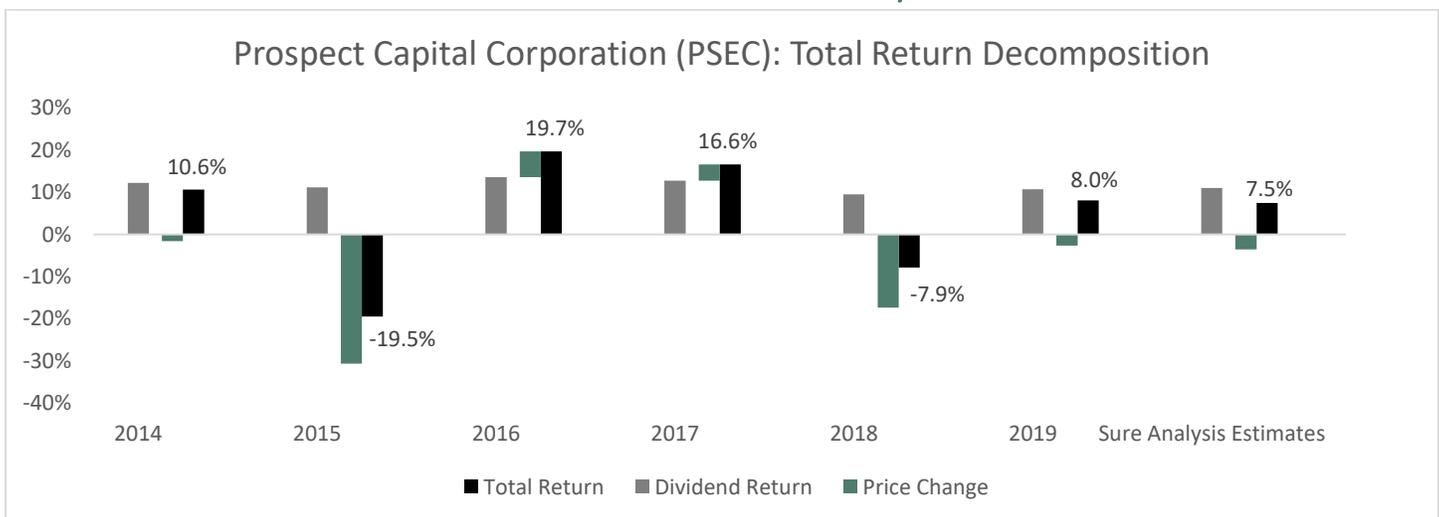
One of the issues with business development companies is that competitive advantages are very difficult to come by, and Prospect is certainly no exception. Scale is the name of the game for BDCs and with a shrinking balance sheet, Prospect has lost some of its scale over time.

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 with certainty that 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 should wait for a better price. We are forecasting 7.5% in total returns in the coming years, consisting of the 11% yield, no growth, and a small headwind from the valuation. With this in mind, we are downgrading Prospect from hold to sell given the risk to the company's NII, as well as the valuation.

Total Return Breakdown by Year



[Click here to rate and review this research report. Your feedback is important to us.](#)

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.



Prospect Capital Corporation (PSEC)

Updated September 9th, 2019 by Josh Arnold

Income Statement Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Revenue										
SG&A Exp.										
Net Profit										
Net Margin										
Free Cash Flow										

Balance Sheet Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Total Assets										
Cash & Equivalents										
Accounts Receivable										
Total Liabilities										
Accounts Payable										
Long-Term Debt										
Shareholder's Equity										
D/E Ratio										

Profitability & Per Share Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Return on Assets										
Return on Equity										
ROIC										
Shares Out.										
Revenue/Share										
FCF/Share										

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

Disclaimer

Nothing presented herein is, or is intended to constitute, specific investment advice. Nothing in this research report should be construed as a recommendation to follow any investment strategy or allocation. Any forward-looking statements or forecasts are based on assumptions and actual results are expected to vary from any such statements or forecasts. No reliance should be placed on any such statements or forecasts when making any investment decision. While Sure Dividend has used reasonable efforts to obtain information from reliable sources, we make no representations or warranties as to the accuracy, reliability or completeness of third-party information presented herein. No guarantee of investment performance is being provided and no inference to the contrary should be made. There is a risk of loss from an investment in marketable securities. Past performance is not a guarantee of future performance.