



Prospect Capital Corporation (PSEC)

Updated February 19th, 2020 by Josh Arnold

Key Metrics

Current Price:	\$6.54	5 Year CAGR Estimate:	5.7%	Market Cap:	\$2.4B
Fair Value Price:	\$5.00	5 Year Growth Estimate:	0.0%	Ex-Dividend Date:	04/29/20
% Fair Value:	130%	5 Year Valuation Multiple Estimate:	-5.1%	Dividend Payment Date:	05/21/20
Dividend Yield:	11.0%	5 Year Price Target	\$5.00	Years Of Dividend Growth:	0
Dividend Risk Score:	F	Retirement Suitability Score:	C	Last Dividend Increase:	N/A

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.

We note that Prospect has had to file amended 1099 tax forms at times in the past, causing additional work for those that own shares when filing taxes for dividends received from the company.

Prospect reported Q2 earnings on February 10th and results were slightly below expectations. Net investment income came to \$67.9 million, or 18 cents per share, both of which were down from last year's Q2. Those figures were \$80.8 million and 22 cents per share, respectively. Total investment income was \$161.9 million, which was down from \$187.9 million in the year-ago period.

Total originations were \$326.6 million in Q2 while repayments were \$431.5 million. However, the first half of the March quarter saw originations at \$322.3 million against just \$22.8 million in repayments. This net gain in portfolio size should help offset some of the recent declines but Prospect continues to struggle with growth.

Net asset value per share was \$8.66 at the end of 2019, down from \$8.87 in the September quarter. We've also cut our net investment income per share estimate from 78 cents to 72 cents on relatively weak results, as well as net repayments that have thus far occurred. We continue to think Prospect will struggle to grow NII.

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	\$0.72	\$0.72
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	367	385

Growth has been tough to come by for Prospect in 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

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.



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today, and that we don't see any meaningful net investment income growth. Should NII deteriorate meaningfully from current levels, the distribution will be at risk of yet another cut. We note that Prospect is willing and able to issue shares to cover any deficits between NII and the payout. While this doesn't make the dividend safe necessarily, this behavior is far from unprecedented for a BDC.

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	9.1	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%	14.3%

Prospect's 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 ~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 is bit overvalued. We see the yield rising to 14.3%, which is the result of a stagnant payout on a lower share price.

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%	100%	100%

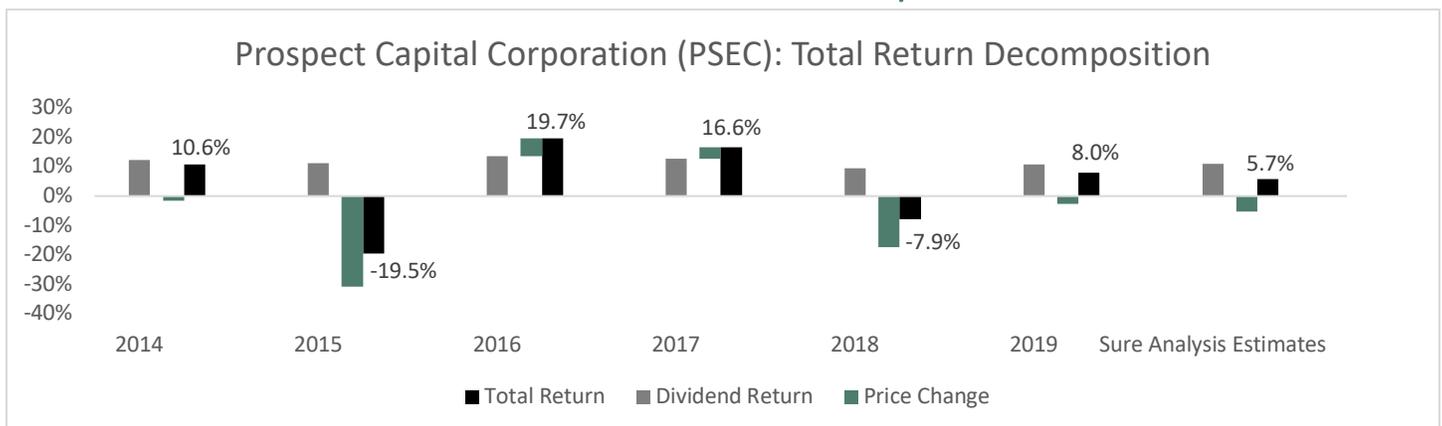
One of the issues with business development companies is that competitive advantages are very difficult to come by, and Prospect is certainly no exception. Scale is the name of the game for BDCs and with a shrinking balance sheet, Prospect has lost some of its scale over time.

The company's payout ratio was over 100% for several years in the past decade, but current net investment income covers the dividend, if only just. While we cannot say with certainty that no further cuts are coming, the dividend is in 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 high today, particularly in light of the company's growth outlook. The yield is also low by historical standards. We are forecasting 5.7% in total returns in the coming years, consisting of the 11% yield, no growth, and a headwind from the valuation. With this in mind, we are reiterating Prospect as a sell given the risk to the company's NII, as well as the valuation.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Revenue	178	326	284	137	379	346	245	204	130	28
SG&A Exp.	34	26	32	32	30	31	18	13	12	7
Net Profit	144	300	253	103	346	319	221	191	118	20
Net Margin	81.1%	92.0%	89.2%	75.3%	91.4%	92.3%	90.2%	93.5%	91.1%	70.4%
Free Cash Flow	224	369	376	862	45	-1725	-1786	-229	-582	55

Balance Sheet Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Total Assets	5800	5839	6173	6236	6798	6477	4448	2255	1549	833
Cash & Equivalents	107	84	318	318	110	134	203	3	1	1
Total Liabilities	2494	2432	2818	2800	3095	2859	1792	743	435	121
Accounts Payable	56	56	69	71	70	75	52	21	11	
Long-Term Debt	2383	2312	2642	2667	2984	2773	1683	664	407	100
Shareholder's Equity	3306	3407	3355	3436	3703	3618	2656	1512	1114	711
D/E Ratio	0.72	0.68	0.79	0.78	0.81	0.77	0.63	0.44	0.37	0.14

Profitability & Per Share Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Return on Assets	2.5%	5.0%	4.1%	1.6%	5.2%	5.8%	6.6%	10.0%	9.9%	2.6%
Return on Equity	4.3%	8.9%	7.4%	2.9%	9.5%	10.2%	10.6%	14.5%	13.0%	3.2%
ROIC	2.5%	5.1%	4.2%	1.6%	5.3%	5.9%	6.8%	10.3%	10.1%	2.7%
Shares Out.	59	86	114	207	343	359	357	360	364	367
Revenue/Share	0.49	0.90	0.79	0.39	1.07	1.15	1.18	1.78	1.51	0.47
FCF/Share	0.61	1.02	1.05	2.42	0.13	-5.75	-8.63	-2.01	-6.76	0.92

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

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