



Capitala Finance Corp. (CPTA)

Updated March 23rd, 2020 by Samuel Smith

Key Metrics

Current Price:	\$3.09	5 Year CAGR Estimate:	15.6%	Market Cap:	\$50M
Fair Value Price:	\$0.60	5 Year Growth Estimate:	47.6%	Ex-Dividend Date:	4/19/20 ¹
% Fair Value:	515%	5 Year Valuation Multiple Estimate:	-27.9%	Dividend Payment Date:	4/30/20 ²
Dividend Yield:	8.1%	5 Year Price Target	\$4.00	Years Of Dividend Growth:	0
Dividend Risk Score:	F	Retirement Suitability Score:	C	Last Dividend Increase:	NA

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 \$45 million in revenue annually and trades with a \$50 million market capitalization.

Capitala reported Q4 earnings on March 2nd. It reported new investments of \$29 million during the quarter, of which \$27.4 million were first lien debt with a weighted average interest rate of 9%. The remainder was invested in equity stakes. At year-end, net asset value per share stood at \$9.14, down sequentially from \$9.40. The company also amended its senior secured revolving credit facility, requiring the company to maintain 150% asset coverage, and also dismissed a class action lawsuit with no settlement.

Growth on a Per-Share Basis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
NII	---	---	---	\$1.50	\$1.54	\$1.67	\$1.84	\$0.98	\$1.00	\$0.90	\$0.10	\$0.70
DPS	---	---	---	\$0.47	\$1.88	\$2.38	\$1.80	\$1.47	\$1.00	\$1.00	\$0.25	\$0.60
Shares³	---	---	---	13.0	13.0	15.2	15.8	15.9	16.0	16.2	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.

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.

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. We've moved our dividend forecast to a negative growth rate due to these headwinds. The outbreak of the coronavirus and the Fed's decision to significantly cut interest rates serve as additional major headwinds that we think will force the company to suspend the remainder of its dividends for the year.

¹ Estimate

² Estimate

³ 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.



Capitala Finance Corp. (CPTA)

Updated March 23rd, 2020 by Samuel Smith

Valuation Analysis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Now	2025
Avg. P/NII	---	---	---	12.8	12.2	9.6	7.1	11.9	8.1	9.5	30.9	6.0
Avg. Yld.	---	---	---	2.4%	10.0%	14.9%	13.8%	12.6%	12.3%	11.7%	8.1%	14.3%

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 the headwinds from the coronavirus and economic headwinds are prompting us to lower our fair value estimate further from 9 times NII to 6 times NII.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
Payout	---	---	---	31%	122%	143%	98%	150%	100%	111%	250%	86%

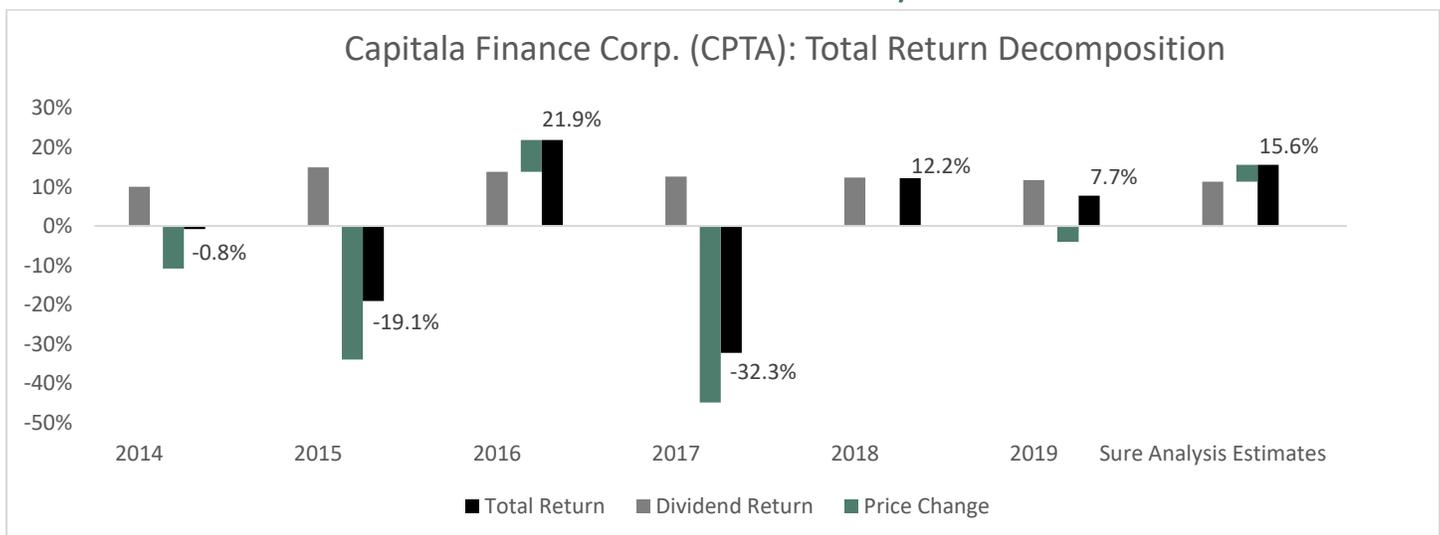
Capitala doesn't have any competitive advantages as it offers the same financing products as any other company in the sector. Its small scale doesn't help either, and this contributes to slim margins. Capitala didn't exist during the Great Recession but middle market lenders suffered immensely due to 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 likely unsustainable because the coronavirus will likely crush earnings this year and force the company to suspend it or at least make a deep cut. The risky and mandated high-payout business model prevents this company from ever becoming a safe dividend payer.

Final Thoughts & Recommendation

Capitala looks quite risky given the current environment, prompting us to forecast steep drops in earnings and a deep cut in the dividend. Despite the risks, the stock has sold off so hard that we still think there is a chance that it could generate strong total returns of 15.6% annualized over the next half decade. However, it cannot be overstated that this remains a very speculative investment that is not suited for conservative income focused investors, and there are probably better opportunities in this space right now. We therefore rate it a sell for conservative investors and a hold for aggressive investors.

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.



Capitala Finance Corp. (CPTA)

Updated March 23rd, 2020 by Samuel Smith

Income Statement Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Revenue				30	1	17	11	0	-13	-23
SG&A Exp.				1	4	4	4	7	5	5
Net Profit				29	-3	14	9	-7	-16	(28)
Net Margin				96.7%	-555%	82.2%	81.1%	N/A	121%	122%
Free Cash Flow				-39	-119	-96	69	44	27	65
Income Tax						0	0	1	-2	1

Balance Sheet Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Total Assets				476	540	633	584	535	493	427
Cash & Equivalents				102	55	34	36	31	39	62
Total Liabilities				208	299	364	334	313	303	279
Accounts Payable				3	3	3	3	3	3	3
Long-Term Debt				202	296	359	321	299	297	273
Shareholder's Equity				269	241	269	251	222	191	148
D/E Ratio				0.75	1.23	1.34	1.28	1.35	1.56	1.84

Profitability & Per Share Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Return on Assets				7.2%	-0.7%	2.4%	1.5%	-1.2%	-3.1%	-6.0%
Return on Equity				14.0%	-1.4%	5.4%	3.5%	-3.0%	-7.8%	-16.3%
ROIC				7.3%	-0.7%	2.4%	1.5%	-1.3%	-3.2%	-6.1%
Shares Out.				13.0	13.0	15.2	15.8	15.9	15.99	16.2
Revenue/Share				2.30	0.05	1.11	0.71	0.00	-0.83	(1.40)
FCF/Share				-2.99	-9.20	-6.34	4.37	2.75	1.71	4.01

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.