



Stellus Capital Management (SCM)

Updated March 8, 2020 by Josh Arnold

Key Metrics

Current Price:	\$12	5 Year CAGR Estimate:	11.0%	Market Cap:	\$233M
Fair Value Price:	\$12	5 Year Growth Estimate:	2.0%	Ex-Dividend Date:	03/30/20
% Fair Value:	99%	5 Year Valuation Multiple Estimate:	0.3%	Dividend Payment Date:	04/15/20
Dividend Yield:	11.4%	5 Year Price Target	\$13	Years Of Dividend Growth:	0
Dividend Risk Score:	F	Retirement Suitability Score:	C	Last Dividend Increase:	N/A

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, should produce about \$65 million in revenue this year, and has a \$233 million market capitalization.

Stellus reported Q4 and full-year earnings on March 3rd and results beat on the bottom line, but slightly missed top line consensus. Net investment income, or NII, came to \$1.23 for the year. The company also saw \$1.07 per share in realized gains on its portfolio, bringing totally realized income to \$2.30 per share for 2019. We report NII as that is the standard for BDCs, and is a measure of true operating earnings. However, Stellus uses realized gains, in addition to NII, to pay its dividend, so the surplus for 2019 was meaningful at nearly a dollar per share.

Stellus boosted its total assets from \$526 million to \$649 million year-over-year, while net assets rose from \$225 million to \$271 million. On a per-share basis, net assets were essentially flat, adding less than half a percent to \$14.14.

We see NII per share at \$1.28 for this year as Stellus continues to grow its portfolio, but offsets those gains with share issuances. We are also somewhat cautious on the company's ability to issue new loans at favorable rates given the new, lower yield curve, but also note this should help with funding costs.

Growth on a Per-Share Basis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
NII	---	---	\$0.11	\$1.33	\$1.34	\$1.33	\$1.39	\$1.21	\$1.42	\$1.23	\$1.28	\$1.41
DPS	---	---	\$0.18	\$1.43	\$1.36	\$1.36	\$1.36	\$1.36	\$1.36	\$1.36	\$1.36	\$1.36
Shares¹	---	---	12.0	12.1	12.3	12.5	12.5	14.9	16.0	18.9	20.0	26.0

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 largely 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. Stellus has had net new portfolio activity of \$125 million and \$118 million, respectively, in the past two years, and we see this asset growth continuing indefinitely. Stellus recently boosted the size of its credit line to \$220 million from \$180 million, giving it extra cash to lend when an opportunity arises.

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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Valuation Analysis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Now	2025
Avg. P/NII	---	---	N/A	11.2	10.5	8.5	7.5	11.3	9.0	11.4	9.4	9.5
Avg. Yld.	---	---	1.2%	9.6%	9.7%	12.0%	13.0%	9.9%	10.6%	9.7%	11.4%	10.1%

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 fairly valued today given it trades for 9.4 times NII, implying essentially no impact from the valuation in the coming years.

The dividend yield is back to 11.4%, which is more in line with its historical values, so we see Stellus as much more attractive on a valuation and yield basis than it was at the time of our last report.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
Payout	---	---	164%	108%	101%	102%	98%	112%	96%	106%	106%	96%

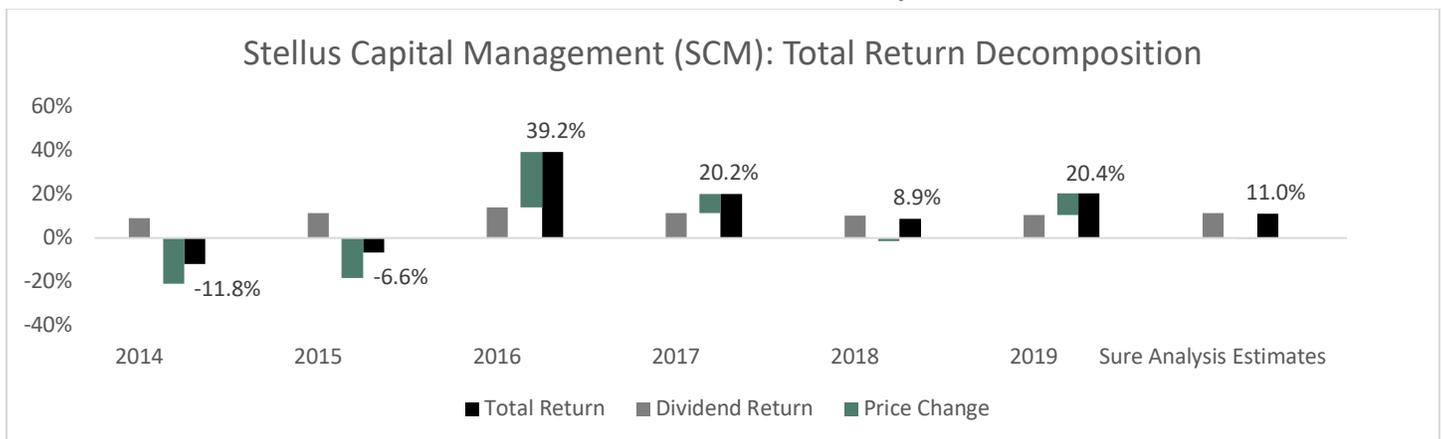
Stellus, like other BDCs, has no competitive advantages. It offers the same products as any other BDC to the same set of customers, so advantages are virtually impossible to achieve. In addition, BDCs suffer mightily during recessions because borrowers have a more difficult time meeting repayment timelines. 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, as well as using realized gains on its portfolio. 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 strong total returns in the coming years of 11.0%, consisting of 2% NII growth, the 11.4% dividend yield, and little impact from the valuation. Stellus has many inherent risks, as outlined above, but the strong total return outlook has us upgrading shares to hold.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Revenue	N/A	N/A	N/A	29	32	35	26	27	31	32
Gross Profit	N/A	N/A	N/A	25	27	29	N/A	N/A	N/A	
Gross Margin	N/A	N/A	N/A	85.6%	83.9%	83.4%	0.0%	0.0%	0.0%	
SG&A Exp.	N/A	N/A	N/A	7	7	7	4	5	4	4
Operating Profit	N/A	N/A	N/A	18	20	22	N/A	N/A	N/A	
Operating Margin	N/A	N/A	N/A	61.8%	63.2%	62.8%	0.0%	0.0%	0.0%	
Net Profit	N/A	N/A	N/A	18	10	8	23	23	26	26
Net Margin	N/A	N/A	N/A	59.7%	31.5%	21.8%	87.7%	83.0%	84.3%	83.4%
Free Cash Flow	N/A	N/A	N/A	29	32	35	26	27	31	
Income Tax	N/A	N/A	N/A	25	27	29	N/A	N/A	N/A	

Balance Sheet Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Total Assets	N/A	N/A	263	298	327	365	380	400	526	649
Cash & Equivalents	N/A	N/A	62	14	2	11	9	25	17	16
Accounts Receivable	N/A	N/A	N/A	0	0	0	N/A	N/A	N/A	
Total Liabilities	N/A	N/A	89	122	153	201	209	180	301	378
Accounts Payable	N/A	N/A	5	3	3	3	3	3	4	4
Long-Term Debt	N/A	N/A	N/A	119	148	196	203	174	292	366
Shareholder's Equity	N/A	N/A	174	176	174	165	171	220	225	271
D/E Ratio	N/A	N/A	N/A	0.68	0.85	1.19	1.19	0.79	1.30	1.35

Profitability & Per Share Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Return on Assets	N/A	N/A	N/A	N/A	3.3%	2.2%	6.2%	5.8%	5.7%	4.5%
Return on Equity	N/A	N/A	N/A	10.0%	5.8%	4.5%	13.8%	11.6%	11.8%	10.7%
ROIC	N/A	N/A	N/A	N/A	3.3%	2.2%	6.3%	5.9%	5.7%	4.6%
Shares Out.	N/A	N/A	12.0	12.1	12.3	12.5	12.5	14.9	16.0	18.9
Revenue/Share	N/A	N/A	N/A	2.44	2.63	2.82	2.12	1.83	1.95	1.73
FCF/Share	N/A	N/A	N/A	-5.67	-2.21	-1.96	0.71	1.27	-6.42	-5.10

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

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