



Gladstone Capital (GLAD)

Updated May 9th, 2020 by Josh Arnold

Key Metrics

| | | | | | |
|-----------------------------|--------|--|--------|----------------------------------|----------|
| Current Price: | \$6.33 | 5 Year CAGR Estimate: | 14.2% | Market Cap: | \$197M |
| Fair Value Price: | \$8.00 | 5 Year Growth Estimate: | 1.0% | Ex-Dividend Date: | 06/18/20 |
| % Fair Value: | 79% | 5 Year Valuation Multiple Estimate: | 4.8% | Dividend Payment Date: | 06/30/20 |
| Dividend Yield: | 12.3% | 5 Year Price Target | \$8.40 | Years Of Dividend Growth: | 0 |
| Dividend Risk Score: | F | Retirement Suitability Score: | C | Last Dividend Increase: | N/A |

Overview & Current Events

Gladstone Capital is a business development company, or BDC, that primarily invests in small and medium businesses. These investments are made via a variety of equity (10% of portfolio) and debt instruments (90% of portfolio), generally with very high yields. Loan size is typically in the \$7 million to \$30 million range and has terms up to seven years. The BDC's stated purpose is to generate income it can distribute to its shareholders. It trades today with a market capitalization of \$197 million and for income investors, it pays distributions monthly, instead of quarterly.

Gladstone reported second quarter earnings on May 4th with results coming in largely in line with expectations. Net investment income came to 21 cents per share, even with the first quarter of this fiscal year. Total investment income was \$11.5 million, down from Q1's \$12.2 million. Interest income was down due to lower average LIBOR rates, which sent Gladstone's weighted average yield on its interest-bearing portfolio to 10.9% during the quarter, which was down from 11.3% in Q1.

Net assets decreased by \$28 million, or \$0.89 per share during the quarter, which now stands at \$6.99 per share. We've cut our NII-per-share estimate from \$0.85 to \$0.80 for this year as Gladstone seems to be holding up quite well during the downturn.

Gladstone also cut its distribution for the first time in more than a decade as it slashed -7% from its monthly payout, which now stands at an annualized \$0.78 per share. We think the relatively small cut to the payout signals management's confidence that damage to NII-per-share will be relatively limited.

Growth on a Per-Share Basis

| Year | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2025 |
|---------------------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|---------------|---------------|
| NII | \$0.84 | \$0.88 | \$0.91 | \$0.88 | \$0.87 | \$0.84 | \$0.84 | \$0.84 | \$0.85 | \$0.84 | \$0.80 | \$0.84 |
| DPS | \$0.84 | \$0.84 | \$0.84 | \$0.84 | \$0.84 | \$0.84 | \$0.84 | \$0.84 | \$0.84 | \$0.84 | \$0.78 | \$0.78 |
| Shares¹ | 21.1 | 21.0 | 21.0 | 21.0 | 21.0 | 21.1 | 23.2 | 25.5 | 27.1 | 29.3 | 33.0 | 41.0 |

Gladstone reports net investment income per share, or NII, instead of earnings-per-share, which is consistent with other BDCs. On that measure, the company's results have been fairly lackluster in terms of growth over the past decade. Our estimate of 80 cents for this year is down from historical NII, but only slightly. Gladstone's share issuances have funded higher NII in dollar terms but haven't earned enough above its cost of capital to move the needle on NII-per-share. Given this history, we estimate Gladstone's long-term growth at 1%.

The yields on the company's portfolio influence its ability to earn income and therefore, cover its expenses and pay distributions to shareholders. Over time, the company's portfolio yield has drifted higher to ~11% where it is today. However, higher expenses have offset that growth recently, which is part of the reason why NII-per-share continues to be flat over time. Gladstone's portfolio continues to grow in dollar terms, but given its offsetting rising expenses, and loan non-accruals, NII hasn't grown. We see this cycle of new investments being largely offset by losses and higher expenses.

¹ Share count in millions

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Gladstone's dividend had been at \$0.07 monthly, or \$0.84 annually, since 2010. However, the cut for Q2 has the annualized payout at \$0.78 now. We see this payout as covered by NII-per-share moving forward.

Valuation Analysis

| Year | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | Now | 2025 |
|------------|------|------|-------|------|------|-------|-------|------|------|------|-------|------|
| Avg. P/NII | 13.1 | 10.7 | 9.2 | 10.1 | 10.9 | 10.0 | 9.1 | 11.4 | 10.7 | 10.8 | 7.9 | 10.0 |
| Avg. Yld. | 7.6% | 8.9% | 10.1% | 9.5% | 8.8% | 10.0% | 11.0% | 8.8% | 9.3% | 9.2% | 12.3% | 9.3% |

Gladstone has traded at a price-to-NII ratios of between 7.8 and 13.1 in the past decade, both of which occurred at the beginning of the period. More recently, the stock has traded around 10 times NII, which is where we assess fair value. At 7.9 times NII, the stock appears to be undervalued. Should it revert to 10 times NII, shareholders would see a sizable annual tailwind to total returns.

The yield is also much higher than it typically is at 12.3%; Gladstone's average yield in the past decade has been 10%, and we see the yield falling back to that level over time. Both metrics suggest the stock is undervalued at present.

Safety, Quality, Competitive Advantage, & Recession Resiliency

| Year | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2025 |
|--------|------|------|------|------|------|------|------|------|------|------|------|------|
| Payout | 100% | 95% | 92% | 95% | 97% | 100% | 100% | 100% | 99% | 100% | 98% | 93% |

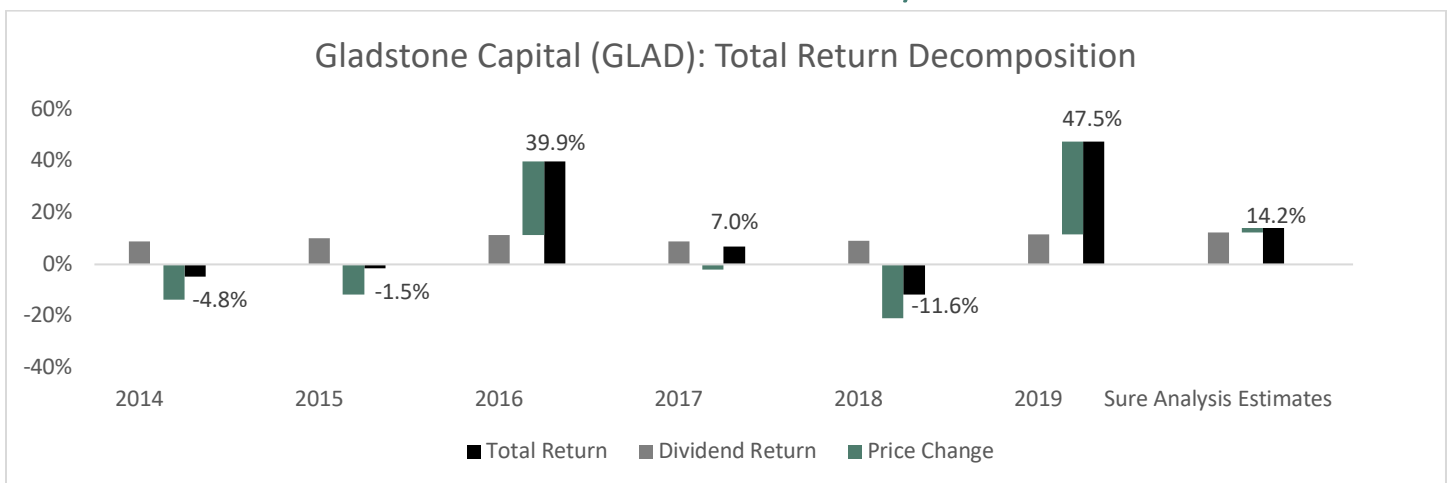
Gladstone doesn't have any competitive advantages as it operates in much the same way as any other BDC. It is also dependent upon funding costs and the spreads it can earn on its debt and equity investments. During recessions, Gladstone will likely struggle as repayments may become a problem for its debt investments. Indeed, this caused the company to cut its dividend during the Great Recession, and it hasn't recovered.

Gladstone cut its distribution for this reason in Q2 2020, and we believe the cut should be enough for this year.

Final Thoughts & Recommendation

We see 14.2% total annual returns in the coming years as Gladstone's valuation tailwind is aided by the generous yield. We're giving Gladstone a two-notch upgrade from sell to buy as the company's valuation has improved sizably, and even with the lower payout, the yield is nearly 10%. We think the current share price compensates for the risk of Gladstone, and we see this as an attractive entry point for long-term investors.

Total Return Breakdown by Year



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Income Statement Metrics

| Year | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|----------------|-------|------|-------|-------|-------|-------|-------|-------|-------|-------|
| Revenue | 29 | -12 | 4 | 43 | 24 | 21 | 25 | 30 | 31 | 33 |
| SG&A Exp. | 4 | 6 | 7 | 6 | 6 | 6 | 7 | 7 | 8 | 8 |
| Net Profit | 16 | -21 | -8 | 32 | 11 | 8 | 11 | 17 | 19 | 20 |
| Net Margin | 57.3% | 175% | -212% | 75.4% | 46.1% | 40.4% | 46.0% | 56.8% | 59.5% | 59.4% |
| Free Cash Flow | 87 | -68 | 26 | 32 | 0 | -74 | 60 | -13 | -18 | 9 |

Balance Sheet Metrics

| Year | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|----------------------|------|------|------|------|------|------|------|------|------|------|
| Total Assets | 271 | 318 | 293 | 295 | 301 | 382 | 336 | 366 | 400 | 426 |
| Cash & Equivalents | 8 | 7 | 10 | 14 | 6 | 4 | 6 | 5 | 2 | 16 |
| Accounts Receivable | 3 | 3 | 3 | 2 | 3 | 6 | 2 | 2 | 3 | 3 |
| Total Liabilities | 21 | 104 | 105 | 89 | 102 | 191 | 134 | 146 | 162 | 177 |
| Accounts Payable | 1 | 0 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 |
| Long-Term Debt | 18 | 100 | 62 | 47 | 38 | 127 | 71 | 93 | 110 | 123 |
| Shareholder's Equity | 249 | 214 | 189 | 206 | 200 | 191 | 201 | 220 | 237 | 249 |
| D/E Ratio | 0.07 | 0.47 | 0.33 | 0.23 | 0.19 | 0.66 | 0.35 | 0.42 | 0.46 | 0.49 |

Profitability & Per Share Metrics

| Year | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 |
|------------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| Return on Assets | 5.4% | -7.2% | -2.6% | 10.9% | 3.8% | 2.5% | 3.2% | 4.9% | 4.9% | 4.8% |
| Return on Equity | 6.6% | -9.1% | -4.0% | 16.3% | 5.5% | 4.3% | 5.8% | 8.2% | 8.2% | 8.2% |
| ROIC | 5.5% | -7.3% | -2.8% | 12.8% | 4.6% | 3.0% | 3.8% | 5.9% | 5.7% | 5.5% |
| Shares Out. | 21.06 | 21.04 | 21.01 | 21.00 | 21.00 | 21.07 | 23.20 | 25.50 | 27.10 | 29.30 |
| Revenue/Share | 1.36 | -0.57 | 0.18 | 2.03 | 1.16 | 1.00 | 1.07 | 1.19 | 1.16 | 1.14 |
| FCF/Share | 4.11 | -3.25 | 1.25 | 1.53 | 0.02 | -3.54 | 2.59 | -0.51 | -0.66 | 0.32 |

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

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