



Prospect Capital Corporation (PSEC)

Updated May 12th, 2020 by Josh Arnold

Key Metrics

Current Price:	\$4.29	5 Year CAGR Estimate:	14.3%	Market Cap:	\$1.5B
Fair Value Price:	\$4.80	5 Year Growth Estimate:	0.0%	Ex-Dividend Date:	05/29/20
% Fair Value:	90%	5 Year Valuation Multiple Estimate:	2.1%	Dividend Payment Date:	06/18/20
Dividend Yield:	16.8%	5 Year Price Target	\$4.80	Years Of Dividend Growth:	0
Dividend Risk Score:	F	Retirement Suitability Score:	B	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 \$1.5 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 third quarter earnings on May 11th, and results beat lowered expectations on the top and bottom lines. Net investment income came to \$68.5 million, or 19 cents per share in Q3, both of which were up from Q2, but were lower than the year-ago period values of \$77.3 million and 21 cents per share, respectively. Estimates had been much worse, with analysts expecting just 14 cents per share in NII.

Total investment income was \$154.5 million, down from \$171.1 million in the year-ago period as the company's net yields continue to be under pressure. BDCs across the industry are struggling with ways to produce stronger yields in a very low interest rate environment, and Prospect is grappling with that as well.

Total originations came to \$402 million, up from \$327 million in Q2. Total repayments were \$267 million, down from \$432 million in Q2. NAV per share was \$7.98 at the end of March, down 68 cents from the end of December.

The company said it is seeking shareholder approval to sell common shares below NAV for one year, presumably to help sustain the dividend. The company has no current plans to reduce or suspend the dividend.

We've cut our NII per share estimate from 72 cents to 68 cents for 2020 after Q3 results.

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	\$0.68	\$0.68
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	368	400

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 just over \$5 billion today, while total assets were \$6.4 billion five years ago.

¹ Share count in millions

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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 with a combination of NII and new shares, 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	6.3	7.0
Avg. Yld.	12.2%	11.3%	12.3%	11.5%	12.1%	13.1%	13.8%	11.8%	11.3%	10.6%	16.8%	15.1%

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 see a small tailwind to total annual returns from the valuation drifting higher over time.

The company's current dividend yield at 16.8% is enormous by historical standards, implying that the stock may be undervalued. We see the yield falling to 15.1%, which is the result of a stagnant payout on a higher 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%	106%	106%

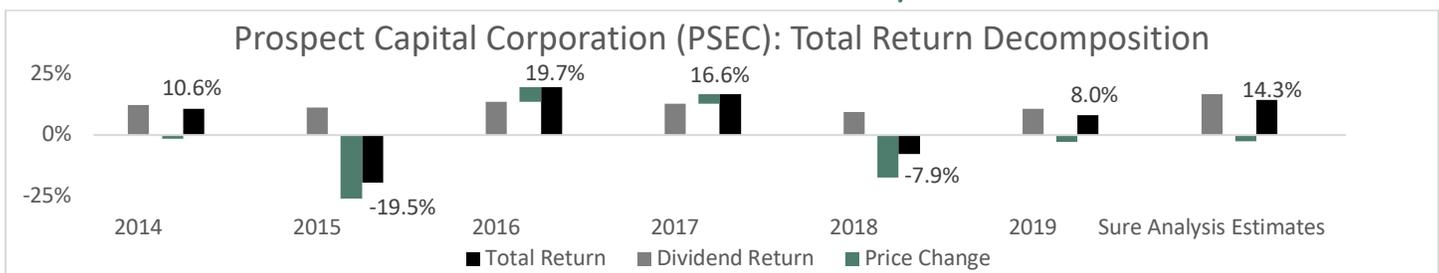
One of the issues with business development companies is that competitive advantages are very difficult to come by, and Prospect is certainly no exception. Scale is the name of the game for BDCs and with a shrinking balance sheet, Prospect has lost some of its scale over time.

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 reasonable today, particularly in light of the company's reduced growth outlook. The yield is also very high by historical standards. We are forecasting 14.2% in total returns in the coming years, consisting of the 16.8% yield, no growth, and a tailwind from the valuation. Given this, we are bumping Prospect from sell to hold as we think the current share price is fair given the risks facing the company.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Revenue	28	130	204	245	346	379	137	284	326	178
SG&A Exp.	7	12	13	18	31	30	32	32	26	34
Net Profit	20	118	191	221	319	346	103	253	300	144
Net Margin	70.4%	91.1%	93.5%	90.2%	92.3%	91.4%	75.3%	89.2%	92.0%	81.1%
Free Cash Flow	55	(582)	(229)	(1,786)	(1,725)	45	862	376	369	224

Balance Sheet Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Total Assets	833	1,549	2,255	4,448	6,477	6,798	6,236	6,173	5,839	5,800
Cash & Equivalents	1	1	3	203	134	110	318	318	84	107
Total Liabilities	121	435	743	1,792	2,859	3,095	2,800	2,818	2,432	2,494
Accounts Payable	---	11	21	52	75	70	71	69	56	56
Long-Term Debt	100	407	664	1,683	2,773	2,984	2,667	2,642	2,312	2,383
Shareholder's Equity	711	1,114	1,512	2,656	3,618	3,703	3,436	3,355	3,407	3,306
D/E Ratio	0.14	0.37	0.44	0.63	0.77	0.81	0.78	0.79	0.68	0.72

Profitability & Per Share Metrics

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

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

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