



Stellus Capital Management (SCM)

Updated June 1st, 2020 by Josh Arnold

Key Metrics

Current Price:	\$8.05	5 Year CAGR Estimate:	12.8%	Market Cap:	\$157 M
Fair Value Price:	\$8.00	5 Year Growth Estimate:	2.0%	Ex-Dividend Date:	06/30/20 ¹
% Fair Value:	101%	5 Year Valuation Multiple Estimate:	-0.1%	Dividend Payment Date:	07/15/20 ²
Dividend Yield:	16.9%	5 Year Price Target	\$8.80	Years Of Dividend Growth:	0
Dividend Risk Score:	F	Retirement Suitability Score:	B	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 \$60 million in revenue this year, and has a \$157 million market capitalization.

Stellus reported first quarter earnings on May 12th, with results coming in largely as expected. Net investment income, or NII, came in at \$0.32 per share, up from \$0.27 in the year-ago period. However, realized gains were \$0.63 per share in the year-ago period, but just \$0.07 in this year's Q1. Unrealized depreciation on the company's portfolio was up more than ten-fold year-over-year due to disruptions in the debt markets due to COVID-19. Total net unrealized depreciation was \$2.65 per share in Q1, compared to \$0.28 in last year's Q1.

Net asset value per share declined from \$14.14 to \$11.55 year-over-year, despite the fact that the company was able to grow its loan portfolio. New investments of \$61.5 million compared to repayments of \$31.8 million, for a net increase of \$29.7 million. Last year's Q1 saw a net increase of just \$6.8 million.

We've cut our estimate of NII per share for this year again to \$1.00 as Stellus' earnings capacity is holding up quite well despite numerous headwinds, but we're still cautious.

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	\$1.00	\$1.10
DPS	---	---	\$0.18	\$1.43	\$1.36	\$1.36	\$1.36	\$1.36	\$1.36	\$1.36	\$1.36	\$1.05
Shares³	---	---	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 from today's relatively low level.

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

¹ Estimated date

² Estimated date

³ Share count in millions

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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.

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	8.1	8.0
Avg. Yld.	---	---	1.2%	9.6%	9.7%	12.0%	13.0%	9.9%	10.6%	9.7%	16.9%	11.9%

Stellus has traded with an average price-to-NII ratio of 9.7 in its relatively short history as a public company, but given economic and interest rate-related headwinds, we've moved fair value to 8 times NII. 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 8.1 times NII, implying essentially no impact from the valuation in the coming years.

The dividend yield is up to 16.9%, which is in excess of historical values, as we believe the market is pricing in a dividend cut that has yet to occur.

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%	136%	95%

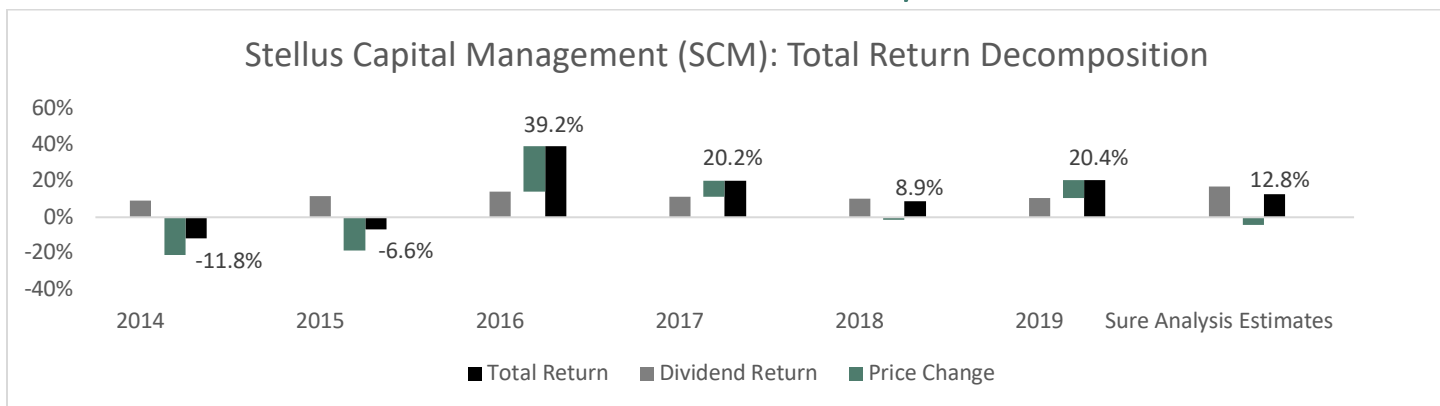
Stellus, like other BDCs, has no competitive advantages. It offers the same products as any other BDC to the same set of customers, so advantages are virtually impossible to achieve. In addition, BDCs suffer mightily during recessions because borrowers have a more difficult time meeting repayment timelines. Stellus wasn't around during the last recession but we see it as having significant issues with NII generation during this recession.

Stellus is required to pay virtually all of its NII in distributions as a BDC, so the payout ratio will always be high. We are currently forecasting a dividend cut over time, but note that Stellus hasn't cut the distribution yet. 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. We don't believe the payout is safe.

Final Thoughts & Recommendation

Stellus recently changed to a quarterly dividend schedule, rather than monthly, and with the share price having fallen, prospective returns are attractive at 12.8% annually. However, this is a high-risk, high-reward situation, so despite attractive projected returns, we rate Stellus a 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	---	---	---	---
Gross Margin	N/A	N/A	N/A	85.6%	83.9%	83.4%	---	---	---	---
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	---	---	---	---
Operating Margin	N/A	N/A	N/A	61.8%	63.2%	62.8%	---	---	---	---
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	---	---	---	---

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	---	---	---	---
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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