



# Gladstone Capital (GLAD)

Updated August 9<sup>th</sup>, 2020 by Josh Arnold

## Key Metrics

<b>Current Price:</b>	\$7.64	<b>5 Year CAGR Estimate:</b>	9.6%	<b>Market Cap:</b>	\$238 M
<b>Fair Value Price:</b>	\$8.20	<b>5 Year Growth Estimate:</b>	0.0%	<b>Ex-Dividend Date:</b>	08/21/20
<b>% Fair Value:</b>	93%	<b>5 Year Valuation Multiple Estimate:</b>	1.4%	<b>Dividend Payment Date:</b>	08/31/20
<b>Dividend Yield:</b>	10.2%	<b>5 Year Price Target</b>	\$8.20	<b>Years Of Dividend Growth:</b>	0
<b>Dividend Risk Score:</b>	D	<b>Retirement Suitability Score:</b>	B	<b>Last Dividend Increase:</b>	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 \$238 million and for income investors, it pays distributions monthly, instead of quarterly.

Gladstone reported third quarter earnings on July 29<sup>th</sup>, with results missing expectations on the top and bottom lines. Gladstone posted net investment income of 20 cents per share, which was a penny light against estimates, and down from 21 cents in fiscal Q2.

Total investment income was \$11.7 million, up from \$11.5 million in the prior quarter. Interest income was up by 5.7%, driven primarily by an increase in the weighted average principal balance of the company's interest-bearing investment portfolio, which was up 6% from the end of the prior quarter, ending at \$429 million.

The company invested \$54 million in new portfolio companies and an additional \$2.2 million in existing positions. Gladstone received \$17 million in repayments, resulting in net originations of \$38.6 million. Net increase in assets from operations was \$15 million in Q3, up from a decline in Q2 of \$28 million.

Net asset value came to \$7.27 at the end of Q3, up from \$6.99 in Q2. We've moved our estimate of NII per share to 82 cents for this year.

## Growth on a Per-Share Basis

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2025
<b>NII</b>	\$0.84	\$0.88	\$0.91	\$0.88	\$0.87	\$0.84	\$0.84	\$0.84	\$0.85	\$0.84	<b>\$0.82</b>	<b>\$0.82</b>
<b>DPS</b>	\$0.84	\$0.84	\$0.84	\$0.84	\$0.84	\$0.84	\$0.84	\$0.84	\$0.84	\$0.84	<b>\$0.78</b>	<b>\$0.78</b>
<b>Shares<sup>1</sup></b>	21.1	21.0	21.0	21.0	21.0	21.1	23.2	25.5	27.1	29.3	<b>33.0</b>	<b>41.0</b>

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 82 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 rate at 0%.

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 10%+ 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.

<sup>1</sup> 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. We see this payout as covered by NII-per-share moving forward, but only just.

## 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	9.3	10.0
Avg. Yld.	7.6%	8.9%	10.1%	9.5%	8.8%	10.0%	11.0%	8.8%	9.3%	9.2%	10.2%	9.5%

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 9.3 times NII, the stock appears to be somewhat undervalued. Should it revert to 10 times NII, shareholders would see a small annual tailwind to total returns.

The yield is more in line with its historical range at 10.2%; Gladstone's average yield in the past decade has been 10%, and we see the yield declining slightly over time, but remaining near 10%.

## 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%	95%	95%

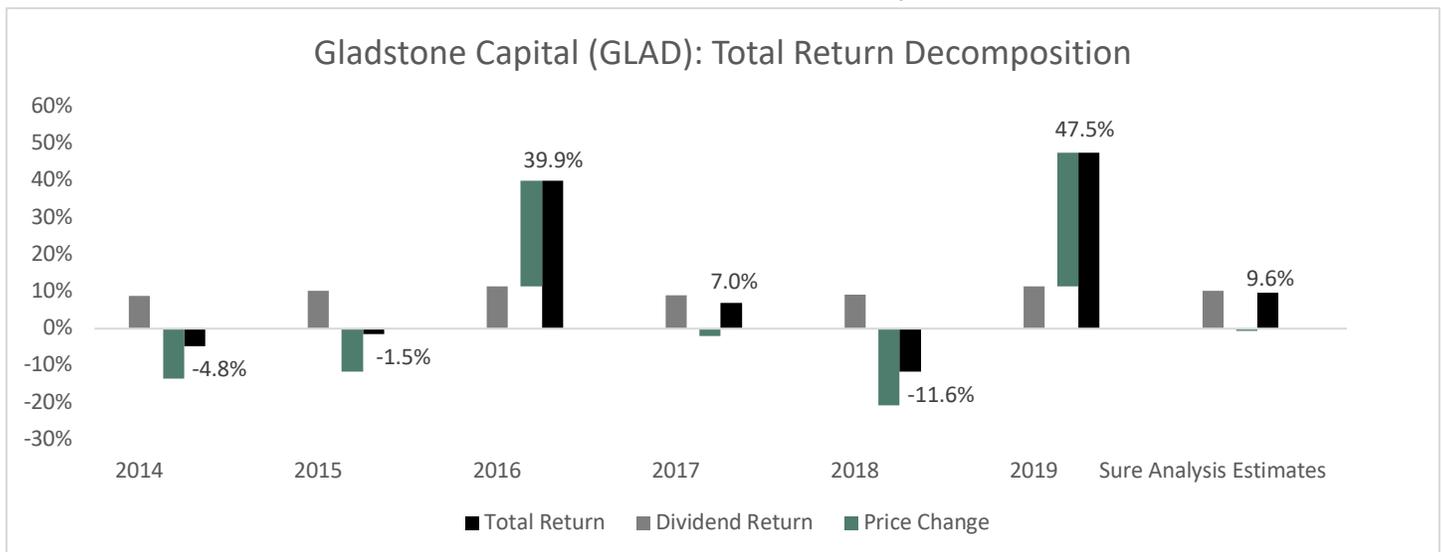
Gladstone doesn't have any competitive advantages as it operates in much the same way as any other BDC. It is also dependent upon funding costs and the spreads it can earn on its debt and equity investments. During recessions, Gladstone will likely struggle as repayments may become a problem for its 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 9.6% total annual returns in the coming years as Gladstone's valuation tailwind is aided by the generous yield. We are reiterating Gladstone at a buy rating. 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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