Stellus Capital Management (SCM)

Updated August 25th, 2020 by Josh Arnold

Key Metrics

Current Price:	$8.23	**5 Year CAGR Estimate:**	9.8%	**Market Cap:**	$160 M
Fair Value Price:	$8.40	**5 Year Growth Estimate:**	0.0%	**Ex-Dividend Date:**	09/14/20
% Fair Value:	98%	**5 Year Valuation Multiple Estimate:**	0.4%	**Dividend Payment Date:**	09/30/20
Dividend Yield:	12.2%	**5 Year Price Target**	$8.40	**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 $57 million in revenue this year, and has a $160 million market capitalization.

Stellus reported second quarter earnings on July 31st, with revenue coming in light against expectations, but adjusted earnings beating consensus. Net investment income came to 28 cents per share, with core NII coming in slightly better at 29 cents per share. The company posted net realized losses on investments of 20 cents per share, and total realized income of 8 cents per share, which helped somewhat offset realized portfolio losses. Unrealized portfolio gains of $1.96 per share were the result of a strong rebound in financial markets in the second quarter. In total, net assets rose $2.04 per share, essentially reversing losses seen in Q1. Net asset value now stands at $13.34 per share, meaning the stock trades for just 62% of NAV.

We've moved our estimate of NII per share for this year to $1.05 as we see Stellus facing a tougher second half given the strong performance of its portfolio in Q2.

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	***$1.05***	***$1.05***
DPS	---	---	$0.18	$1.43	$1.36	$1.36	$1.36	$1.36	$1.36	$1.36	***$1.00***	***$0.90***
Shares[1]	---	---	12.0	12.1	12.3	12.5	12.5	14.9	16.0	18.9	***19.5***	***25.0***

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, and we've moved our long-term growth estimate to 0% from 2%.

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. However, a possible headwind to this is more central bank intervention, which could keep yields lower for longer. 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, and that Stellus will have a difficult time offsetting this with earnings gains. 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. Net assets, however, are currently lower than they were at the end of 2019.

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[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	***7.8***	***8.0***
Avg. Yld.	---	---	1.2%	9.6%	9.7%	12.0%	13.0%	9.9%	10.6%	9.7%	***12.2%***	***10.8%***

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 7.8 times NII, implying essentially no impact from the valuation in the coming years.

The dividend yield is now 12.2%, which is in excess of historical values despite the recent dividend cut. Stellus moved from a monthly dividend to a quarterly one, which accompanied the cut from $1.36 annually to $1.00. We are expecting another small reduction in the dividend over time given the high payout ratio and murky NII outlook.

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%	***95%***	***86%***

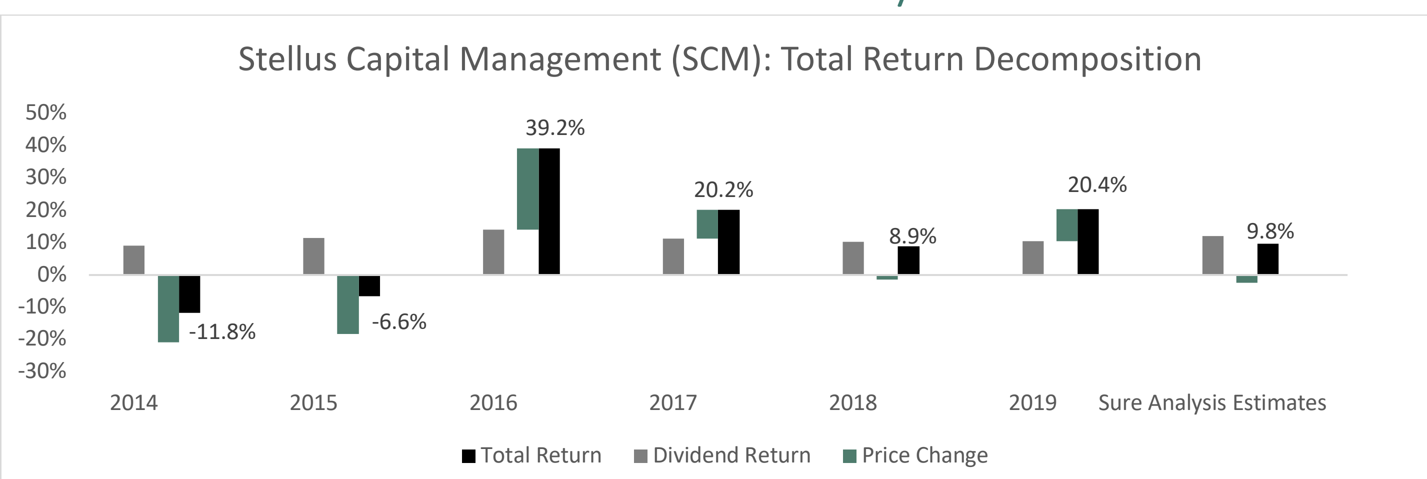
Stellus, like other BDCs, has no competitive advantages. It offers the same products as any other BDC to the same set of customers, so advantages are virtually impossible to achieve. In addition, BDCs suffer mightily during recessions because borrowers have a more difficult time meeting repayment timelines.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

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 another dividend cut in addition to the one that already happened. While the current payout should be safe for the time being, we note that the risk of lower rates means the payout is constantly at risk as well.

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 9.8% 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	---	---	---	29	32	35	26	27	31	32
Gross Profit	---	---	---	25	27	29	---	---	---	---
Gross Margin	---	---	---	85.6%	83.9%	83.4%	---	---	---	---
SG&A Exp.	---	---	---	7	7	7	4	5	4	4
Operating Profit	---	---	---	18	20	22	---	---	---	---
Operating Margin	---	---	---	61.8%	63.2%	62.8%	---	---	---	---
Net Profit	---	---	---	18	10	8	23	23	26	26
Net Margin	---	---	---	59.7%	31.5%	21.8%	87.7%	83.0%	84.3%	83.4%
Free Cash Flow	---	---	---	29	32	35	26	27	31	
Income Tax	---	---	---	25	27	29	---	---	---	---

Balance Sheet Metrics

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Total Assets	---	---	263	298	327	365	380	400	526	649
Cash & Equivalents	---	---	62	14	2	11	9	25	17	16
Accounts Receivable	---	---	N/A	0	0	0	---	---	---	---
Total Liabilities	---	---	89	122	153	201	209	180	301	378
Accounts Payable	---	---	5	3	3	3	3	3	4	4
Long-Term Debt	---	---	N/A	119	148	196	203	174	292	366
Shareholder's Equity	---	---	174	176	174	165	171	220	225	271
D/E Ratio	---	---	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	---	---	---	---	3.3%	2.2%	6.2%	5.8%	5.7%	4.5%
Return on Equity	---	---	---	10.0%	5.8%	4.5%	13.8%	11.6%	11.8%	10.7%
ROIC	---	---	---	---	3.3%	2.2%	6.3%	5.9%	5.7%	4.6%
Shares Out.	---	---	12.0	12.1	12.3	12.5	12.5	14.9	16.0	18.9
Revenue/Share	---	---	---	2.44	2.63	2.82	2.12	1.83	1.95	1.73
FCF/Share	---	---	---	-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.