



Prospect Capital Corporation (PSEC)

Updated December 8th, 2020 by Josh Arnold

Key Metrics

Current Price:	\$5.40	5 Year CAGR Estimate:	8.4%	Market Cap:	\$2.1 B
Fair Value Price:	\$4.90	5 Year Growth Estimate:	0.0%	Ex-Dividend Date:	12/30/20
% Fair Value:	111%	5 Year Valuation Multiple Estimate:	-2.0%	Dividend Payment Date:	01/21/21
Dividend Yield:	13.3%	5 Year Price Target	\$4.90	Years Of Dividend Growth:	0
Dividend Risk Score:	F	Retirement Suitability Score:	C	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 \$2.1 billion. Prospect produces nearly \$600 million in annual revenue.

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 first quarter earnings on November 9th, 2020 with results coming in weaker than expected on the top and bottom lines. The company said it made progress in Q1 in retiring older, more expensive liabilities in exchange for newer, cheaper vintages to reduce debt servicing costs over time.

Net investment income came to 15 cents per share, which was two cents behind estimates, and down from 16 cents per share in the prior quarter, and down further from the 19 cents per share in the year-ago period. Total investment income was \$143 million in Q1, down from \$162 million in the year-ago period.

Total originations were \$177 million in Q1, up from \$57 million in Q4. Repayments were \$145 million, up from \$72 million in Q4. Net of repayments, originations rose from -\$16 million in the year-ago period to +\$32 million in Q1.

Our estimate for this year stands at NII per share of \$0.65; Prospect continues to pay an annualized dividend of \$0.72.

Growth on a Per-Share Basis

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2026
NII	\$1.38	\$1.67	\$1.57	\$1.19	\$1.03	\$1.04	\$0.85	\$0.79	\$0.79	\$0.72	\$0.65	\$0.65
DPS	\$1.21	\$1.22	\$1.28	\$1.32	\$1.19	\$1.00	\$1.00	\$0.77	\$0.72	\$0.72	\$0.72	\$0.59
Shares¹	86	114	207	343	359	357	360	364	367	374	374	385

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 any 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 \$5.4 billion today, while total assets were \$6.4 billion five years ago.

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 declining as we don't believe Prospect will be able to cover it with NII any time soon.

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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Prospect has funded deficits in its NII in the past, but we are still cautious on its ability to fund the dividend at current levels.

Valuation Analysis

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	Now	2026
Avg. P/NII	7.8	6.0	7.1	9.2	8.8	6.9	9.9	8.7	8.0	8.2	8.3	7.5
Avg. Yld.	11.3%	12.3%	11.5%	12.1%	13.1%	13.8%	11.8%	11.3%	10.6%	12.1%	13.3%	12.0%

Prospect's price to net investment income has averaged 8.2 in the past decade. We see fair value as lower than that at 7.5 times net investment income given that the company's growth outlook has deteriorated. We see a small headwind to total annual returns from the valuation drifting lower over time.

The company's current dividend yield at 13.3% is sizable by historical standards. We see the yield falling to 12%, which would be the result of a lower payout over time.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2026
Payout	88%	73%	82%	111%	116%	96%	118%	97%	85%	100%	111%	90%

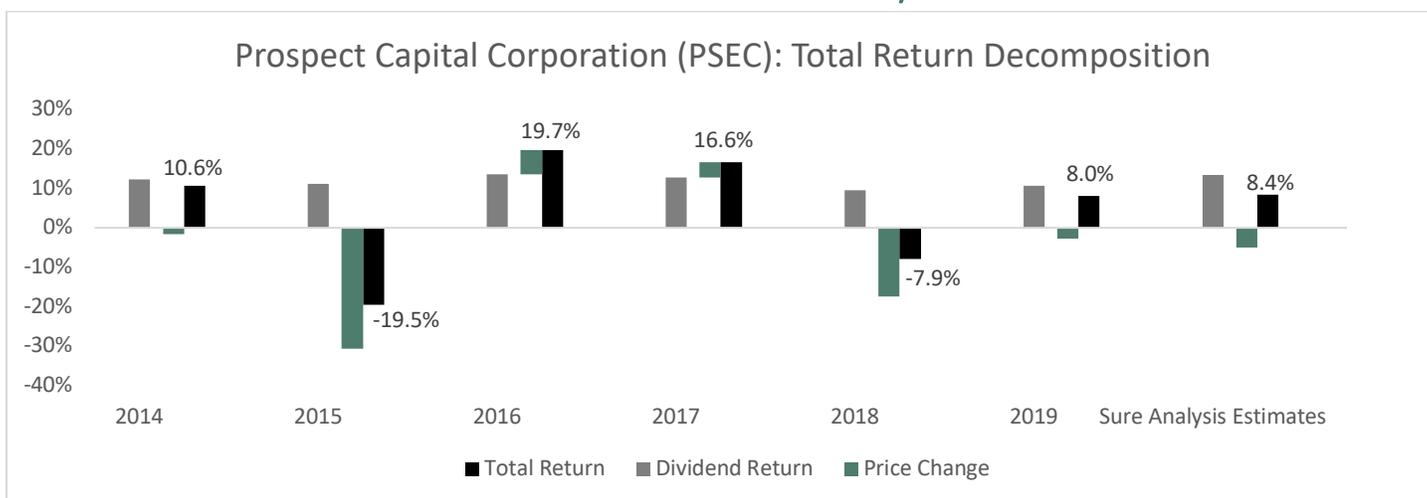
One of the issues with business development companies is that competitive advantages are very difficult to come by, and Prospect is certainly no exception. Scale is the name of the game for BDCs and with a shrinking balance sheet, Prospect has lost some of its scale over time.

The company's payout ratio was over 100% for several years in the past decade, and it is once again. The payout ratio has deteriorated once again as NII estimates have drifted lower. We have become more cautious on Prospect's ability to continue to fund the dividend at the current rate, but note it has funded deficits for several quarters at a time in the past, and may continue to do so indefinitely.

Final Thoughts & Recommendation

Prospect Capital offers investors a huge yield, but it is not without its risks. The valuation is still high, particularly in light of the company's reduced growth outlook. The yield is also slightly high by historical standards, however. We are forecasting 8.4% in total returns in the coming years, consisting of the ample yield, no growth, and a headwind from the valuation. With all this taken into account, we reiterate our hold rating on Prospect.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Revenue	130	204	245	346	379	137	284	326	199	37
SG&A Exp.	12	13	18	31	30	32	32	26	34	33
Net Profit	118	191	221	319	346	103	253	300	144	-16
Net Margin	91.1%	93.5%	90.2%	92.3%	91.4%	75.3%	89.2%	92.0%	81.1%	-43.7%
Free Cash Flow	(582)	(229)	(1,786)	(1,725)	45	862	376	369	224	429

Balance Sheet Metrics

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Total Assets	1,549	2,255	4,448	6,477	6,798	6,236	6,173	5,839	5,800	5,300
Cash & Equivalents	1	3	203	134	110	318	318	84	107	45
Total Liabilities	435	743	1,792	2,859	3,095	2,800	2,818	2,432	2,494	2,244
Accounts Payable	11	21	52	75	70	71	69	56	56	51
Long-Term Debt	407	664	1,683	2,773	2,984	2,667	2,642	2,312	2,383	2,138
Shareholder's Equity	1,114	1,512	2,656	3,618	3,703	3,436	3,355	3,407	3,306	3,056
D/E Ratio	0.37	0.44	0.63	0.77	0.81	0.78	0.79	0.68	0.72	0.70

Profitability & Per Share Metrics

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Return on Assets	9.9%	10.0%	6.6%	5.8%	5.2%	1.6%	4.1%	5.0%	2.5%	-0.3%
Return on Equity	13.0%	14.5%	10.6%	10.2%	9.5%	2.9%	7.4%	8.9%	4.3%	-0.5%
ROIC	10.1%	10.3%	6.8%	5.9%	5.3%	1.6%	4.2%	5.1%	2.5%	-0.3%
Shares Out.	86	114	207	343	359	357	360	364	367	374
Revenue/Share	1.51	1.78	1.18	1.15	1.07	0.39	0.79	0.90	0.54	0.10
FCF/Share	(6.76)	(2.01)	(8.63)	(5.75)	0.13	2.42	1.05	1.02	0.61	1.17

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

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