



# Prospect Capital Corporation (PSEC)

Updated February 16<sup>th</sup>, 2021 by Josh Arnold

## Key Metrics

<b>Current Price:</b>	\$7.30	<b>5 Year CAGR Estimate:</b>	3.6%	<b>Market Cap:</b>	\$2.8 B
<b>Fair Value Price:</b>	\$5.30	<b>5 Year Growth Estimate:</b>	-1.0%	<b>Ex-Dividend Date:</b>	02/25/21
<b>% Fair Value:</b>	136%	<b>5 Year Valuation Multiple Estimate:</b>	-6.0%	<b>Dividend Payment Date:</b>	03/18/21
<b>Dividend Yield:</b>	9.9%	<b>5 Year Price Target</b>	\$5.10	<b>Years Of Dividend Growth:</b>	0
<b>Dividend Risk Score:</b>	F	<b>Retirement Suitability Score:</b>	C	<b>Last Dividend Increase:</b>	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. The company went public in 2004 and currently has a market capitalization of \$2.8 billion. Prospect produces about \$650 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 second quarter earnings on February 9<sup>th</sup>, 2021 with results coming in largely ahead of expectations. Net investment income was 21 cents per share, which was well ahead of estimates of 15 cents per share, and also up from 15 cents per share in Q1.

Net asset value ended the quarter at \$8.96, up strongly from \$8.40 in the first quarter. Total interest income was \$145 million, up fractionally from the year-ago quarter. Control investments income was \$51 million, up from \$50 million. Non-control investments interest income was \$52 million, down from \$59 million a year ago. And structured credit securities interest income was \$31 million, up from \$29 million.

Total originations were \$346 million, nearly double the \$177 million the company produced in the first quarter. Total repayments were \$338 million, more than double the \$145 million from the first quarter. That meant that Prospect had net originations of just \$8 million in Q2, down from \$32 million in Q1.

We've boosted our estimate of NII-per-share for this year to 71 cents on strong Q2 results.

## Growth on a Per-Share Basis

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2026
<b>NII</b>	\$1.38	\$1.67	\$1.57	\$1.19	\$1.03	\$1.04	\$0.85	\$0.79	\$0.79	\$0.72	<b>\$0.71</b>	<b>\$0.68</b>
<b>DPS</b>	\$1.21	\$1.22	\$1.28	\$1.32	\$1.19	\$1.00	\$1.00	\$0.77	\$0.72	\$0.72	<b>\$0.72</b>	<b>\$0.72</b>
<b>Shares<sup>1</sup></b>	86	114	207	343	359	357	360	364	367	374	<b>384</b>	<b>400</b>

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 at times. Given this history of dilution and weak net investment income performance, we expect -1% annual 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 \$5.7 billion today, while total assets were \$6+ 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 before the financial crisis. Shrinking net investment income has taken its toll on the company's ability to

<sup>1</sup> Share count in millions

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finance the dividend. We see the dividend remaining where it is for the foreseeable future as NII isn't quite covering the payout today. Prospect has funded deficits in its NII in the past, and we are still cautious on its ability to fund the dividend at current levels. However, the company has made it clear it intends to defend the payout.

## 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	10.2	7.5
Avg. Yld.	11.3%	12.3%	11.5%	12.1%	13.1%	13.8%	11.8%	11.3%	10.6%	12.1%	9.9%	14.2%

Prospect's price to net investment income has averaged ~8 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 sizable headwind to total annual returns from the valuation moving lower over time from today's 10.2.

The company's current dividend yield is 9.9%, which is well down against its historical average after a massive rally in the stock since our last update. We see the yield rising to 14%, which would result from a lower share price but stagnant payout per share.

## 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%	101%	107%

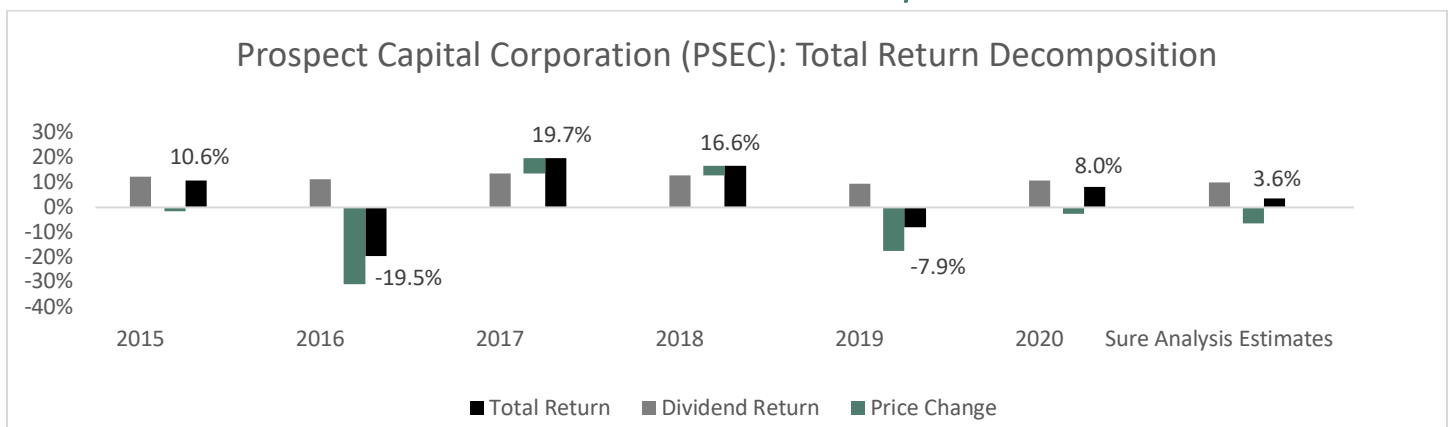
One of the issues with business development companies is that competitive advantages are very difficult to come by, and Prospect is certainly no exception. Scale is the name of the game for BDCs and with a shrinking balance sheet, Prospect has lost some of its scale over time.

The company's payout ratio was over 100% for several years in the past decade, and it is once again. 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 now extremely high, particularly in light of the company's modest growth outlook. The yield is now quite low by historical standards, however. We are forecasting just 3.6% in total returns in the coming years, consisting of the ample yield, slightly negative growth, and a sizable headwind from the valuation. With all this taken into account, we are downgrading Prospect from hold to sell as the big rally we've seen has deteriorated the stock's total return outlook.

## 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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