



Stellus Capital Management (SCM)

Updated November 22nd, 2021, by Josh Arnold

Key Metrics

Current Price:	\$14	5 Year CAGR Estimate:	3.9%	Market Cap:	\$271 M
Fair Value Price:	\$11	5 Year Growth Estimate:	1.0%	Ex-Dividend Date:	11/29/21
% Fair Value:	130%	5 Year Valuation Multiple Estimate:	-5.1%	Dividend Payment Date:	12/15/21
Dividend Yield:	8.0%	5 Year Price Target	\$11.40	Years Of Dividend Growth:	0
Dividend Risk Score:	F	Retirement Suitability Score:	C	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, and has a \$271 million market cap.

Stellus reported third quarter earnings on October 28th, 2021, and results were better than expected for both revenue and profit. Investment income for the three months total \$17 million, up from \$14 million in the same period a year ago, most of which was interest income from its portfolio components.

Operating expenses were \$13 million, up from \$8.7 million in the year-ago period. Base management fees were \$3.5 million, up from \$2.8 million, incentive fees tripled to \$1.5 million, capital gain incentive fees were \$1.7 million from nothing in the year-ago period, and expenses related to borrowings were \$4.9 million, up from \$3.9 million. Net investment income was \$4.1 million, or 21 cents per share, down from \$5.3 million, or 27 cents, a year ago.

The investment portfolio had a net change of unrealized appreciation of \$2.1 million, equal with the year-ago period. Realized gains were \$7.9 million, up from just \$0.2 million in last year's Q3.

We've reduced our estimate for this year slightly to \$1.08 following Q3 results.

Growth on a Per-Share Basis

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2026
NII	---	\$0.11	\$1.33	\$1.34	\$1.33	\$1.39	\$1.21	\$1.42	\$1.23	\$1.13	\$1.08	\$1.14
DPS	---	\$0.18	\$1.43	\$1.36	\$1.36	\$1.36	\$1.36	\$1.36	\$1.36	\$1.09	\$1.12	\$1.12
Shares¹	---	12.0	12.1	12.3	12.5	12.5	14.9	16.0	18.9	19.5	20	29

Stellus, like most BDCs, has a difficult time growing NII. The combination of high funding costs (generally 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. With NII coming in better than expected again in Q3, we're increasing our growth estimate to 1% as the company struggles to cover funding costs; rates remain very low on the company's investments but are improving.

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' net new portfolio activity was just \$18 million in 2020, a small fraction of its prior years, which were ~\$120 million annually. We note that Stellus has finally crested the prior peak in net assets set in 2019 as of the end of 2020. The company's recovery from the pandemic appears complete, but low interest rates and share issuances remain a constant headwind.

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	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	Now	2026
Avg. P/NII	---	---	11.2	10.5	8.5	7.5	11.3	9.0	11.4	8.4	13.0	10.0
Avg. Yld.	---	1.2%	9.6%	9.7%	12.0%	13.0%	9.9%	10.6%	9.7%	12.8%	8.0%	9.9%

Stellus has traded with an average price-to-NII ratio of ~10 in its relatively short history as a public company, and we assess fair value in that area. 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 overvalued today given it trades for 13 times NII, implying a negative impact from the valuation in the coming years.

The dividend yield is now 8%, which is below historical values. Stellus moved from a monthly dividend to a quarterly one, which accompanied the dividend cut from \$1.36 annually to \$1.00. It has since been raised to \$1.12 annually, along with a special one-cent dividend announced in August. We currently believe Stellus can maintain its dividend payment for the foreseeable future, but also that room for increases is minimal.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2026
Payout	---	164%	108%	101%	102%	98%	112%	96%	106%	96%	104%	99%

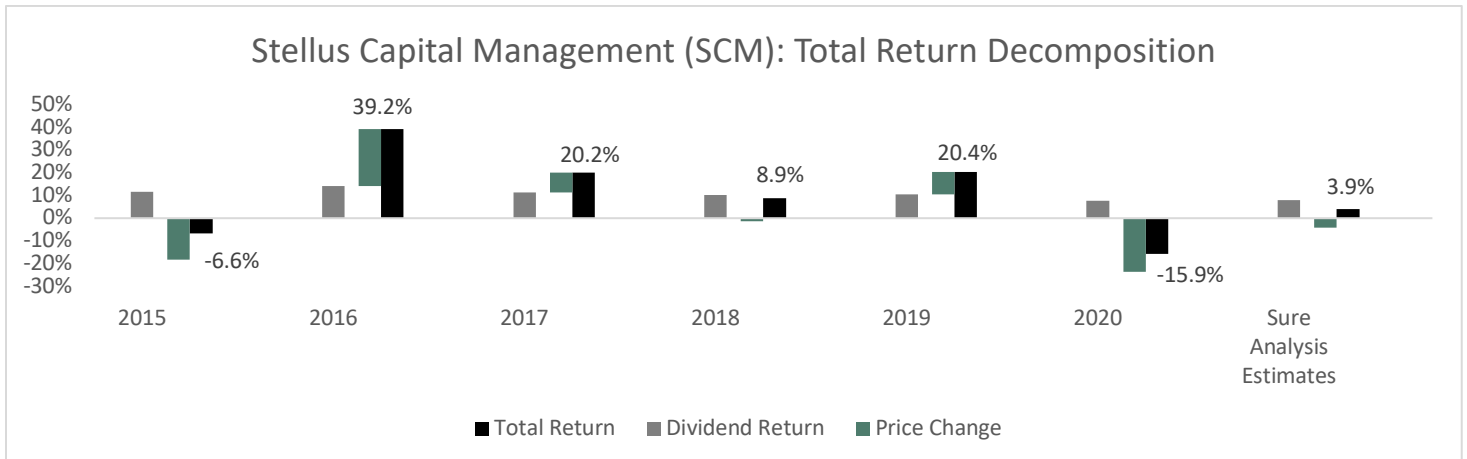
Stellus, like other BDCs, has no competitive advantages. It offers the same products as any other BDC to the same set of customers, so advantages are virtually impossible to achieve. In addition, BDCs suffer mightily during recessions because borrowers have a more difficult time meeting repayment timelines.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

Stellus is required to pay virtually all its NII in distributions as a BDC, so the payout ratio will always be high. 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. We are currently not expecting another dividend cut, but it cannot be ruled out.

Final Thoughts & Recommendation

Total return potential comes in at 3.9% annually. Given the inherent risk of owning a BDC, as well as low projected total returns, we are reiterating Stellus at a sell rating. The yield is very high, but we note the risks of owning a small BDC are high as well, so only investors with high-risk tolerances should consider Stellus. In addition, the valuation has deteriorated with the rally in the stock, so we see the margin of safety as minimal.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Revenue	---	---	29	32	35	26	27	31	32	26
Gross Profit	---	---	25	27	29	---	---	---	---	---
Gross Margin	---	---	85.6%	83.9%	83.4%	---	---	---	---	---
SG&A Exp.	---	---	7	7	7	4	5	4	4	5
Operating Profit	---	---	18	20	22	---	---	---	---	---
Operating Margin	---	---	61.8%	63.2%	62.8%	---	---	---	---	---
Net Profit	---	---	18	10	8	23	23	26	26	20
Net Margin	---	---	59.7%	31.5%	21.8%	87.7%	83.0%	84.3%	83.4%	78.0%
Free Cash Flow	---	---	(68)	(27)	(24)	9	19	(102)	(93)	(3)
Income Tax	---	---		0	0	(0)	(0)	1	1	1

Balance Sheet Metrics

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Total Assets	---	263	298	327	365	380	400	526	649	675
Cash & Equivalents	---	62	14	2	11	9	25	17	16	18
Accounts Receivable	---	---	0	0	0	---	---	---	---	---
Total Liabilities	---	89	122	153	201	209	180	301	378	402
Accounts Payable	---	5	3	3	3	3	3	4	4	2
Long-Term Debt	---	---	119	148	196	203	174	292	366	393
Shareholder's Equity	---	174	176	174	165	171	220	225	271	273
D/E Ratio	---	---	0.68	0.85	1.19	1.19	0.79	1.30	1.35	1.44

Profitability & Per Share Metrics

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Return on Assets	---	---	---	3.3%	2.2%	6.2%	5.8%	5.7%	4.5%	3.1%
Return on Equity	---	---	10.0%	5.8%	4.5%	13.8%	11.6%	11.8%	10.7%	7.4%
ROIC	---	---	---	3.3%	2.2%	6.3%	5.9%	5.7%	4.6%	3.1%
Shares Out.	---	12.0	12.1	12.3	12.5	12.5	14.9	16.0	18.9	19.5
Revenue/Share	---	---	2.44	2.63	2.82	2.12	1.83	1.95	1.73	1.33
FCF/Share	---	---	-5.67	-2.21	-1.96	0.71	1.27	-6.42	-5.10	-0.18

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

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