



# Capital Southwest Corporation (CSWC)

Updated February 1<sup>st</sup>, 2022 by Nikolaos Sismanis

## Key Metrics

|                             |         |  |      |                                  |                |
|-----------------------------|---------|--|------|----------------------------------|----------------|
| <b>Current Price:</b>       | \$24.90 | <b>5 Year CAGR Estimate:</b>               | 9.9% | <b>Market Cap:</b>               | \$581.1 M      |
| <b>Fair Value Price:</b>    | \$25.35 | <b>5 Year Growth Estimate:</b>             | 3.0% | <b>Ex-Dividend Date:</b>         | 03/14/2022     |
| <b>% Fair Value:</b>        | 99%     | <b>5 Year Valuation Multiple Estimate:</b> | 0.4% | <b>Dividend Payment Date:</b>    | 03/31/2022     |
| <b>Dividend Yield:</b>      | 7.7%    | <b>5 Year Price Target</b>                 | \$29 | <b>Years Of Dividend Growth:</b> | 5 <sup>1</sup> |
| <b>Dividend Risk Score:</b> | F       | <b>Retirement Suitability Score:</b>       | C    | <b>Last Dividend Increase:</b>   | 2.1%           |

## Overview & Current Events

Capital Southwest Corporation is an internally managed investment company that has elected to be regulated as a BDC (Business Development Company). The company specializes in providing customized debt and equity financing to lower middle market (LMM) companies and debt capital to upper-middle market (UMM) companies located primarily in the United States. Capital Southwest generates around \$68 million in annual revenues and is based in Dallas, Texas.

On January 31<sup>st</sup>, 2022, Capital Southwest reported its Q3-2022 results for the quarter ending December 31<sup>st</sup>, 2021. It's important to note that the company's fiscal year ends March 31<sup>st</sup>. This applies to the figures shown in our tables. For the quarter, the company achieved a total investment income of \$223 million, 9.8% higher than the previous quarter. The increase in investment income was primarily attributable to an increase in average debt investments outstanding and an increase in prepayment fees received from portfolio companies. Pre-tax net investment income (NII) came in at \$11.8 million, 19.1% higher versus Q2-2022. However, due to a higher share count, pre-tax EPS came in at \$0.51, a cent lower quarter-over-quarter. Amid robust results, the company raised its dividend by 2.1% to \$0.48, which rises to \$0.58 when adding the usual \$0.10 supplemental dividend. Therefore, the current annualized DPS comes out at \$1.92, though investors should expect the actual full-year DPS to be higher when accounting for the supplemental payouts. We now expect FY2022 pre-tax NII/share of \$1.95.

CSWC's credit portfolio currently consists of 58 lower and 12 upper-middle market companies. About \$745 million is allocated in Capital Southwest's credit portfolio, 91% of which is allocated in 1st Lien Senior Secured Debt. The weighted average yield on debt is currently at an acceptable 9.5%. The equity part of the portfolio is worth around \$70.1 million. Overall, the investment portfolio is well-diversified, with exposure to over 25 industries. Business Services, Healthcare Services, and Consumer Products & Retail account for 14%, 10%, and 9% of the total holdings, respectively.

## Growth on a Per-Share Basis

| Year                      | 2012   | 2013   | 2014   | 2015   | 2016     | 2017   | 2018   | 2019   | 2020   | 2021   | 2022          | 2027          |
|---------------------------|--------|--------|--------|--------|----------|--------|--------|--------|--------|--------|---------------|---------------|
| <b>NII</b>                | \$6.18 | \$7.09 | \$7.32 | \$3.44 | (\$0.76) | \$0.61 | \$1.02 | \$1.48 | \$1.68 | \$1.79 | <b>\$1.95</b> | <b>\$2.26</b> |
| <b>DPS</b>                | \$0.20 | \$5.29 | \$0.20 | \$0.20 | \$0.14   | \$0.79 | \$0.99 | \$2.27 | \$2.75 | \$2.05 | <b>\$1.92</b> | <b>\$2.23</b> |
| <b>Shares<sup>2</sup></b> | 15.0   | 15.2   | 15.3   | 15.5   | 15.6     | 15.9   | 16.1   | 16.7   | 18.0   | 19.0   | <b>23.4</b>   | <b>30.0</b>   |

On September 30<sup>th</sup>, 2015, Capital Southwest completed the spin-off of CSW Industrials (CSWI). This explains the stock price's sudden "nosedive" around this period and the higher financials before the spin-off, as depicted in the table. The company's prolonged history as a BDC company and its experienced management team allow the company to sustain a double-digit investment yield. The company has refinanced its own loans at lower rates over time, resulting in higher net investment income. Additionally, with only 21 employees, operating expenses as a percentage of total assets have also been declining. They were 4.9% in FY2016, but are currently less than half this amount at 2.3%. In terms of the dividend, the company has been growing its DPS annually since the spin-off in 2015. The higher dividends seen over the past few years are due to special dividends that the company can afford from additional gains (e.g., equity sales), which are not

<sup>1</sup> Refers to the base dividend rate which excludes supplemental payouts.

<sup>2</sup> Share count is 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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recorded as investment income. Hence, both the supplemental and special dividends are technically covered. We expect both NII/share and DPS to grow by around 3% in the medium term. Dividends are likely to be higher amid one-off additional gains from equities, though since they are impossible to predict, we are not speculating higher figures.

## Valuation Analysis

| Year      | 2012 | 2013  | 2014 | 2015 | 2016 | 2017 | 2018 | 2019  | 2020  | 2021 | Now         | 2027        |
|-----------|------|-------|------|------|------|------|------|-------|-------|------|-------------|-------------|
| Avg. P/E  | 3.7  | 4.4   | 5.1  | 14.5 | ---  | 26.6 | 18.9 | 14.4  | 12.5  | 12.8 | <b>12.8</b> | <b>13.0</b> |
| Avg. Yld. | 0.9% | 17.1% | 0.5% | 0.4% | 1.0% | 4.9% | 5.1% | 10.7% | 13.1% | 9.0% | <b>7.7%</b> | <b>7.6%</b> |

Capital Southwest has attracted a slightly higher valuation multiple than its industry peers, which are usually valued in the high single to very low double-digit figures. This is likely attributable to the company's operational efficiencies and growth potential by the superior yield on its debt investments and historically optimally-performing equity investments. We expect the company to retain a premium valuation. Following the recent dividend hike the stock yields 7.7% excluding the special/supplementary dividends. Including the special/supplementary dividends the stock yields 9.3%.

## Safety, Quality, Competitive Advantage, & Recession Resiliency

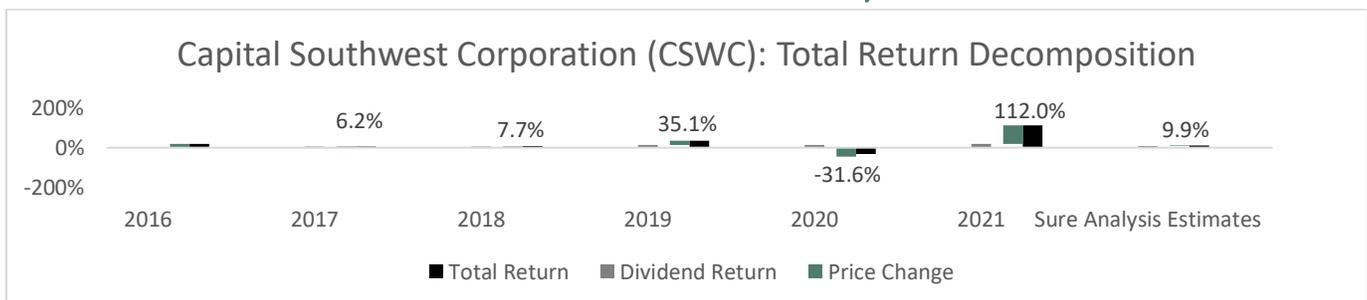
| Year   | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022       | 2027       |
|--------|------|------|------|------|------|------|------|------|------|------|------------|------------|
| Payout | 3%   | 75%  | 3%   | 6%   | ---  | 130% | 97%  | 153% | 164% | 115% | <b>98%</b> | <b>98%</b> |

Capital Southwest's dividend should be considered safer than its 98%+ payout ratio implies, considering the supplemental payouts, the special payouts, and latest quarterly dividend increase. The payout ratio does not include the realized gains that are in the form of non-investment income, hence the abnormally high figures. Overall, the company's diversified portfolio has proven very resilient, with COVID-19 having no material impact on interest income over the past few quarters. Considering 2015's spin-off transformed the company, this is the closest we can get to measure the company's recession resiliency, which should prove to be quite strong based on its recent results. Being an investment company, Capital southwest does not have a distinct competitive advantage compared to its peers other than management's experience. However, the company does enjoy lower financing costs, with its cost of debt at a decent 6%. At the same time, the high-single-digit yield on the stock makes for a cheaper cost of equity, allowing the company to issue stock more comfortably compared to its double-digit-yielding industry peers.

## Final Thoughts & Recommendation

Capital Southwest is a well-diversified business development company and one of the oldest ones in the market, having prospered through numerous cycles. Its financials have been growing fast following the 2015 spinoff, and its optimal financing costs have resulted in a rapid portfolio expansion. We forecast annualized returns of around 9.9% in the medium-term, excluding any supplementary dividends, driven primarily by the stock's hefty dividend yield, and relatively stable valuation expectations. We rate the stock as a hold.

## Total Return Breakdown by Year



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## Income Statement Metrics

| Year                  | 2012  | 2013  | 2014  | 2015  | 2016   | 2017  | 2018  | 2019  | 2020  | 2021  |
|-----------------------|-------|-------|-------|-------|--------|-------|-------|-------|-------|-------|
| <b>Revenue</b>        | 99.8  | 116.8 | 119.7 | 65.8  | 14.4   | 38.4  | 53.2  | 48.9  | -0.2  | 71.6  |
| <b>SG&amp;A Exp.</b>  | 3.3   | 3.3   | 2.8   | 5.8   | 11.4   | 4.4   | 4.4   | 4.8   | 5.6   | 5.2   |
| <b>D&amp;A Exp.</b>   | 0.0   | 0.0   | 0.0   | 0.1   | 0.1    | 0.5   | 0.9   | 1.4   | 2.4   | 2.0   |
| <b>Net Profit</b>     | 93.0  | 107.8 | 112.0 | 53.4  | -5.4   | 23.5  | 39.3  | 33.1  | -22.4 | 50.9  |
| <b>Net Margin</b>     | 93.2% | 92.4% | 93.6% | 81.2% | N/A    | 61.1% | 73.9% | 67.6% | N/A   | 71.1% |
| <b>Free Cash Flow</b> | 22.3  | 93.2  | 8.4   | 194.3 | -111.5 | -89.6 | -63.9 | -94.7 | -47.9 | -68.3 |
| <b>Income Tax</b>     | 0.1   | 0.6   | -0.7  | 0.3   | -1.3   | 2.1   | 0.1   | 0.9   | 6.2   | 4.7   |

## Balance Sheet Metrics

| Year                          | 2012  | 2013  | 2014  | 2015  | 2016  | 2017  | 2018  | 2019  | 2020  | 2021  |
|-------------------------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| <b>Total Assets</b>           | 633.0 | 667.7 | 778.7 | 776.9 | 284.5 | 325.8 | 417.5 | 551.8 | 585.0 | 735.6 |
| <b>Cash &amp; Equivalents</b> | 64.9  | 81.8  | 88.2  | 225.8 | 96.0  | 22.4  | 7.9   | 9.9   | 13.7  | 31.6  |
| <b>Total Liabilities</b>      | 4.3   | 7.9   | 8.3   | 9.5   | 11.9  | 40.7  | 109.2 | 225.9 | 312.7 | 399.3 |
| <b>Long-Term Debt</b>         | 0.0   | 0.0   | 0.0   | 0.0   | 0.0   | 25.0  | 95.3  | 216.1 | 303.3 | 381.3 |
| <b>Shareholder's Equity</b>   | 628.7 | 659.8 | 770.4 | 767.4 | 272.6 | 285.1 | 308.3 | 326.0 | 272.2 | 336.3 |
| <b>D/E Ratio</b>              | 0.0   | 0.0   | 0.0   | 0.0   | 0.0   | 0.1   | 0.3   | 0.7   | 1.1   | 1.1   |

## Profitability & Per Share Metrics

| Year                    | 2012  | 2013  | 2014  | 2015  | 2016  | 2017  | 2018  | 2019  | 2020  | 2021  |
|-------------------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| <b>Return on Assets</b> | 15.8% | 16.6% | 15.5% | 6.9%  | -1.0% | 7.7%  | 10.6% | 6.8%  | -3.9% | 7.7%  |
| <b>Return on Equity</b> | 15.9% | 16.7% | 15.7% | 7.0%  | -1.0% | 8.4%  | 13.2% | 10.4% | -7.5% | 16.7% |
| <b>ROIC</b>             | 15.9% | 16.7% | 15.7% | 7.0%  | -1.0% | 8.1%  | 11.0% | 7.0%  | -4.0% | 7.9%  |
| <b>Shares Out.</b>      | 15.2  | 15.4  | 15.3  | 15.5  | 15.7  | 15.9  | 16.1  | 16.7  | 18.0  | 19.1  |
| <b>Revenue/Share</b>    | 6.55  | 7.59  | 7.83  | 4.24  | 0.92  | 2.42  | 3.30  | 2.92  | -0.01 | 3.76  |
| <b>FCF/Share</b>        | 1.46  | 6.06  | 0.55  | 12.51 | -7.09 | -5.64 | -3.96 | -5.66 | -2.66 | -3.6  |

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

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