



Gladstone Capital (GLAD)

Updated February 18th, 2022, by Josh Arnold

Key Metrics

Current Price:	\$11.26	5 Year CAGR Estimate:	1.9%	Market Cap:	\$386 M
Fair Value Price:	\$8.50	5 Year Growth Estimate:	0.0%	Ex-Dividend Date:	03/22/22
% Fair Value:	132%	5 Year Valuation Multiple Estimate:	-5.5%	Dividend Payment Date:	03/31/22
Dividend Yield:	6.9%	5 Year Price Target	\$8.50	Years Of Dividend Growth:	0
Dividend Risk Score:	F	Retirement Suitability Score:	C	Last Dividend Increase:	N/A

Overview & Current Events

Gladstone Capital is a business development company, or BDC, that primarily invests in small and medium businesses. These investments are made via a variety of equity (10% of portfolio) and debt instruments (90% of portfolio), generally with very high yields. Loan size is typically in the \$7 million to \$30 million range and has terms up to seven years. The BDC's stated purpose is to generate income it can distribute to its shareholders. The company trades with a market capitalization of \$386 million and it pays distributions monthly, instead of quarterly.

Gladstone reported first quarter earnings on February 2nd, 2022, and results were largely in line with expectations. NII-per-share, which is the company's equivalent to earnings, came in at 20 cents, in line with expectations. Total investment income, which is analogous to revenue, was up 26% year-over-year to \$16.2 million. That was well ahead of expectations, beating by \$1.7 million. Total investment income rose because of an increase in success fees associated with the exit of Lignetics, a former portfolio company. Interest income was down fractionally quarter-over-quarter.

Total expenses were down \$0.5 million quarter-over-quarter, primarily attributable to a \$1.3 million decrease in net base management fees, partially offset by a \$0.6 million gain in net incentive fees due.

Net increase in net assets was \$12.1 million, or 35 cents per share, driven by the increase in net investment income and \$2.9 million in net realized and unrealized gains. NAV ended the quarter up 1.7% to \$9.44 per share. We now forecast 85 cents in NII-per-share following Q1 results, up slightly from our initial estimate.

Growth on a Per-Share Basis

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2027
NII	\$0.91	\$0.88	\$0.87	\$0.84	\$0.84	\$0.84	\$0.85	\$0.84	\$0.81	\$0.79	\$0.85	\$0.85
DPS	\$0.84	\$0.84	\$0.84	\$0.84	\$0.84	\$0.84	\$0.84	\$0.84	\$0.78	\$0.78	\$0.78	\$0.78
Shares¹	21.0	21.0	21.0	21.1	23.2	25.5	27.1	29.3	33.0	34.0	35.0	42.0

Gladstone reports net investment income per share, or NII, instead of earnings-per-share, which is consistent with other BDCs. On that measure, the company's results have been lackluster in terms of growth over the past decade. Our estimate of 85 cents for this year is largely in line with historical NII. Gladstone's share issuances have funded higher NII in dollar terms but haven't earned enough above its cost of capital to move the needle on NII-per-share. Given this history, we reiterate our estimate of Gladstone's long-term growth rate at 0%.

The yields on the company's portfolio influence its ability to earn income and therefore, cover its expenses and pay distributions to shareholders. Over time, the company's portfolio yield has drifted higher to 10%+, where it is today. However, higher expenses have offset that growth recently, which is part of the reason why NII-per-share continues to be roughly flat over time. Gladstone's portfolio continues to grow in dollar terms, but given its offsetting rising expenses, NII hasn't grown. We see this cycle of new investments being largely offset by losses and higher expenses. The company has made profitable exits of late, not only generating gains, but also the ability to recycle that capital.

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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Gladstone's dividend had been at \$0.07 monthly, or \$0.84 annually, since 2010. However, the cut for Q2 of 2020 still has the annualized payout at \$0.78. We see this payout as covered by NII-per-share moving forward, but only just.

Valuation Analysis

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Now	2027
Avg. P/NII	9.2	10.1	10.9	10.0	9.1	11.4	10.7	10.8	10.2	12.7	13.2	10.0
Avg. Yld.	10.1%	9.5%	8.8%	10.0%	11.0%	8.8%	9.3%	9.2%	9.4%	7.8%	6.9%	9.2%

Gladstone has traded at a price-to-NII ratio very near 10 in the past decade, which is where we assess fair value. At 13.2 times NII, the stock appears to be overvalued. We therefore see a sizable headwind to total returns should the valuation normalize.

The yield is now lower than it has been for most of the past decade; Gladstone's average yield in the past decade has been close to 10%, and we see the yield rising sharply over time, closer to 9%. We see the yield as warning investors that Gladstone is quite overpriced today, a condition that has been exacerbated by a sustained rally of late.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2027
Payout	92%	95%	97%	100%	100%	100%	99%	100%	96%	99%	92%	92%

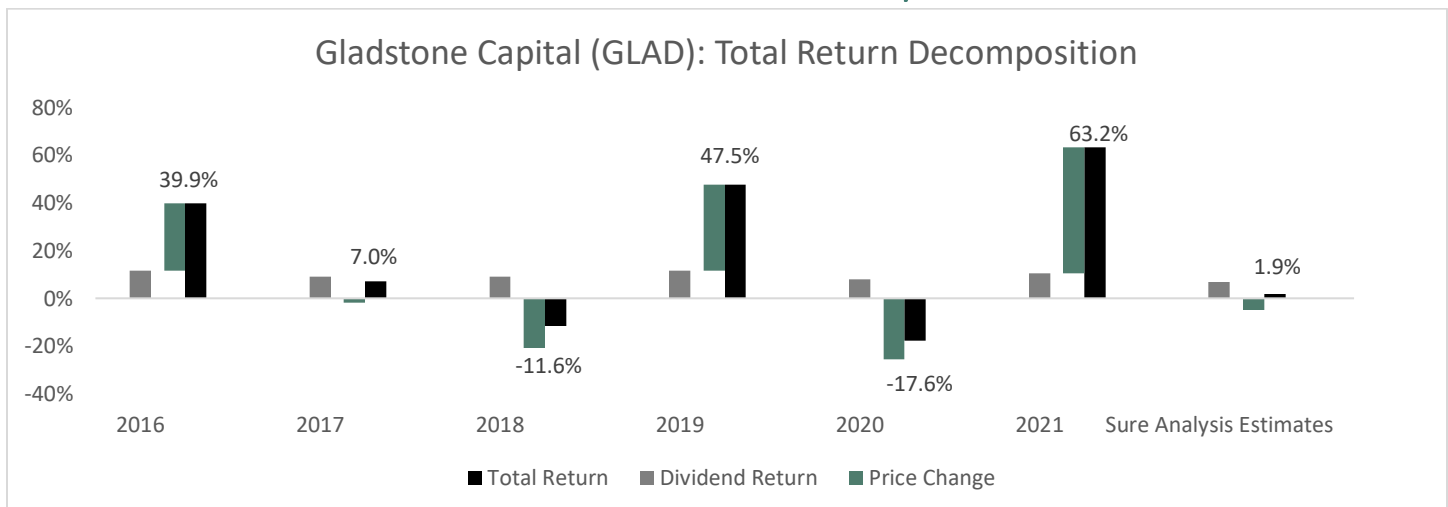
Gladstone doesn't have any competitive advantages as it operates in much the same way as any other BDC. It is also dependent upon funding costs and the spreads it can earn on its debt and equity investments. During recessions, Gladstone will likely struggle as repayments may become a problem for its debt investments. Indeed, this caused the company to cut its dividend during the Great Recession, and it hasn't recovered.

Gladstone cut its distribution for this reason in Q2 2020, and we believe the cut should be enough for the foreseeable future. NII appears to have stabilized, and we see the payout as sustainable currently, particularly with strong recent earnings results supporting NII.

Final Thoughts & Recommendation

We forecast 1.9% total annual returns in the coming years. The stock remains elevated as the market is bidding up interest rate sensitive stocks. However, Gladstone's fundamentals don't appear to have improved materially. Given this, we are reiterating Gladstone at a sell rating, primarily due to valuation, but note that Gladstone's yield is high.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Revenue	4	43	24	21	25	30	31	33	8	95
SG&A Exp.	7	6	6	6	7	7	8	8	8	8
Net Profit	(8)	32	11	8	11	17	19	20	(2)	84
Net Margin	-212%	75.4%	46.1%	40.4%	46.0%	56.8%	59.5%	59.4%	-22.3%	89.0%
Free Cash Flow	26	32	0	(74)	60	(13)	(18)	9	(46)	(14)

Balance Sheet Metrics

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Total Assets	293	295	301	382	336	366	400	426	459	567
Cash & Equivalents	10	14	6	4	6	5	2	16	2	1
Accounts Receivable	3	2	3	6	2	2	3	3	3	2
Total Liabilities	105	89	102	191	134	146	162	177	225	248
Accounts Payable	1	1	1	1	1	1	1	1	2	2
Long-Term Debt	62	47	38	127	71	93	110	123	222	237
Shareholder's Equity	189	206	200	191	201	220	237	249	234	318
LTD/E Ratio	0.33	0.23	0.19	0.66	0.35	0.42	0.46	0.49	0.95	0.74

Profitability & Per Share Metrics

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Return on Assets	-2.6%	10.9%	3.8%	2.5%	3.2%	4.9%	4.9%	4.8%	-0.4%	16.4%
Return on Equity	-4.0%	16.3%	5.5%	4.3%	5.8%	8.2%	8.2%	8.2%	-0.8%	30.5%
ROIC	-2.8%	12.8%	4.6%	3.0%	3.8%	5.9%	5.7%	5.5%	-0.5%	16.7%
Shares Out.	21.0	21.0	21.0	21.1	23.2	25.5	27.1	29.3	33.0	34.0
Revenue/Share	0.18	2.03	1.16	1.00	1.07	1.19	1.16	1.14	0.27	2.85
FCF/Share	1.25	1.53	0.02	(3.54)	2.59	(0.51)	(0.66)	0.32	(1.48)	(0.42)

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

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