Prospect Capital Corporation (PSEC)

Updated February 12th, 2022, by Josh Arnold

Key Metrics

Current Price:	$8.33	**5 Year CAGR Estimate:**	4.2%	**Market Cap:**	$3.3 B
Fair Value Price:	$6.60	**5 Year Growth Estimate:**	0.0%	**Ex-Dividend Date:**	02/28/22[1]
% Fair Value:	126%	**5 Year Valuation Multiple Estimate:**	-4.5%	**Dividend Payment Date:**	03/20/22
Dividend Yield:	8.6%	**5 Year Price Target**	$6.60	**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 U.S. 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 $3.3 billion. Prospect produces about $710 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 8th, 2022, and results were better than expected on both the top and bottom lines. Net investment income per share was 22 cents, five cents ahead of expectations, and up a penny from the first quarter. Total investment income, which is a measure of revenue, was $175 million, up 1.8% year-over-year, and nearly $12 million ahead of estimates. Total originations of $855 million more than doubled from the first quarter, and the company noted its originations subsequent to the end of the quarter was $284 million. These numbers note that Prospect is more than happy to aggressively deploy capital in today's conditions.

Repayments were $444 million in Q2, up from $324 million in Q1. Quarter-to-date, repayments were $108 million.

Prospect ended the quarter with a NAV per share of $10.60, up from $10.12 at the end of the September quarter. We've boosted our estimate of NII-per-share to 78 cents for this year on strong originations.

Growth on a Per-Share Basis

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2027
NII	$1.67	$1.57	$1.19	$1.03	$1.04	$0.85	$0.79	$0.79	$0.72	$0.75	***$0.78***	***$0.78***
DPS	$1.22	$1.28	$1.32	$1.19	$1.00	$1.00	$0.77	$0.72	$0.72	$0.72	***$0.72***	***$0.72***
Shares[2]	114	207	343	359	357	360	364	367	374	389	***389***	***400***

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 nearly four 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 0% 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 $7 billion today, with Q2 2022 marking the first quarter in years total assets have grown materially.

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 finance the dividend. We see the dividend remaining where it is for the foreseeable future as NII barely covers the

[1] Estimated date

[2] Share count in millions

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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	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Now	2027
Avg. P/NII	7.1	9.2	8.8	6.9	9.9	8.7	8.0	8.2	8.2	8.5	***10.7***	***8.5***
Avg. Yld.	11.5%	12.1%	13.1%	13.8%	11.8%	11.3%	10.6%	12.1%	12.1%	11.3%	***8.6%***	***10.9%***

Prospect's price to net investment income has averaged ~8 in the past decade. We see fair value as 8.5 times net investment income given that the company's growth outlook has improved slightly with higher rates. We see a sizable headwind to total annual returns from the valuation moving lower over time from today's 10.7.

The company's current dividend yield is 8.6%, which is well down against its historical average given the very high valuation and share price that is up since our last update. We forecast the yield rising to 10.9%, which would result from a lower share price but stagnant payout per share.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2027
Payout	73%	82%	111%	116%	96%	118%	97%	85%	100%	96%	***92%***	***92%***

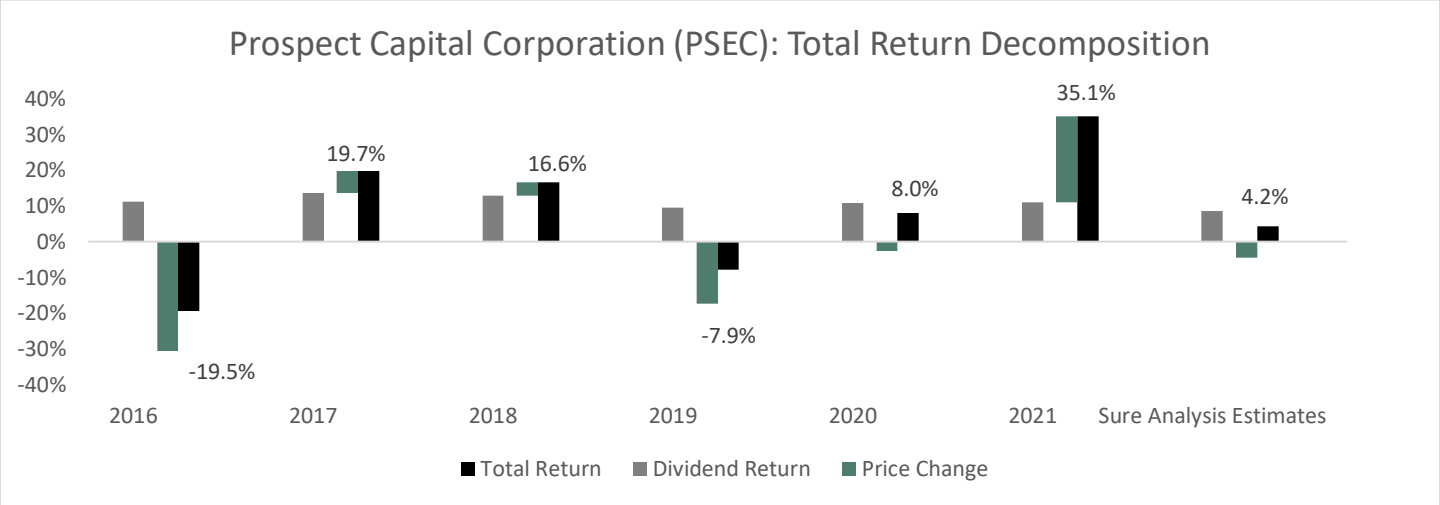
One of the issues with business development companies is that competitive advantages are very difficult to come by, and Prospect is certainly no exception. Scale is the name of the game for BDCs and with a stagnant balance sheet, Prospect has lost some of its relative scale over time. That has begun to reverse given Q2 2022 results.

The company's payout ratio was over 100% for several years in the past decade but is slightly under that now given the increasing NII-per-share estimate. We are 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 do so again.

Final Thoughts & Recommendation

Prospect Capital offers investors a huge yield, but it is not without its risks. The valuation is still high, particularly considering the company's modest growth outlook. The yield is now quite low by historical standards, however. We are forecasting just 4.2% in total returns in the coming years, consisting of the ample yield, no growth, and a sizable headwind from the valuation. We are reiterating the stock at a sell rating.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Revenue	204	245	346	379	137	284	326	199	37	1,008
SG&A Exp.	13	18	31	30	32	32	26	34	33	30
Net Profit	191	221	319	346	103	253	300	144	-16	964
Net Margin	93.5%	90.2%	92.3%	91.4%	75.3%	89.2%	92.0%	81.1%	-43.7%	95.7%
Free Cash Flow	(229)	(1,786)	(1,725)	45	862	376	369	224	429	31

Balance Sheet Metrics

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Total Assets	2,255	4,448	6,477	6,798	6,236	6,173	5,839	5,800	5,300	6,303
Cash & Equivalents	3	203	134	110	318	318	84	107	45	64
Total Liabilities	743	1,792	2,859	3,095	2,800	2,818	2,432	2,494	2,244	2,358
Accounts Payable	21	52	75	70	71	69	56	56	51	51
Long-Term Debt	664	1,683	2,773	2,984	2,667	2,642	2,312	2,383	2,138	2,233
Shareholder's Equity	1,512	2,656	3,618	3,703	3,436	3,355	3,407	3,306	3,056	3,808
D/E Ratio	0.44	0.63	0.77	0.81	0.78	0.79	0.68	0.72	0.70	0.57

Profitability & Per Share Metrics

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Return on Assets	10.0%	6.6%	5.8%	5.2%	1.6%	4.1%	5.0%	2.5%	-0.3%	16.6%
Return on Equity	14.5%	10.6%	10.2%	9.5%	2.9%	7.4%	8.9%	4.3%	-0.5%	28.1%
ROIC	10.3%	6.8%	5.9%	5.3%	1.6%	4.2%	5.1%	2.5%	-0.3%	17.0%
Shares Out.	114	207	343	359	357	360	364	367	374	389
Revenue/Share	1.78	1.18	1.15	1.07	0.39	0.79	0.90	0.54	0.10	2.61
FCF/Share	(2.01)	(8.63)	(5.75)	0.13	2.42	1.05	1.02	0.61	1.17	0.08

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

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