



Gladstone Capital (GLAD)

Updated May 20th, 2022, by Josh Arnold

Key Metrics

Current Price:	\$10.92	5 Year CAGR Estimate:	4.1%	Market Cap:	\$375 M
Fair Value Price:	\$9.77	5 Year Growth Estimate:	-1.0%	Ex-Dividend Date:	06/21/22
% Fair Value:	112%	5 Year Valuation Multiple Estimate:	-2.2%	Dividend Payment Date:	06/30/22
Dividend Yield:	7.4%	5 Year Price Target	\$9.29	Years Of Dividend Growth:	1
Dividend Risk Score:	F	Retirement Suitability Score:	C	Rating:	Hold

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 \$375 million and it pays distributions monthly, instead of quarterly.

Gladstone reported second quarter earnings on May 3rd, 2022, and results handily beat expectations on both the top and bottom lines. The company reported net investment income of 25 cents per share, which was a nickel ahead of expectations. In addition, total investment income, which is equivalent to revenue for a BDC, was up 34% year-over-year to \$17.3 million, and \$2.6 million ahead of estimates.

Gladstone noted that interest income was essentially flat quarter-over-quarter, but that other income was up by \$1 million, or 30%, due to success fees received in connection with the repayment of a debt investment in NetFortris.

Total expenses were up 22% due to a \$1.8 million increase in the net base management fee as the reduction in new deal originations and closing fees reduced portfolio company fee credits.

Net assets resulting from operations increased \$8.3 million, or 24 cents per share. The gain was driven by \$8.7 million of net investment income, partially offset by a \$0.4 million net asset depreciation.

Following Q2 results, we've boosted our estimate to 93 cents in earnings-per-share for this year.

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	\$0.93	\$0.88
DPS	\$0.84	\$0.84	\$0.84	\$0.84	\$0.84	\$0.84	\$0.84	\$0.84	\$0.78	\$0.78	\$0.81	\$0.81
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 93 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're moving our growth estimate from 0% to -1%.

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 payout was trimmed in 2020, although Gladstone is in the process of rebuilding it. The current payout looks quite sustainable.

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	11.7	10.5
Avg. Yld.	10.1%	9.5%	8.8%	10.0%	11.0%	8.8%	9.3%	9.2%	9.4%	7.8%	7.4%	8.7%

Gladstone has traded at a price-to-NII ratio very near 10.5 in the past decade, which is where we assess fair value. At 11.7 times NII, the stock still appears to be overvalued. We therefore see a sizable headwind to total returns should the valuation normalize.

The yield is 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.

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%	87%	92%

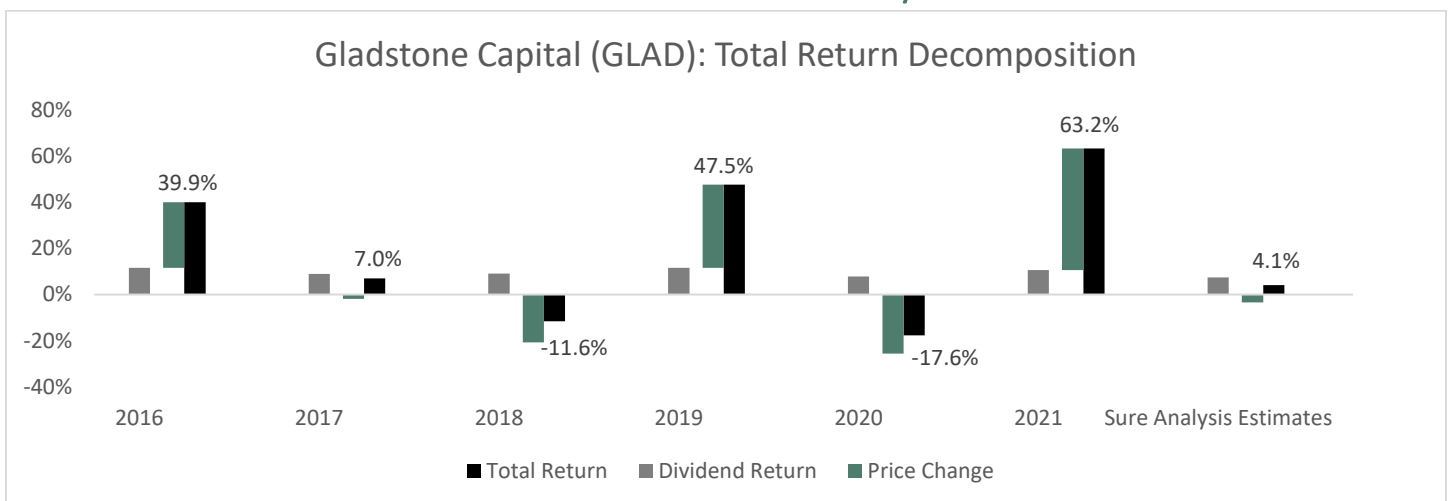
Gladstone doesn't have any competitive advantages as it operates in much the same way as any other BDC. It is also dependent upon funding costs and the spreads it can earn on its debt and equity investments. During recessions, Gladstone will likely struggle as repayments may become a problem for its 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 4.1% 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. We see a headwind from the valuation, and slightly negative growth partially offsetting a very strong yield.

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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