



Stellus Capital Management (SCM)

Updated June 6th, 2022, by Josh Arnold

Key Metrics

Current Price:	\$13	5 Year CAGR Estimate:	7.3%	Market Cap:	\$247 M
Fair Value Price:	\$12	5 Year Growth Estimate:	1.0%	Ex-Dividend Date:	06/29/22
% Fair Value:	107%	5 Year Valuation Multiple Estimate:	-1.4%	Dividend Payment Date:	07/15/22
Dividend Yield:	8.8%	5 Year Price Target	\$12.40	Years Of Dividend Growth:	1
Dividend Risk Score:	F	Retirement Suitability Score:	C	Rating:	Hold

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 \$67 million in revenue, and has a \$247 million market cap.

Stellus reported first quarter earnings on May 11th, 2022, and results were weaker than expected on both the top and bottom lines. Stellus reported adjusted net investment income per share, or NII, of 29 cents. This was one penny below estimates. In addition, total investment income, which is how Stellus measures revenue, was \$15.5 million. This was 11% better than the year-ago period, but missed estimates by almost a million dollars. The gain in investment income was due to higher interest income on the company's portfolio investments.

Operating expenses were \$10 million for the quarter, up from \$8.9 million a year ago. Base management fees were \$3.5 million, up from \$3.0 million. Fees and expenses related to borrowings were \$4.9 million, up from \$4.3 million. Administrative costs were flat at \$0.5 million.

NII was \$5.5 million, up from \$5.1 million a year ago. On a per-share basis, NII was up from 26 cents to 29 cents. The company noted its portfolio at fair value increased by \$65 million, to \$838 million.

We've left our estimate of NII per-share unchanged for this year at \$1.18.

Growth on a Per-Share Basis

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2027
NII	\$0.11	\$1.33	\$1.34	\$1.33	\$1.39	\$1.21	\$1.42	\$1.23	\$1.13	\$1.12	\$1.18	\$1.24
DPS	\$0.18	\$1.43	\$1.36	\$1.36	\$1.36	\$1.36	\$1.36	\$1.36	\$1.09	\$1.08	\$1.12	\$1.12
Shares¹	12.0	12.1	12.3	12.5	12.5	14.9	16.0	18.9	19.5	19.5	20	25

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 slightly lower than expected for the first quarter, we're reiterating our growth estimate at 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

¹ Share count in millions

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was just \$18 million in 2020, a small fraction of its prior years, which were ~\$120 million annually. The company's recovery from the pandemic appears complete, but low interest rates and share issuances remain a constant headwind.

Valuation Analysis

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Now	2027
Avg. P/NII	---	11.2	10.5	8.5	7.5	11.3	9.0	11.4	8.4	11.5	10.7	10.0
Avg. Yld.	1.2%	9.6%	9.7%	12.0%	13.0%	9.9%	10.6%	9.7%	12.8%	8.4%	8.8%	9.0%

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 10.7 times NII, implying a negative impact from the valuation in the coming years.

The dividend yield is now 8.8%, 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. 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	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2027
Payout	164%	108%	101%	102%	98%	112%	96%	106%	96%	96%	95%	90%

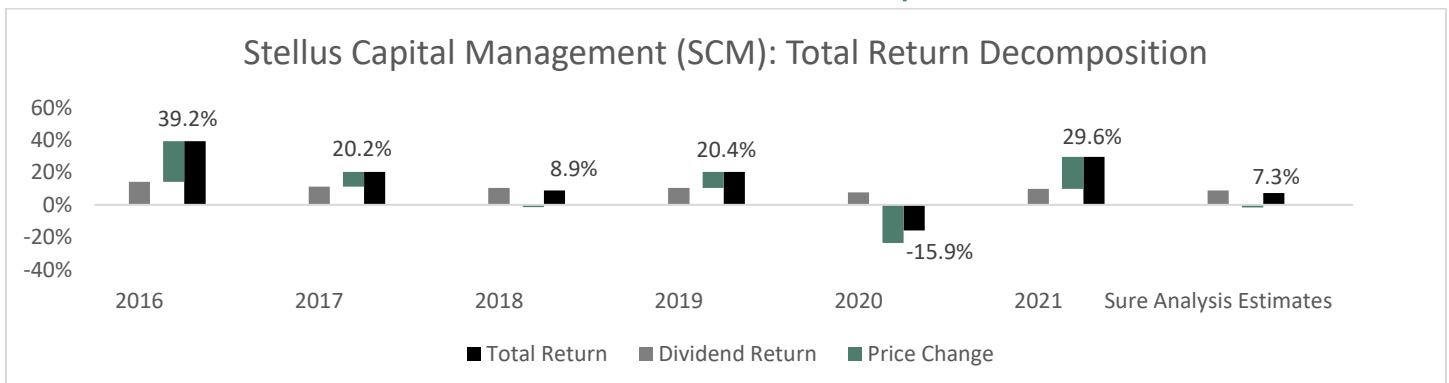
Stellus, like other BDCs, has no competitive advantages. It offers the same products as any other BDC to the same set of customers, so advantages are virtually impossible to achieve. In addition, BDCs suffer mightily during recessions because borrowers have a more difficult time meeting repayment timelines. 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 7.3% annually. Given the inherent risk of owning a BDC, as well as modest projected total returns, we are reiterating Stellus at a hold 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. The valuation has improved, but the stock remains expensive and with a relatively low 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	---	29	32	35	26	27	31	32	26	43
Gross Profit	---	25	27	29	---	---	---	---	---	---
Gross Margin	---	85.6%	83.9%	83.4%	---	---	---	---	---	---
SG&A Exp.	---	7	7	7	4	5	4	4	5	5
Operating Profit	---	18	20	22	---	---	---	---	---	---
Operating Margin	---	61.8%	63.2%	62.8%	---	---	---	---	---	---
Net Profit	---	18	10	8	23	23	26	26	20	34
Net Margin	---	59.7%	31.5%	21.8%	87.7%	83.0%	84.3%	83.4%	78.0%	78.7%
Free Cash Flow	---	(68)	(27)	(24)	9	19	(102)	(93)	(3)	(76)
Income Tax	---		0	0	(0)	(0)	1	1	1	4

Balance Sheet Metrics

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Total Assets	263	298	327	365	380	400	526	649	675	821
Cash & Equivalents	62	14	2	11	9	25	17	16	18	44
Accounts Receivable	---	0	0	0	---	---	---	---	---	---
Total Liabilities	89	122	153	201	209	180	301	378	402	536
Accounts Payable	5	3	3	3	3	3	4	4	2	5
Long-Term Debt	---	119	148	196	203	174	292	366	393	518
Shareholder's Equity	174	176	174	165	171	220	225	271	273	285
LTD/E Ratio	---	0.68	0.85	1.19	1.19	0.79	1.30	1.35	1.44	1.82

Profitability & Per Share Metrics

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Return on Assets	---	---	3.3%	2.2%	6.2%	5.8%	5.7%	4.5%	3.1%	4.5%
Return on Equity	---	10.0%	5.8%	4.5%	13.8%	11.6%	11.8%	10.7%	7.4%	12.0%
ROIC	---	---	3.3%	2.2%	6.3%	5.9%	5.7%	4.6%	3.1%	4.6%
Shares Out.	12.0	12.1	12.3	12.5	12.5	14.9	16.0	18.9	19.5	19.5
Revenue/Share	---	2.44	2.63	2.82	2.12	1.83	1.95	1.73	1.33	2.19
FCF/Share	---	-5.67	-2.21	-1.96	0.71	1.27	-6.42	-5.10	-0.18	-3.90

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

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