



Capital Southwest Corporation (CSWC)

Updated November 1st, 2022 by Nikolaos Sismanis

Key Metrics

Current Price:	\$19.16	5 Year CAGR Estimate:	13.0%	Market Cap:	\$527.5 M
Fair Value Price:	\$20.60	5 Year Growth Estimate:	3.0%	Ex-Dividend Date:	12/14/2022
% Fair Value:	93%	5 Year Valuation Multiple Estimate:	1.5%	Dividend Payment Date:	12/30/2022
Dividend Yield:	10.9%	5 Year Price Target	\$23.88	Years Of Dividend Growth:	6 ¹
Dividend Risk Score:	F	Retirement Suitability Score:	C	Rating:	Buy

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 \$82 million in annual revenues and is based in Dallas, Texas.

On September 30th, Capital Southwest increased its base dividend by 4% to a quarterly rate of \$0.52. The company announced a supplemental dividend of \$0.05, in line with its prior supplemental dividend. Special dividends are not reflected on our Fiscal 2022 entries in our tables below.

On October 31st, 2022, Capital Southwest reported its Q2 results for the period ending September 30th, 2022. It's important to note that the company's fiscal year ends on March 31st. This applies to the figures shown in our tables. For the quarter, the company achieved a total investment income of \$26.8 million, 3.9% higher than the previous quarter. The increase in investment income was primarily attributable to an increase in average debt investments outstanding, an increase in the weighted average yield on investments, and higher dividend income. Pre-tax net investment income (NII) came in at \$15.0 million, 19% higher than in Q1-2023. On a per-share basis, pre-tax net investment income came in at \$0.54 compared to \$0.45 in the previous quarter. For fiscal 2023, our estimates point toward a pre-tax NII/share of \$2.06.

CSWC's credit portfolio currently consists of 78 lower and upper-middle-market companies. About \$903 million is allocated in Capital Southwest's credit portfolio, 84.8% of which is allocated in 1st Lien Senior Secured Debt. The weighted average yield on debt is standing at a fair 10.6%. The equity part of the portfolio is worth around \$90 million. CSWC's investment portfolio is well-diversified and exposed to nearly 25 industries. Media, Marketing & Entertainment, Business Services, and Consumer Products & Retail account for 11%, 11%, and 9% of the total holdings, respectively.

Growth on a Per-Share Basis

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2028
NII	\$7.09	\$7.32	\$3.44	(\$0.76)	\$0.61	\$1.02	\$1.48	\$1.68	\$1.79	\$1.90	\$2.06	\$2.39
DPS	\$5.29	\$0.20	\$0.20	\$0.14	\$0.79	\$0.99	\$2.27	\$2.75	\$2.05	\$2.52	\$2.08	\$2.41
Shares²	15.2	15.3	15.5	15.6	15.9	16.1	16.7	18.0	19.0	22.8	27.9	45.0

On September 30th, 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 experienced management team have allowed it to sustain a double-digit investment yield most of the time. The company has refinanced its own loans at lower rates over time, resulting in higher net investment income. Additionally, with only 23 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 2.1%. In terms of the dividend, the company has been growing its base DPS annually since the spin-off in 2015. The higher

¹ Refers to the base dividend rate which excludes supplemental payouts.

² Share count is in millions.

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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 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. Rising interest rates should benefit the company, though we remain prudent. 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	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2028
Avg. P/E	4.4	5.1	14.5	---	26.6	18.9	14.4	12.5	12.8	12.1	9.3	10.0
Avg. Yld.	17.1%	0.5%	0.4%	1.0%	4.9%	5.1%	10.7%	13.1%	9.0%	10.9%	10.9%	10.1%

Capital Southwest is currently trading at around 9.3X our projected net investment income year. We believe this is a discounted valuation given the companies operating excellence and resilient, cash-flow-producing investments. We have set our fair multiple at 10X, lower than our previous multiple of 11X, to account for higher interest rates. Still, we expect valuation tailwinds from the stock's multiple. At the current base DPS, the stock yields 10.9%, excluding any special/supplementary dividends.

Safety, Quality, Competitive Advantage, & Recession Resiliency

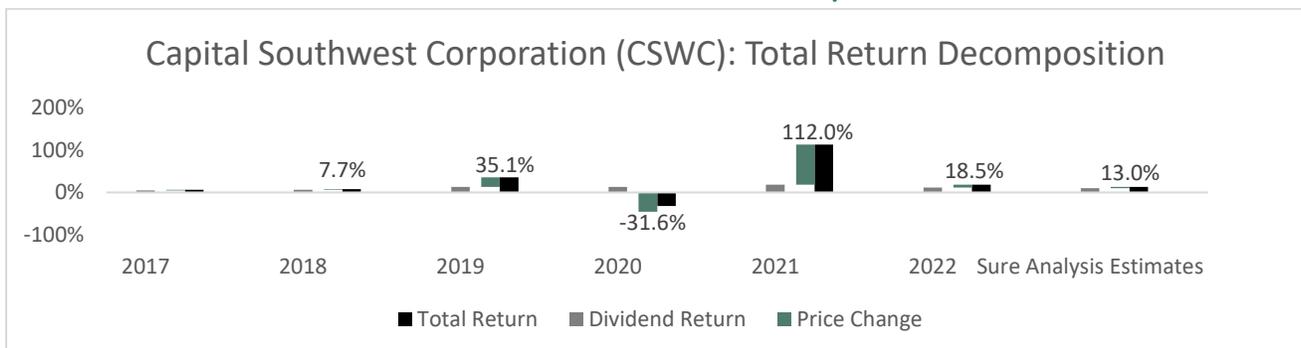
Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2028
Payout	75%	3%	6%	-18%	130%	97%	153%	164%	115%	133%	101%	101%

Capital Southwest's dividend should be considered safer than its 101% payout ratio implies, considering the supplemental payouts, the special payouts, and the 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, even during COVID-19, when interest income remained robust. Considering 2015's spin-off transformed the company, this is the closest we can get to measure the company's recession resiliency, which could prove to be quite strong based on its 2020-2021 results. Being an investment company, Capital Southwest does not have a distinct competitive advantage compared to its peers other than management's experience.

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 13.0% in the medium-term, excluding any supplementary dividends, driven primarily by the stock's hefty dividend yield and our growth rates, further boosted by a potential valuation tailwind. We rate the stock as a buy.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Revenue	116.8	119.7	65.8	14.4	38.4	53.2	48.9	-0.2	71.6	78.9
SG&A Exp.	3.3	2.8	5.8	11.4	4.4	4.4	4.8	5.6	5.2	2.5
D&A Exp.	0.0	0.0	0.1	0.1	0.5	0.9	1.4	2.4	2.0	2.2
Net Profit	107.8	112.0	53.4	-5.4	23.5	39.3	33.1	-22.4	50.9	42.8
Net Margin	92.4%	93.6%	81.2%	N/A	61.1%	73.9%	67.6%	N/A	71.1%	54.2%
Free Cash Flow	93.2	8.4	194.3	-111.5	-89.6	-63.9	-94.7	-47.9	-68.3	-184.7
Income Tax	0.6	-0.7	0.3	-1.3	2.1	0.1	0.9	6.2	4.7	4.0

Balance Sheet Metrics

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Total Assets	667.7	778.7	776.9	284.5	325.8	417.5	551.8	585.0	735.6	974
Cash & Equivalents	81.8	88.2	225.8	96.0	22.4	7.9	9.9	13.7	31.6	11.4
Total Liabilities	7.9	8.3	9.5	11.9	40.7	109.2	225.9	312.7	399.3	553
Long-Term Debt	0.0	0.0	0.0	0.0	25.0	95.3	216.1	303.3	381.3	529
Shareholder's Equity	659.8	770.4	767.4	272.6	285.1	308.3	326.0	272.2	336.3	421
LTD/E Ratio	0.0	0.0	0.0	0.0	0.1	0.3	0.7	1.1	1.1	1.27

Profitability & Per Share Metrics

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Return on Assets	16.6%	15.5%	6.9%	-1.0%	7.7%	10.6%	6.8%	-3.9%	7.7%	5.0%
Return on Equity	16.7%	15.7%	7.0%	-1.0%	8.4%	13.2%	10.4%	-7.5%	16.7%	11.3%
ROIC	16.7%	15.7%	7.0%	-1.0%	8.1%	11.0%	7.0%	-4.0%	7.9%	5.1%
Shares Out.	15.4	15.3	15.5	15.7	15.9	16.1	16.7	18.0	19.1	22.84
Revenue/Share	7.59	7.83	4.24	0.92	2.42	3.30	2.92	-0.01	3.76	3.46
FCF/Share	6.06	0.55	12.51	-7.09	-5.64	-3.96	-5.66	-2.66	-3.6	-8.09

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

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