



Stellus Capital Management (SCM)

Updated November 26th, 2022, by Josh Arnold

Key Metrics

Current Price:	\$14	5 Year CAGR Estimate:	7.7%	Market Cap:	\$269 M
Fair Value Price:	\$13	5 Year Growth Estimate:	2.0%	Ex-Dividend Date:	11/29/22
% Fair Value:	106%	5 Year Valuation Multiple Estimate:	-1.2%	Dividend Payment Date:	12/15/22
Dividend Yield:	8.1%	5 Year Price Target	\$14.35	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 \$73 million in revenue, and has a \$269 million market cap.

Stellus reported third quarter earnings on November 3rd, 2022, and results were better than expected on both the top and bottom lines. Net investment income per share came to 37 cents, which was eight cents better than expected. Total investment income was \$20.1 million, up 18% year-over-year, and beating estimates by \$2.6 million. The gain was mostly due to higher interest income on the portfolio.

Operating expenses were \$13 million, flat to a year ago. Base management fees were \$3.8 million, up from \$3.5 million year-over-year. Income incentive fees were \$1.6 million, up slightly from \$1.5 million. Fees and expenses related to borrowings were \$6.4 million, up from \$4.9 million a year ago.

Net investment income was \$7.2 million, up sharply from \$4.1 million a year ago. On a per-share basis, NII rose from 21 cents to 37 cents. We see \$1.30 in NII per share for the full year with one quarter remaining.

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	\$1.30	\$1.44
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 better than expectations in Q3 by a wide margin, we're boosting our growth estimate to 2% as the company grapples with higher funding costs, but higher interest income on the portfolio is helping to more than offset that.

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 interest rates declining off of currently elevated levels. 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. The company's recovery from the pandemic appears complete, but low interest rates and share issuances remain a constant headwind. We note Q3 results are supportive of higher NII estimates going forward, barring a big reduction in market interest rates.

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.



Stellus Capital Management (SCM)

Updated November 26th, 2022, by Josh Arnold

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	10.6	10.0
Avg. Yld.	1.2%	9.6%	9.7%	12.0%	13.0%	9.9%	10.6%	9.7%	12.8%	8.4%	8.1%	7.8%

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

The dividend yield is now 8.1%, 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%	86%	78%

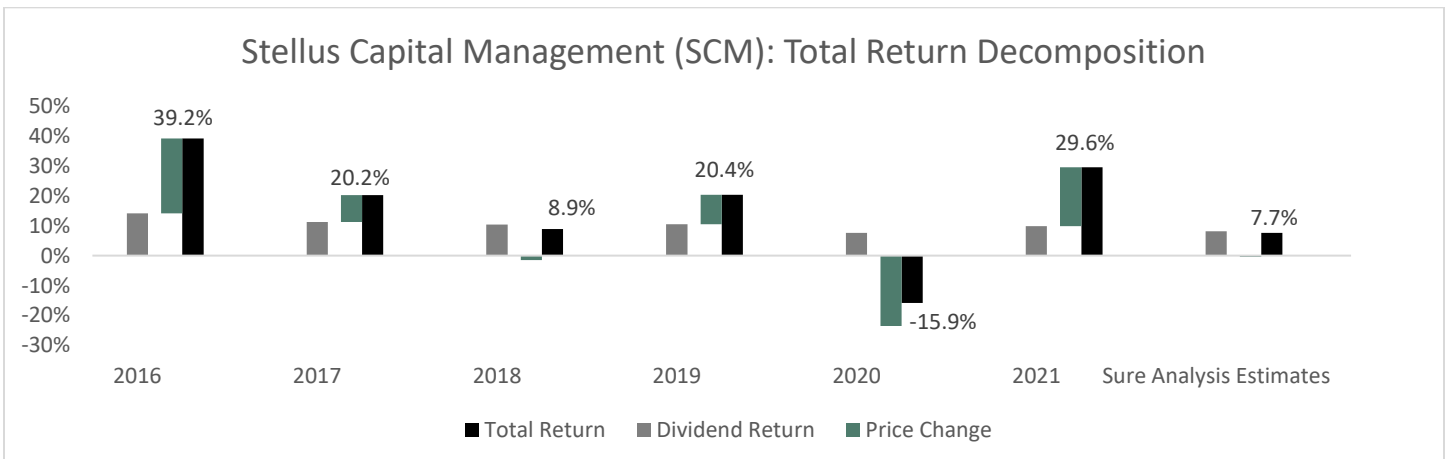
Stellus, like other BDCs, has no competitive advantages. It offers the same products as any other BDC to the same set of customers, so advantages are virtually impossible to achieve. In addition, BDCs suffer mightily during recessions because borrowers have a more difficult time meeting repayment timelines. 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 7.7% 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 at 8.1%, 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 remains ahead of fair value and could offer a 1.2% headwind, and we see 2% growth.

Total Return Breakdown by Year



[Click here to rate and review this research report. Your feedback is important to us.](#)

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.



Stellus Capital Management (SCM)

Updated November 26th, 2022, by Josh Arnold

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.

Disclaimer

Nothing presented herein is, or is intended to constitute, specific investment advice. Nothing in this research report should be construed as a recommendation to follow any investment strategy or allocation. Any forward-looking statements or forecasts are based on assumptions and actual results are expected to vary from any such statements or forecasts. No reliance should be placed on any such statements or forecasts when making any investment decision. While Sure Dividend has used reasonable efforts to obtain information from reliable sources, we make no representations or warranties as to the accuracy, reliability or completeness of third-party information presented herein. No guarantee of investment performance is being provided and no inference to the contrary should be made. There is a risk of loss from an investment in marketable securities. Past performance is not a guarantee of future performance.