



Prospect Capital Corporation (PSEC)

Updated December 14th, 2022, by Josh Arnold

Key Metrics

Current Price:	\$7.29	5 Year CAGR Estimate:	9.6%	Market Cap:	\$2.9 B
Fair Value Price:	\$7.91	5 Year Growth Estimate:	0.0%	Ex-Dividend Date:	12/27/22
% Fair Value:	92%	5 Year Valuation Multiple Estimate:	1.6%	Dividend Payment Date:	01/19/23
Dividend Yield:	9.9%	5 Year Price Target	\$7.91	Years Of Dividend Growth:	0
Dividend Risk Score:	F	Retirement Suitability Score:	C	Rating:	Hold

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 \$2.9 billion. Prospect produces about \$860 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 first quarter earnings on November 9th, 2022, and results were better than expected on both the top and bottom lines, and by wide margins. Net investment income per-share came to 22 cents, which was four cents ahead of expectations. Total investment income, which is a form of revenue for a BDC, was up almost 20% year-over-year to \$203 million. That was also \$16 million better than expectations.

Net asset value per-share ended the quarter at \$10.01, which was down fractionally year-over-year, but still a significant premium to the share price.

The portfolio ended the quarter at \$7.6 billion, in 128 portfolio companies. Those values were both essentially flat to the prior quarter. The current annualized yield of the portfolio is 9.9%, up from 8.7% from the June quarter.

We've boosted our estimate of NII per-share to 93 cents after strong first quarter results.

Growth on a Per-Share Basis

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2028
NII	\$1.57	\$1.19	\$1.03	\$1.04	\$0.85	\$0.79	\$0.79	\$0.72	\$0.75	\$0.75	\$0.93	\$0.93
DPS	\$1.28	\$1.32	\$1.19	\$1.00	\$1.00	\$0.77	\$0.72	\$0.72	\$0.72	\$0.72	\$0.72	\$0.72
Shares¹	207	343	359	357	360	364	367	374	389	392	395	415

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 double today what 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 \$7.6 billion today, with Q2 2022 marking the first quarter in years that 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 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. The boost in projected earnings is helping to increase dividend safety.

Valuation Analysis

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	Now	2028
Avg. P/NII	9.2	8.8	6.9	9.9	8.7	8.0	8.2	8.2	8.5	9.3	7.8	8.5
Avg. Yld.	12.1%	13.1%	13.8%	11.8%	11.3%	10.6%	12.1%	12.1%	11.3%	10.3%	9.9%	9.1%

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 tailwind to total annual returns from the valuation moving higher over time from today's 7.8.

The company's current dividend yield is 9.9%, which is somewhat lower against its historical average. We forecast the yield declining to 9.1%, which would result from a higher share price but stagnant payout per share.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2028
Payout	82%	111%	116%	96%	118%	97%	85%	100%	96%	90%	77%	77%

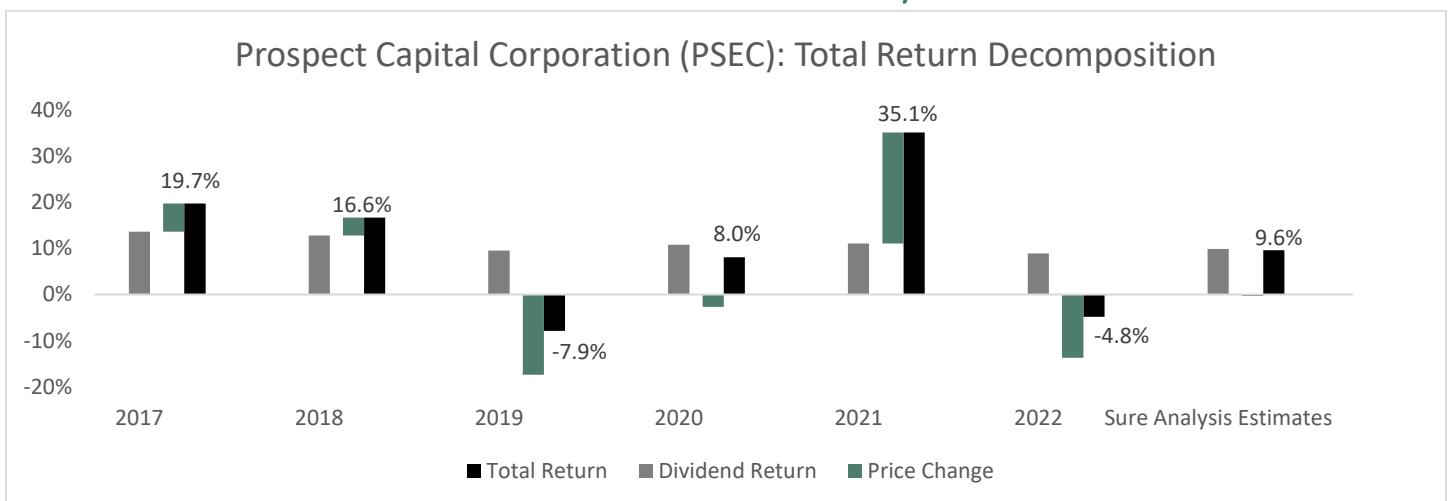
One of the issues with business development companies is that competitive advantages are very difficult to come by, and Prospect is certainly no exception. Scale is the name of the game for BDCs and with a stagnant balance sheet, Prospect has lost some of its relative scale over time. That began to reverse 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 now much more favorable, particularly considering the company's modest growth outlook. The yield is better as well. We are forecasting 9.6% in total returns in the coming years, consisting of the 9.9% yield, 0% growth, and a 1.6% tailwind from the valuation. We reiterate Prospect at a hold rating.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Revenue	245	346	379	137	284	326	199	37	1,008	635
SG&A Exp.	18	31	30	32	32	26	34	33	30	30
Net Profit	221	319	346	103	253	300	144	-16	964	583
Net Margin	90.2%	92.3%	91.4%	75.3%	89.2%	92.0%	81.1%	-43.7%	95.7%	91.8%
Free Cash Flow	(1,786)	(1,725)	45	862	376	369	224	429	31	(795)

Balance Sheet Metrics

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Total Assets	4,448	6,477	6,798	6,236	6,173	5,839	5,800	5,300	6,303	7,663
Cash & Equivalents	203	134	110	318	318	84	107	45	64	35
Total Liabilities	1,792	2,859	3,095	2,800	2,818	2,432	2,494	2,244	2,358	3,544
Accounts Payable	52	75	70	71	69	56	56	51	51	50
Long-Term Debt	1,683	2,773	2,984	2,667	2,642	2,312	2,383	2,138	2,233	2,737
Shareholder's Equity	2,656	3,618	3,703	3,436	3,355	3,407	3,306	3,056	3,808	4,119
LTD/E Ratio	0.63	0.77	0.81	0.78	0.79	0.68	0.72	0.70	0.57	0.66

Profitability & Per Share Metrics

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Return on Assets	6.6%	5.8%	5.2%	1.6%	4.1%	5.0%	2.5%	-0.3%	16.6%	8.3%
Return on Equity	10.6%	10.2%	9.5%	2.9%	7.4%	8.9%	4.3%	-0.5%	28.1%	14.7%
ROIC	6.8%	5.9%	5.3%	1.6%	4.2%	5.1%	2.5%	-0.3%	17.0%	8.9%
Shares Out.	207	343	359	357	360	364	367	374	389	434
Revenue/Share	1.18	1.15	1.07	0.39	0.79	0.90	0.54	0.10	2.61	1.46
FCF/Share	(8.63)	(5.75)	0.13	2.42	1.05	1.02	0.61	1.17	0.08	(1.83)

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

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