



# Prospect Capital Corporation (PSEC)

Updated February 14<sup>th</sup>, 2023, by Josh Arnold

## Key Metrics

<b>Current Price:</b>	\$7.64	<b>5 Year CAGR Estimate:</b>	7.8%	<b>Market Cap:</b>	\$3.0 B
<b>Fair Value Price:</b>	\$7.91	<b>5 Year Growth Estimate:</b>	-1.0%	<b>Ex-Dividend Date:</b>	04/24/23
<b>% Fair Value:</b>	97%	<b>5 Year Valuation Multiple Estimate:</b>	0.7%	<b>Dividend Payment Date:</b>	05/18/23
<b>Dividend Yield:</b>	9.4%	<b>5 Year Price Target</b>	\$7.52	<b>Years Of Dividend Growth:</b>	0
<b>Dividend Risk Score:</b>	F	<b>Retirement Suitability Score:</b>	C	<b>Rating:</b>	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 \$3 billion. Prospect produces about \$870 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 fourth quarter and full-year earnings on February 8<sup>th</sup>, 2023, and results were mixed. The company posted net investment income of 23 cents per share, which was two cents better than expected. However, total investment income was \$213 million. That was up 21% year-over-year, but missed estimates by about half a million dollars.

Interest as a percentage of total investment income was 89.6%, which was up sharply from 81.1% in the year-ago period, as the company is generating much more interest on its portfolio. This is the result of higher prevailing interest rates.

We continue to see 93 cents in net investment income for this year but note that it is possible 2023 represents the top for the medium term given favorable interest rate conditions.

## Growth on a Per-Share Basis

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2028
<b>NII</b>	\$1.57	\$1.19	\$1.03	\$1.04	\$0.85	\$0.79	\$0.79	\$0.72	\$0.75	\$0.75	<b>\$0.93</b>	<b>\$0.88</b>
<b>DPS</b>	\$1.28	\$1.32	\$1.19	\$1.00	\$1.00	\$0.77	\$0.72	\$0.72	\$0.72	\$0.72	<b>\$0.72</b>	<b>\$0.72</b>
<b>Shares<sup>1</sup></b>	207	343	359	357	360	364	367	374	389	392	<b>395</b>	<b>415</b>

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 -1% 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

<sup>1</sup> 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	8.2	8.5
Avg. Yld.	12.1%	13.1%	13.8%	11.8%	11.3%	10.6%	12.1%	12.1%	11.3%	10.3%	9.4%	9.6%

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 8.2.

The company's current dividend yield is 9.4%, which is somewhat lower against its historical average. We forecast the yield increasing to 9.6%, which would result from a slightly lower 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%	81%

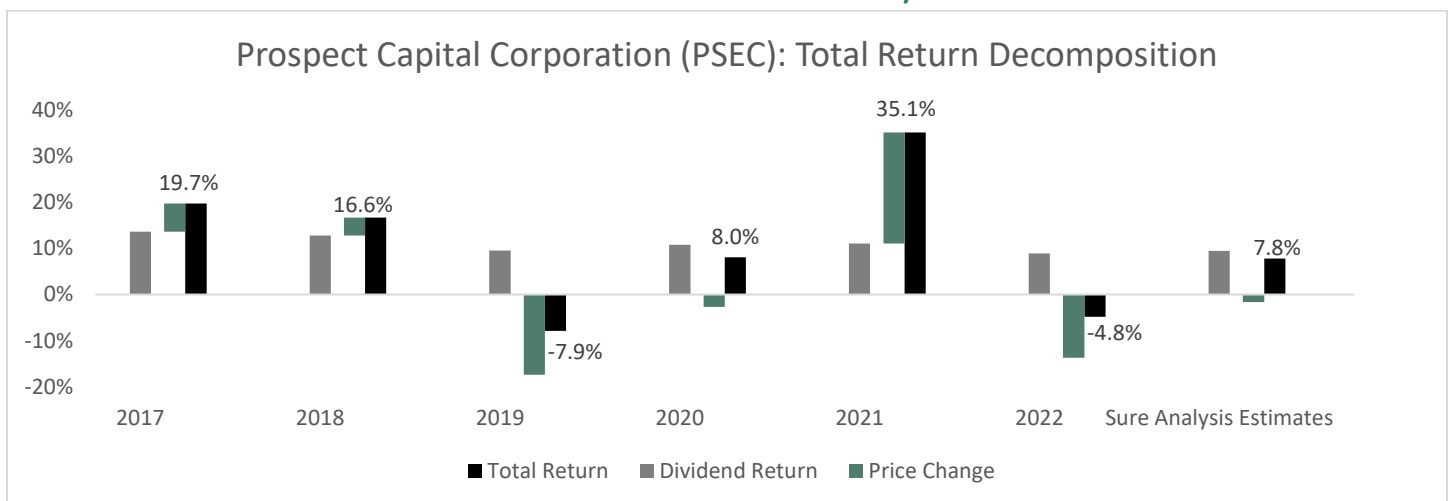
One of the issues with business development companies is that competitive advantages are very difficult to come by, and Prospect is certainly no exception. Scale is the name of the game for BDCs and with a stagnant balance sheet, Prospect has lost some of its relative scale over time. That began to reverse 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 7.8% in total returns in the coming years, consisting of the 9.4% yield, -1% growth, and a 0.7% 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
<b>Revenue</b>	245	346	379	137	284	326	199	37	1,008	635
<b>SG&amp;A Exp.</b>	18	31	30	32	32	26	34	33	30	30
<b>Net Profit</b>	221	319	346	103	253	300	144	-16	964	583
<b>Net Margin</b>	90.2%	92.3%	91.4%	75.3%	89.2%	92.0%	81.1%	-43.7%	95.7%	91.8%
<b>Free Cash Flow</b>	(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
<b>Total Assets</b>	4,448	6,477	6,798	6,236	6,173	5,839	5,800	5,300	6,303	7,663
<b>Cash &amp; Equivalents</b>	203	134	110	318	318	84	107	45	64	35
<b>Total Liabilities</b>	1,792	2,859	3,095	2,800	2,818	2,432	2,494	2,244	2,358	3,544
<b>Accounts Payable</b>	52	75	70	71	69	56	56	51	51	50
<b>Long-Term Debt</b>	1,683	2,773	2,984	2,667	2,642	2,312	2,383	2,138	2,233	2,737
<b>Shareholder's Equity</b>	2,656	3,618	3,703	3,436	3,355	3,407	3,306	3,056	3,808	4,119
<b>LTD/E Ratio</b>	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
<b>Return on Assets</b>	6.6%	5.8%	5.2%	1.6%	4.1%	5.0%	2.5%	-0.3%	16.6%	8.3%
<b>Return on Equity</b>	10.6%	10.2%	9.5%	2.9%	7.4%	8.9%	4.3%	-0.5%	28.1%	14.7%
<b>ROIC</b>	6.8%	5.9%	5.3%	1.6%	4.2%	5.1%	2.5%	-0.3%	17.0%	8.9%
<b>Shares Out.</b>	207	343	359	357	360	364	367	374	389	434
<b>Revenue/Share</b>	1.18	1.15	1.07	0.39	0.79	0.90	0.54	0.10	2.61	1.46
<b>FCF/Share</b>	(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.

### Disclaimer

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