



# Gladstone Capital (GLAD)

Updated May 7<sup>th</sup>, 2023, by Josh Arnold

## Key Metrics

<b>Current Price:</b>	\$9.42	<b>5 Year CAGR Estimate:</b>	11.9%	<b>Market Cap:</b>	\$340 M
<b>Fair Value Price:</b>	\$11.03	<b>5 Year Growth Estimate:</b>	1.0%	<b>Ex-Dividend Date:</b>	05/22/22
<b>% Fair Value:</b>	85%	<b>5 Year Valuation Multiple Estimate:</b>	3.2%	<b>Dividend Payment Date:</b>	05/31/22
<b>Dividend Yield:</b>	10.2%	<b>5 Year Price Target</b>	\$11.59	<b>Years Of Dividend Growth:</b>	2
<b>Dividend Risk Score:</b>	F	<b>Retirement Suitability Score:</b>	C	<b>Rating:</b>	Buy

## Overview & Current Events

Gladstone Capital is a business development company, or BDC, that primarily invests in small and medium businesses. These investments are made via a variety of equity (10% of portfolio) and debt instruments (90% of portfolio), generally with very high yields. Loan size is typically in the \$7 million to \$30 million range and has terms up to seven years. The BDC's stated purpose is to generate income it can distribute to its shareholders. The company trades with a market capitalization of \$340 million and it pays distributions monthly, instead of quarterly.

Gladstone reported second quarter earnings on May 2<sup>nd</sup>, 2023, and results were largely in line with expectations. The BDC reported net interest income of 26 cents per share, which was in line with expectations. Total investment income, which is a measure of revenue, came to \$20.56 million, 19% higher year-over-year, and beating estimates by \$0.57 million. The company noted the increase in NII was due to increases in the weighted average yield and weighted average principal balance of interest-bearing investments.

Total expenses were fractionally higher, primarily due to interest expense rising. This was due to an increase in the company's line of credit interest rate.

The increase in net assets from operations was \$12 million, or 33 cents per share. This was attributable to NII moving higher, and \$1.9 million in net unrealized appreciation recognized during the quarter. We now see \$1.05 in NII-per-share for this year after Q2 results.

Gladstone also put in a larger-than-normal dividend increase, boosting the payout by 6.7% to a new value of 96 cents per share on an annualized basis.

## Growth on a Per-Share Basis

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2028
<b>NII</b>	\$0.88	\$0.87	\$0.84	\$0.84	\$0.84	\$0.85	\$0.84	\$0.81	\$0.79	\$0.94	<b>\$1.05</b>	<b>\$1.10</b>
<b>DPS</b>	\$0.84	\$0.84	\$0.84	\$0.84	\$0.84	\$0.84	\$0.84	\$0.78	\$0.78	\$0.78	<b>\$0.96</b>	<b>\$1.01</b>
<b>Shares<sup>1</sup></b>	21.0	21.0	21.1	23.2	25.5	27.1	29.3	33.0	34.0	35.1	<b>36.0</b>	<b>40.0</b>

Gladstone reports net investment income per share, or NII, instead of earnings-per-share, which is consistent with other BDCs. On that measure, the company's results have been lackluster in terms of growth over the past decade. Our estimate of \$1.05 for this year is meaningfully higher than historical NII. Gladstone's share issuances have funded higher NII in dollar terms but haven't earned enough above its cost of capital to move the needle on NII-per-share. Given this history, we're reiterating our growth estimate of 1%.

The yields on the company's portfolio influence its ability to earn income and therefore, cover its expenses and pay distributions to shareholders. Over time, the company's portfolio yield has drifted higher to 10%+. However, higher expenses have offset that growth recently, which is part of the reason why NII-per-share continues to be roughly flat over time. Gladstone's portfolio continues to grow in dollar terms, but given its offsetting rising expenses, NII hasn't

<sup>1</sup> Share count in millions

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grown. We see this cycle of new investments being largely offset by losses and higher expenses. The company has made profitable exits of late, not only generating gains, but also the ability to recycle that capital.

Gladstone's dividend had been at \$0.07 monthly, or \$0.84 annually, since 2010. However, the payout was trimmed in 2020, although Gladstone is in the process of rebuilding it, and it is now up to 96 cents annually. The current payout looks sustainable.

## Valuation Analysis

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	Now	2028
Avg. P/NII	10.1	10.9	10.0	9.1	11.4	10.7	10.8	10.2	12.7	9.0	9.0	10.5
Avg. Yld.	9.5%	8.8%	10.0%	11.0%	8.8%	9.3%	9.2%	9.4%	7.8%	9.2%	10.2%	8.7%

Gladstone has traded at a price-to-NII ratio very near 10.5 in the past decade, which is where we assess fair value. At 9 times NII, the stock now appears to be undervalued. We therefore see a modestly positive impact to total returns from the valuation.

The yield is lower than it has been for most of the past decade; Gladstone's average yield in the past decade has been close to 10%, and we see the yield with the potential to move lower in the coming years, as the stock could see a valuation tailwind.

## Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2028
Payout	95%	97%	100%	100%	100%	99%	100%	96%	99%	83%	91%	91%

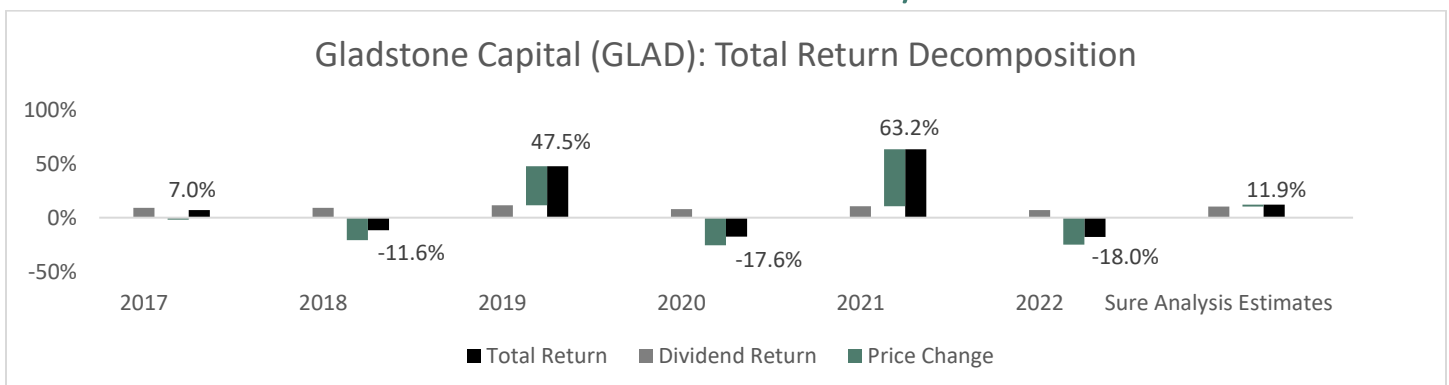
Gladstone doesn't have any competitive advantages as it operates in much the same way as any other BDC. It is also dependent upon funding costs and the spreads it can earn on its debt and equity investments. During recessions, Gladstone will likely struggle as repayments may become a problem for its debt investments. Indeed, this caused the company to cut its dividend during the Great Recession, and it hasn't recovered.

Gladstone cut its distribution for this reason in Q2 2020, and we believe the cut should be enough for the foreseeable future. NII is once again moving higher, and we see the payout as sustainable currently, particularly with strong recent earnings results supporting NII. The most recent increase is seen as a vote of confidence from management.

## Final Thoughts & Recommendation

We forecast 11.9% total annual returns in the coming years. The stock is now much cheaper than it has been in recent quarters. In addition, we see higher earnings this year supporting a higher share price, as well as the dividend. We see a 3.2% tailwind from the valuation, as well as 1% growth and the 10.2% yield. The stock now earns a buy 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	43	24	21	25	30	31	33	8	95	32
SG&A Exp.	6	6	6	7	7	8	8	8	8	10
Net Profit	32	11	8	11	17	19	20	(2)	84	20
Net Margin	75.4%	46.1%	40.4%	46.0%	56.8%	59.5%	59.4%	-22.3%	89.0%	62.5%
Free Cash Flow	32	0	(74)	60	(13)	(18)	9	(46)	(14)	(76)

## Balance Sheet Metrics

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Total Assets	295	301	382	336	366	400	426	459	567	661
Cash & Equivalents	14	6	4	6	5	2	16	2	1	2
Accounts Receivable	2	3	6	2	2	3	3	3	2	3
Total Liabilities	89	102	191	134	146	162	177	225	248	345
Accounts Payable	1	1	1	1	1	1	1	2	2	3
Long-Term Debt	47	38	127	71	93	110	123	222	237	339
Shareholder's Equity	206	200	191	201	220	237	249	234	318	315
LTD/E Ratio	0.23	0.19	0.66	0.35	0.42	0.46	0.49	0.95	0.74	1.08

## Profitability & Per Share Metrics

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Return on Assets	10.9%	3.8%	2.5%	3.2%	4.9%	4.9%	4.8%	-0.4%	16.4%	3.2%
Return on Equity	16.3%	5.5%	4.3%	5.8%	8.2%	8.2%	8.2%	-0.8%	30.5%	6.3%
ROIC	12.8%	4.6%	3.0%	3.8%	5.9%	5.7%	5.5%	-0.5%	16.7%	3.3%
Shares Out.	21.0	21.0	21.1	23.2	25.5	27.1	29.3	33.0	34.0	34.4
Revenue/Share	2.03	1.16	1.00	1.07	1.19	1.16	1.14	0.27	2.85	0.94
FCF/Share	1.53	0.02	(3.54)	2.59	(0.51)	(0.66)	0.32	(1.48)	(0.42)	(2.22)

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

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