



Gladstone Capital (GLAD)

Updated August 9th, 2023, by Josh Arnold

Key Metrics

Current Price:	\$11.00	5 Year CAGR Estimate:	11.2%	Market Cap:	\$422 M
Fair Value Price:	\$11.76	5 Year Growth Estimate:	3.0%	Ex-Dividend Date:	08/20/22
% Fair Value:	94%	5 Year Valuation Multiple Estimate:	1.3%	Dividend Payment Date:	08/31/22
Dividend Yield:	9.0%	5 Year Price Target	\$13.63	Years Of Dividend Growth:	2
Dividend Risk Score:	F	Retirement Suitability Score:	C	Rating:	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 \$422 million and it pays distributions monthly, instead of quarterly.

Gladstone posted third quarter earnings on July 26th, 2023, and results were ahead of expectations on both the top and bottom lines. Net investment income per share was 31 cents, which was four cents better than expected. Total investment income was \$22.8 million, up 66% year-over-year, which was \$1.15 million better than estimates. The increase in investment income was due to higher interest income, which was attributable to increases in the weighted average yield and weighted average principal balance of the company's interest-bearing investments.

Total expenses were up fractionally quarter over quarter, which was due to higher interest expense. That was attributable to higher rates on its outstanding credit facility. There were also higher incentive fees, partially offset by lower net base management fees.

The net increase in assets resulting from operations was \$11.9 million, or 32 cents per share. The gain was driven by higher net investment income and a \$3 million realized gain from sales of assets.

Gladstone invested \$53.5 million in three new portfolio companies, and \$17.1 million in existing companies. It also received \$35.2 million in repayments and net proceeds.

We've boosted our estimate of NII per-share to \$1.12 after good Q3 results.

Growth on a Per-Share Basis

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2028
NII	\$0.88	\$0.87	\$0.84	\$0.84	\$0.84	\$0.85	\$0.84	\$0.81	\$0.79	\$0.94	\$1.12	\$1.30
DPS	\$0.84	\$0.84	\$0.84	\$0.84	\$0.84	\$0.84	\$0.84	\$0.78	\$0.78	\$0.78	\$0.99	\$1.04
Shares¹	21.0	21.0	21.1	23.2	25.5	27.1	29.3	33.0	34.0	35.1	36.0	40.0

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 \$1.12 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. However, that appears to be changing, and we've increased our growth estimate to 3% annually.

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%+. Despite the cost of funding rising as well, Gladstone has managed to increase its yield spreads. Gladstone's portfolio continues to grow in dollar terms, and the higher spreads on a larger portfolio is leading to earnings growth.

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.



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Gladstone's dividend had been at \$0.07 monthly, or \$0.84 annually, for many years. However, the current payout is up to 99 cents annually after another raise in July 2023.

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	9.8	10.5
Avg. Yld.	9.5%	8.8%	10.0%	11.0%	8.8%	9.3%	9.2%	9.4%	7.8%	9.2%	9.0%	7.6%

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 9.8 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%	88%	80%

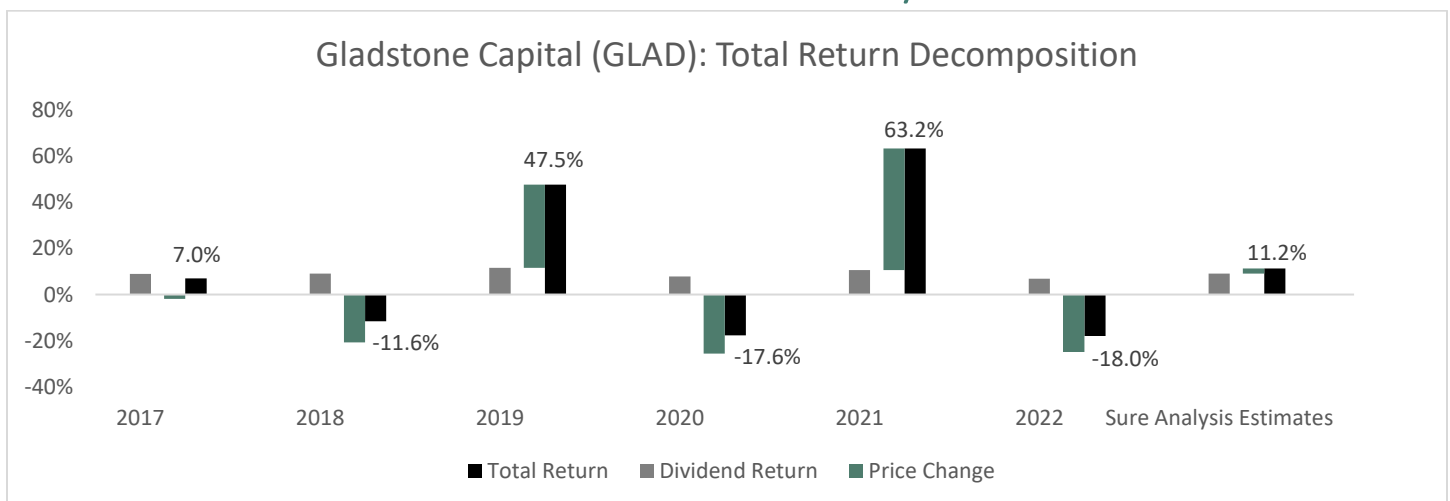
Gladstone doesn't have any competitive advantages as it operates in much the same way as any other BDC. It is also dependent upon funding costs and the spreads it can earn on its debt and equity investments. During recessions, Gladstone will likely struggle as repayments may become a problem for its 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, but we believe the current dividend is sustainable. 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 11.2% total annual returns in the coming years. The stock remains undervalued, in our view. In addition, we see higher earnings this year supporting a higher share price, as well as the dividend. We see a 1.3% tailwind from the valuation, as well as 3% growth and the 9% yield. The stock continues to earn 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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