



Prospect Capital Corporation (PSEC)

Updated September 3rd, 2023, by Josh Arnold

Key Metrics

Current Price:	\$6.05	5 Year CAGR Estimate:	11.8%	Market Cap:	\$2.4 B
Fair Value Price:	\$7.31	5 Year Growth Estimate:	-1.0%	Ex-Dividend Date:	09/26/23
% Fair Value:	83%	5 Year Valuation Multiple Estimate:	3.9%	Dividend Payment Date:	10/19/23
Dividend Yield:	11.9%	5 Year Price Target	\$6.95	Years Of Dividend Growth:	0
Dividend Risk Score:	F	Retirement Suitability Score:	C	Rating:	Buy

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 \$2.4 billion. Prospect produces over \$800 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 Capital posted fourth quarter and full-year earnings on August 29th, 2023, and results were somewhat weaker than expected. Net investment income was up from the prior quarter and the year-ago quarter, as originations more than doubled. However, results missed consensus estimates. Net investment income for the quarter was \$113 million, or 23 cents per share. That missed estimates by a penny, but was up from 21 cents.

Total investment income, which is a measure of revenue, was up to \$222 million from \$185 million a year ago. That also beat estimates by about \$5 million.

Net asset value was \$9.24 per share, down from \$9.48 in the March quarter. Total originations were \$373 million, up from just \$92 million a year ago. Total repayments were \$122 million, up from \$59 million in last year's Q4. Operating expenses were \$109 million, up from \$90 million a year ago.

We start fiscal 2024 with an estimate of NII per share of 86 cents.

Growth on a Per-Share Basis

Year	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2029
NII	\$1.19	\$1.03	\$1.04	\$0.85	\$0.79	\$0.79	\$0.72	\$0.75	\$0.75	\$0.89	\$0.86	\$0.82
DPS	\$1.32	\$1.19	\$1.00	\$1.00	\$0.77	\$0.72	\$0.72	\$0.72	\$0.72	\$0.72	\$0.72	\$0.72
Shares¹	343	359	357	360	364	367	374	389	392	402	408	425

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 ~\$8 billion today, after having expanded rapidly in recent quarters.

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. Prospect can cover it for now, but if projected earnings declines worsen, that may change.

Valuation Analysis

Year	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	Now	2029
Avg. P/NII	8.8	6.9	9.9	8.7	8.0	8.2	8.2	8.5	9.3	7.0	7.0	8.5
Avg. Yld.	13.1%	13.8%	11.8%	11.3%	10.6%	12.1%	12.1%	11.3%	10.3%	11.6%	11.9%	10.4%

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.

The company's current dividend yield is 11.9%, which is somewhat lower than its historical average. We forecast the yield declining to 10.4%, which would result from a lower share price but stagnant payout per share.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2029
Payout	111%	116%	96%	118%	97%	85%	100%	96%	90%	81%	84%	88%

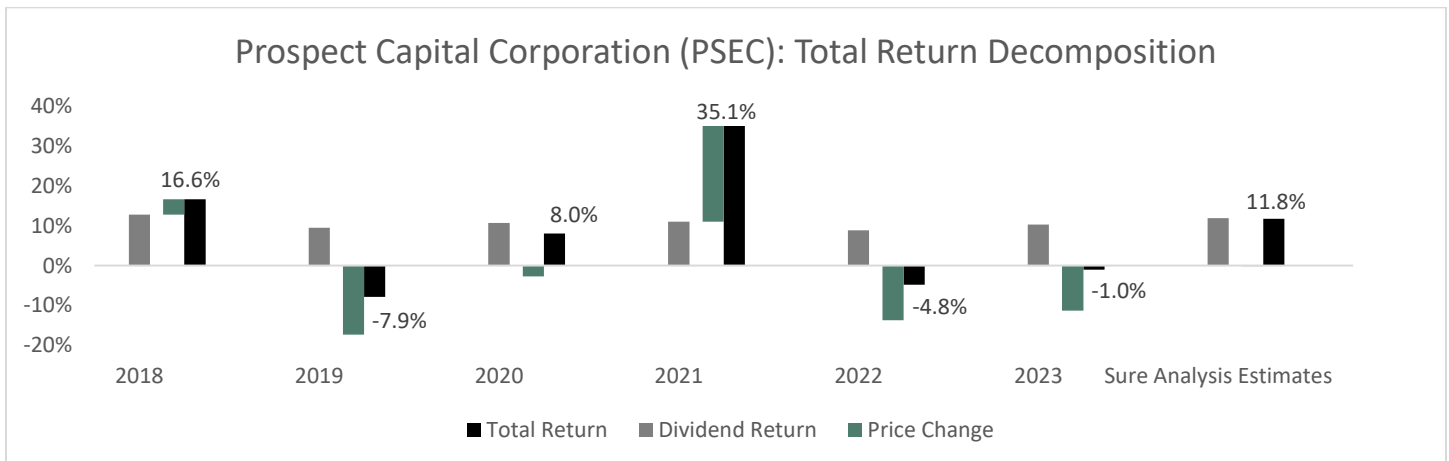
One of the issues with business development companies is that competitive advantages are very difficult to come by, and Prospect is certainly no exception. Scale is the name of the game for BDCs and with a stagnant balance sheet, Prospect has lost some of its relative scale over time. That began to reverse given Q2 2022 results, however, and total assets are reaching new highs again.

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 more optimistic that Prospect can fund the dividend indefinitely given the move up in earnings in recent quarters.

Final Thoughts & Recommendation

Prospect Capital offers investors a huge yield, but it is not without its risks. The valuation is quite favorable, particularly considering the company's modest growth outlook. The yield is strong as well. We are forecasting 11.8% in total returns in the coming years, consisting of the 11.9% yield, -1% growth, and a 3.9% tailwind from the valuation. We reiterate our speculative buy rating on the stock after Q4 results.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Revenue	346	379	137	284	326	199	37	1,008	635	(61)
SG&A Exp.	31	30	32	32	26	34	33	30	30	41
Net Profit	319	346	103	253	300	144	-16	964	583	(102)
Net Margin	92.3%	91.4%	75.3%	89.2%	92.0%	81.1%	-43.7%	95.7%	91.8%	-167%
Free Cash Flow	(1,725)	45	862	376	369	224	429	31	(795)	---

Balance Sheet Metrics

Year	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Total Assets	6,477	6,798	6,236	6,173	5,839	5,800	5,300	6,303	7,663	7,862
Cash & Equivalents	134	110	318	318	84	107	45	64	35	91
Total Liabilities	2,859	3,095	2,800	2,818	2,432	2,494	2,244	2,358	3,544	4,129
Accounts Payable	75	70	71	69	56	56	51	51	50	54
Long-Term Debt	2,773	2,984	2,667	2,642	2,312	2,383	2,138	2,233	2,737	2,585
Shareholder's Equity	3,618	3,703	3,436	3,355	3,407	3,306	3,056	3,808	4,119	3,733
LTD/E Ratio	0.77	0.81	0.78	0.79	0.68	0.72	0.70	0.57	0.66	0.69

Profitability & Per Share Metrics

Year	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Return on Assets	5.8%	5.2%	1.6%	4.1%	5.0%	2.5%	-0.3%	16.6%	8.3%	-1.3%
Return on Equity	10.2%	9.5%	2.9%	7.4%	8.9%	4.3%	-0.5%	28.1%	14.7%	-2.6%
ROIC	5.9%	5.3%	1.6%	4.2%	5.1%	2.5%	-0.3%	17.0%	8.9%	-1.5%
Shares Out.	343	359	357	360	364	367	374	389	434	401
Revenue/Share	1.15	1.07	0.39	0.79	0.90	0.54	0.10	2.61	1.46	(0.15)
FCF/Share	(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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