



Stellus Capital Management (SCM)

Updated November 13th, 2023, by Josh Arnold

Key Metrics

Current Price:	\$12.67	5 Year CAGR Estimate:	11.6%	Market Cap:	\$302 M
Fair Value Price:	\$17.10	5 Year Growth Estimate:	-4.0%	Ex-Dividend Date:	11/29/23
% Fair Value:	74%	5 Year Valuation Multiple Estimate:	6.2%	Dividend Payment Date:	12/15/23
Dividend Yield:	12.6%	5 Year Price Target	\$13.94	Years Of Dividend Growth:	2
Dividend Risk Score:	F	Retirement Suitability Score:	C	Rating:	Buy

Overview & Current Events

Stellus Capital Management is a business development company, or BDC, that bills itself as a flexible source of capital for the middle market. The company provides capital solutions to companies with \$5 million to \$50 million of EBITDA and does so with a variety of instruments, the majority of which are debt. Stellus provides first lien, second lien, mezzanine, convertible debt, and equity investments to a diverse group of customers, generally at high yields, in the US and Canada. The company was formed in 2012, should produce about \$100 million in revenue for 2023, and has a \$302 million market cap.

Stellus posted third quarter earnings on November 7th, 2023, and results were mixed. Adjusted net investment income was 49 cents per share, which was two cents better than expected. Total investment income was \$27.2 million, up 35% year-over-year, but fractionally missed estimates.

The company saw its portfolio grow by a net \$5 million to \$886 million, and the loan portfolio yield was 11.5% as of the end of the quarter. Investment income was up from \$20.1 million a year ago.

Operating expenses for the quarter totaled \$16.3 million, up from \$13 million a year ago. Net investment income was \$10.8 million, up from \$7.2 million a year ago. On a per-share basis, net investment income rose from 37 cents to 47 cents. Core investment income rose from 35 cents per share in last year's Q3 to 49 cents.

We continue to see \$1.90 in NII per-share for this year after Q3 results.

Growth on a Per-Share Basis

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2028
NII	\$1.33	\$1.34	\$1.33	\$1.39	\$1.21	\$1.42	\$1.23	\$1.13	\$1.12	\$1.46	\$1.90	\$1.55
DPS	\$1.43	\$1.36	\$1.36	\$1.36	\$1.36	\$1.36	\$1.36	\$1.09	\$1.08	\$1.36	\$1.60	\$1.60
Shares¹	12.1	12.3	12.5	12.5	14.9	16.0	18.9	19.5	19.5	19.7	21	23

Stellus, like most BDCs, has a difficult time growing NII. The combination of high funding costs (generally with debt and/or preferred stock) as well as varying yields on the company's debt portfolio, make it difficult to offset a rising share count over time. We're moving our growth estimate down from -3% annually to a decline of 4%, given the very high base of earnings for 2023. The company's floating rate portfolio and fixed rate liabilities mean that it stands to do very well in 2023, but we don't necessarily think that's sustainable.

Stellus has reset much of its investment portfolio with higher rates, leading to a very strong portfolio yield. However, a possible headwind to this is interest rates declining off of currently elevated levels. The company's net assets continue to grow over time, but these gains have been largely offset by a rising share count. We think the share count will continue to be a headwind moving forward, and that Stellus will have a difficult time offsetting this with earnings gains. The company's recovery from the pandemic appears complete, but low interest rates and share issuances remain a constant headwind. We note Q3 results are supportive of higher NII estimates going forward, barring a big reduction in market interest rates, which would reduce portfolio yields.

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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Valuation Analysis

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	Now	2028
Avg. P/NII	11.2	10.5	8.5	7.5	11.3	9.0	11.4	8.4	11.5	9.1	6.7	9.0
Avg. Yld.	9.6%	9.7%	12.0%	13.0%	9.9%	10.6%	9.7%	12.8%	8.4%	10.3%	12.6%	11.5%

Stellus has traded with an average price-to-NII ratio of ~10 in its relatively short history as a public company, and we assess fair value at 9 times NII. We note, however, that Stellus' valuation has moved somewhat erratically, trading for 7.5 times NII in 2016 and then 11.3 times the next year, for instance. We see the stock as undervalued today given it trades for 6.7 times NII, implying a meaningful tailwind from the valuation in the coming years.

The dividend yield is now 12.6%, which is in line with historical values. Stellus moved from a monthly dividend to a quarterly one, which accompanied the dividend cut from \$1.36 annually to \$1.00. It has since been reinstated as a monthly payout, and raised to \$1.60 annually. We currently believe Stellus can maintain its dividend payment for the foreseeable future, but also that room for further increases is minimal.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2028
Payout	108%	101%	102%	98%	112%	96%	106%	96%	96%	93%	84%	103%

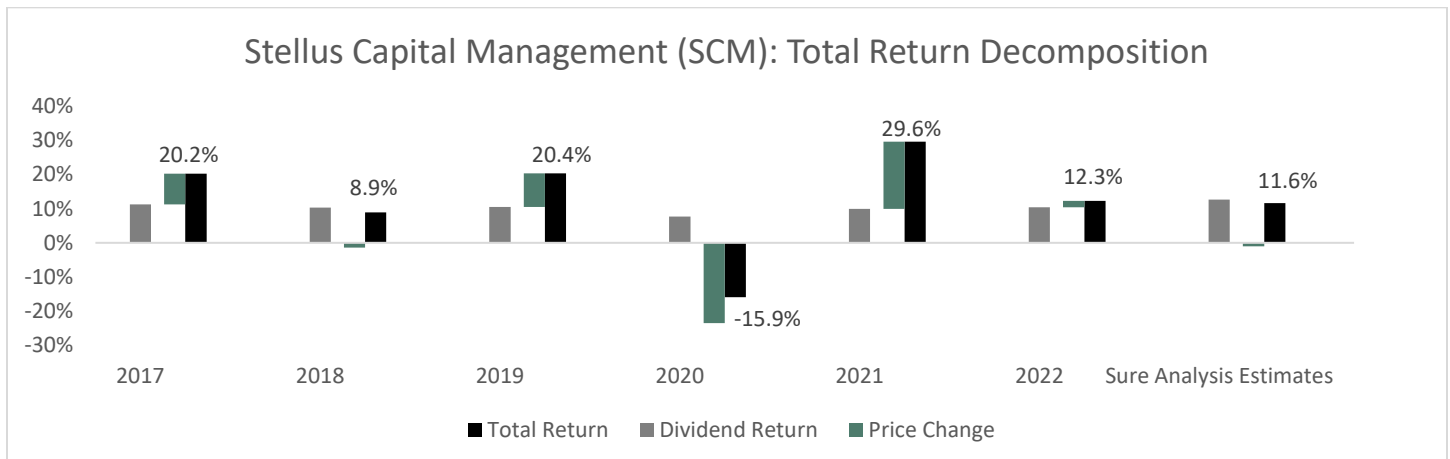
Stellus, like other BDCs, has no competitive advantages. It offers the same products as any other BDC to the same set of customers, so advantages are virtually impossible to achieve. In addition, BDCs suffer mightily during recessions because borrowers have a more difficult time meeting repayment timelines. Stellus wasn't around during the last recession, but we see it as having significant issues with NII generation during future recessions, although it seems to be holding up.

Stellus is required to pay virtually all its NII in distributions as a BDC, so the payout ratio will always be high. While the current payout should be safe for the time being, we note that the risk of lower rates means the payout is constantly at risk as well. We are currently not expecting another dividend cut, but it cannot be ruled out.

Final Thoughts & Recommendation

Total return potential comes in at 11.6% annually. Given the higher projected returns, boosting the stock from hold to buy. The yield is very high at 12.6%, but we note the risks of owning a small BDC are high as well, so only investors with high-risk tolerances should consider Stellus. The valuation could drive a 6.2% tailwind, which could be offset by negative NII growth.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Revenue	29	32	35	26	27	31	32	26	43	21
Gross Profit	25	27	29	---	---	---	---	---	---	---
Gross Margin	85.6%	83.9%	83.4%	---	---	---	---	---	---	---
SG&A Exp.	7	7	7	4	5	4	4	5	5	5
Operating Profit	18	20	22	---	---	---	---	---	---	---
Operating Margin	61.8%	63.2%	62.8%	---	---	---	---	---	---	---
Net Profit	18	10	8	23	23	26	26	20	34	14
Net Margin	59.7%	31.5%	21.8%	87.7%	83.0%	84.3%	83.4%	78.0%	78.7%	66.7%
Free Cash Flow	(68)	(27)	(24)	9	19	(102)	(93)	(3)	(76)	(56)
Income Tax		0	0	(0)	(0)	1	1	1	4	1

Balance Sheet Metrics

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Total Assets	298	327	365	380	400	526	649	675	821	898
Cash & Equivalents	14	2	11	9	25	17	16	18	44	48
Accounts Receivable	0	0	0	---	---	---	---	---	---	---
Total Liabilities	122	153	201	209	180	301	378	402	536	622
Accounts Payable	3	3	3	3	3	4	4	2	5	5
Long-Term Debt	119	148	196	203	174	292	366	393	518	604
Shareholder's Equity	176	174	165	171	220	225	271	273	285	276
LTD/E Ratio	0.68	0.85	1.19	1.19	0.79	1.30	1.35	1.44	1.82	2.19

Profitability & Per Share Metrics

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Return on Assets	---	3.3%	2.2%	6.2%	5.8%	5.7%	4.5%	3.1%	4.5%	1.7%
Return on Equity	10.0%	5.8%	4.5%	13.8%	11.6%	11.8%	10.7%	7.4%	12.0%	5.2%
ROIC	---	3.3%	2.2%	6.3%	5.9%	5.7%	4.6%	3.1%	4.6%	1.7%
Shares Out.	12.1	12.3	12.5	12.5	14.9	16.0	18.9	19.5	19.5	19.6
Revenue/Share	2.44	2.63	2.82	2.12	1.83	1.95	1.73	1.33	2.19	1.07
FCF/Share	-5.67	-2.21	-1.96	0.71	1.27	-6.42	-5.10	-0.18	-3.90	-2.88

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

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