



Gladstone Capital (GLAD)

Updated March 2nd, 2024, by Josh Arnold

Key Metrics

Current Price:	\$10.15	5 Year CAGR Estimate:	9.7%	Market Cap:	\$442 M
Fair Value Price:	\$11.00	5 Year Growth Estimate:	0.0%	Ex-Dividend Date:	03/20/24
% Fair Value:	92%	5 Year Valuation Multiple Estimate:	1.6%	Dividend Payment Date:	03/29/24
Dividend Yield:	9.8%	5 Year Price Target	\$11	Years Of Dividend Growth:	2
Dividend Risk Score:	F	Retirement Suitability Score:	C	Rating:	Hold

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 \$442 million and it pays distributions monthly, instead of quarterly.

Gladstone posted first quarter earnings on February 3rd, 2024, and results were slightly worse than consensus estimates. Net investment income per share came to 27 cents, while total investment income (Gladstone's measure of revenue) was \$23.22 million. NII missed estimates by a penny, while total investment income was off fractionally.

Portfolio activity consisted of \$11 million of investment in one new portfolio company, plus an additional \$47 million in existing portfolio companies. The company's weighted average yield on debt investments finished the quarter at 13.9%, which was flat to the prior period.

The company noted interest income fell, reflecting a 1.6% decrease in the weighted average principal balance of its interest-bearing investments. That measure declined from \$668 million to \$658 million. Net assets changed as a result of operations by \$20 million, up from \$13.1 million in the prior quarter.

We start the year with an estimate of \$1.10 in NII-per-share for this year, which would be equal to 2023. This is down from our initial estimate that was three cents higher.

Growth on a Per-Share Basis

Year	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2029
NII	\$0.87	\$0.84	\$0.84	\$0.84	\$0.85	\$0.84	\$0.81	\$0.79	\$0.94	\$1.10	\$1.10	\$1.10
DPS	\$0.84	\$0.84	\$0.84	\$0.84	\$0.84	\$0.84	\$0.78	\$0.78	\$0.78	\$0.96	\$0.99	\$1.04
Shares¹	21.0	21.1	23.2	25.5	27.1	29.3	33.0	34.0	35.1	37.3	39	45

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 \$1.10 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, but we've moved our estimate of growth to zero for the time being.

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.

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.

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	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	Now	2029
Avg. P/NII	10.9	10.0	9.1	11.4	10.7	10.8	10.2	12.7	9.0	8.8	9.2	10.0
Avg. Yld.	8.8%	10.0%	11.0%	8.8%	9.3%	9.2%	9.4%	7.8%	9.2%	10.0%	9.8%	9.5%

Gladstone has traded at a price-to-NII ratio very near 10.5 in the past decade, which is near where we assess fair value. At 9.2 times NII, the stock 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 slightly lower in the coming years, as the stock could see a valuation tailwind.

Safety, Quality, Competitive Advantage, & Recession Resiliency

Year	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2029
Payout	97%	100%	100%	100%	99%	100%	96%	99%	83%	87%	90%	95%

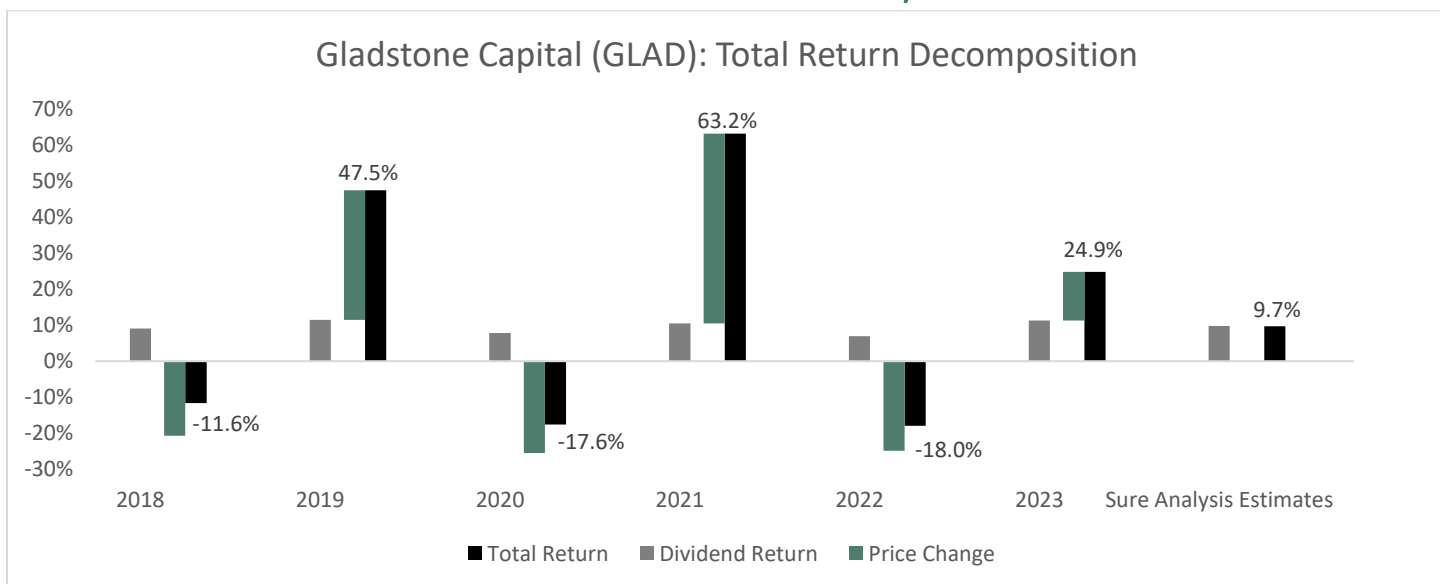
Gladstone doesn't have any competitive advantages as it operates in much the same way as any other BDC. It is also dependent upon funding costs and the spreads it can earn on its debt and equity investments. During recessions, Gladstone will likely struggle as repayments may become a problem for its 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 9.7% 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 1.6% tailwind from the valuation, as well as no growth and the 9.8% yield. The stock now earns a hold rating, down from buy previously.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Revenue	24	21	25	30	31	33	8	95	32	59
SG&A Exp.	6	6	7	7	8	8	8	8	10	3
Net Profit	11	8	11	17	19	20	(2)	84	20	43
Net Margin	46.1%	40.4%	46.0%	56.8%	59.5%	59.4%	-22.3%	89.0%	62.5%	72.8%
Free Cash Flow	0	(74)	60	(13)	(18)	9	(46)	(14)	(76)	(11)

Balance Sheet Metrics

Year	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Total Assets	301	382	336	366	400	426	459	567	661	719
Cash & Equivalents	6	4	6	5	2	16	2	1	2	1
Accounts Receivable	3	6	2	2	3	3	3	2	3	6
Total Liabilities	102	191	134	146	162	177	225	248	345	311
Accounts Payable	1	1	1	1	1	1	2	2	3	4
Long-Term Debt	38	127	71	93	110	123	222	237	339	301
Shareholder's Equity	200	191	201	220	237	249	234	318	315	409
LTD/E Ratio	0.19	0.66	0.35	0.42	0.46	0.49	0.95	0.74	1.08	0.74

Profitability & Per Share Metrics

Year	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Return on Assets	3.8%	2.5%	3.2%	4.9%	4.9%	4.8%	-0.4%	16.4%	3.2%	6.2%
Return on Equity	5.5%	4.3%	5.8%	8.2%	8.2%	8.2%	-0.8%	30.5%	6.3%	11.8%
ROIC	4.6%	3.0%	3.8%	5.9%	5.7%	5.5%	-0.5%	16.7%	3.3%	6.3%
Shares Out.	21.0	21.1	23.2	25.5	27.1	29.3	33.0	34.0	34.4	37.3
Revenue/Share	1.16	1.00	1.07	1.19	1.16	1.14	0.27	2.85	0.94	1.57
FCF/Share	0.02	(3.54)	2.59	(0.51)	(0.66)	0.32	(1.48)	(0.42)	(2.22)	(0.29)

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

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