

# BDC's Providing High Yield, At A Discount

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**B**DCs provide investors high recurring income and are trading at significantly deeper discounts than average, providing opportunity for growth and yield.

## Prospect Capital And The Rising Rate Environment

Don't be surprised when closed end funds and BDC's in particular come back into vogue. The asset class still offers some of the highest yield and total-return in the market and is now trading at significantly larger discounts to NAV than is typical for the industry.

This was caused in part by the uncertain interest rate environment in which the FOMC has put us but has set the industry up for gains into the coming years. Why? Because most of the lending done by BDC's is at a floating rate while the credit facilities used to finance those loans are usually set at a fixed rate.

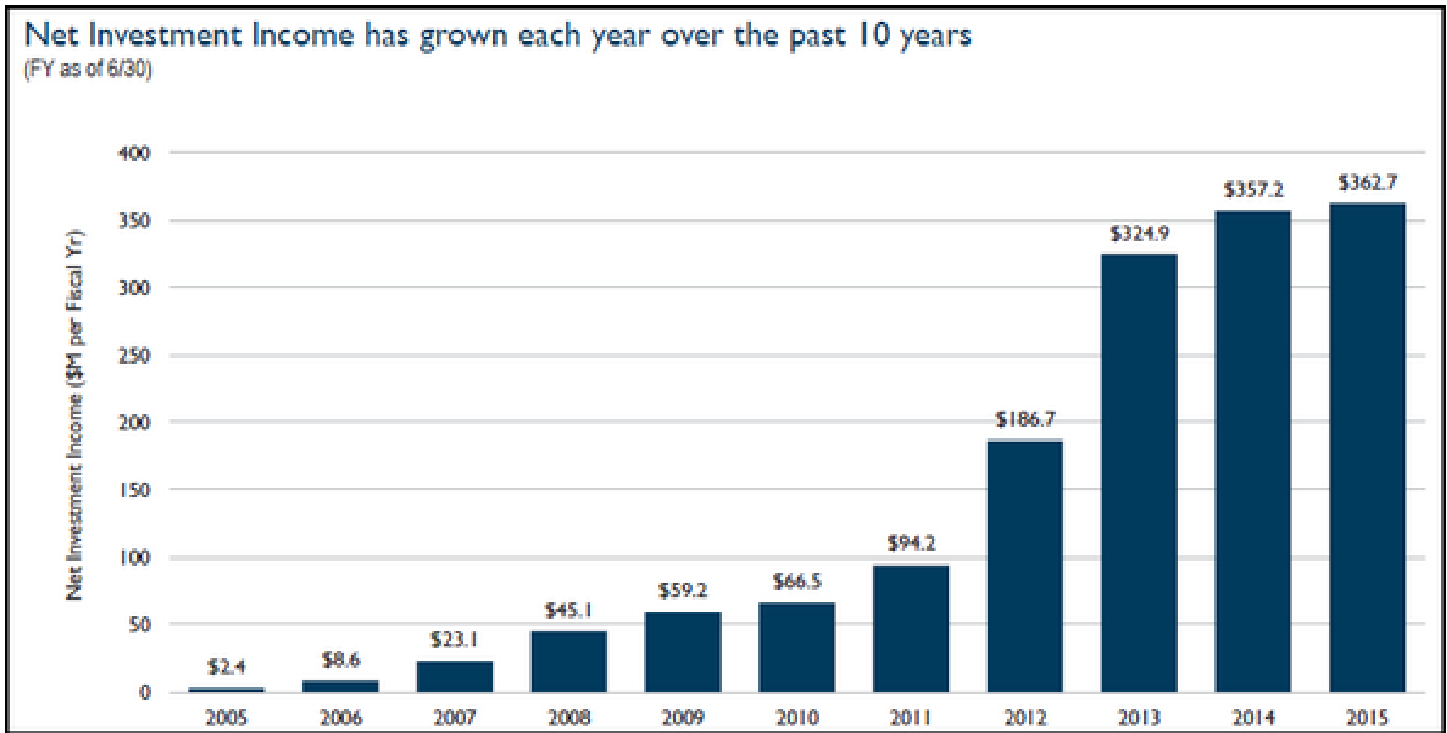
Prospect Capital for one is well positioned to benefit from a rising rate environment. At current mix, 89% of interest bearing assets are pegged to a floating rate while 87% of liabilities are pegged to a fixed rate, well above BDC average. Fund managers have estimated a rise in rates on the forward end of the LIBOR curve of 5% would increase net investment earnings by \$0.28 per share in 2016, and \$0.34 per share in 2017, all due to portfolio

positioning. The caveat is that it will take at least a 1% move to affect income due to the terms of PSEC's credit terms.

## Dividend History Is Good, Outlook Good

In the end, when it comes to CEF's and BDC's, it is all about dividends and dividend health. Prospect Capital Corporation has paid a regular dividend since its IPO in 2004 with no expectations for that to stop, as you know BDC's are required to pay out 90% of their taxable earnings to shareholders. PSEC's rate has steadily risen since inception, minus two cuts, and has paid in excess of 10% for over 5 years, as it now. At today's share prices the fund yields over 15% and is the highest in the class. Fund managers receive some criticism due to the fact that NII is barely covering distributions, and that is a concern, but considering the fact that taxable income covers payments it's not as big of one as some would lead you to believe.

To date, Prospect has been able to earn in excess of its distributions on a quarter to quarter basis and



◀ is expected to continue covering payments into the future. Dividend coverage ran near 107% in the last fiscal year and current year earnings estimates more than cover distributions at their present level of \$1.00 annually, or 0.0833 monthly. Low estimates for full year earnings is \$1.00, high estimate is \$1.09 with average estimate just over \$1.03. At the same time recurring income is on the rise, reaching 96.1% in the last quarter.

Regardless of criticisms, NII has been growing on an annual basis since the funds IPO. Growth has slowed in 2015 but still expected into 2016 and beyond as the fund originates and manages new loans.

**Historic Discounts Offer Huge Returns**

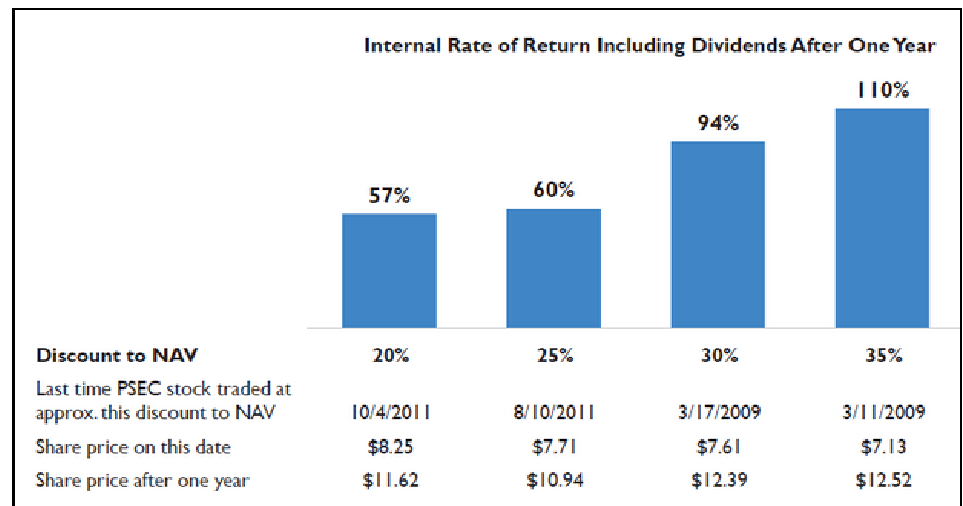
It is not unusual for CEF's and BDC's in particular to trade a discount to NAV. It is also not unusual for PSEC to trade at a deeper discount to NAV than many of its peers.. The thing to take note of is that, at current share prices, the fund is trading at a much deeper discount to NAV than is typical, nearly double

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the industry average and PSEC's own average. Some analysts have suggested the discount represents a mis-pricing of portfolio value but not according to management. Prospect Capital Corporation president Grier

Eliasek had this to say in an interview with Tom Sizemore . . . "We actually consider our book value accounting to be a major source of strength. We don't value the portfolio ourselves. Our third-party valuation firms start with a blank piece of paper every quarter and value our portfolio from scratch. And our auditors approve."

Reinforcing that opinion are some notable insider purchases and a company stock buy back plan. Over the past 6 months alone insiders have bought more than 529,000 shares. ▶



◀ That number more than doubles if you look back over the past 18 months and that is on top of a buy back plan that has so far flown largely under the radar. While so far purchases have been small, with the company trading at such a deep discount more are expected by the analyst community.

At \$7.50 PSEC is trading at less than half the value of its peers on a forward P/E basis, on a price-to-book basis and on a discount to NAV basis. At last reporting NAV had increase to \$10.31 leaving shares trading at a +30% discount. Looking back at the historical data, as provided in a company presentation, strategic investors can expect to receive some big gains over the next 12 months. The average gain in share price alone is over 55% for each of the four previous times PSEC has traded at such a deep discount. Including dividends average returns in the forward 12 month period are over 80% and when you consider only the two times the discount was 30% or greater average return jumps to over 100%.

### Some Things To Consider

There are some things to consider when looking at an investment in

Prospect Capital Corporation. One of which is taxes. Prospect Capital Corporation, as a registered BDC, is in actuality a pass-thru company. This means that they are exempt from any of the taxes normally incurred by a business of this type. It is an advantage for the company as it frees up cash flow for investments, among other things, and to investors as it allows for above average dividend distributions and yield. The downside is that it can also be a burden; shareholders become liable for taxes upon receipt of those distributions. Depending on the type of account in which you are holding the stock there are a number of ways in which you can be affected.

First, Ordinary Income. This results from the regular, day to day business of the company and comes in the forms of interest income from debt securities. This is listed in box 1a of the 1099 DIV form. After that comes dividend income. Prospect Capital invests in equity positions in companies per its secondary objective; capital gains. As a shareholder in these companies Prospect receives dividends but the tax liability falls to shareholders

of PSEC, not Prospect Capital Corporation. This income is qualified for the 15% tax rate on dividends and listed on line 1b. If fund managers decide to sell equity positions there is a chance of short and/or long term capital gains. These pass through as well and are reported on lines 1A for short term, and 2A for long term. From time to time there may also be a distribution not sourced from income and would be considered a "return of capital" and not subject to tax.

### The Bottom Line

The bottom line is that if you are looking to add yield to your portfolio, and gain exposure to anticipated benefits rising from higher interest rates, then Prospect Capital Corporation is a good place to find it. The fund has a solid portfolio of income producing assets, is paying over 15% in annualized distributions and is trading at a discount to NAV that has provided some incredible 1-year returns in the past. The only negative that I can see at this time is potential tax impact on investor accounts, but paying taxes is a good thing if it means your making money.

The following is a table representing dividends and distributions paid by Prospect Capital:

Year	Amount Per Share	Taxable Percentage	Qualified Dividend Percentage	Non-Qualified Dividend Percentage	Return of Capital Percentage
2004	\$0.10	100.00%	100.00%	0.00%	0.00%
2005	\$0.76	100.00%	33.33%	66.67%	0.00%
2006	\$1.41	100.00%	18.80%	81.20%	0.00%
2007	\$1.57	100.00%	15.51%	84.49%	0.00%
2008	\$1.61	100.00%	15.67%	84.33%	0.00%
2009	\$1.63	72.56%	28.13%	71.87%	27.44%
2010	\$1.11	71.38%	9.32%	90.68%	28.62%
2011	\$1.22	86.93%	13.08%	86.92%	13.07%
2012	\$1.23	100.00%	56.61%	43.39%	0.00%
2013	\$1.32	100.00%	4.28%	95.72%	0.00%
2014	\$1.33	100.00%	0.60%	99.40%	0.00%

\* To Be Determined as of each year-end.

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