Prospect Capital, Undervalued With Positive Outlook

6 June 2015

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Prospect Capital reported earnings in early May. Despite a decline in net investment income, analysts across the board have maintained current ratings. The consensus rating is hold with a definite bias toward the buy side. As a group, the analyst see Prospect as extremely undervalued with good chances for income and portfolio growth into the coming year. They take note of the fact earnings have been below expectations but, according to UBS, " otherwise the portfolio holds up", citing developments over the past quarter and progress on 3 planned spin-offs as positive signals.

Wells Fargo characterizes PSEC as a "deeply discounted name trading at historically low levels... due to market view of higher risk portfolio", a track record of declining earnings and a recent dividend cut. They maintain a hold rating at Market Perform/Overweight.

Results reflected the general economic slow-down in the first and second quarter of this year. First quarter NII was only $0.24, slightly below current yield of $0.25, last quarters $0.26, Q1 2014's $0.31and -5.6% below estimates. On a year over year basis NII has declined by $1.1 million driven by a $0.07 decline per share in structuring fees and a $0.02 increase in interest and credit facility expenses. Off-setting these were a decrease in management compensation fees of $0.02. Notably, 97% of interest income in the quarter was recurring, which bodes well for stable results in the future.

Taxable income was $0.26 per share, exceeding PSEC's dividend obligations and reducing fear of yield cut. Shortfalls were due in large part to under-performance in loan originations and dividend income. Income from loan originations declined primarily because of a shift to online lending, which does not generate the same structuring fees as more traditional models and is one reason the company is spinning off the portion of the portfolio. Dividend income was $1.4 million, 30% below projections.

The grain of salt that goes with

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the report is the fact the company suspended at-the-market sales of stock at the end of last year. This program was raising capital for new loan originations and is a key factor in why growth of asset values and income has stalled in recent quarters. It is also a fundamental reason share prices have stabilized following the 22.7% decline seen in the 2nd half of last year. Share prices declined from a peak near $11 to near $8.50 by December 2014, well below NAV, and have since stabilized near $8.

Update Of Operations

Looking past declining core income the company is still making headway with plenty of opportunity for growth. Loan originations in the first quarter added a full 1.2% to portfolio value, totaling $111 million net of repayments, small when compared to previous quarters but that has already been explained away. Credit quality remains strong as the non-accrual rate was 0.5% in the March quarter.

There was a marginal increase in portfolio yield, 10 basis points, bringing it up to 12.4%. This is worthy of note as most of Prospect's competitors reported declines in yield. Net leverage to EBITDA increased slightly to 4.1x, but the energy portion of the portfolio declined to only 4.1% of assets.

Net asset value per share for the quarter declined modestly to $10.30 from $10.35 in the previous quarter. NAV per share was $10.47 at 9/30/14. This still leaves Prospect undervalued when compared to its peers. Current share price near $7.80 is a 25% discount to NAV and reason enough to get interested in this stock. Additional reasons are management's ongoing operation to roll lower yielding assets into higher yielding ones. Some of Prospects lower yielding assets are only producing 6-8%, well below the 12% average on new loans. The plan should increase portfolio yield and income from new structuring fees.

"We're also going through an optimization program to sell off some of our lower yielding assets and redeploying to higher yielding assets. That's both a profit driver as well as a source of liquidity so between those two sources, we think we have plenty of capital for new originations."

Wunderlich says in their statement PSEC could realize a significant gain in yield by converting its lower performing assets, 8% or so, with higher yields, another move targeted by management. Current on-board yield is near 12.5% for new loans and would also generate additional structuring fees.

MLV&Co believe the moves proposed by management, and in particular the roll into higher yielding loans, could result in significant upside for EPS over the next few quarters. They base their estimate on filings and indications from PSEC itself, "we estimate that if $750 million … were reinvested at 11%, it would add $0.10 to EPS".

Another positive development is the possible sale of high value businesses such as Harbor Touch. Harbor Touch is a payment processor that could be liquidated at a substantial premium to what Prospect paid for it. Wunderlich believes "one or two consumer finance companies could be sold in the next 12 months.... PSEC could realize $67 million in gross gains and free up $540 million...for reinvestment". A move such as this could dramatically off-set declines in asset growth attributable to suspended at-the-market sales of stock. However, a comment from CEO John Barry only went so far as to say that it was a possibility.

Spin-offs Are Coming

The company proposed a number of spin-offs in the early part of this year that have been slow in coming but coming they are. These include the CLO, real estate and on-line lending portions of the business. These "pure-plays" are intended to free up Prospects balance sheet to originate new loans, and to capitalize on reduced constraints of operating these companies in a non-BDC format. The CLO operation is closest

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Dividend Check Up

Prospect has one of the highest and most stable dividends in the BDC arena, even with the recent cut. Looking back it is was either very lucky or incredibly foresighted for management to have made that cut as it helps alleviate fears of additional decreases now. At current share prices, near $7.80, the stock is yielding $12.82% and, based on recent lows and long term support levels, it may yet be possible to lock this one in above 13%.

The company declared dividend payments for the next three months with the May, 6th earnings release. Shareholders of record can expect to receive $0.08333 per share in June, July and August, no decline from the previous 3 months. Annual yield remains steady at $1.00. These will bring the total number of consecutive dividend payments up to 85, the last several years of which have all been 10% or more. There is no sign of impending rate cuts, quite the opposite in fact. Management continues to reiterate the chances of a special dividend although no sign of one is forthcoming. As a BDC the dividend pay-out requirement is based on taxable income, not net investment income. Since its inception in 2004, Prospect has generated taxable income in excess of cumulative dividends. Taxable income for the quarter and the 9 months ended with the recent quarter exceeded obligations, at least securing the relative safety of current yields if not suggesting a special disbursement is actually possible.

Outlook Positively Mixed

Outlook for the company is mixed but generally positive. The average rating is a hold/market perform with a number of analysts calling Prospect a buy. UBS an BMO are two of the least optimistic. UBS has a neutral rating with a 12 month outlook and a price target of $8.50, well below net asset value. BMO Capital has a Market Perform rating and price target of $9. They claim "lower originations (and subsequently lower structuring fees) are only partially offset by lower … costs".

DeutscheBank went both ways, they both lowered their estimates for 2015 and 2016 earnings and maintained their buy rating, price target $10.25. They believe shares are undervalued, but also that management will reinstate sales of stock if shares should trade above NAV. Others, like Wunderlich Securities, have a more healthy outlook, predicting prices will rise to trade more in-line to NAV, in the range of $10-$11. Analysts there have reiterated a buy rating with a target of $11.50.

Looking forward, the shift to online lending could continue to impact top and bottom line earnings but is expected to be removed from the portfolio in the near future. Even with this headwind, portfolio and income growth are expected as the company continues to roll lower yielding assets into higher ones, originate new loans, spin off pure plays and redeploy capital as it becomes available. Add to this current expectations for broad economic growth into the end of 2015, and expectations for growth to gain momentum into 2016, and Prospect's prospects begin to look even better.

Economic outlook for the broad market into the end of 2015 are positive, and looking out to the end of 2016 quite robust. S&P 500 earnings growth for 2016 is predicted by FactSet in the range of 12.4% with GDP tracking over 3% by most estimates. The financial sector alone is expected to grow by 16% this year, and an additional 10% next year. This, along with Prospects portfolio mix, put it in prime position for growth in asset values as well as increased originations.

And when interest rates rise, Prospect's earnings stand to benefit. Approximately 89% of interest bearing assets are floating rate and approximately 89% of liabilities are fixed rate as of 3/31/2015.

The bottom line is that PSEC is good company that pays a great dividend and one that is undervalued relative to its peers. The company has a sound portfolio and is making headway in terms of generating income and increasing asset value, despite a recent downturn in both. This has helped to drive share prices down to historic lows and, in light of ongoing operations and forward expectations, offering up a fantastic entry point.