Prospect 2nd quarter earnings and the future

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Prospect Capital(PSEC) is a BDC with paying nearly 12% in annual yield. I know for many, myself included, such a high yield is often cause for concern but that is not the case here. BDC's, business development corporations, are legally bound to deliver 90% of their taxable income to shareholders which means that profitable companies like this one have cash to deliver.

Prospect has been in business for over ten years. It uses a revolving credit facility to finance a number of lending operations dedicated to the middle market. The company is primarily invested in 3rd party sponsored deals but also has a sizable portfolio of CLO structured credit, online lending and to a lesser extent real estate and other investments.

Prospect Capital, 2nd Quarter Earnings And The Future

Often times high dividend yields are warning signs for investors. They can often be a sign of impending bankruptcy, a sharp drop in share prices or upcoming cut in dividend amount. All issues that lead to what many call the "high yield trap". A high yield can attract investors, and then leave them in the poor house as share prices plunge and dividend payments are suspended. I have to admit that this was what I first thought when checking out Prospect, mostly because other BDC's are rumored to be cutting this year, but you don't need to fear this one.

The company has a sound reputation and long history of profitable operations and sustained that reputation in the most recent earnings release. This quarter the company earned in excess of projections and is set up to grow earnings more over the next few quarters provided business trends continue as expected. Net investment income was $0.25, slightly better than forecast, with total taxable income another nickel above that. As of the end of calendar year 2014 the company has earned $0.11 in excess of current distributions. This is an important fact to take note of as it has direct bearing on the dividend, the safety of the payment and possible special returns.

Positioned For The Future

The company is fundamentally well

positioned for the future and even though it still carries investment exposure to oil&gas is not suffering greatly because of it. Portfolio exposure to the sector only declined by 1.2% over the past quarter, much less than the oil sector itself, and offset by other investments. While we don't want to see declines in asset values this is not too alarming, yet.

At the same time other investments saw a substantial increase in FMV during the quarter that more than offset any declines in the oil&gas segment of the portfolio. Not to mention that CLO, on line lending and real estate businesses continue to grow with plans to expand these facilities further; total loan originations were up nearly $525 million in the quarter and ahead of consensus estimates.

Additionally, several investments that were already valued at or near $0 FMV were moved to the realized column. The move has no material impact on the value of the portfolio but serves to trim the dead wood off the balance sheet.

A Chance For Capital Appreciation

I also see a real chance for capital appreciation with this stock. Not only is it well positioned for business in the current environment it is extremely undervalued, a combination too attractive to simply dismiss. Compared to the S&P 500 the stock is trading at less than half of its market value with a P/E near 7.5X forward earnings. Competitors Pzena and American Capital are valued at 16.5 and 33.7 respectively, making Prospect look really good.

The company stock is also undervalued compared to its holdings. Current NAV, based on 100% independent valuations, is $10.35, roughly 25% above current

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share value. Simply based on this it is not unreasonable to assume the stock could rise as much as 23.5% to match NAV, or over 100% or higher to match the broader market and you wouldn't be alone if you did. Wunderlich Securities is only one of several investment managers to maintain a buy rating on this stock, their target price is $11.50, another 10% above NAV.

There is at least one reason why the stock is undervalued and that reason also plays into why it could see some growth in share prices. Prospect management has engaged in at-the-market sales of shares over the past year in order to raise capital, a program they paused in December 2014. They did much, most in fact, of that selling below NAV levels causing dilution and decline of share holder value. While this program of selling was underway short interest rose to levels of 8% and greater, adding downward pressure to share prices and further depressing value. Now that management has suspended this program, due to low share price, they have removed the primary force driving prices lower as well as the impetus for shorts to enter the market. Since the announcement short interest has declined noticeably but at 6.5% is still high enough to spark a short-covering rally.

If you need further evidence to support the idea that Prospect is poised for growth you only have to look to the Fed; the company's assets and liabilities are positioned in a way to benefit from the upcoming expected FOMC interest rate hikes. Not only are lending operations on the rise, 94% of assets are pegged to a floating rate to maximize potential profits, 87% of liabilities are pegged to a fixed rate in order to control costs. This means that not only are loan originations expected to increase, margins are also expected to improve even more and will provide an additional boost to earnings.

Portfolio Strategy

Part of future portfolio strategy is for expansion of CLO and on-line lending as they are material to current performance and expectations. This, combined with expected improvements to margin, could add significantly to the top and bottom lines.

Another move that increases the chance for some capital appreciation are a couple of proposed spin-offs. Prospect has been hinting at the spin-off of some of its pure play assets in the CLO, on-line lending and real-estate segments of its business for some time. These pure plays are performing better than the aggregate portfolio and represent a significant amount of value that could be unlocked for shareholders. The only caveat is that to date management has been unclear of when exactly the spin-off's will come, only saying to expect to see moves in that direction over the next few weeks or months.

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Don't Fear The Dividend

First, Prospect has a long history of regular dividend payments going back to its inception. Second, Prospect has consistently paid a yield over 10% for the past five years. Third, Prospect has always generated positive cash flow above its dividend requirements which means at no time have past earnings been used to pay current obligations. This means that not only have they paid the dividend, they have consistently earned more than that which puts them in position to up the yield, or declare a special dividend. In fact, in this quarters earnings call company CEO John Barry commented that the company's ability to produce positive cash flow in excess of costs "raises the chance for future special dividends" and additional returns to shareholders. In my opinion there is more chance for Prospect to increase returns, unlike some other BDC's.

My Conclusion- The 2nd Quarter Was OK And The Future Looks Bright

The 2nd quarter of 2015 wasn't fantastic for Prospect, but it was definitely OK. Future prospects, no pun intended, are also quite good and that is what is getting me excited about this investment. Earnings are on the rise with expected expansion of key businesses as well as improvements to margins, all in an environment of economic growth and expected higher rates of return.

It is surprising to me how undervalued this stock is and it is extremely undervalued no matter how you choose to measure it. P/E relative to the broad market is low, P/E relative to its peers is low, price to NAV is roughly a 16% discount and consensus targets are in the range of $11.50, all reasons why this stock is a buy.

In total, I think the stock could gain an additional 40-50% of share value over the next 12-24 months with. In the nearer terms it is more likely in my view to trade back to NAV and range between $10 and $11. Regardless, the chance at a $1.00 per share dividend and a 25% increase in share value is more than enough to get me into this one.

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