Prospect Capital: Ignore The Hype and Trust the Yield

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Prospect Capital (PSEC) is one of the most hotly debated stocks on the market. Not because it is trendy, growing like a weed or producing wild amounts of profits. It is debated because of the yield, the nature of the business and shareholder perception of management. PSEC is consistently one of the highest yielding issues on the market today, about 12% currently, and as such draws a lot of attention. The thing that investors need to keep in mind that the reason for such a high yield is because of the type of operation that Prospect is, a Business Development Company utilizing a credit facility of its own to provide funding to the middle market.

One of the biggest criticisms the company faces is that they are focused on getting themselves rich, not the shareholders. Some even go so far as to say the company deserves its low valuation, in part due to a lack of trust with the management team but also because of declining asset values. This has been evidenced by numerous articles blaming the companies valuation on missteps and errors made by management. Among these blunders are poor underwriting, capital mismanagement, poor risk control, increased fees, poorly planned spin-offs and a rapid increase in gross assets.

One of several moves the company has made in recent in months which has drawn criticism is its proposed spin-off of the CLO operations. This was first announced as a way to increase share older value by creating a pure play company but the end result is much different from what many shareholders had expected. The most obvious method of spinning off a sub-business would be to created a new company, owned by the parent, and then give shares of that new company to current shareholders. Prospect, counter to that, is creating a right offering in a move with dubious benefits for shareholders. A right offering gives shareholders the right to buy shares in the new company just like a stock offering.

On the other hand there are others, like myself, who believe the company is setting itself up for increased profits in 2015 and 2016. Taken from this light many of the blunders, which have admittedly been a negative for share prices over the past 6 months, can be seen

as a net positive. The company has taken on more risk and increased its portfolio size with the expectations that the US economy is still expanding. They have accomplished this through a number of means and is expected to continue doing so into the end of 2015.

Forward Outlook For The Financial Sector Is Good

Based on current earnings expectations for the broader market you can't blame management for being so upbeat about the future. Not discounting the poor expectations for the 1st quarter and 1st half of 2015 we are actually expecting overall earnings growth, and acceleration of earnings growth, into the end of the year and next year as well. Estimates for the 1st quarter of 2015 started out at -4.8% and are only supposed to improve to about -1% by the end of the reporting season. The expectations move up to -2.5% for the second quarter but looking out to the end of the year however, full year growth for the S&P 500 is supposed to be in the range of 2.5%. Looking out to next year it grows to nearly 10% on an annualized basis.

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If you look at earnings growth expectations with a more focused approach the outlook is even better. Stripping out the expected decline attributable to the energy sector 1st quarter growth should be in excess of 2% and the full year in excess of 8%. Looking at the financial sector alone the outlook gets even better, especially in the nearer terms. The financial sector is expected to see an increase in earnings of at least 8% in the 1st quarter, 5.2% in the 2nd quarter and a whopping 15.5% for the full year, driven by expanding margins and increased economic activity. Next year expectations are still positive, but only looking for a growth of 10.5%, slower than this year but still robust.

Declining earnings in the energy sector is a concern for Prospect as they do have some exposure. However, it is very limited at just 4% of total portfolio value but I expect to see that increase over the next few quarters. Earnings growth expectations for the sector improve dramatically in 2016, rising to +44.5% from the -44.5% expected this year.

Prospect Is Undervalued And Positioning For Growth

No matter how you look at it Prospect is undervalued. This is despite a decline in NAV experienced in 2014. Strictly based on forward earnings the company has more than a 50% discount versus the broader market. The S&P 500 is hovering around a 17 forward P/E while Prospect is cheap at only 7.7 times forward earnings. Based on net asset value the company is trading at a 17% discount to book. Granted, this discount is largely due to sales of shares below NAV enacted by company management in order to raise capital; about $95 million in the fourth quarter of 2014 alone.

Prospect used its new capital to increase its assets and the portfolio is only growing. While many pundits and shareholders are calling for the company to boost value through financial manipulations such as buybacks, insider purchases and special dividends Prospect remains focused on new loan originations. Capital is being used to cover its credit obligations and to secure new business. 2015 has started off conservatively with only about $175 million in new loans but management expects to match or exceed the $3.2 billion in originations generated in 2014. So far the company has announced at least 7 new loans including additional funding for IWCO Direct and a loan to the Carlyle Group for its acquisition of PrimeSport Holdings. The bottom line; expect increased lending, increased net assets and increased NII in 2015.

"After witnessing budget-beating performance by IWCO Direct, Prospect and Court Square developed a win-win structure that rewards shareholders for the results to date and for continued growth," says Prospect's Jason Wilson.

It's All About The Yield

When you boil it all down it's always about the yield and Prospect pays a high one. Regardless of the issues Prospect has a long and steady history of distributing its earnings to its shareholders. The company has generated positive cash flow since its inception, it has never had to use a previous quarters earnings to pay the current quarters distributions, has produced yield in excess of 10% for the past 5 years and has enough free cash to declare a special dividend at just about any time. Compared to its peers it is also carries very low risk of having the yield cut, probably because it already reduced payout once this year.

A further dilution of share value is always a concern but based on the February earnings statement and conference call can be put on the back burner for now. The company has ceased its sales and the stock has since been able to put in a bottom. On the flip-side, insiders purchased many of those shares and are attributed to over $11 million in new purchases for the year.

Looking forward there is not only a chance of capital appreciation, there is also the chance of dividend increases making a super-charged cash producing investment. In the near term be on the watch for earnings which are due out May 5th and rising short interest. Over the past two months negative market sentiment has nearly doubled from 7% to 13.6% and could produce a sharp rally when Prospect delivers its results.

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