It's a Buyers' Market for Business Development Companies, and PSEC's the Way to Go

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By **Jason Van Steenwyk**
Senior Editor of Global Investor Spotlight

It's been busy at PSEC of late. The prominent business development company – one of the largest of its type – has recently emerged from a bruising proxy battle over its leverage policy, and took a price beating over a cut in its dividend. Even so, Prospect Capital is still sporting a yield of about 11.4 percent. That's an eye-catching return for income-focused investors, who are struggling to eke out an acceptable return in an environment where 10-year Treasuries are bouncing around the 2 percent level.

That said, yield-chasing is notoriously tricky. Many an investor has tried to chase yields to infinity and gotten stuck with a fist-full of nearly worthless junk bonds for his trouble.

There are bond mutual funds, of course – and even high-yield funds. But they aren't getting investors close to double-digit mark these days. The S&P U.S. Issued High-Yield Corporate Bond Index is kicking off an average yield to maturity of 6.21 percent, in comparison.

The low-yield environment is unlikely to let up soon, and money has been piling into equities, pushing the S&P 500 into the stratosphere – and pushing expected returns and yields down.

But Prospect Capital, on the other

hand, is trading at a steep discount to its NAV – a circumstance that makes the original investors want to pull their hair out, but it's great for new investors, who can pile in to the fund and get a substantial dividend at 85 cents on the dollar.

As yields go, it's a screaming deal, compared to the alternatives available.

But let's take a look at the broader issues and put Prospect Capital in context.

BDC Basics

Prospect Capital is a business development company. If you're not familiar with that form, think of a REIT:

- Like a REIT, BDC's must distribute at least 90 percent of their taxable earnings to shareholders.
- Like a REIT, BDC's are exempt from corporate income taxes provided they comply with the 90 percent distribution requirement above.
- Like a REIT, the net tax effect for shareholders is that of holding a pass-through entity. The income received flows through the REIT, untaxed, and goes straight to the shareholders' individual income tax return.
- Like a REIT, BDCs may employ leverage. The law restricts BDCs to a 1:1 leverage ratio, which is much more conservative than you'll find at banks.

BDCs also differ from REITs in important ways:

- The holdings, of course, are different. Instead of real estate, BDCs are designed to hold the kinds of equity and debt opportunities normally restricted to accredited investors in the venture capital, private equity and private debt markets. However, unlike most VC and private placement opportunities, you don't have to be an accredited investor to purchase shares in a BDC. Participation is open to everyone.
- There is little correlation between BDC and REIT performance. They tend to do well at different times. REIT-friendly investors may get some diversification benefit by allocating a portion of their income/REIT portfolio to BDCs to pick up competitive yields while spreading out their sector-specific risk somewhat.

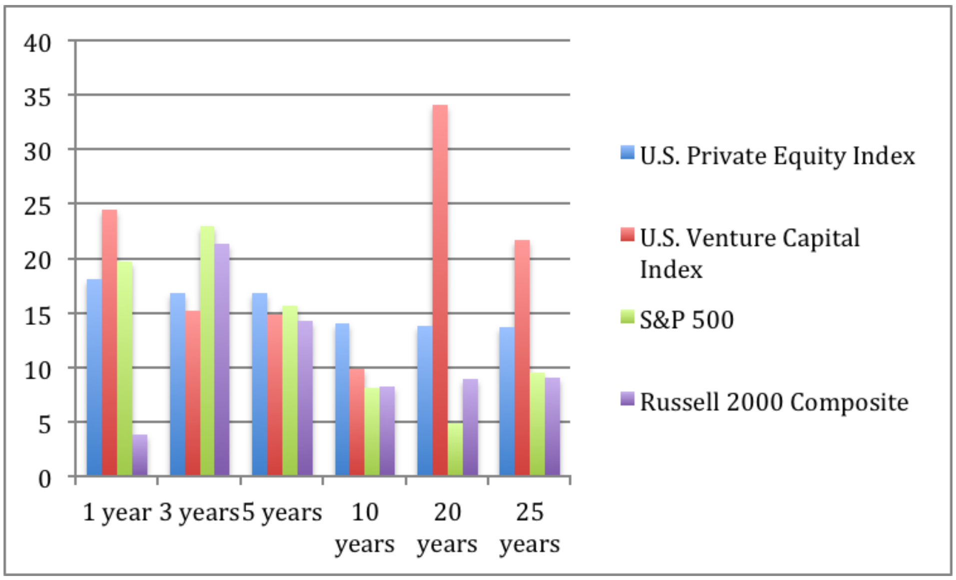
Overall, the median business development company currently yields about 10 percent. Its yield advantage over other asset classes has been consistent for the last five years.

Why? Well, taken individually, any given holding in the BDC space carries a great deal of uncertainty by its very nature. These are generally growth-oriented, early-stage companies that for whatever reason aren't qualifying for lower-cost financing, and are willing to give up some substantial concessions to the investor in exchange for their capital.

Taken in the aggregate, though, the space in which BDCs typically operate has been rewarding investors handsomely for the risks they take. [Let's take a look at historic returns in the VC and private equity spaces.]

As you can see, performance results for Private Equity and Venture Capital are mixed compared to the S&P 500 and the Russell 2000 Composite. But over the longer term, investors in the Private Equity and Venture Capital spaces are handsomely rewarded for the risk they take. Standard and Poor's has a [BDC Index], but it's too new to be a meaningful benchmark for comparison at this point.

As an industry, BDCs have taken a beating for a major reason beyond



	1 year	3 years	5 years	10 years	20 years	25 years
U.S. Private Equity Index	18.1	16.8	16.8	14.1	13.8	13.7
U.S. Venture Capital Index	24.5	15.2	14.9	9.9	34.1	21.7
S&P500	19.7	23	15.7	8.1	4.9	9.5
Russell 2000 Composite	3.9	21.3	14.3	8.2	9	9.1

their control. Last year, Standard and Poor's and Russell – two major indexes – made the decision to drop BDCs from the S&P 500 and Russell 2000 Indices. This in turn forced the Index Funds to sell their shares all at once, resulting in a temporary share glut. As much as 15 percent of the BDC float hit the market at the same time like a tsunami. That cut share prices, but didn't hurt dividends, and has nothing to do with the underlying fundamentals of the industry, which appear solid. The result is that BDCs appear very cheap now compared to other asset classes. For example:

The BDC sector as a whole is currently trading at about 9.9 times earnings - a 50 percent discount to the S&P 500's 19.9 times earnings. Sure, we expect these smaller companies and riskier positions to sell at some discount to the S&P. But the historical average P/E discount for BDCs compare to the venerable large cap index is only 24 percent.

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Meanwhile, PSEC investors are paid well to wait, with an 11 percent dividend (based on share price). According to the company, their current dividend rate of 8.3 cents per month/25 cents per quarter results in a comfortable dividend coverage of 120 percent based on taxable earnings and 104 percent based on net investment income. Yes, the dividend is lower than it was – the company recently cut its dividend, as we mentioned, but we'd rather deal with a company that was willing to slash a dividend to a sustainable level than keep up a fantasy with a pretty lie and have less than solid dividend coverage. That just increases the risk of a future slashing – and corresponding price haircut. We'll take good coverage and high-quality earnings any day.

Why PSEC?

If you had to choose one BDC, PSEC is a logical choice for several reasons:

- **Size**. It's the 2nd largest BDC on the market at present, and as a consequence deals in much larger transactions than other alternatives. Most BDCs are small and fight over the $5 to $15 million dollar market, which puts them well out on the risk continuum because the companies tend to be smaller. PSEC focuses on loans of $100 million and up. Its sheer size allows them to do that without over exposure to any one position. Meanwhile they are able to deal with more established companies owned by the top private equity firms.
- **Earnings quality**. Many BDCs go

further out on the risk continuum and reach for yield by taking on lower debt tranches. That means that if things get tight, these debts get paid last. In contrast, 75 percent of PSEC's portfolio is comprised of 1st and 2nd lien loans, with the emphasis on 1st lien. Over the last year, 70 percent of the new positions taken have been first-lien. The company is still taking on deals, but tightening up on risk exposure. We like that.

- **Dividend coverage**. As we mentioned, we'd rather have earnings easily cover regularly issued dividends even as a BDC lowers its risk exposure rather than iffy coverage based on a best-case scenario. PSEC has already paid a price in the market for having cut its dividend at the beginning of this year – making for a convenient on-ramp for new shareholders, and also potentially setting them up to benefit from a possible special dividend in the future, if things go better than expected. For those who would like a detailed discussion of dividend coverage, see here.
- **Flexibility**. While most BDCs have a handful of origination strategies at best, PSEC has nine at its disposal – which gives managers a bit of leeway in negotiation changing markets. Currently, the management team is generating particularly strong risk-adjusted returns in the following strategies:
  - Private Equity Sponsored Finance
  - Collateralized Loan Obligations
  - Online Lending
- **Future plans**: According to PSEC's Michael Cimini, head of investor relations, Prospect Capital plans to spin off its collateralized loan obligation, real estate and online lending businesses, on the theory that these will do better as standalone businesses rather than under the thumb of a BDC. I wholeheartedly agree. This will be better for these segments, and provide shareholders to benefit from some 'pop' as these companies are liberated from the Mother Ship to find their own fortunes, while also providing some capital that PSEC can use to focus on its core competency. The company filed with the SEC the initial Form N-2 for the CLO business earlier this month (https://www.sec.gov/Archives/edgar/data/1623848/000162384815000006/ pyldn-2.htm). Filings for the other two should be forthcoming in the near term.

"In addition to our planned spinoffs, there are several other initiatives we are pursuing that are aimed at increasing value for shareholders. Specifically, we continue to work on our asset optimization strategy and explore additional refinancing opportunities to help drive future performance. We are also looking at possibly monetizing certain controlled companies in our portfolio at attractive multiples. In further strengthening our ability to expand Prospect's earnings potential, we are well positioned to benefit from a rising interest rate environment as 95% of our interest-bearing assets are floating rate and about 94% of liabilities are fixed rate."