Prospect Capital Is A Must Have Stock Relative To It's Peers

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Prospect Capital (PSEC) is trading near long term lows and has recently offered up what some might call the buying opportunity of a lifetime. The stock traded below a major long term support level where it met with buyers and an increase in volume greater than 10X the previous 30 day average. The increase in volume is notable not only for its magnitude but also for its duration. While trading volume has fallen off from its peak it remains at levels more than double the prior 30 day period. Volume, as I am sure you know, is a fantastic indicator of market sentiment and often precedes significant moves in share prices, alone a reason to be interested in this stock. Add to this the ridiculously high dividend yield and value relative to its peers makes PSEC a must buy.

Why Is PSEC So Undervalued?

PSEC had a little trouble over the past few quarters that has contributed to the recent fall in share prices. To get the full picture we have to look back into last year when management set the stage for today's opportunity. PSEC had been raising capital through below-NAV sales of stock, a move which helped them increase asset growth and income at a pace above industry average but ultimately diluted shareholder value. These sales continued into the end of 2014 at which time were stopped due to the substantial discount to NAV already being offered.

At the same time, calendar Q4 2014 earnings, management reduced the dividend furthering negative sentiment in the stock. At the time it was touted by many analysts as a sign of underlying weakness in the company and a sign that more dividend reductions would ensue, and they were more or less right. The following quarter PSEC reported weaker than expected earnings and a host of BDC's including 5th Street and Medley lowered their yields with a half dozen more expected to lower yields sometime this year. What they were wrong about is risk of PSEC

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reducing its dividend again, and that weak earnings growth was a sign of weakness in PSEC.

The thing most analysis overlook is that PSEC's miss on earnings is directly attributable to two things. First is the halt of below NAV sales of stock, a move that decreased available capital resulting in fewer loan originations and thereby slowing asset and earnings growth. The second is a shift from traditional loan types to online lending. On line lending does not bring in the same structuring fees as the more traditional types of loans, resulting in increased portfolio value while having a negative impact on earnings. With all this in mind it looks now as if PSEC management was showing incredible foresight in lowering yield when they did. Now

PSEC is ahead of the curve and, with economic/FOMC outlook the way it is, set up for growth into the next few years.

How Does PSEC Stack Up Versus The Field

I've discussed PSEC 1st quarter earnings in previous articles so I won't rehash it again. The purpose today is to see how PSEC stacks up versus the rest of the field. The first factor to look at is the yield. PSEC is paying $1.00 annually in monthly distributions which equals +13% yield at today's prices. The high rate of return might be a red flag of impending rate cut but there is little chance of that. For one thing, management has already anticipated the need and acted on it, for another, earnings are above distribution obligations and have led management to hint at special dividends several times this year.

Another reason why the high yield is not alarming is PSEC's valuation relative to it's peers and PSEC is undervalued any way you slice it. On a P/E basis the company is trading at only 7 times earnings, not the lowest in the field but nowhere the highest. Ares Capital (ARCC) is trading at over 10 times earnings with Mainstreet (MAIN) trading near 15 times earnings. Based on this metric PSEC could see a gain of 50% - 100% just to get in line with the industry. This is backed up by valuation relative to NAV. Both Ares Capital and Apollo Capital (AINV) trade in the range of -2% discount to NAV. Mainstreet leads the pack and trades at massive premium to NAV, nearly 50%. PSEC is currently trading about 27% below NAV putting it in shape to rise $2 or more from current levels.

Prospect Capital is current yield is only 2% higher than Apollo which is

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also undervalued in terms of earnings with PE near 7. The caveat with them is they trade at only 3% discount to NAV and are projecting declining earnings and revenue for next year, nearly 10%, which may make the low valuation more in-line than it looks. This also puts them in shape to see a drop in NAV and produce a substantial drop in distributions further widening the gap between them and PSEC.

Ares is yielding about 9% at current prices and carries an even higher valuation relative to the market. They trade near 10 times earnings, nearly 50% richer than PSEC's 7 times and only have a -1.3% discount compared to NAV. Another caveat here is that they have had a special dividend in recent quarters and since reported a big miss on earnings and revenues. This makes them less likely than most to hike rates and a prime candidate to cut them although the jury is still out on that. Prospect on the other hand continues to hint at special returns and to date has performance to back it up, posting taxable income above dividend requirement every quarter since inception.

Mainstreet is not really in the running for this comparison since it has already seen a massive rise in share prices that reduced yield to only 6.5%. Mainstreet has gained nearly 10% in the last 6 months as rising revenues, earnings and NAV have attracted dividend seekers. Now the stock is among the most overvalued on the market trading at a near 50% premium to NAV and more than double the field in terms of value relative to earnings. At this time yield is not expected to be increased based on declines in NII but special returns are always a possibility.

What You Get With PSEC

With PSEC you get an undervalued stock in a hot market that is expected to see gains near 25-50% based on current market valuations. At the same time you get one of the highest, and safest, yields in the sector, about 13% at today's prices, with the chance of special dividends in the near future. So, bottom line, what you get is a chance for double digit capital appreciation while the company pays you to hold the stock, the buying opportunity of a lifetime.

Risks are few as the stock is trading at long term support with positive forward outlook but they are present. One includes an ongoing spin-off of three "pure play" companies that are expected to benefit the company in a number of ways, risks being that share holder value will not be improved substantially. The most obvious benefit is to raise capital for new originations which would lead to a rise in NAV, revenue and earnings. Another is to capture fair market value for business segments currently undervalued as part of the greater BDC portfolios. The third is to rebalance the portfolio so that it is more focused on traditional, and fee incurring, loan types.

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