

Prospect Capital - A Compelling Investment Opportunity

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When Grier Eliasek, President and Chief Operating Officer of Prospect Capital Corporation wrote in this Newsletter July 1 that investors had been given a great opportunity to enter the BDC arena, his gift for understatement drew smiles among analysts who track business development corporations.

Because the SEC modified its rules, BDCs had been dropped from the S&P 500 and Russell indices. Naturally the market knee-jerked and the price of Prospect stock (PSEC) took a hit as did other BDCs. That obviously created a buy opportunity.

Analysts knew that technically SEC's actions were a "non-event" – an accounting change from rules that date from when SEC clarified financial notes reporting. The non-issue was raised in an SEC advisement a year ago September citing Rule 4-08(g) and shouldn't have caused consternation within the BDC community; and it didn't.

The crux of the SEC decision was that since a BDC is structured very much like a mutual fund, certain business expenses must be passed on as additional "acquired fund fees" in the reported expense ratios. ▶



But thinking at the indexes was, however, that reporting of Acquired Fund Fees and Expenses (AFFE) created a distortive impact on index fund expense ratios. David Blitzer, chairman of the index committee at S&P, asserted that the decision had nothing to do with the investment merits of BDCs; which is true; but the oft confirmed adage of “buy the rumor, sell the news” held sway for PSEC and other BDCs.

Grier Eliasek’s hint that the market result created an opportunity for new investors in Prospect Capital Corporation was well founded. He anticipated releasing earnings for Prospect on Aug. 25 for fiscal year 2014 knowing PSEC had recorded a 44 percent increase in net income over the previous year. Next day Prospect stock gyrated from between 10.41 and 10.74, closing at \$10.56, down 3.83 percent. Five Wall Street analysts recorded buy recommendations.

The chance to take advantage a great opportunity to enter the BDC arena still exists. The high market price of 17.74 was recorded in 2007. Returning to that market price would be a realistic 70 percent gain from current trading levels. As a broader public becomes aware of the high-yield nature of BDCs like Prospect, analysts expect investment interest in the larger BDCs with solid track records to intensify.

Eliasek’s middle name could well be “Yield.” The chemical engineer with a Harvard MBA runs a shop of diversified strategists, not all Harvard buddy-buddies like some organizations; although Chairman John Francis Barry III, a Princeton guy, did earn J.D. cum laude from Harvard Law School, where he was an editor of the Harvard Law Review. But “Yield” is the password at Prospect Capital Corporation.



While Eliasek has been known to videotape explanations of just how BDCs operate with great precision (he uses tales of his 5-year old daughter to help illustrate a point), the Prospect COO inevitably comes back to “Yield” for yield’s sake.

“We are Yield-Focused” notes Eliasek in a video on the company’s website [here](#)

Behind that 44 percent increase in net income lay a story of a company preparing to experience a new growth, albeit a planned steady kind of growth. The earnings details themselves portend that preparation.

For the June 2014 fiscal year, Prospect’s net investment income was \$357.2 million or \$1.19 per weighted average share for the year. For the June 2013 fiscal year, net investment income was \$324.9

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million or \$1.57 per weighted share for the year. For the 2014 fiscal year, net increase in net assets resulting from operations was \$319.0 million or \$1.06 per weighted average share. For the 2013 fiscal year, the net increase was \$220.9 million or \$1.07 per weighted average share. The nets had decreased on a per share basis primarily due to non-recurring income from Energy Solutions Holdings Inc. (ESHI) in the 2013 period. ESHI had sold its gas gathering and processing assets (“Gas Solutions”) for \$200 million in 2012 and continued to generate

◀ a generous amount of cash for Prospect.

Prospect has selectively monetized certain companies like ESHI and won't hesitate to monetize other positions if attractive opportunities show up. Prospect has thus benefited from the solid performance of several controlled positions in its portfolio. As such opportunities materialize, Prospect expects to reinvest such proceeds into new income-producing opportunities.

"We are pleased with the performance of our controlled portfolio companies, and are actively exploring other new investment opportunities at attractive multiples of cash flow," the company earnings statement said. The report pointed out that in the June 2014 year, "We made three investments in non-controlled third-party-sponsor-backed companies that brought our total investment in each such company to more than \$100 million, demonstrating the competitive differentiation of our scale balance sheet to close one-stop financing opportunities. We have also made multiple control investments that each individually aggregate more than \$100 million in size."

During the June 2014 fiscal year, with an initial \$92.6 million investment in Echelon to finance a diversified airplane asset acquisition, Prospect entered the aircraft leasing sector. Echelon focuses on acquiring aviation assets with attractive contracted cash flows, strong lessee credit risk attributes, and stable residual value characteristics. The Echelon management team expects to generate double digit yields through a focus on mid-life aircraft.

During the June 2014 fiscal year Prospect also entered the online lending industry with a focus on prime, near-prime, and subprime



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consumer and small business borrowers. "We intend to grow our investment, which stands at approximately \$75 million today, across multiple third-party and captive origination and underwriting

platforms," the earnings report said.

As a yield enhancement, Prospect has launched a senior loan initiative in which Prospect would collaborate with third-party investor capital that would acquire lower yielding loans from Prospect's balance sheet, thereby allowing Prospect to rotate into higher yielding assets and to expand the company's ability to close scale one-stop investment opportunities with efficient pricing.

Prospect's advanced investment pipeline aggregates more than \$400 million of potential opportunities diversified across multiple sectors. These opportunities are primarily secured investments with double-digit coupons, sometimes coupled with equity upside through additional investments.

As Eliasek has said, "Prospect is a

◀ compelling investment opportunity due to its 12-13 percent dividend yield, which is higher than virtually all of its peers with dividends fully covered by net investment income during the history of the company (and with substantial spillback dividend excess available for the future). Prospect trades at a discount to the peer group (only ~8x forward earnings compared to ~11.5x for the peer group), offering a value-driven entry point for new investors. Prospect intends to close that valuation gap through enhanced investor outreach and communication as well as continued superior performance.”

One investor wrote on a blog recently, “There is likely a lack of understanding about BDCs that keeps most BDCs off many investor screens, as it is typically “safer” to avoid dividend stocks with payout

ratios approaching or above 100 percent. Therefore, BDCs will often lag the market as they tend to trade based on NAV and TTM PE. For PSEC, forward earnings are forecast higher. There is an unnaturally high yield because the whole class is out of favor, not because risk is any higher . . . I own and follow PSEC closely. I’m trying to find something positive here. Could there be some better buying opportunities ahead? I still say the underlying business of PSEC and many BDCs is solid, and if you’re not afraid of ‘private investment vehicles,’ this could be a great opportunity. Perhaps not all BDCs are worthy, but I believe PSEC is. PSEC represents a pool of ~130 (mostly) Investment Grade Bond equivalent investments that average twice the normal yield because the stock is trading below its net asset value with little appreciation of its

total return. PSEC is being thrown out with the baby and the bath water. Why would you sell here? What can you do that is better?”

PSEC employs a scale team of about 100 professionals, one of the largest dedicated middle-market credit groups in the industry. They helped Prospect originate and close nearly \$3 billion of investments during the 2014 fiscal year.

While analysts are reluctant to use terms like “the baby and the bath water,” many agree with Eliasek’s understatement, that investors had been given a great opportunity to enter the BDC arena. Two days after the earnings announcement, the PSEC bath water temperature hovered around 10.27 dollars. ■

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