Prospect Capital Managers Bet On Big Year

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A peak in insider buying, alongside an historical deep discount to NAV, could be pointing to a big year for PSEC Investors.

PSEC -
Insider Buying At Deep Discounts

Prospect Capital Corporation, PSEC, is one of the most criticized firms on the public market today. No matter what management does, shareholders and pundits alike seem to find something wrong. Admittedly, some decisions by the company have helped to increase their fees, but at the same time they have been able to produce industry leading returns. The current distribution, $1.00 per share annually, is one of the highest in the industry with no expectations for a cut.

The past year has seen the stock fall to historic lows driven by FOMC rate hike fear, energy concerns, overall market volatility, a cut in distributions to the current level and most recently, management's pursuit for permission to sell shares below NAV. While there are many reasons for investors to be skeptical, sales of these types have in the past provided capital for new business and portfolio expansion, increased earnings as well as helping to maintain investment grade credit ratings and command lower rates for liabilities.

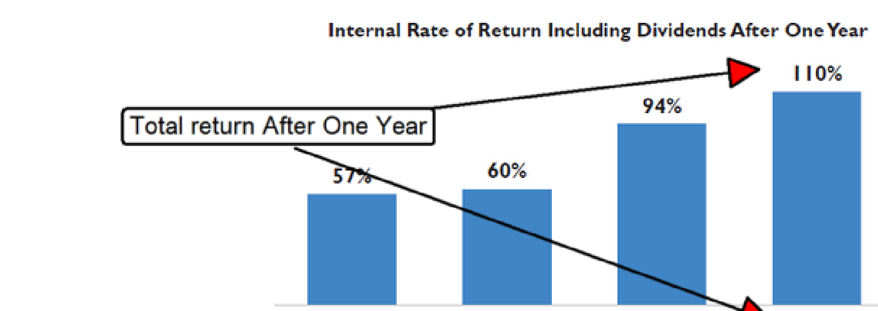
The mitigating factor is that, according to the statements, they are not seeking to sell shares now. The company did not complete any equity offerings in over a year and has in fact repurchased over $30 million of stock for the benefit of shareholders. Every year since 2008, Prospect has received shareholder approval of the NAV proposal, which opens an avenue of possible income and enhances access to financing on attractive terms. At this time the decision is still undecided and will be voted on at the January 8th shareholder meeting.

Managers Have Skin In The Game

One of the biggest criticisms PSEC gets is that there is a conflict of interest between management and shareholders. The company is externally managed, managers receive fees based on assets and performance. Mitigating this conflict is what has been described as a "staggering" amount of insider buying. Over the past year, senior management has been scooping up shares, below NAV I might add, and accelerated their purchases over the past month. December alone saw CEO Barry and COO Eliasek more than double their personal holdings, total insider purchases for 2015 is greater than $50 million.

Deep Discounts Could Lead To Big Returns

At current share prices the company is trading at roughly a 30% discount, levels only seen twice before in the company's history, both times preceding massive increases in share value as well as increased in dividend distributions. Based on the historical perspective, PSEC is trading at such a deep discount to its NAV that this author believes new investors can reasonably expect to see total returns greater than 100% over the next 12 to 18 months.



Discount to NAV	20%	25%	30%	35%
Last time PSEC stock traded at approx. this discount to NAV	10/4/2011	8/10/2011	3/17/2009	3/11/2009
Share price on this date	$8.25	$7.71	$7.61	$7.13
Share price after one year	$11.62	$10.94	$12.39	$12.52

Prospect Capital Corporation is a business development company registered under section 54 of the Investment Company Act of 1940. Their business is investing in middle market businesses that may not have access to more traditional forms of capitalization, providing the average public investor with exposure to private U.S. businesses. They are very similar to venture capital companies with one major difference: Prospect does not invest in start-ups. The company invests in profitable middle market businesses with annual EBITDA of approximately $45 million on average. As a BDC, the company trades on the open market just like a stock, allowing for easy access and liquidity not found in other types of private funds.

The real benefit for investors is income. BDC's and Prospect Capital Corporation are required to pay at least 90% of their taxable income to investors through dividend and special distributions. This means that they pay above average returns, averaging 10% for the industry. Prospect, however, due to it deep discount to NAV, is paying close to 14% at current share prices.

High yield like this is often a warning sign of imminent share price declines or dividend cuts but that is not the case here. PSEC has been earning in excess of its distribution levels since inception and is not expected to stop any time soon. In fact, a case can be made that an increased or special dividend could be coming in 2016.

What The Analysts Are Saying

Despite the nay-saying analysts maintain a strong hold rating on the stock. I say strong because of 11 analysts 8 have maintained a hold or neutral rating over the past 6 months with 2 issuing buys and 1 a strong buy. The high price target is $10.50, just above last reported NAV, with low target of $7.50. Firms covering the company include Barclays, Cantor Fitzgerald, Deutsche Bank, and FBR & Co..

Consensus forecast for earnings over the next year are positive and more than cover the current dividend distribution. The average estimate is $1.02 per share, the low of $0.95 is an outlier, with the high end near $1.06 for both 2016 and 2017.

Taking into account the rising interest rate environment we are now in these estimates could be low..

The Bottom Line

No matter the criticism, Prospect Capital Corp is a stock insiders and analysts want to own. Insider buying alone points to a serious expectation the company is going to do well in the future. CEO John Barry and COO Grier Eliasek aren't dummies and they aren't charities: They aren't buying up the stock because they think they will lose money. What they, along with the rest of the PSEC management team, have done is voted a resounding yes in the way that only market participants can, with their money. Even if share prices continue to bob along the long term low like they have been of late there is still the dividend and that ~14% looks real nice compared to the S&P's flat return in 2015.