



Prospect Capital, Earnings And Dividend Health

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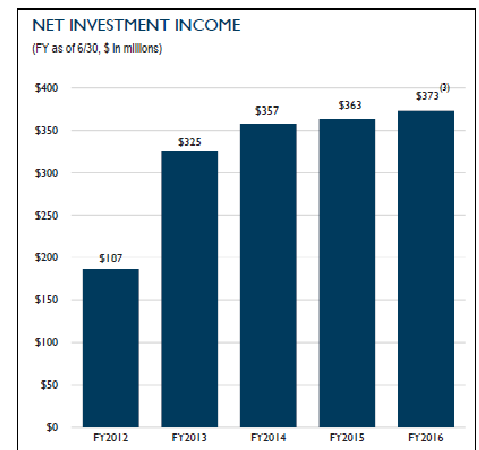
Prospect Capital recently released FQ3 earnings, the miss on NII is a bit concerning but but not the issue Wall St bears would like you to believe.

Prospect Capital Reports Q3 Earnings

Prospect Capital recently released FQ3 earnings and to be honest, the headline wasn't that great. A miss on net investment income raise a red flag for any investor, it should, you

never want to see earnings come in below expectations. NII in Q3 was \$0.25, one penny below consensus. Over the past 9 months, fiscal year to date, NII is running at \$0.79. This is down \$0.03 from the previous quarter when the company exceeded expectation, but up a penny from the same quarter last year and on a year-to-date basis. So far in 2016, year to date NII is already above full year 2015 with an entire quarter left to go.

Of course, if you understand why the miss happened, and all other factors are good then the miss isn't quite as bad as the bears would like you to think. In fact, understanding that NII fell short because management purposely slowed down the pace of new investment



due to market volatility, and that new investment in the present quarter is already back on track, you'd know that the Q3 performance is actually quite good.

To put the miss into perspective

◀ new investment in Q3 was only \$23.2 million dollars, a drop in the bucket for a firm with nearly \$3.5 billion in net assets and \$6 billion under management. In the previous quarter new investments totaled more than \$692.3 million, over the past 12 months more than \$1.1 billion. Considering this, a mere 1 penny miss on NII is really amazing, it could have been so much more. Further, looking forward, the pace of new investments has already picked up and promises to enhance income in the current and follow-on quarters. According to the release Prospect Capital has already originated over \$115 million in new investment in fiscal Q4.

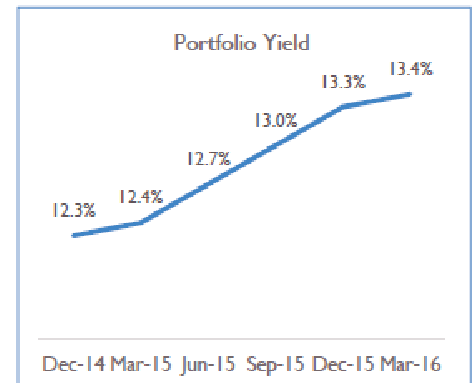
“We slowed originations in the March 2016 quarter due to market volatility but expect to increase our investment pace, depending on market conditions, in the coming quarters. . .

Since March 31, 2016 (in the

current June 2016) quarter, we have completed new and follow-on investments of \$115.4 million, sold \$25.0 million of one investment, and received partial repayments of \$22.4 million,”

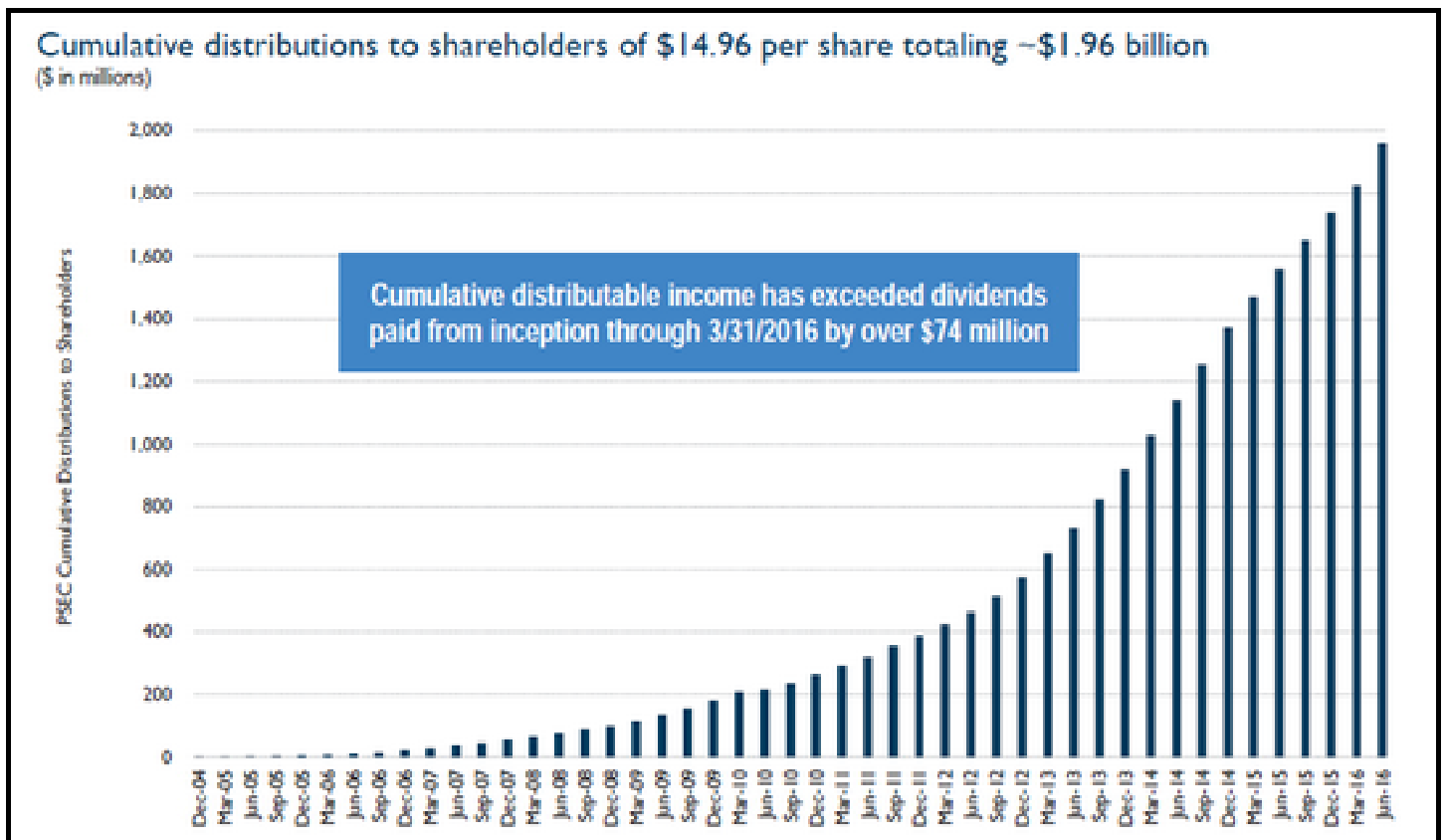
One reason that the miss on NII wasn’t larger is managements efforts to improve portfolio quality. They have been working diligently over the past year or more to roll lower yielding investments in higher yields and those efforts have been paying off. Portfolio yield in the 3rd quarter was 13.4%, up 0.1% from the previous quarter and up a full 1% from the same quarter last year, the 6th consecutive quarter of yield growth and does not include dividend yield from equity holdings within the portfolio.

“So far in the June 2016 fiscal year, we have made four sales of such lower yielding investments totaling \$91.9 million with a weighted average coupon of 6.1%. . . We expect



additional similar sales in the future as a potential earnings contributor for the June 2016 fiscal year and beyond.

Credit quality remains good. Prospect is one of only a very few BDC’s to maintain investment grade credit ratings and has a positive outlook, Moody’s Aa3. Over the past year two debt offerings have been repaid with only one due in 2016. This is expected to be refinanced, at a much lower cost, through an as yet untapped revolving credit facility. ▶



◀ This will raise the leverage marginally, but is not viewed as a major hurdle as new originations could be slowed again in order to recoup cash from portfolio exits.

Yeah, But How Safe If The Dividend?

So, down to the nitty gritty. Prospect Capital pays one of the highest dividends of any BDC on the market, nearly 14% at today's prices, and is of the utmost concern to investors new and old alike. As a BDC the company must pay at least 90% of income to shareholders, a number that means even a small shift in earnings could have significant impact on dividend coverage and overall health.

In terms of dividend and income coverage is good. Distributions paid this fiscal year are \$0.75, well covered by current NII, and will be \$1.00 by year end. This means that 4th quarter NII only needs to be \$0.21, well below expectations. Since low estimate is \$0.24 it would seem that the dividend is quite safe for this year. In fact, based on the recently announced distributions for June, July, August and September, it looks like the dividend is safe unless into the first part of next year with little to no expectation for a cut.

Now, if you assume that the company will be able to produce results more in line with consensus, or better yet, at the top end of the expected range, full year 2016 NII could be as high as \$1.08 per share. Considering the reported increase



in new investment for the current quarter it is very possible that Prospect will exceed expectations for the year and next. Taking into account that BDC's must distribute at least 90% of their income to shareholders, simply meeting high end expectations puts them firmly in position to issue a special dividend or increase the standard dividend by the end of the calendar year.

Undervalued With Room To Move Higher

Despite performance over the course of the fiscal year, and the health of the quite substantial dividend, the

stock remains undervalued. In terms of NAV and the discount commonly associated with BDC's Prospect Capital is trading more than twice the historical. At today's prices the discount is running near 28%, historical is closer to 12% and tends to run in a range between 10% and 14%. Simply taking into account the possibility of a mean reversion to average discount we can expect to see the stock appreciate as much 13% in the next few months to trade near \$8.50. The bottom line is that Prospect Capital continues to perform, the dividend is safe and the outlook is good.