



Stellus Capital Management (SCM)

Updated September 15th, 2024, by Josh Arnold

Key Metrics

Current Price:	\$13.75	5 Year CAGR Estimate:	8.8%	Market Cap:	\$357 M
Fair Value Price:	\$15.05	5 Year Growth Estimate:	-3.0%	Ex-Dividend Date:	09/30/24
% Fair Value:	91%	5 Year Valuation Multiple Estimate:	1.8%	Dividend Payment Date:	10/15/24
Dividend Yield:	11.6%	5 Year Price Target	\$12.92	Years Of Dividend Growth:	2
Dividend Risk Score:	F	Retirement Suitability Score:	C	Rating:	Hold

Overview & Current Events

Stellus Capital Management is a business development company, or BDC, that bills itself as a flexible source of capital for the middle market. The company provides capital solutions to companies with \$5 million to \$50 million of EBITDA and does so with a variety of instruments, the majority of which are debt. Stellus provides first lien, second lien, mezzanine, convertible debt, and equity investments to a diverse group of customers, generally at high yields, in the US and Canada. The company was formed in 2012, should produce about \$100 million in revenue for 2024, and has a \$357 million market cap.

Stellus posted second quarter earnings on August 7th, 2024, and results were somewhat mixed. Core net investment income was 50 cents, which was a nickel ahead of estimates. Revenue was flat year-over-year at \$26.6 million, but that missed expectations by almost \$400k.

The company's loan portfolio yielded 11.7% as of the end of June, and management noted that investors have received \$15.75 per share in distributions since the stock went public.

Gross operating expenses were \$16.5 million in Q2, which was up from \$16.2 million in the year-ago period. The increase was driven primarily by income tax expense. Base management fees were \$3.9 million, which was the same year-over-year.

Net investment income was \$11.8 million, up from \$10.4 million a year ago. Core net investment income, which is an adjusted earnings measure, was \$12.4 million, up from \$10.8 million. On a per-share basis, core NII came to 50 cents, down from 51 cents.

We now see \$1.77 in NII per-share for this year after the most recent quarter.

Growth on a Per-Share Basis

Year	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2029
NII	\$1.34	\$1.33	\$1.39	\$1.21	\$1.42	\$1.23	\$1.13	\$1.12	\$1.46	\$1.92	\$1.77	\$1.52
DPS	\$1.36	\$1.36	\$1.36	\$1.36	\$1.36	\$1.36	\$1.09	\$1.08	\$1.36	\$1.60	\$1.60	\$1.60
Shares¹	12.3	12.5	12.5	14.9	16.0	18.9	19.5	19.5	19.7	24.1	25	35

Stellus, like most BDCs, has a difficult time growing NII. The combination of high funding costs (generally with debt and/or preferred stock) as well as varying yields on the company's debt portfolio, make it difficult to offset a rising share count over time. We're moving our estimate of growth from -1% to -3% after Q2 results as we think the current interest rate environment is likely unfavorable for Stellus.

Stellus has reset much of its investment portfolio with higher rates, leading to a very strong portfolio yield. However, a possible headwind to this is interest rates declining off of currently elevated levels. The company's net assets continue to grow over time, but these gains have been largely offset by a rising share count. We think the share count will continue to be a headwind moving forward, and that Stellus will have a difficult time offsetting this with earnings gains.

¹ Share count in millions

Disclosure: This analyst has no position in the security discussed in this research report, and no plans to initiate one in the next 72 hours.



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Valuation Analysis

Year	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	Now	2029
Avg. P/NII	10.5	8.5	7.5	11.3	9.0	11.4	8.4	11.5	9.1	6.7	7.8	8.5
Avg. Yld.	9.7%	12.0%	13.0%	9.9%	10.6%	9.7%	12.8%	8.4%	10.3%	12.5%	11.6%	12.4%

Stellus has traded with an average price-to-NII ratio of ~10 in its relatively short history as a public company, and we assess fair value at 8.5 times NII. We note, however, that Stellus' valuation has moved somewhat erratically, trading for 7.5 times NII in 2016 and then 11.3 times the next year, for instance. We see the stock as undervalued today given it trades for 7.8 times NII, implying a small tailwind from the valuation in the coming years.

The dividend yield is now 11.6%, which is in line with historical values. Stellus moved from a monthly dividend to a quarterly one, which accompanied the dividend cut from \$1.36 annually to \$1.00. It has since been reinstated as a monthly payout, and raised to \$1.60 annually. We now believe there's a reasonable chance Stellus will need to cut its dividend again, but it's continuing for now.

Safety, Quality, Competitive Advantage, & Recession Resiliency

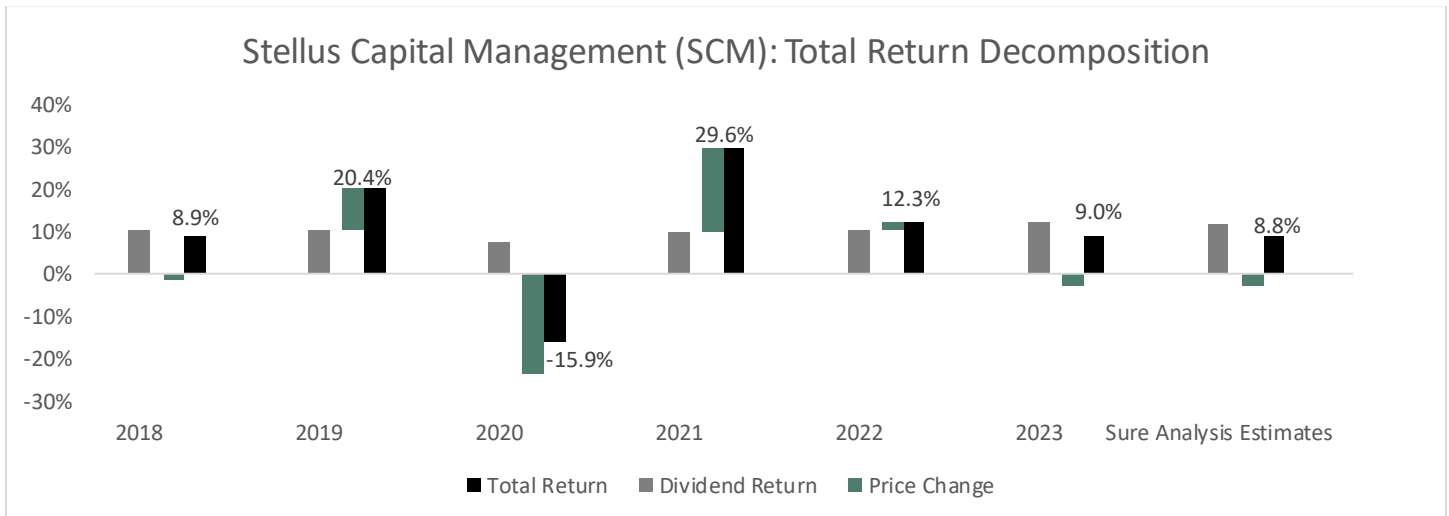
Year	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2029
Payout	101%	102%	98%	112%	96%	106%	96%	96%	93%	83%	90%	105%

Stellus, like other BDCs, has no competitive advantages. It offers the same products as any other BDC to the same set of customers, so advantages are virtually impossible to achieve. In addition, BDCs suffer mightily during recessions because borrowers have a more difficult time meeting repayment timelines. Stellus wasn't around during the last recession, but we see it as having significant issues with NII generation during future recessions, although it seems to be holding up. Stellus is required to pay virtually all its NII in distributions as a BDC, so the payout ratio will always be high. While the current payout should be safe for the time being, we note that the risk of lower rates means the payout is constantly at risk as well. We are currently not expecting another dividend cut, but it cannot be ruled out.

Final Thoughts & Recommendation

Total return potential comes in at 8.8% annually. Given the projected returns, we're moving the stock from buy to hold. The yield is very high at 11.6%, but we note the risks of owning a small BDC are high as well, so only investors with high-risk tolerances should consider Stellus. The valuation could drive a 1.8% tailwind, which could be offset and then some by negative NII growth.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Revenue	32	35	26	27	31	32	26	43	21	21
Gross Profit	27	29	---	---	---	---	---	---	---	---
Gross Margin	83.9%	83.4%	---	---	---	---	---	---	---	---
SG&A Exp.	7	7	4	5	4	4	5	5	5	6
Operating Profit	20	22	---	---	---	---	---	---	---	---
Operating Margin	63.2%	62.8%	---	---	---	---	---	---	---	---
Net Profit	10	8	23	23	26	26	20	34	14	18
Net Margin	31.5%	21.8%	87.7%	83.0%	84.3%	83.4%	78.0%	78.7%	66.7%	85.7%
Free Cash Flow	(27)	(24)	9	19	(102)	(93)	(3)	(76)	(56)	(17)
Income Tax	0	0	(0)	(0)	1	1	1	4	1	(2)

Balance Sheet Metrics

Year	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Total Assets	327	365	380	400	526	649	675	821	898	908
Cash & Equivalents	2	11	9	25	17	16	18	44	48	26
Accounts Receivable	0	0	---	---	---	---	---	---	---	---
Total Liabilities	153	201	209	180	301	378	402	536	622	588
Accounts Payable	3	3	3	3	4	4	2	5	5	5
Long-Term Debt	148	196	203	174	292	366	393	518	604	576
Shareholder's Equity	174	165	171	220	225	271	273	285	276	320
LTD/E Ratio	0.85	1.19	1.19	0.79	1.30	1.35	1.44	1.82	2.19	1.80

Profitability & Per Share Metrics

Year	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Return on Assets	3.3%	2.2%	6.2%	5.8%	5.7%	4.5%	3.1%	4.5%	1.7%	1.9%
Return on Equity	5.8%	4.5%	13.8%	11.6%	11.8%	10.7%	7.4%	12.0%	5.2%	5.9%
ROIC	3.3%	2.2%	6.3%	5.9%	5.7%	4.6%	3.1%	4.6%	1.7%	2.0%
Shares Out.	12.3	12.5	12.5	14.9	16.0	18.9	19.5	19.5	19.6	22.0
Revenue/Share	2.63	2.82	2.12	1.83	1.95	1.73	1.33	2.19	1.07	0.96
FCF/Share	-2.21	-1.96	0.71	1.27	-6.42	-5.10	-0.18	-3.90	-2.88	-0.78

Note: All figures in millions of U.S. Dollars unless per share or indicated otherwise.

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