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Prospect Capital's altar call

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While most of my career has been spent observing commercial banks, I have always thought the specialty finance sector is more interesting. The lending tends to be edgier than commercial bank lending, which usually is at the top of a company's capital stack and is partially funded with the borrower's deposits. Funding for some specialty finance companies periodically becomes a problem as CIT Group Inc. in its pre-bank holding company structure can attest. And the stocks tend to be controversial — especially when the credit and funding cycles are poised to turn.

Earlier this year I had a post about business development companies, noting pressure on asset yields, a more challenging period to establish fair value marks after five years of mostly uninterrupted appreciation following the financial crisis, and dividend cuts at some BDCs. Also noted was the apparent tension between Prospect Capital Corp. management and Wells Fargo analyst Jonathan Bock during the Feb. 5 conference call to review its quarterly earnings.

Prospect may fit the description of edgy presently given the 27% decline in its shares for the one-year period ended June 11 compared to a loss of 10% in the SNL U.S. Investment Companies index. The decline likely reflects a number of factors, including a cut in the monthly dividend to 8 cents per share from 11 cents per share earlier this year. I think management would describe the shares as a value play, not edgy. On June 4, management hosted a conference call that covered the company's investment history, value proposition and the like. It was an altar call for value investors who may agree with the company's investment merits.

One of the challenges BDC managements face today is how to grow when the shares trade below book value, or net asset value, which is the case with most today. Shareholder permission usually is required when this is the case. And because their tax structure requires that at least 90% of taxable income be distributed each year, internal capital generation is minimal. If a BDC is not overly levered relative to statutory restrictions and management's (and lenders') comfort, then more leverage can be employed. Or, given a highly competitive lending environment, now might be a good time to back off from originations. Fitch noted that the BDCs it rates saw a 47% decline in first-quarter originations, which Fitch attributed to the lack of access to equity markets and a slower M&A market for middle market companies.

Like many of its peers, Prospect trades at a discount to book value, though its discount is somewhat steeper at 73% as of June 11. The discounts seem to be creating opportunities. Capital Southwest Corp. is spinning off certain control investments to shareholders to unlock value. Its shares have risen 40% the past year through June 11 and now trade near book value. Also, PennantPark Floating Rate Capital Ltd. entered into an agreement to acquire MCG Capital Corp. on April 29 in what the PennantPark CEO described as a synthetic common raise. The agreement is now being contested by HC2 Holdings Inc. MCG Capital now trades near book value compared to 83% on March 31.

Prospect Capital also is working on several transactions designed to unlock value and raise capital through spinning out three of its investment verticals: the structured credit business that invests in collateralized loan obligations; online business lending; and the real estate lending business. The CLO spin is not a spin in a traditional sense via a dividend distribution of the business; rather, shareholders will receive rights to purchase shares in Prospect Yield Corp. LLC That is they have to write a check, or sell the rights to someone else who will write a check.

Assuming I understand the N-2 prospectus correctly, the result of the rights offering will be that Prospect Yield will acquire a majority if not most of Prospect Capital's CLO portfolio provided at least 75% of the rights are exercised. As of March 31, the CLO portfolio had a fair value of $1.1 billion. In effect, Prospect Capital will monetize a majority of its CLO investments and use the proceeds to invest in other assets, reduce debt and/or repurchase shares.

There is nothing wrong with CLOs other than bank regulators do not like them on deposit-funded bank balance sheets. They are structured finance investments in which a pool of leveraged loans is financed with a tranched capital structure. Cash flow from the leveraged loans is used to cover the CLOs' expenses and pay returns to the capital tranches in a "waterfall" structure with the lowest yielding senior debt paid first.

Prospect Capital's portfolio of over 30 CLO investments consists primarily of the equity and junior debt tranches. So, presumably there is more gearing to the credit cycle within Prospect Capital's portfolio because the lower debt and equity tranches are paid last. When times are good, the equity gets excess cash flow. If defaults rise sufficiently, cash flow to the equity evaporates. Prospect Capital management indicated on the June 4 call that the CLO portfolio yields 16% on a GAAP basis and 21% on a cash basis.

The spin transaction is interesting and may also point to another issue that has weighed on Prospect Capital's shares. What is the portfolio worth in a transaction? It is not insignificant because the CLO book represents 17% of Prospect Capital's $6.6 billion investment portfolio and 30% of its $3.7 billion of net asset value. As of March 31, the CLOs fair value exceeded the cost basis by about 4%. Bock stated during the Feb. 5 call that CLO equity was trading 6 to 8 points lower, although this seemed to be a general observation rather than a reference to specific broker quotes for Prospect Capital's portfolio.

Prospect Yield's N-2 notes that its and Prospect Capital's board of directors will approve the fair value price at which the transaction will occur. The rights will be traded on Nasdaq Global Select Market. So price action in the rights prior to their expiration and then in the shares of Prospect Yield may reveal a lot about the value of the CLO portfolio — provided the board approves a value that is not too different from where it was carried at March 31. Alternatively, I assume the boards could determine the fair value at the time of the transaction is materially lower or higher than the March 31 mark.

The market may suspect there is a gap given the size of the portfolio and Prospect's discount to net asset value. Plus, the credit cycle is aging, and CLOs by definition are levered investments both in terms of the underlying loans and the tranched capital structure employed to fund the assets. Working in the company's favor are the narrowing credit spreads over the past few months. The option-adjusted spread on B-rated high yield loans as tracked in the BAML high yield index has narrowed about 100bps since Feb. 1 through June 11. Also, the CLO portfolio produces a high yield, much of which should flow through to shareholders as dividends after management fees and other expenses provided some exogenous shock does not cause today's low default rates to quickly climb.

In any event, Prospect Capital's CLO "spin" is going to be an interesting transaction to watch in terms of how the market values a focused portfolio. As I noted in the BDC post earlier this year, investors tend to question much less when asset values are appreciating. It is a trickier proposition when markets become choppy or begin to decline. It is a small data point, but the transaction may tell investors something about where the credit cycle stands and if Prospect Capital is a reasonable value play.

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