Credit marks, asset yields and dividend capacity are going to get more scrutiny

By Jeff K. Davis

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I assume most reading this post – especially bank investors – missed Prospect Capital Corp.’s second quarter results that were released on Feb. 4. The company reported net investment income of 26 cents per share compared to the 27 cents consensus estimate. BDC competitor Fifth Street Finance Corp., which reported on Feb. 9, posted net investment income of 23 cents per share compared to the consensus of 26 cents. Both companies posted linked quarter declines in net asset value per share. Fifth Street cut its monthly dividend to 6.0 cents per share from 9.2 cents; its shares fell 15% on Feb. 9. Prospect Capital reduced its monthly dividend to 8.3 cents per share from 11.1 cents on Dec. 8, 2014; its shares fell 7% on Dec. 8. It has been a tough year. Fifth Street's shares have declined 25% over the past year as of Feb. 9, while Prospect Capital’s shares have fallen 23%.

More interesting than the numbers to me was the exchange between Wells Fargo analyst Jonathan Bock and Prospect Capital management during the Feb. 5 conference call. While it was not of the caliber of the years ago feud between First Union CEO Ed Crutchfield and then Donaldson Lufkin & Jenrett analyst Tom Brown, there seems to be some tension between the two. Quarterly conference calls often times are mindless exercises in which analysts ask roll-call questions about information that is clearly presented in the earnings release and PowerPoint presentation; however, the exchange between Bock and management touched on some of the issues I expect investors in financials will be considering the next few years.

One issue relates to fair value marks. Bock asked management if they could liquidate the CLO book at fair value marks, noting that CLO equity is trading 6 to 8 points lower. Prospect's CLO residual interest investments totaled $1.1 billion on a fair value basis and $1.0 billion at cost as of year-end 2014, or about 17% of the $6.5 billion investment portfolio. Management responded that it would want to liquidate the book at that mark.

Want to and can are two different things. Fair value is guided by ASC 820. It is the accounting standard for fair value, which defines value as the price received upon selling an investment in an orderly transaction to an independent buyer. It is a subjective process that involves assumptions about market conditions, multiples for comp companies, cash flows, appropriate discount rates and the like. When markets are appreciating year after year, I think the process is easier because subsequent valuations tend to validate the prior valuation as reasonable; however, when the market turns the reverse can be true too. Valuation marks in down and illiquid markets will get much more investor scrutiny. That may be where we are today for BDCs, private equity, specialty finance companies and eventually commercial banks.

Last year saw heightened volatility in credit markets, especially high yield energy credit. An additional overlay on the market is the reduction in market-making support by banks due to the Volcker Rule. Credit versus illiquidity issues are always hard to discern, especially in a volatile market. Nevertheless, Bock raised an issue that has not been on investors’ radars much in recent years as improving economic conditions and narrowing credit spreads pushed asset values, including credit, higher. With increased volatility, investors probably are going to begin to question marks applied to a broad range of level 3 assets beyond just energy-related credits.

During the quarter Prospect Capital realized $133 million of net losses on investments that were sold, while Fifth Street realized $18 million of net losses and recorded additional net unrealized depreciation in its portfolio. My point is not that there is an inconsistency between the two companies (the portfolios are different); rather, it is that results for companies that mark-to-market (or model) are transitioning to reflect more volatility and maybe downward pressure on a broader swath of asset values.

The dividend cuts surprised the market given the movement in the shares when the cuts were announced; however, I do not see how the cuts were a surprise with ongoing pressure on asset yields – especially given the high yield BDC portfolios produce. For instance, Fifth Street's portfolio yield for the quarter was 10.4%, compared to 7.0% as of year-end 2014 for Bank of America Merrill Lynch's U.S. High Yield Index of B-rated bonds. The impact of the Fed's zero interest rate policies (ZIRP) gradually is making its way to shareholder cash flows.

Maybe it is not a great analogy, but SNL had a recent post on Pinnacle Bank’s financing of its investment in Bankers Healthcare Group. The base interest rate is the greater of zero percent and one-month LIBOR, plus an applicable margin of 1.65% to 1.95%. I guess U.S. Bank management is preparing for the possibility of negative short-term rates in the U.S. too. BDC yields will not come close to that, but the direction is clear.

Companies can increase leverage to offset lower yields, but there is a limit to how much leverage BDCs can employ and what investors and rating agencies will accept. High payout ratio companies like BDCs are susceptible to dividend cuts. Lower payout ratio entities such as commercial banks are not as long as credit quality is okay, but future dividend hikes may be much more limited than envisioned by investors for the same reason.

And then there is the third rail of asset management that Bock questioned: fees. Bock raised the issue with Prospect Capital’s management, noting that the combined base and incentive fee increased to $57 million in the current quarter from $43 million in the year ago quarter while the NAV and dividend declined. (The portfolio increased by 34% from year-end 2013 to $6.5 billion.) Bock’s question did not go over well with management. Nevertheless, grinding pressure on asset yields that translate into lower shareholder cash flows may eventually create pressure on the industry to reduce...
management fees.

My point is not that disaster looms for BDCs and other financial service companies that utilize leverage to create spread income; that is not the case absent the onset of a deep recession. It may be that Fifth Street, Prospect Capital and other companies in a similar predicament offer an attractive risk-reward proposition now that the dividends have been cut and share prices have fallen. That said I think the Street has an inability to get its head wrapped around what years of ZIRP imply about earning power and dividend capacity if ZIRP stays with us, even if the Fed makes a token rate hike or two. Also, credit has been a one way trade since 2009 other than a few periods of volatility. Asset values and NAVs can go down too, especially in a cyclical business like lending.