BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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# Ares Capital Corp (ARCC)- 3Q20 Update
# Maintain BUY

We are maintaining our BUY recommendation on ARCC. The company beat forecasts by 1-cent, with 39-cents of core EPS. It saw its portfolio value recover to $14.4 billion vs. $14.4 billion pre-COVID for 4Q19. We still see levers available to drive EPS higher. ARCC is sitting at Debt/Equity of 1.10x. ARCC can get to 1.25x. Every 0.05x addition is worth about 1.1-cents per quarter in core EPS. Also, the yield can improve further. Every 10bp of net yield is worth 0.9-cents in core EPS per quarter.

- **The Libor Floors are kicking in for yield.** ARCC has an average of 1.1% floors on its floating rate investments. Floating rate is 83% of the portfolio and 70% overall has a Libor Floor, which is currently at 22-bp. Plus, newer loans have been made at higher spreads and some of existing portfolio saw adjustments that boosted rates. **Average yield on the portfolio ticked up 20bp on 3Q vs 2Q and 1Q. They are getting better yield on new deals on companies with lower leverage to EBITDA.**

- **The portfolio value is recovering. Much of their focus has been in growth areas like software and health care. In the quarter, portfolio companies moving up in the ranking scale out-numbered declining securities 3:1.** Other stats point to improvement as well:

    - **99% of contractual interest due was collected in the quarter** – investors in these deals have backed the companies who owe ARCC where needed.

    - **Liquidity has continued to improve** as more companies in the portfolio have paid down their revolvers with ARCC:

| | 3Q20 | 2Q20 | 1Q20 | 4Q19 |
| --- | --- | --- | --- | --- |
| Revolvers Available | $2,002 | $1,945 | $2,083 | $2,009 |
| Revolvers Drawn | $534 | $685 | $921 | $460 |

- **The number of new amendments fell 60% in 3Q from 2Q**. These 3Q amendments were characterized as less serious issues by the CEO. Also, the CEO noted that he believes ARCC has identified and addressed all the companies with COVID/Economic problems.
- Their larger companies are showing greater earnings stability and **the market has switched from risk management to growth opportunities for these businesses**.

- **Two earnings trends that move inverse to each other could become more of an earnings tailwind going forward.**

  - **When the economy is slow and there are more loans that require amendment – ARCC sees its "other income" increase clients pay additional fees.** In most quarters this is about $7-$8 million or 1.9-cents in EPS. In 3Q, it was $23 million or 5.4-cents in EPS – or what should be an unsustainable 3.5-cents in EPS.

  - **Moving inversely to this income source is "capital structuring fees" which occur with new loan commitments.** These rise when ARCC is making more loans and are generally about 1.8% of new loans. These can be $40 million per quarter or 9.5 cents in EPS. In 3Q, these fees amounted to only $12 million or 2.8 cents in EPS, for a 6.7-cent headwind.

  - **Net/net – ARCC EPS suffered by more than 3-cents in the give-n-take of these two income sources and still beat forecasts in 3Q**.

  - With new loan activity at less than one-third 2019 levels in 3Q at $706 million vs. $2.4 billion in 3Q19, ARCC is talking about new deals picking up. In the first 21 days of 4Q, it had commitments for $409 million of new loans. They appear on pace to exceed 3Q levels and that could boost capital fees as adjustment fees decline.

# Explanation of EQ Rating Scale

| | |
|---|---|
| 6- "Exceptionally Strong" | Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises |
| 5- "Strong" | Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods. |
| 4- "Acceptable" | Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement |
| 3- "Minor Concern" | Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future. |
| 2- "Weak" | Indicates the company's recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears. |
| 1- "Strong Concerns" | Indicates that the company's recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely. |

In addition to the numerical rating, the EQ Review Rating may also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into the next quarter. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

**Key Points to Understand About the EQ Score**

**The EQ Review Rating is much more than a blind, quantitative scoring method**. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

**The EQ Review Rating is not comparable to a traditional buy/sell rating**. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

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