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Ares Capital Corp (ARCC) -3Q18 Update

ARCC beat forecasts by 5-cents per share in the quarter. Much of this was due to rising interest rates. The company's earnings are sensitive to LIBOR, with every 100bp of increase adding about 17-cents to EPS per year or just over 4-cents per quarter. The cushion on the new increased dividend has improved:

	3Q18	2Q18	1Q18	4Q17	3Q17	2Q17
Core EPS	$0.45	$0.39	$0.39	$0.38	$0.36	$0.34
Dividend	$0.39	$0.38	$0.38	$0.38	$0.38	$0.38

While EPS may be lumpy and not grow in every quarter, we did not see any new problems with the quarter and think the long-term potential is still here. The large cash balance coming out of the quarter due to exiting a large investment in 3Q may be small a 4Q headwind depending on how quickly the excess cash can be deployed as it earns very little compared to a traditional debt or equity deal for ARCC. We think the dividend has much further to rise as ARCC grows its portfolio and boosts its income. Under the tax rules for a BDC – it needs to distribute at least 90% of its income so higher income should mean rising dividends. We still see this company as undervalued with a solid growth plan based four key points:

- Maintaining a positive bias for earnings to grow if interest rates increase.
- Boosting Debt/Equity from the current 0.54x to 0.9-1.25x over the coming years without raising new capital. That should also boost EPS.
- Focusing on growing investments and yield-producing investments, while maintaining safety. Investing in growth may create more opportunities to invest further.
- Capitalizing on its sheer size of being the largest player in the BDC sector and experience with customers to avoid the brunt of competitive pressure.

Bulk of the ARCC's Portfolio is Floating Rate

After 3Q18, ARCC noted that the total portfolio is 83% floating rate, 6% fixed, and 11% equity. It added $1.9 billion new investments with 97% being floating and exited $1.9 billion in investments where 80% were floating rate. Also, the bulk of the floating rate loans have interest rate floors as well.

CEO Kipp DeVeer called this portfolio design as a key for 3Q earnings growth:

> *"Our core earnings were $0.45 per share, a 25% increase over the same period a year ago. The improved earnings were driven by higher total portfolio yields as* ***we benefited from continued increases in LIBOR*** *and stronger fee income."*

CFO Penni Roll confirmed that earnings will see solid gains if rates continue to rise:

> *"For example, using our balance sheet at September 30 and assuming* ***a 100 basis point further increase in LIBOR, our annual GAAP earnings are positioned to increase by up to approximately $0.17 per share."***

Debt to Equity Ratio Is Expected to Grow

In our August 16, 2018 report on ARCC, we modeled that boosting the company's portfolio by $500 million adds about 1.0-1.5 cents per quarter to EPS (4-6 cents annually based on the interest spread realized between 5%-8%). That assumes each $500 million is done 100% with debt. Investing $500 million in cash without debt should be a larger source of EPS growth.

The company wants to add leverage to the portfolio over the next three years. Currently, the debt/equity ratio net of $0.8 billion in cash is only 0.54x. The goal is to reach 0.90x-1.25x with more leverage without raising new equity.

With equity at $7.3 billion, ARCC could put $0.5 billion of cash to work and add another $1.0 in debt to boost the portfolio by $1.5 billion and the debt/equity ratio net of $0.3 billion in cash would still only be 0.75x. However, $1.5 billion adds 12-18 cents per share annually.

This plan will be lumpy as new commitments are netted against returned capital. Historically, ARCC only closes about 4% of deals it looks at in any given year. Also, in recent years the acquisition of American Capital resulted in ARCC selling many of those acquired assets that came with low or no yield and redeploying the capital. In the 3Q, ARCC realized a large investment that resulted in a $324 million gain. It also helped drive total realizations to $1.9 billion.

	3Q18	2Q18	1Q18	4Q17	3Q17
New Commitments	$1,924	$1,619	$1,792	$1,506	$1,546
Exit Commitments	$1,914	$2,200	$1,342	$1,321	$1,644
Net Debt/Equity	0.54	0.57	0.69	0.66	0.64

There is probably one more quarter before this Net Debt/Equity starts to rise noticeably again. ARCC noted that it probably has about $350 million of non-core assets from the American Capital deal it would like to move out of the portfolio and redeploy the assets. From October 1-24, it made $412 million in new deals and exited another $389 million. The CEO also guided that they would need to have a backloaded 4Q as with the holidays not much usually closes after mid-December.

After 4Q18, we expect the ratio to increase as repositioning the American Capital assets ends. Also, ARCC finished amending their bank facility documents to operate with lower total assets to debt ratios which allows ARCC to take advantage of the new higher leverage rules allowed for BDCs. The backlog of investments is $1.46 billion as of October 24.

We also take comfort that much of the reason the net debt to equity ratio is so low is the cash balance is abnormally high at $800 million following some exit realizations in the quarter. Cash is a drag on earnings as it earns very little and gives ARCC a huge incentive to put it back to work. Simply putting $500 million in cash back to work would add to EPS and only move the ratio back to 0.61x. Also, the ratio was 0.69x only a few quarters ago, so getting above 0.7x does not look unrealistic to us for early 2019.

The other reason we are optimistic is ARCC is several times bigger than all the other publicly traded BDCs. They also have more experience and know many more companies well than most of the competitors that started up after 2009. This allows them to look for larger deals and there is less competition in that area, so they are more likely to win the business. According to the CEO:

> ***"In today's competitive market, we're able to differentiate ourselves from the competition by writing large-scale commitments and delivering certainty with our***

significant final hold capabilities. We also utilize our long-standing relationship to take advantage of our sizable portfolio of incumbent borrowers. And finally, the flexibility of our capital remains a tremendous advantage. We continue to remain very selective on new deals, as evidenced by the fact that we closed just 3% of the transactions that we reviewed for new companies in the third quarter, just running below our average close rate since 2010 of just over 4%.

And it's an indication that we're being even more selective in today's environment. We also continue to invest in larger companies as our capital base provides us opportunity to be relevant with larger middle market borrowers. The weighted average EBITDA of third quarter new commitments was over $100 million, which demonstrates how our size allows us to grow with our best borrowers and to be meaningful to larger, more established companies in transactions where we find compelling risk-adjusted returns."

We Are Not Seeing Erosion in Portfolio Quality

	3Q18	2Q18	1Q18	4Q17	3Q17	2Q17
Avg EBITDA	$92.9	$82.4	$76.5	$62.2	$65.9	$70.1
LTM EBITDA Growth	6%	7%	7%	6%	4%	5%
1st Lien Sr. Secured	44%	40%	42%	44%	41%	25%
2nd Lien Sr Secured	30%	30%	30%	32%	35%	33%

The portfolio is not only generating more income with higher yields, the companies are also seeing solid growth with y/y EBITDA gains of 6%-7%. The companies are getting larger as shown in the move from the low $60 million in EBITDA to over $90 million. And, ARCC is getting a higher percentage of 1st Lien Senior Secured loans. The company was specifically asked if there is any deterioration in loan terms – is it a borrower's market. The CEO noted that smaller loans where there is more competition, that is more likely to happen. However, with its focus on larger deals and experience with the borrowers that has not been an issue. Nonaccrual loans have been flat for several quarters at 2.7% of the portfolio.

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