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Ares Capital Corp. (ARCC) 3Q19 Update
Maintain BUY

We are maintaining our BUY recommendation on ARCC. There are several positives and some negatives that are coming out of 3Q19. Overall, we still believe this company has ample room to both pay the current dividend and expand it. The underlying companies that ARCC is financing continue to grow and ARCC believes it can continue to put more money to work without stretching its credit quality. In the 3Q19, the underlying businesses in the portfolio grew EBITDA at 3% y/y. That comes against a tough comp of 6% growth the year before. We believe the 3% still represents a solid growth figure, where historic growth has been about 4%.

- Core EPS of $0.48 easily outpaces the dividend of $0.40 plus the additional $0.02 per quarter of additional earnings being distributed in 2019. That should set the company up for additional dividend growth.

- The $0.02 per share in additional quarterly dividends in 2019 may increase in 2020. The $0.02 amounts to $34 million of additional distributions. After the 2018 tax return, ARCC determined that spillover income from 2018 that has not been distributed is $343 million or $0.80 per share.

- The leverage ratio is rising and is now at 0.89x – which is the low-end of what ARCC wants to achieve of 0.9x-1.25x on a debt to equity basis.

- Lower LIBOR plus a push toward more first-lien senior-secured financing combined to lower yield by about 50bp in the quarter. Financing costs did not fall as rapidly due to some fixed-rate debt. Overall, rising rates help more than falling rates. However, there are interest rate floors on many of the loans where the yield will not decline as much while most of the floating rate financing has no floors for ARCC. Thus, falling rates may have less of an impact going forward.

- The 10-quarters of waiving $10 million in quarterly management fees (about 2-cents per quarter) have ended. This was set up when ACAS was purchased in 2017 and had a large percentage of non-yielding investments. ARCC has transitioned the bulk of that acquired portfolio into yield during the period of lower management fees and that process is now complete.

- Spreads on loans in the market have increased off the lows. The St. Louis Fed shows the spread at just over 4% vs. the low 3% range a year ago for high-yield debt. Also, spreads in retail and energy have risen much higher – where ARCC has very little exposure. The company is seeing signs that better terms and documentation are returning to the market.

- ARCC and the BDC market is now petitioning the SEC to gain relief from investors having to report double management fees in the expense line if they own ARCC. Essentially, this would treat ownership in ARCC more like a regular stock instead of a portfolio. This would be another catalyst for the stock as it could open up ownership of BDCs to index funds and other large mutual funds. As the largest BDC, we think ARCC would benefit the most from opening the size of the potential ownership pool and could push the stock price higher if this change is successful.

Current Situation with Changes in the Quarter

ARCC continues to grow its portfolio without raising equity, which is pushing up the debt/equity ratio as planned. 3Q19 saw it increase to 0.89x. Core income has exceeded the dividend even with the additional $0.02 per quarter for 2019.

	3Q19	2Q19	1Q19	4Q18
Core EPS	$0.48	$0.49	$0.48	$0.45
Distribution	$0.42	$0.42	$0.42	$0.39
Debt/Equity	0.89	0.77	0.79	0.69
Yield on Portfolio	9.8%	10.4%	10.4%	10.2%
Inv. Income	$387	$382	$373	$345
Financing Cost	$76	$69	$67	$60
Base Mgt Fee	$52	$50	$49	$45

If there is an issue, it is that the company is seeing falling LIBOR push down yield on the portfolio. This was very noticeable in 3Q. The company attributes this coming from both

falling LIBOR for about 20bp and boosting quality in loans in the quarter for about 30bp. In the quarter 90% of new loans funded were first-lien senior-secured. We are not going to question that effort to boost credit quality. Since quarter end, 90% of loans in October have also been first-lien senior-secured.

The emphasis on floating rate loans clearly took a toll in the quarter. Even with the portfolio growing, interest income rose only $5 million sequentially while the financing costs rose $7 million. Also, the larger portfolio led to higher base management fees as well.

ARCC may not see the movement continue at the same level. First, most of the loans have interest rate floors on them and will not see much more downward movement. At the same time, the variable-rate financing does not have floors and could fall more than rate on loans. The company is still set up nicely should rates increase to see faster growth in income. ARCC reported the following sensitivity analysis:

	Interest Income	Interest Expense
300bp +	$365	$55
200bp +	$243	$37
100bp +	$122	$19
100bp -	-$117	-$18
200bp -	-$141	-$37
300bp -	-$142	-$37

The squeeze of falling rates has an end to it, while higher income from rising rates continues to have upside increase.

On top of that, there is a spread where loans trade vs. treasury bonds. This has widened from multi-year lows of about 3.5% in 2018 to about 4.1% now according to the St. Louis Fed's High-yield bond tracking figures. There have been periods of late where the spread has reached 4.5% too. Problems with debt in the energy and retail sector have been the primary culprits for this spread widening.

Historically, the warning sign has come when the spread is over 8% so we do not consider 4% a red-flag. The market is simply viewing 4% vs. 3.5% as a negative trend, but it is hardly out of line with history. ARCC's focus on boosting credit quality is something we view as a positive especially given there remains room to still boost the dividend.

ARCC noted that as the spread has widened and hurt some of the more leveraged players in the field, it is causing some funds to pull back. That is good for ARCC as it can be pickier about loans it makes. At the same time, it is starting to see more discipline on loan terms which also boosts safety.

Other Changes to Watch

3Q19 was the last quarter where the management fee will be reduced by $10 million. This was part of the deal when ARCC bought American Capital – which had a large equity portfolio. The goal was to transition out of non-income producing securities into ARCC's style of producing yield. During that transition, the management fees were cut by $10 million for 10-quarters.

This is a 2-cent expense that will rise and lower GAAP EPS going forward. This was an expected change and over the 10-quarters, ARCC has seen core EPS rise noticeably above the distribution. Core EPS was $0.32 in the 1Q17 following the acquisition and is now $0.48.

A BDC must distribute a minimum of 90% of its income to shareholders to remain a tax-free vehicle. It can also avoid a 4% excise tax if it distributes 98% of ordinary income and 98% of capital gains. GAAP earnings have been exceeding the regular $0.40 dividend in most periods by more than 90%. ARCC noted on the call:

> *"Following the filing of our 2018 tax return, we determined that our final taxable income spillover from 2018 going into 2019 was $343 million or $0.80 per share, which provides us with a significant amount of undistributed earnings. Given the amount of spillover coming into 2019 combined with our year-to-date 2019 core earnings in excess of dividends paid, we believe we will continue to be in a strong undistributed taxable income position at the end of this year."*

We believe this is a good sign that the dividends will continue to rise from ARCC.

When we first wrote ARCC it was based on the catalyst of the government changing the rules around BDC leverage and boosting the cap from 100% of equity to 200%. We believed this would create growth without raising equity and the larger portfolio would result in higher EPS and higher dividends.

Another change is being pushed in 2019 too. This one would modify the rules of funds who buy BDCs to report their share of the BDC's management fees as an expense item on their own fund. The proposed change would eliminate that separate expense item and make BDC's more attractive to own. It is also believed it would effectively reduce the cost of equity capital for BDCs by raising their stock prices if the pool of potential owners could be increased. As the largest publicly traded BDC – ARCC would stand to benefit if it was allowed to be included in index funds and other large funds could more easily add BDC exposure to their portfolios.

There is no timeframe on when something could happen here if it does at all – but valuing the dividend at ARCC at even 6% or 7% would move the stock into the mid-$20s.

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