BEHIND
THE NUMBERS
Quality of Earnings Analysis

February 12, 2021

Jeff Middleswart
jmiddleswart@btnresearch.com

Bill Whiteside, CFA
bwhiteside@btnresearch.com

www.btnresearch.com

Ares Capital Corp. (ARCC) Earnings Quality Update

6- Exceptionally Strong
5- Strong
4- Acceptable
3- Minor Concern
2- Weak
1- Strong Concern
+ quality improving
- quality deteriorating

We discontinue our BUY rating on ARCC and initiate earnings quality coverage with a 5- (Strong) rating. We are moving all our buy/sell ratings to earnings quality coverage and will use our quarterly Focus List to communicate top long ideas and sell recommendations. Note that we do see reduced upside for ARCC with the company selling above book value and the Q4 performance likely difficult to duplicate in the near-term.

For an explanation of the EQ Review Rating scale, please refer to the end of this report.

Summary

ARCC had a blow-out 4Q with core EPS coming in at 54-cents vs. the dividend of 40-cents. The problems in 2Q and in 3Q were reduced gross fundings of $867 million and $706 million. That in turn lowered capital structuring fees to only $16 and $12 million. Net investment income and capital fees only produced 39-cents in core EPS in those quarters. That rebounded strongly for 4Q results:

Core	4Q20	3Q20	2Q20	1Q20	4Q19
Gross Commitments	$3,868	$706	$867	$1,272	$1,608
Invest. Income	$136	$154	$151	$148	$152
Inv. Core EPS	$0.32	$0.36	$0.36	$0.34	$0.35
Capital fees	$93	$12	$16	$28	$38
Cap fees Core EPS	$0.22	$0.03	$0.03	$0.07	$0.09
Total Core EPS	$0.54	$0.39	$0.39	$0.41	$0.43

- 4Q20 saw a higher level of incentive fees liked tied to the huge commitment level and higher fees that we estimate cut core EPS by about 3-cents.

So a regular quarter is essentially 35-36 cents in investment income net of expenses and 9-10 cents in capital fees for a core EPS of about 45-cents against a dividend of 40-cents. Even ARCC admits it is unlikely to do $3.9 billion in new investments in a quarter going forward. That's the first reason we are moving ARCC to a Neutral.

The second reason for moving to a Neutral rating is the company is trading above book value. That is rare for a BDC and it can only issue stock when the stock is above book. Book ended at $17 and ARCC announced a secondary for 13.5-15.5 million shares (about a 3.2-3.7% increase in the share count) after the 4Q earnings call at over $18. As we will discuss below – this offering looks opportunistic for future growth, but it probably reduces the potential for much capital appreciation in the near future for the stock and investors will need to be satisfied with the nearly 9% cash yield, which we consider solid.

What is strong?

- Investors should remember that ARCC bought back $100 million in stock at the start of Covid for under $12 per share. That was about a 25% discount to impaired book value at the time. That also reduced total dividends by about $13 million per year during Covid. It is now issuing about 3-4% new shares at $18 and a 10% premium to book that already rose 9% off the low. When many other companies refuse to buy when shares are cheap and cannot wait to buy when their shares are expensive – it is nice to see a company follow basic investment philosophy of buy cheap and sell dear.

- Interest income may have some drivers to boost income going forward. First, not all the new deals were in place for the whole quarter. Thus, interest income rose 5% from 3Q but the portfolio rose by 8%. If both had grown (along with interest expense) by the 8% figure, ARCC would have realized another 2-cents in EPS in 4Q. The average yield is also rising about 10bp. There are about 84% of investments listed as floating rate and 84% of those have Libor floors of 1.1% so rates can rise and likely not fall much at this point.

- ARCC is still set up to benefit from rising interest rates. When rates are more normalized – a 10bp bump in yield is worth about 1-cent in core EPS per quarter. At the same time, ARCC has locked in some more financing on fixed-rate notes at 2.15% so funding costs should not rise as quickly as investment yields.

- There is still about $1.07 per share in spill-over income. This is earned income that ARCC needs to pay out over time and views it as a way to support the 40-cent dividend in volatile or weak periods for results. It is also possible, ARCC could declare more special dividends as it did in 2019 adding 2-cents per quarter to the regular payout.

- Stats on the portfolio look strong. Non-accruals peaked in 3Q at 5.1% and are now 3.3% of the portfolio. These investments have already been marked down to 58% of cost. Average EBITDA for the companies rose 5% y/y in 4Q. Many of the companies being funded now had lesser Covid issues and are still growing. Many are long-time customers who ARCC is familiar with. It has seen stronger covenants and terms and it is dealing with larger and more established companies overall – the average EBITDA is $156 million up from $99 million two years ago. The Loan-to-Value ratio is about 50%. 4Q saw ARCC collect 99% of scheduled interest too. It is now known that private equity investors in many of these deals were willing to support the companies during Covid too.

What is weak?

- Much of what we see at ARCC at this point for weak points are more of an issue of they will have a tough time duplicating the level of business in 4Q. Even the CFO noted that there were deals being worked on through 2020 that finally closed in 4Q along with other deals that may have happened in 1Q21 that were pulled into 4Q. He highlighted that the backlog is about equal to last February pre-Covid, but that's not enough to reproduce the 4Q results.

- Debt to Equity ended the quarter at 1.17x net of cash. ARCC wants to remain between 1.0-1.25x, so there is less room to grow that ratio at first glance and expanding investments paying 9% with 2% debt is how income grows for ARCC. We would note that the company's stock offering should raise $240-$270 million which would add to equity and lower net debt and should push the ratio below 1.1x.

- Issuing shares has some downside in that it will add $25 million to the total dividend pay-out per year at 40-cents per quarter. That could have been used to grow the current dividend by 1.5 cents per existing share. Plus, the cost of equity capital is about 9% for ARCC vs. 2% for debt. That is expensive if it is not put to work quickly. From the comments on the call, ARCC's team is excited about the outlook to grow, but 1Q volumes should be much lower and it may take longer to put this new money to work and boost the debt/equity ratio again. The higher share count would have cut about 2-cents off core EPS in the quarter assuming it is not employed quickly. That is not a deal-breaker for the

dividend by any means – but it does point to perhaps less capital appreciation potential at this point.

- Ultimately, capital appreciation on ARCC may require the new equity be put to work and at a debt/equity ratio closer to 1.2x. That would drive core EPS higher and perhaps lead to dividend growth.

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 Concern)- 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 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 upcoming quarters. 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.

Disclosure

Behind the Numbers, LLC is an independent research firm structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. All research is based on fundamental analysis using publicly available information including SEC filed documents, company presentations, annual reports, earnings call transcripts, as well as those of competitors, customers, and suppliers. Other information sources include mass market and industry news resources. These sources are believed to be reliable, but no representation is made that they are accurate or complete, or that errors, if discovered, will be corrected. Behind the Numbers, LLC does not use company sources beyond what they have publicly written or discussed in presentations or media interviews. Behind the Numbers does not use or subscribe to expert networks. All employees are aware of this policy and adhere to it.

The authors of this report have not audited the financial statements of the companies discussed and do not represent that they are serving as independent public accountants with respect to them. They have not audited the statements and therefore do not express an opinion on them. Other CPAs, unaffiliated with Mr. Middleswart, may or may not have audited the financial statements. The authors also have not conducted a thorough "review" of the financial statements as defined by standards established by the AICPA.

This report is not intended, and shall not constitute, and nothing contained herein shall be construed as, an offer to sell or a solicitation of an offer to buy any securities referred to in this report, or a "BUY" or "SELL" recommendation. Rather, this research is intended to identify issues that investors should be aware of for them to assess their own opinion of positive or negative potential.

Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them may have a position in, and from time-to-time purchase or sell any of the securities mentioned in this report. Initial positions will not be taken by any of the aforementioned parties until after the report is distributed to clients, unless otherwise disclosed. It is possible that a position could be held by Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them for stocks that are mentioned in an update, or a BTN Thursday Thoughts.