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Ares Capital Corp. (ARCC) - 4Q19 Update
Maintain BUY

We are maintaining our BUY recommendation on ARCC after a continuation of the same issues from 3Q and a yield of 8.4%. The $10 million per quarter management fee waiver is over and that cost ARCC about 2.3 cents in 4Q19 vs 4Q18 and is largely why core earnings declined from 48-cents to 45-cents.

There are pluses and minuses here. **We still believe that boosting the total Debt/Equity ratio over 1.0x will drive EPS higher and in turn, cause the dividend to increase.** Essentially, the ratio is 0.95x and every $400 million increase in the portfolio funded entirely with debt boosts that ratio by 5bp.

ARCC is earning about 9.6% on investments and paying 4.5% in interest for a spread of 5.1%. Every $400 million increase in the portfolio then generates about $5.1 million per quarter and management fees will lower that to about $3.5-$4.0 million. **That is 0.8-0.9 cents per quarter in EPS for every $400 million increase and the goal is to move closer to 1.25x from 0.95x.** We think conservatively, ARCC could see about 2-3 cents per quarter in higher EPS before the end of 2020.

Here are the current issues:

Falling LIBOR – It fell 74bp through 2019 and 78% of the investments are floating rate. Here are the pluses and minuses:

- Plus – the bulk of these investments have a 1.1% floor in place and if Libor continues to fall, eventually funding costs will decline more than investment income.
- Plus – New investments are seeing higher floors of 1.3% and some existing loans are being reworked to raise the floor too.

- Plus – If Libor does increase – ARCC has a built-in hedge against rising rates as some of its financing is fixed and the investment income will rise.
- Minus - Libor would still need to decline further to hit the floors so declining rates are still pressuring yields.
- Minus – the current decline has already cost ARCC about 1-2 cents per share in EPS in 3Q19 and 4Q19.

Dividends – The company has to distribute 90% of its income and can avoid excise taxes by distributing 98% of ordinary income and 98% of capital gains:

- Plus – ARCC covers its 40-cent quarterly dividend now with core earnings of 45-cents.
- Plus – It has 95-cents per share of spillover income that grew from 80-cents at the end of 2018. That represents additional income that will likely need to be paid out as dividends.
- Plus – ARCC has a history of paying supplemental dividends as well as boosting the dividend. The regular dividend has grown by 2-cents per quarter recently and the company paid 2-cent additional dividends each quarter of 2019.
- Minus – ARCC is watching the Libor situation for it to turn up before announcing more additional dividends.
- Minus – 2020 may see smaller total additional dividends than 2019 and any that are announced could be backloaded.

How Fast Can the Portfolio Grow and Produce Higher EPS?

- Plus – ARCC is the largest player in this group and has the longest tenure. That allows it to look at larger deals and it also means that it has experience with many of its portfolio companies going back many years. Current portfolio companies are over half of new investments.
- Plus – The company sees a larger pipeline of potential investments and that continues to grow. Current companies continue to see growth in EBITDA y/y of 3%-4% in most quarters.
- Plus – ARCC is picky and only closes about 4% of the investments it looks at.
- Minus – Being picky means ARCC doesn't plan to ramp up the portfolio size in a hurry. The goal was to get closer to 1.25x over 3-years and management admits they are behind plan at 0.95x at the end of 2019.

- Minus – Competition in the BDC space has grown too and those other companies are also boosting leverage. ARCC has noted in several recent quarters that there more deals being done with lighter covenants and tighter pricing. ARCC continues to focus on better quality and passes on those more aggressive loans.
- Minus- Being the largest means ARCC needs more investments to grow the portfolio meaningfully vs. some of the smaller competitors.

Without trying to time this quarter to quarter – we see that investors are getting paid 8.4% to wait for more of this play out after the first year of rising leverage and dividend growth. Bottoming Libor should start to reverse the earnings headwind of falling rates and start to grow EPS at a faster rate – or floors should eventually help too. EPS should also grow via the longer-term plan to boost the leverage ratio. There is a sizeable amount of excess earnings that will need to be distributed too. With three ways to grow the yield, getting this to a 10% yield would only require about 8-cents in additional dividends per quarter. Libor reversing to the start of 2019 is 1-2 cents, boosting the leverage for the portfolio to 1.1-1.15x equity would add about 2-3 cents as well, and 90-cents of undistributed EPS is 3-cents per quarter for 7.5 years.

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