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Ares Capital Corp. (ARCC) – 4Q18 Update

ARCC had a strong 4Q despite market volatility during the quarter. The company reported core EPS of $0.45 ahead of forecasts by $0.04. Assets at work increased and the company boosted its dividend again to $0.40 per share per quarter. It also added a special dividend of $0.08 that will be paid as $0.02 per quarter during 2019. The CEO highlighted several of the catalysts we listed in previous reports as working to boost results:

> *"With higher LIBOR, higher aggregate portfolio yields attained with the substantial completion of the American Capital portfolio rotation, and limited credit issues; we believe the company has reached a higher level of sustainable recurring earnings."*

The stock repurchase plan was expanded from $300 million to $500 million. The trend still looks very favorable to grow the earnings without raising new capital and in turn passing through more dividend growth on a base yield that is already 9.3%. We maintain a BUY recommendation.

- The assets on the balance sheet should continue to rise and drive Core EPS. The rotation of American Capital assets is largely over which boosted exited investments for many quarters. Floating rates still provide higher earnings if interest rates increase. The leverage ratio is rising but remains below goal.

- ARCC is by far the largest BDC and simply has less competition too than smaller BDCs and passively indexed funds or those that must be managed for liquidity.

- Asset quality is improving – volatility like that seen in 4Q pulls funds away from the market and shifts it to be more favorable toward lenders

- Investment portfolio continues to see strong EBITDA growth from underlying companies, along with floating rate terms, and largely first lien/senior secured terms

- Path to higher core EPS and Dividends over next 2-3-years looks doable. A rising 9.3% dividend with potential capital appreciation trading for book value should be appealing in our view

Investment Assets are Rising and Security Yields Exceed 10%

Since early 2017 when ARCC closed on the American Capital acquisition, it has been rotating out of the low/non-yielding assets that came with American Capital, realizing gains, and reinvesting into assets with better yield. The yield on the total portfolio has risen from 8.1% in 1Q17 to 9.0% in 4Q18. For the income-producing securities, the yield has increased from 9.1% in 1Q17 to 10.2% in 4Q18. That rotation made it tough to keep money at work as exits were often as large as new commitments. Plus, there was a lag between completing exits and putting money back to work. In 4Q18, the company announced the exits from American Capital are essentially done:

> *"Throughout the year, we used the strong demand for private assets to largely complete the rotation of the acquired American Capital portfolio, to monetize gains, and to reinvest the proceeds into our core assets. Our rotation of the American Capital portfolio is now largely complete, in what was a successful acquisition by any measure for our shareholders.*
>
> *Since our purchase of the American Capital portfolio at the beginning of 2017, we've generated investment income as well as $426 million of net realized gains on exited investments, which results in a 37% realized IRR from the transaction. Of the $2.5 billion portfolio acquired, only $683 million at fair value remains, most of which we consider to be core assets. At this point, we will likely provide less robust updates on American Capital as that story is largely complete."*

And that has enabled net investments to finally grow:

	4Q18	3Q18	2Q18	1Q18	4Q17	3Q17	2Q17	1Q17
Gross Commitments	$2,709	$1,924	$1,619	$1,792	$1,506	$1,546	$1,973	$864
Exits of Commitments	$1,021	$1,914	$2,200	$1,342	$1,321	$1,644	$1,792	$836
Net change	$1,688	$10	-$581	$450	$185	-$98	$181	$28
Investments	$12,417	$11,220	$11,527	$12,199	$11,841	$11,456	$11,498	$11,407

The limit for BDCs is currently 1.0x Debt/Equity. They want to keep some cushion so an increase in loss rates on investments doesn't drive the ratio above 1.0x. Thus, 0.8-0.9x is a common goal. In June the new rules kick in where BDCs upper limit rises to 2.0x Debt/Equity.

With the heavy rotation of assets, ARCC was continually operating at a below target leverage ratio.

	4Q18	3Q18	2Q18	1Q18	4Q17	3Q17	2Q17	1Q17
Debt/Equity	0.73	0.63	0.64	0.73	0.70	0.67	0.70	0.67
Net of Cash	0.69	0.54	0.57	0.69	0.66	0.64	0.64	0.64

The company is still at the low end of its current target range before the new rules take effect. Thus, it is possible to grow the leverage range to 0.75-0.85x in the next couple of quarters. Ultimately, the company's goal is to operate in a range of 0.90-1.25x from mid-2019-2021. The key point is with the rotation over, more efforts can be made to keep money at work and generating returns. The second point is leverage is still below optimal levels and that should also continue adding to earnings.

The pipeline for future deals stands at $1.4 billion. That compares to $710 million after 2Q18, and $505 million after 4Q17. That bodes well for a rising portfolio size too. The company also noted that it is working on more buy and hold situations with large private equity players who look to lock up their financing and let the businesses grow for a long time as opposed to trying to flip them quickly. That also would bode well for slowing portfolio turnover.

Finally, while ARCC believes interest rates have paused for now, higher rates over time would help results. In the 4Q18, 97% of new investments were floating rate securities vs. exits that were 82% floating rate. The total portfolio stands at 85% floating, up from 78%-79% earlier in 2018. A few quarters ago, with a smaller portfolio and a lower percentage of floating rate securities, ARCC forecast that 100bp of higher LIBOR added 17cents to EPS per year. Given where the situation stands, that 17 cents should be a bit higher too.

Size and Flexibility Still Gives ARCC a Competitive Edge

We have highlighted that ARCC and STWD both benefit from years of banking regulations pushing banks out of many traditional areas of lending. Here was another reference to that on the last conference call:

> *"I'd love to engage in buy and hold deals with a couple of folks. We did one of those with a few of our competitors that was publicly announced, that entailed a $1 billion-plus type transaction. That in the old days is a bank deal, right. In this world, because it was a take private it was a three-handed club between ourselves and two other substantial players in the market."*

Looking at the full BDC market – ARCC is $7.3 billion in market cap. Of the remaining public market, there are only a couple over $2.0 billion and many are under $0.5 billion. Also, most BDCs need to raise equity capital to expand the investment portfolio. To issue equity, the stock needs to trade at or above book value – and very few do. The average EBITDA of the companies ARCC is investing in is now $99 million. That is up from $62 million a year ago.

Doing some rough math, let's say an investment has 4-5x of EBITDA in debt – that's basically $400-$500 million on an average ARCC company. Now, another BDC with an equity and market cap under $500 million leveraged 0.7-0.8x and wants a diversified portfolio – how much can they bring to a deal like this? Maybe $20-$25 million?

There are private BDCs that exist with larger asset managers that would be competitors. However, the bulk of the publicly traded ones, simply aren't large enough to compete with ARCC. Also, ARCC has an edge over many of the passive and funds that can face redemption pressure:

> *"We are not a benchmark investor, and as a matter of practice we can largely avoid cyclical industries such as retail, homebuilding, media, broadcasting, and metals and mining. And in these types of competitive markets we can also use strong market demand to optimize our portfolio and exit some more difficult situations.*
>
> *We saw that when sentiment shifts and outflows occurs, as they did rapidly in late 2018, many funds, particularly retail and passive funds, are forced to sell to meet redemptions. <u>Many retail funds and passive vehicles are structured to manage liquidity, and not necessarily credit.</u> But we believe that the big negative move that we saw in December was largely a technical event. As a result, during the fourth quarter, the broadly syndicated loan market experienced price weakness, <u>but the buy and hold middle market, where we are most active, demonstrated materially less price volatility</u>."*

There are Signs that Credit Quality Is Improving Still

As the company noted, it can avoid cyclical areas. By focusing on larger deals, it doesn't see the same level of volatility that the smaller players do. If anything, volatility pulls money out of this area and shifts lending terms to be more favorable to the lender. It has seen the percentage of the portfolio that is first lien and senior secured rise of late:

	4Q18	3Q18	2Q18	1Q18	4Q17	3Q17	2Q17	1Q17
1st Lien Sr Sec.	72%	68%	67%	47%	72%	51%	59%	74%

Also, the companies in the portfolio continue to grow. The EBITDA at the companies that ARCC is invested with rose 5% in TTM for the 4Q and that is now over two years of 4%-7% growth rates.

ARCC is dealing heavily with companies it has experience with too. This should be companies it has studied for a long time and perhaps over business cycles. Also, these are companies that likely have grown during the relationship and are likely to turn to ARCC again.

> *"During 2018, we closed on 8 billion of commitments with 113 of our 172 commitments about 65% made to incumbent borrowers. We believe our incumbent position not only enables us to grow with our best companies, but it also results in enhance portfolio performance."*

> *"We're also focusing on larger companies with more diversified business lines and stronger market positions. The weighted average EBITDA of transactions originated in Q4 was over $100 million."*

Despite the larger portfolio, the non-accrual rate declined from 3.1% to 2.5% over 2018 and declined in dollar terms as well. The leverage rate for companies is 5.4x EBITDA. In focusing on credit scores 4 being the highest and 1 the lowest – 95% of the portfolio is rated 4 (9%) and 3 (86%).

ARCC Looks Well Positioned to Grow EPS and the Dividend

The changes the company has planned out have been working for them so far as the EPS has grown faster in the last couple of quarters. This is the result of converting non-income producing securities into income-oriented investments, more floating rate securities in a rising rate environment, and finally seeing the leverage ratio start to increase.

	4Q18	3Q18	2Q18	1Q18	4Q17	3Q17	2Q17	1Q17
Core EPS	$0.45	$0.45	$0.39	$0.39	$0.38	$0.36	$0.34	$0.32
Dividend	$0.42*	$0.39	$0.39	$0.38	$0.38	$0.38	$0.38	$0.38
Net Leverage	0.69	0.54	0.57	0.69	0.66	0.64	0.64	0.64
Portfolio	$12,417	$11,220	$11,527	$12,199	$11,841	$11,456	$11,498	$11,407

*Includes 2-cents special dividend to be paid quarterly in 2019

The company isn't stopping here. They hope to grow leverage a bit more in the first half of 2019 ahead of the regulation changes that allow it to boost leverage even higher. Remember the company has a considerable backlog of deals that are running over 2-3x levels seen in recent quarters. The plan remains in place as noted on the 4Q18 call:

> *"But look, our goal is, over a two to three-year period, generally to be able to take our leverage ratio well up over one, and we think that that improves to ROE, just as a reminder that our company improves our ability to continue to pay the existing dividend, and we hope higher dividends without introducing material risk to the company less effective."*

Getting to 1.0x leverage would involve borrowing another $2.4 billion to invest in securities. Our analysis in our initial report showed that every additional $500 million is worth about 3.3-cents in core EPS per year at a 5% interest spread or 4.2-cents in EPS at the 6% spread ARCC has been posting.

On top of that, while we are not going to predict interest rate moves, we would not surprised to see LIBOR rise by 100bp over the next two years. That would add 17-cents to EPS and given that much of their funding is fixed, may help push up the interest spread ARCC earns.

Plus, ARCC is planning to repurchase $500 million of stock over several quarters. The stock is over $17 and there are 426 million shares outstanding. $500 million should be worth 25-29 million shares. For easy math, we'll assume 26 million which is a 6% decline.

The quarters should show some lumpiness depending on market conditions and speed at which this happens. But right now, quarterly EPS is $0.45. Add 6% from buying back shares makes it $0.48. Having the portfolio increase by $2 billion would keep the leverage ratio at the low-end of the 0.90-1.25x leverage goal. An extra $2 billion deployed by the end of two-years would add another 3-4 cents in quarterly EPS and make the total $0.52. Assuming 100bp of higher LIBOR adds another 4-cents per quarter and boosts the total to $0.56. There would still be room to move closer to the 1.25x leverage goal and add another $2 billion to the portfolio.

This is why we see this as a compelling story. It's a company that had a flat dividend for years that absorbed a large acquisition. The large acquisition generated a 37% IRR. Earnings and the dividend have now started to grow and the stock is flat since the changes have become obvious and still trades at book value. EPS could be set to rise another 24% over two years after already rising 15% in the last two quarters. Investors would earn a 9.4% yield, plus another 0.5% yield in special dividends. Plus, the BDC's tax rules require it to pay out the bulk of its earnings so as earnings rise, so does the dividend. So, the dividend should also be rising.

The only news item – and it came up on the 4Q call – is during the transition of the American Capital portfolio, Ares Management reduced its fees collected from ARCC by $10 million per quarter to reflect that many assets were not producing steady income. Those waivers will end in 2019. That is basically 2.3 cents per share per quarter. The key point to remember is those do impact GAAP earnings – but not Core earnings being discussed here. Core EPS also removes gains and loss and capital incentive fees related to gains and losses. It is expected to reflect the underlying income and expenses produced by the portfolio, interest expense paid, and regular management fees paid. Gains and losses still impact book value as does dividends. Book value has been steadily rising and if the company buys back shares below book value – it should add to it as well.

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