BEHIND
THE NUMBERS
Quality of Earnings Analysis

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Ares Capital Corp. (ARCC)
Earnings Quality Update- 3/21 Qtr.

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

We are discontinuing coverage of ARCC and consider the EQ to be 4+ (Acceptable). We are also removing ARCC from our Focus List where is currently rated as an On Deck Buy.

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

Summary

ARCC beat by 1-cent for 1Q21 and we saw few problems. It was known that 4Q20 could not be duplicated. That quarter saw deals that were delayed during 2020 close en masse in 4Q as well as deals expected to be complete in 1Q21 pulled into 4Q20 as well.

The company still out-earned its dividend – with 43-cents of core EPS vs. the 40-cent dividend. Capital fees have recovered to normal levels as deal flow has resumed. Normally, these fees are $30-$40 million per quarter and came in at $38 million vs. $12 and $16 million in 3Q20 and 2Q20. ARCC still has $1.04 in spill-over income that it has not paid out as dividends. This should help ensure the 8%+ dividend yield as the company can always tap this support the 40-cent quarterly dividend.

We really only see one issue going forward that ARCC needs to improve – it needs to operate at a slightly higher debt/equity ratio to boost total investment income if it wants to grow further. The ratio was down to 1.06x from 1.20 in 4Q as first quarter saw a period of heavy refinancing of in the portfolio and the size of the portfolio declined slightly. The actual portfolio companies

are growing and EBITDA growth was up 7% y/y and exposure remains high in growth areas such as software and medical.

With the stock above book value, ARCC's capital appreciation may be limited or it could look to acquire another BDC trading below book value and create value reworking that portfolio like it did with ACAS the #2 player in recent years.

Accounting quality is solid and beyond mark-to-market issues, there is not much that can create fireworks. It went through COVID fine and continues to see credits improve. We do not think we are adding much value continuing coverage at this point. Also, while ARCC's earnings benefit from rising rates given that most of its investments are floating rate and it has fixed much of its own financing – computer screens do not investigate that far. The computers will see a company with a high non-growing dividend and consider the stock likely to fall with rising interest rates.

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.

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