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Ares Capital Corporation (ARCC) 1Q19 Update
Maintain BUY

We maintain a BUY rating on ARCC following 1Q19 results that saw the company beat forecasts by 6-cents. The quarter saw a sizeable increase in new investments and the company has boosted its borrowing lines and is prepared to deal with the June 21, 2019 official change date that will allow the leverage ratio to exceed 1:1 for BDCs.

There are only two issues we saw potentially negative from the announcement: A heavy realization of investments early in the 2Q19 and an increase in Second Lien positions in the portfolio. The rest of the results looked much stronger, and in our view, continue to point to further dividend increases within the next 2-4 quarters:

- **Gross commitments came in just under $2 billion in 1Q19 and net of exits added $600 million to the portfolio. This continued a strong 4Q18 where net commitments were $1.7 billion. In the first 24-days of April, the company was repaid on $747 million against $183 million in new deals. So, the 2Q is starting in the hole.** This is normally a lumpy situation quarter to quarter, and we think it is important to realize that $500 million lower assets at work for a quarter is only worth about 1.8 cents in EPS. ARCC will likely recover part of that in the 2Q and Core EPS of $0.48 exceeds the $0.42 dividend by the widest margin ARCC has had.

- **Second Lien Senior Secured Notes jumped to 39% of new issues from the low 20% range.** Much of this is from one large deal.

- **Portfolio is still showing growth and improvement. EBITDA for investments is rising 5% y/y, non-accruals are down, and debt to EBITDA is essentially flat.** ARCC has much experience with many of these credits and avoids high-risk and cyclical areas like restaurants and construction.

- **There remains considerable room to grow EPS with a number of levers.** The backlog is still $1.1 billion and the net debt to equity ratio is still below 0.8x versus the target of 0.9-1.25x. Higher rates still drive EPS and we believe the company will look more aggressively at repurchasing shares after the leverage limit rules move from 1:1 times debt to equity to 2:1 times in late June.

Jump in Portfolio in 4Q and 1Q Helped Drive EPS

The company completed the remaking of the American Capital Portfolio a couple of quarters ago, which was a big part of above average exits from the portfolio. ARCC moved many of these deals from non-interest earning into income-producing investments. The portfolio size has finally started to increase:

	1Q19	4Q18	3Q18	2Q18
Fair Value Inv.	$13,064	$12,417	$11,220	$11,527
Avg Yield	9.5%	9.3%	9.2%	9.0%
Core EPS	$0.48	$0.45	$0.45	$0.39
Net Debt/Eq	0.79	0.69	0.54	0.57
Fundings	$1,941	$2,275	$1,907	$1,376
Net of Exits	$652	$1,253	-$3	-$754

Rolling the non-income-producing assets over can be seen in the rising yield. The smaller number of exits can be seen in the rising value of the Investment total. This is all positive in our view. With the Net Debt/Equity ratio rising over the next 12-36 months to a range of 0.9-1.25x, that should continue to help.

In the first 24 days of April at the start of 2Q19, ARCC reported that received $797 million in repaid investments or asset sales and only completed $183 million. That's a mild concern to us as it may break some of the momentum. This is always a lumpy part of the business and changes every quarter. The company is still pointing to a $1.1 billion backlog of deals it is looking at.

The company is still committed to expanding the portfolio and has focused on increasing exposure with customers it has a long history with. It called out a $273 million deal in 1Q with IntraPac that has worked with for years. The deal replaced existing banks with a financing package that can scale with the business as an example of this.

In our view, the drop in fundings less exits is mildly troublesome. It may make it difficult for ARCC to finish 2Q with a net positive figure and grow the portfolio this quarter. However, we don't want to lose sight that the portfolio is up over $1.8 billion in the last two quarters. So, a short-term pause at a high level of assets is not necessarily alarming. Second, assuming a -$500 million swing in the portfolio for the full 2Q19, that is only 1.5-1.8 cents in quarterly EPS. Core EPS is already up 9-cents in the last three quarters and comfortably exceeds the new higher dividend and special dividend of 42-cents.

At this point, it is worth following, but with book value still growing and the asset levels at high levels and the company still focused on boosting leverage ratios, we are not concerned with this potential hiccup in 2Q if it remains a short term issue.

The Surge in New Issue Second Lien Senior Secured Notes Came from One Deal

The company saw new commitments jump in the 1Q19 with more Second Lien Senior Secured Loans than normal:

Commitments	1Q19	4Q18	3Q18	2Q18
1st Lien Sr Sec.	42%	72%	68%	67%
2nd Lien Sr. Sec.	39%	22%	23%	25%

This anomaly came from one large deal – Athenahealth's LBO. This was a $4.9 billion deal with ARCC involved for $1.1 billion of second lien debt. During the period, the company also had a larger exit of Second Lien notes and finished about normal in its total exposure:

	1Q19	4Q18	3Q18	2Q18
2nd Lien Exits	29%	20%	28%	24%
2nd Lien % Portfolio	30%	29%	30%	30%

The company sees better deals when it goes larger as many other BDCs are too small to compete at that level. It also gives it a chance to work with credits it already knows from past deals in many cases. We think the better pricing and spread it can achieve may outweigh some of the negatives of doing larger deals or having a second lien.

The Portfolio Performance Continues to Improve

ARCC highlighted again that it is not trying to match a benchmark for its portfolio. It therefore can avoid areas of lending that can be the most volatile and create the most losses such as commodities, restaurants, and homebuilding. It can focus on companies with stronger cash flow forecasts and should have a portfolio that suffers less in downturns, rebounds first, and can produce more stable growth. In our February 14, 2019 update we discussed this more as the company recapped the 4Q market place and won't cover this in-depth here.

EBITDA growth continues to be strong for ARCC's portfolio companies, growing at 5% y/y which matched 4Q of 5% also. Debt/EBITDA at the companies in the portfolio is 5.5x now vs. 5.4x in the last three quarters. However, the size of the EBITDA continues to rise indicating ARCC is dealing with more established firms:

Portfolio Cos	1Q19	4Q18	3Q18	2Q18
Wgt Avg EBITDA	$121.8	$99.0	$92.9	$82.4
Avg EBITDA	$66.0	$61.3	$54.1	$49.5

Non-accruals were down to 2.3% of the total portfolio from 2.7% of late. The dollar figure of $314 million was also down slightly. We also saw an uptick in the percentage of the portfolio rated at the company's highest score.

We Still See Several Levers to Pull to Boost EPS

In February 2019, ARCC boosted its outstanding stock repurchase plan from $300 million to $500 million. Only $7 million had been used. We believe the company will use this more after June 2019 when the debt to equity ratio limit is raised to 2:1. Buying back shares would effectively boost the leverage ratio without expanding the portfolio. It should boost EPS and also lower the total dividend outlay. Shares are 426 million now. If the company bought back 26 million shares, at $18 for $468 – first quarter would have looked like this:

	Actual	Proforma
Core EPS	$0.48	$0.51
Dividend	$0.42	$0.42
Total Dividend	$178.9	$168.0
Net Debt/EQ	0.79	0.84

EPS/Dividend would have looked even better and the company would save about $11 million in quarterly dividends going forward. It would raise the Net Debt to Equity ratio slightly which is also part of ARCC's goal. This lever has not been used yet.

Every $1 billion deployed without issuing more equity should boost the debt/equity ratio by 0.14x. That is also 1.5-2.0 cents in EPS per quarter. ARCC is looking to boost the leverage ratio at least over 0.9x would easily accommodate this much more in the portfolio.

We've talked about it in more detail in past updates, but 100bp of higher LIBOR is worth over 4-cents in EPS per quarter. We're not going to predict central bankers' actions and we've never seen government programs end once they begin – like buying mortgage bonds, so interest rates could remain low and lumpy for a time. But we doubt there are many people who believe current interest rates are where we will be forever.

The nature of the business for a BDC is it must pay out the bulk of earnings as dividends, so as EPS grows the dividends should follow as well. This company still looks like the EPS has several areas it can grow 12%-16% very easily from here before factoring in interest rates at all which could be another 8%. Plus, the stock is already growing the dividend which is yielding 9.3% now.

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