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Ares Capital Corp. (ARCC) 1Q20 Update
Maintain BUY

We are **maintaining our BUY recommendation** on ARCC after 1Q20 results. Mark-to-Market unrealized losses were the biggest hit to results at $2.04 per share. Much of this was driven by the widening of credit spreads, which increased 730bp during March to 10.9% at the peak. The St. Louis FED tracks this statistic, which has already recovered back to back into a range of 7%-8%. We believe some of the $880 million in unrealized losses will be recovered back into equity before the end of the year.

During March, 99% of scheduled payments were received. ARCC had only 10-loans that were modified in March. April likely saw a larger number of modifications, but their remains a very small weighting in the portfolio of industries that have been hardest hit by all this: Energy is 2.3% of the portfolio, Retail is 2.3% - but the largest customer is a convenience store chain, and the rest is largely distribution related, Restaurants 1.8% - the largest operates in airports (OTG $194mm); Hotels 1.2% the largest is a banquet planning operater (Cipriani $115mm); and Health Clubs 0.2%. Their retail looks OK. Energy has been marked down already as has OTG. These problem areas are only 5.5% of the portfolio now. It is worth noting that the underlying growth rate for the companies in ARCC's portfolio was at 5% before the shutdowns – up from 3% in 4Q19.

ARCC has seen the Debt/Equity ratio rise to 1.26x at the end of 1Q20. That is largely due to Equity declining by $884 million ($612 million loss - fueled by the $880 million unrealized loss from mark-to-market, + $100 million in stock repurchases + $172 million in dividends paid). It would have been 1.11x without the $880 million unrealized loss.

ARCC retains significant liquidity of $2.6 billion to work with existing companies and make new investments. It also has a small backlog at the moment of new deals to fund with potentially more cash coming from loan participations sold to Ivy Hill or repayments. There are many signs pointing to this getting better quickly for ARCC and the stock:

- **Falling LIBOR is unlikely to have a material impact on results going forward**
  - 85% of the portfolio is floating rate while only 44% of the debt is.
  - LIBOR declining has been costing ARCC about 1-2 cents in EPS in recent quarters.
  - We estimate the decline in 1Q20 was 3-cents in EPS.
  - Positive – 79% of the floating rate portfolio has LIBOR floors in place at an average of 1.1%. Those are in the money at this point.
  - If rates stay extremely low, ARCC will see a smaller impact from that going forward.
  - If rates rise, ARCC should see yields increase and help EPS at this point. A 100bp rise in rates adds 6-cents to quarterly EPS and 200bp adds 11-cents.

- **New Loans and New Modifications Should Add to Income and Protections**
  - New loan activity is low – but April investments priced at a 14.7% yield.
  - Many of the loans ARCC works with also have Private Equity backers (83% of the loans) and they are working both the companies and Private Equity investors to ensure liquidity is available for ARCC investments. Many of these are long-standing relationships.
  - ARCC is willing to make concessions in some cases to help ensure survivability of the underlying company.
  - Positive – when modifications do occur – ARCC is often getting more equity put into the situation or some equity participation for itself, tighter loan documents, and re-pricing risk – thus higher yields.
  - As noted above, we only see about 5.5% of the portfolio in problem areas and the underlying businesses have been posting 4%-5% EBITDA growth for several years at this point.
  - We think this along with credit spreads tightening should also help the equity base recover some of the mark-to-market unrealized losses in 1Q20.

- **Liquidity Is Strong at $2.6 billion for ARCC to Cover All Commitments**

  - ARCC does not expect a surge of companies drawing down revolvers from ARCC at this point, but the total remaining commitment there is $1.0 billion. ARCC also has a $210 million backlog of deals to fund.
  - In addition to the current $2.6 billion in liquidity, deals that are sold to Ivy Hill and maturities will add to liquidity. Also, 75% of assets are supported by unsecured debt and could be mortgaged/sold for additional liquidity.
  - If ARCC opted to simply walk on 100% of its $335 million in energy investments, the remaining problem areas of hotels and restaurants only have $435 million at risk and could require some new capital.
  - There will be other issues in the portfolio too, but many may be resolved with smaller amounts of rescue financing. Plus, the private equity players have a stronger incentive to pay for the rescue – they are lower in the capital structure on the deal.
  - Negative – expect bigger non-accruals from energy in our view in 2Q but this looks manageable.
  - Positive – ARCC declared it sees no reason to issue additional equity.

- **ARCC Committed to the Dividend**
  - The spill-over income of $0.96 per share representing past income that has not been distributed yet and helps support the dividend at this time when GAAP EPS was -$1.42 after the $2.04 hit from mark-to-market on unrealized losses.
  - ARCC held the dividend at $0.40 and announced they were confident in holding the steady dividend level for the foreseeable future.
  - At $13 per share, the yield is 12.3%.

- **Share Repurchases Should Boost Provide Solid ROI**
  - The company already spent $100 million repurchasing stock under $12 for a 13% ROI on the deal.
  - ARCC still has $393 million available on repurchase authorization and being comfortable with its liquidity will continue to look at repurchasing shares as a high ROI proposition for cash.
  - Buying back shares below book value of $15.58 is also accretive.
  - We think ARCC will balance share repurchases with seeing some of the mark-to-market valuations recover as buying shares reduces equity and pushes up the Debt-to-Equity ratio.

In our view, ARCC has several tailwinds that should be working in its favor as the worst of the shutdown definitely impacted 2Q20 results but is now past us as business reopens.

- Interest income is likely to be rising going forward with the LIBOR floors in the money
- Fair Market Values should increase with lower risk premium spreads and boost equity
- The bulk of the portfolio is not travel, restaurant, energy-related and was growing at an accelerating rate before this
- The company is in a position to enhance its yield and thus income through any loan modifications needed and any new financings put out in this market
- Non-accruals will likely peak during 2Q and decline thereafter. Non-accruals are 3.1% now and already reflect some sizeable reserves for energy and restaurants.

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 Concerns"	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 may 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 the next quarter. 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.

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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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