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Ares Capital Corp – 2Q19 Update
Maintain BUY

We are maintaining our BUY recommendation on ARCC after 2Q19 results. Results showed several positives continuing and there is more evidence that the dividend could increase in the near future. There are issues of timing to keep in mind going forward as well:

- **Timing – the change to allow BDCs to boost leverage ratios for Debt to Equity from 1:1 to 2:1 only went into effect on June 21.** Thus, the company only had 9-days under the new rules in 2Q19. ARCC's plan remains to take the leverage ratio to between 0.9x-1.25x over 12-36 months vs. a ratio under 0.6x in much of 2018 and 0.7x coming into this year.

- **Timing – Ares Capital Management has been waiving essentially $10 million in management fees from ARCC per quarter** as ARCC restructured the acquired American Capital portfolio. **That $10 million waiver is essentially 2.3 cents per quarter in EPS for ARCC. This waiver will end after 3Q19.**

- **Negative – Only one area has some concern. The company reported that there is growing competition for new business among lenders like BDCs.** This has centered on companies with strong and growing cash flow, with other companies posting less growth not attracting as much attention. **Also, the competition is not causing pricing pressure – but there are more covenant-light terms or other weaker documentation clauses that are being offered by the competition. The result is ARCC only closed about 2% of the potential business** it looked at last quarter vs. a longer-term close ratio of about 4%.

- **Interest Rate Lever – We have noted in the past that in addition to boosting leverage from abnormally low levels to drive EPS growth, ARCC also has 84% of its portfolio on floating rates and that a 100bp rise in LIBOR adds about 4-cents in EPS per quarter. With the potential for interest rate cuts now, it is worth pointing out that**

78% of the floating rate portfolio has interest rate floors in place. That should mitigate some of the negative impact of LIBOR decreasing. Management believes this is a minor headwind for the 2H of 2019. Also, **they have historically seen that a rate cut tends to reduce funding costs faster than loans reset and their spread has often widened** under such a situation. If ARCC loses 25bp of spread on the floating rate investments – it would cost it about 1.6 cents per share in quarterly EPS. The reverse would also be true if the spread widens by 25bp.

- **Positive – the company has the size to chase larger deals that many other BDCs cannot tackle. The weighted average for investment company EBITDA for the portfolio is now $135 million up from $82 million a year ago. At 4-5x EBITDA for a debt figure, that is larger than the market cap of many BDCs in the market. It is also important to remember that ARCC has a long tenure of working with many companies in its portfolio** and backlog. Its knowledge of the companies allows it to move quickly and it has found that it has been able to grow with those businesses it knows. In 2Q, 25 of 33 new investments were made to existing clients.

- **Positive - Companies in the underlying portfolio continue to grow with high credit quality. EBITDA growth came in at 4% y/y against the toughest comp in years:**

ARCC	2Q19	1Q19	4Q18	3Q18	2Q18	1Q18	4Q17	3Q17	2Q17
EBITDA growth	4%	5%	5%	6%	7%	7%	6%	4%	5%

ARCC	2Q19	1Q19	4Q18	3Q18	2Q18
Nonacrruals	$313	$314	$324	$312	$304
Nonaccrual %	2.3%	2.3%	2.5%	2.7%	2.7%
Carrying Value	$25	$51	$75	$70	$90
Carrying %	0.2%	0.4%	0.6%	0.6%	0.8%

No new loans were added to the non-accrual portion of the portfolio and they are carrying those loans at 0.2% of the portfolio now.

- **Positive - Growth in the leverage ratio is still expected to proceed. The growth will likely be lumpy.** In 1Q19, the commitments less exits were +$600 million, in 2Q19 it was flat, in early 3Q19 it was +$184 million. They have locked up $2.2 billion of additional financing and have $3.7 billion in liquidity that can be put to work. That would not require new share issuance and **$1 billion in new assets at a net 6% produces about 3.5 cents per quarter in income.** If the entire $1 billion was borrowed, the debt to equity ratio would only be 0.97x and 0.90x net of cash. They are moving in the right direction to reach 0.9-1.25x:

ARCC	2Q19	1Q19	4Q18	3Q18	2Q18
Debt to EQ net cash	0.76	0.79	0.69	0.54	0.57

- **The dividend has room to expand further. Core EPS of $0.49/Q exceeds the $0.40/Q, plus the $0.02/Q special dividend being paid in 2019. The company has to pay out at least 90% of its taxable income** to keep its RIC (Regulated Investment Company) status where it passes through income tax-free to shareholders. Recent current results would indicate dividends should be about 2-cents per share higher per Q:

ARCC	2Q19	1Q19	4Q18	3Q18	2Q18
Core EPS	$0.49	$0.48	$0.45	$0.45	$0.39
90% of Core	$0.44	$0.43	$0.41	$0.41	$0.35
Dividend Paid	$0.40	$0.40	$0.39	$0.39	$0.38
Special Div.	$0.02	$0.02	$0.00	$0.00	$0.00

A 90% payout would result in ARCC paying more than the current dividend. After 3Q19, the core EPS will see a 2.3-cent drop as the fee-waiver of $10 million per quarter vanishes. That would put the dividend at the current $0.42. However, higher leverage should add to EPS, if lower rates expand the spread – that would boost EPS. The minimum goal for the level of leverage at 0.9x would add about 3.5-cents per quarter to EPS. **In addition, the company guided that its preliminary estimate of undistributed taxable income from 2018 is $323 million or $0.76 per share. That figure will be finalized later this year and also represents more income where a high percentage will need to be paid to shareholders.** That does not mean that ARCC will suddenly declare a $0.76 special dividend. It could announce something like it intends to pay $0.05 in special dividends per quarter for three years. It simply represents another area that could help push the dividend higher.

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