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Ares Capital Corp (ARCC)- 2Q'20 Update
Maintain BUY

We are maintaining our BUY recommendation on ARCC as the worst of Covid lockdowns on the portfolio appear to be over and ARCC remains committed to its dividend of $0.40/quarter. Core EPS of $0.39 beat by 1-cent. Core EPS excludes gains/losses both realized and unrealized and incentive fees related to the realized and unrealized gains/losses. Core EPS in 1Q20 was $0.41 but also suffered from significant mark-downs in portfolio values. In 2Q, the portfolio value rebounded. There are still some questions outstanding, but we believe the worst has been seen and the 11% yield is tough to ignore. We believe the dividend will hold as there is enough liquidity to sustain it and ARCC is simply not very far from out-earning it again in a short period of time:

- Largest negative issue is variable rate investments with LIBOR going down. This is reducing interest income:

ARCC Stats	2Q20	1Q20	2Q19
Avg. Portfolio	$15,177	$15,093	$13,416
Interest Income	$213	$232	$228
Avg. Yield	8.1%	8.4%	9.4%

ARCC has 84% floating rate investments and 79% of those have floors of 1.1% on them so the rate of decline should be largely contained at this point. Interest expense is declining too but not at the same rate. From 1Q to 2Q, interest expense fell $6 million. That is a function of having a diversified balance sheet on the funding side with many fixed rate medium term notes rather than relying heavily on short-term variable rate financing. We consider that a positive for ARCC as it prevents liquidity issues.

- ARCC is also reducing leverage. This is a function of more investments being repaid than new ones originated and also paying down some debt. So that is both good and bad:

ARCC Stats	2Q20	1Q20	2Q19
New Commitments	$867	$1,272	$1,307
Exits	$1,484	$918	$1,348
Net Debt/Equity	1.08	1.19	0.77

We understand why at the moment ARCC is not making a huge number of new investments. However, what makes this work longer-term is pushing the leverage ratio up with more investments. This will need to change.

- The largest positive is it appears the bottom was reached for investments in the quarter and the recovery has begun. There are several signs of this. After the unrealized net loss of $846 million in 1Q20, 2Q20 saw $112 million of unrealized net gains. The sponsors for several of the weaker performing investments have injected new equity in the deals. ARCC has tightened credit terms for several of the deals. The level of drawn revolvers ARCC has for investments has also declined, indicating liquidity issues have abated:

ARCC Stats	2Q20	1Q20	2Q19
Revolver Available	$1,945	$2,083	$2,009
Revolver Drawn	$685	$921	$460

- Supporting the dividend is the goal for ARCC and they are not far from it. They posted core EPS only 1-cent below the dividend. They still have $0.96 per share of spill-over income – prior gains earned – that must be paid out to keep ARCC's tax-exempt status. The debt to equity figure is below the company's goal, which should also boost income in the future. There are no debt maturities in 2020 or 2021 and there is still a significant amount of both investment income and repayments that flows through ARCC. Net investment income in 2Q was essentially equal to the dividend $170 million and the company tends to see about $1 billion per quarter of principal repayments. So income needs to improve with more investments, but the liquidity is here to sustain the dividend as the CEO said on the call, *"I'll reiterate from our call last quarter, the balance sheet is in great shape, with our consistent earnings, strong balance sheet, in our portfolio positioning, we felt highly confident* *in declaring a $0.40 per share quarterly cash dividend for the third quarter of 2020, and we believe that we can continue to support a steady dividend level for the foreseeable future."*

- The non-accruals rose in 2Q to 4.4%. We only see two companies (restaurants) marked to zero, which we would expect. Several of the remaining ones on the surface appear to have COVID business disruptions and may recover with time – three are dental-related, one is pharmaceutical, and one rents equipment. In some of those cases, the company is still paying first-lien debt but not second-lien. ARCC noted that additional equity has been infused by the parent company of several investments and the modifications it has made to loans are largely short-term such as deferring interest, changing some interest to PIK, etc. On the surface, the non-accruals do not seem packed with companies we would expect to see in dire straits. Some of these could recover. ARCC noted on the call that because it works with many of its investments for long periods of time, they understand them and the management well. Over its lifetime, ARCC has realized about $1 billion in gains with 25% coming from companies that needed modifications. This is worth watching, but about 70% of the non-accruals may see recoveries in our view.

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.

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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