

## Ares Capital Corp. (ARCC)

**\$19.20** (As of 02/10/20)

Price Target (6-12 Months): **\$21.00**

Long Term: 6-12 Months

**Zacks Recommendation:**

**Neutral**

(Since: 08/22/19)

Prior Recommendation: Outperform

Short Term: 1-3 Months

**Zacks Rank:** (1-5)

**2-Buy**

Zacks Style Scores:

VGM:F

Value: D

Growth: F

Momentum: B

## Summary

Shares of Ares Capital have outperformed the industry over the past year. Its earnings surpassed the Zacks Consensus Estimate in each of the trailing four quarters. Estimates have remained stable ahead of its fourth quarter 2019 results. The company's investment income growth is expected to continue, driven by regulatory changes and rise in demand for customized financing. Rise in investment commitments are expected to continue to support revenues in the quarters ahead. Further, given a solid liquidity position, the company is expected to continue enhancing shareholder value through efficient capital deployments. However, continuously rising operating expenses (mainly resulting from its expansion strategy) are expected to hurt the bottom line in the near term to some extent. Moreover, the company's higher debt levels might hamper financials.

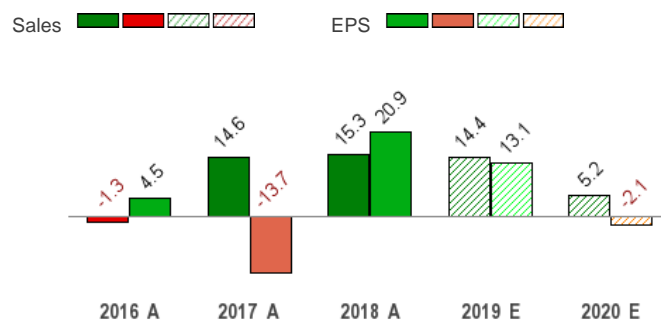
## Price, Consensus & Surprise



## Data Overview

52 Week High-Low	\$19.28 - \$16.58
20 Day Average Volume (sh)	1,651,435
Market Cap	\$8.2 B
YTD Price Change	3.0%
Beta	0.63
Dividend / Div Yld	\$1.60 / 8.3%
Industry	<a href="#">Financial - SBIC &amp; Commercial</a>
Zacks Industry Rank	<a href="#">Bottom 35% (165 out of 255)</a>

## Sales and EPS Growth Rates (Y/Y %)



Last EPS Surprise	4.4%
Last Sales Surprise	4.2%
EPS F1 Est- 4 week change	0.3%
Expected Report Date	02/12/2020
Earnings ESP	-0.3%
P/E TTM	10.2
P/E F1	10.3
PEG F1	NA
P/S TTM	5.5

## Sales Estimates (millions of \$)

	Q1	Q2	Q3	Q4	Annual*
2020	393 E	399 E	406 E	411 E	1,609 E
2019	373 A	382 A	387 A	387 E	1,529 E
2018	317 A	333 A	342 A	345 A	1,337 A

## EPS Estimates

	Q1	Q2	Q3	Q4	Annual*
2020	\$0.46 E	\$0.46 E	\$0.47 E	\$0.47 E	\$1.86 E
2019	\$0.47 A	\$0.49 A	\$0.48 A	\$0.45 E	\$1.90 E
2018	\$0.39 A	\$0.39 A	\$0.45 A	\$0.45 A	\$1.68 A

\*Quarterly figures may not add up to annual.

The data in the charts and tables, including the Zacks Consensus EPS and Sales estimates, is as of 02/10/2020. The reports text is as of 02/11/2020.

## Overview

Incorporated in Maryland, Ares Capital Corporation is a specialty finance company, which primarily invests in U.S. middle-market companies (firms having annual earnings of in the range of \$10-\$250 million). Here, annual earnings refer to earnings that are calculated before deducting interest, taxes, and depreciation and amortization expenses. The company, founded in April 2004, completed its initial public offering in October 2004.

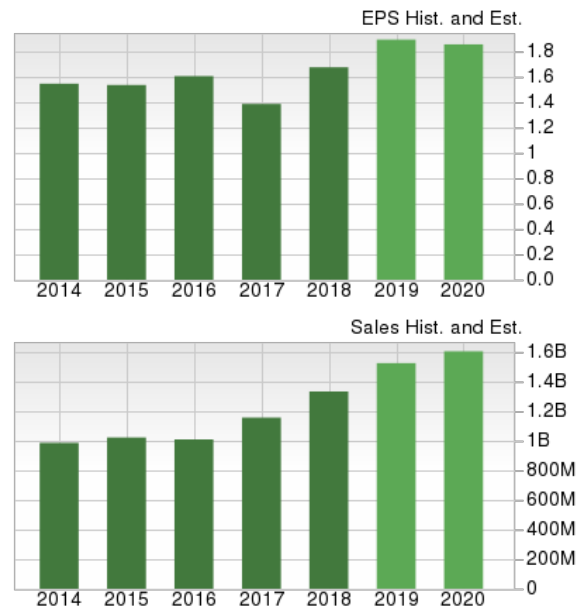
Ares Capital's investments in corporate borrowers generally range from \$30 to \$500 million while investment in power generation projects ranges from \$10 to \$200 million. The company offers customized financing solutions, ranging from senior-debt instruments to equity capital, with a focus on senior secured debt.

As of Sep 30, 2019, Ares Capital had 20.5% of its investment portfolio in healthcare services and 20.7% in business services. Other major investment areas were investment funds and vehicles (6.6%), consumer products (6.5%), and financial services (5.8%).

Ares Capital is structured as a non-diversified closed-end management investment company, regulated as a business development company ("BDC") under the Investment Company Act of 1940. It is treated as a regulated investment company ("RIC") for income-tax purposes. As a BDC, it is required to invest at least 70% of its assets in private or thinly traded public companies. To maintain its RIC status, Ares Capital must distribute the majority of its investment income.

In 2017, Ares Capital acquired American Capital in a cash and stock deal.

As of Sep 30, 2019, Ares Capital had total investment (fair value) of \$13.9 billion, total assets of \$14.5 billion and net asset value of \$17.26 per share.



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## Reasons To Buy:

- ▲ Ares Capital witnessed growth in total investment income over the last five years (2014-2018) and recorded a CAGR of 7.8%. The increase was mainly driven by the acquisition of American Capital in 2017, which boosted investment income greatly. The momentum continued in the first nine months of 2019 as well. Driven by regulatory changes and rising demand for customized financing, the company is expected to witness a rise in total investment income in the quarters ahead.
- ▲ Based on market optimism for public equities and an improving economic environment, Ares Capital is expected to witness growing demand for customized financing from private equity firms and venture capitalists in the coming quarters. Further, the company maintains a robust liquidity position. As of Sep 30, 2019, the company had \$253 million in cash and cash equivalents, and \$2.9 billion under its existing credit facilities.
- ▲ Ares Capital is currently a small participant in a market with huge growth prospects. We are encouraged by the company's concentrated focus on its credit performance. In the third quarter of 2019, the company originated \$2.4 billion of gross investment commitments to new and existing portfolio companies (up from \$1.9 billion in the prior-year quarter). Since the end of the third quarter through Oct 24, 2019, it made new investment commitments of roughly \$360 million to new and existing portfolio companies. Driven by the rise in demand for customized financing, the company will continue witnessing a rise in investment commitments, going forward.
- ▲ Ares Capital's capital deployment policy seems impressive. In order to maintain its RIC status, the company distributes approximately 90% of its taxable income. In February 2019, the company hiked its quarterly dividend by 2.6%. Additionally, it declared an additional 8 cents per share of dividends, which will be distributed in equal quarterly payments during 2019. Further, the company has a share buyback plan worth \$500 million, with expiration on Feb 15, 2020. As of Sep 30, 2019, nearly \$493 million worth of shares were left to be repurchased. Given a solid liquidity position, the company will likely be able to continue enhancing shareholder value through efficient capital deployment activities.

Strong liquidity position and robust loan originations will likely support Ares Capital's financials. Its capital deployments are impressive and will enhance shareholder value.

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## Reasons To Sell:

- ▼ Mounting operating expenses remain a major concern for Ares Capital. Over the last three years, expenses have seen a CAGR of 15.6% (2016-2018), with the uptrend continuing in the first nine months of 2019. The increase was mainly due to rise in interest and credit facility fees, and income-based fees. Costs are likely to remain elevated as the company continues to expand. While its expansion plans will lead to enhanced growth prospects, the bottom line might face some pressure in the near term.
- ▼ To comply with regulatory requirements, Ares Capital invests primarily in the U.S.-based companies and to a lesser extent, in foreign ones. Though the U.S. economy has been gradually improving, persistent regulatory constraints may lead to increased cost of funding, and thereby limit the company's access to capital market. Its foreign investment income will be too limited to support its overall financials.
- ▼ Because of higher interest rates over the past few years, Ares Capital's ability to refinance debt has been restricted while the interest cost on new debt keeps on increasing. This has adversely affected the company's results as debt constituted more than 45% of its total assets as of Sep 30, 2019. Further, to maintain its RIC status, Ares Capital must distribute majority of its investment income. This means that the company must rely significantly on external funding for growth, rather than internal capital generation.
- ▼ Shares of Ares Capital have underperformed the industry over the past six months. The company's 2019 earnings estimates have remained stable over the past 30 days. Further, the stock seems overvalued than the broader industry. Its current price-to-book and price-to-earnings (F1) ratios are above the respective industry averages. Therefore, given the concerns and no estimate revisions, the stock has limited upside potential.

Continuously rising expenses, mainly due to Ares Capital's expansion strategy, will likely hurt profits. Also, higher debt levels might limit the company's flexibility.

## Last Earnings Report

### Ares Capital Beats on Q3 Earnings Despite Higher Costs

Ares Capital's third-quarter 2019 core earnings of 48 cents per share surpassed the Zacks Consensus Estimate of 46 cents. Also, the bottom line rose 6.7% from the year-ago quarter.

Results reflected improvement in total investment income and solid portfolio activity. However, higher expenses recorded in the quarter hurt results to some extent. Also, Ares Capital exited the quarter with higher debt level.

GAAP net income was \$175 million or 41 cents per share, down from \$209 million or 49 cents per share in the prior-year quarter.

### Total Investment Income & Expenses Rise

Total investment income amounted to \$387 million, up 13.2% year over year. The rise reflected an increase in interest income from investments and dividend income. Also, the figure beat the Zacks Consensus Estimate of \$371.4 million.

Total expenses increased 11.8% year over year to \$180 million. The increase was primarily due to rise in almost all expense components.

Net investment income grew 14.6% year over year to \$212 million.

### Strong Balance Sheet

As of Sep 30, 2019, the company's cash and cash equivalents totaled \$253 million, down from \$296 million as of Dec 31, 2018. Total outstanding debt was \$6.6 billion, up from \$5.2 billion as of Dec 31, 2018.

As of Sep 30, 2019, Ares Capital's total assets amounted to \$14.5 billion and stockholders' equity was \$7.4 billion.

Further, net asset value was \$17.26 per share, up from \$17.12 at the end of December.

### Portfolio Activities

New gross commitments worth \$2.4 billion were made during the quarter, up from \$1.9 billion in the prior-year quarter. The company exited \$1.4 billion of commitments in the quarter compared with \$1.9 billion a year ago.

Quarter Ending **09/2019**

Report Date	Oct 30, 2019
Sales Surprise	4.19%
EPS Surprise	4.35%
Quarterly EPS	0.48
Annual EPS (TTM)	1.89

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## Recent News

### Dividend Update

On Oct 30, 2019, Ares Capital declared a quarterly cash dividend of 40 cents per share. The dividend was paid on Dec 30 to shareholders of record as of Dec 16.

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## Valuation

Ares Capital's shares are up 12.5% over the trailing 12-month period. Stocks in the Zacks sub-industry and the Zacks Finance sector are up 9.1% and 10.3% over the past year, respectively.

The S&P 500 index is up 21.9% in the past year.

The stock is currently trading at 10.25X forward 12 months earnings, which compares to 10.69X for the Zacks sub-industry, 14.87X for the Zacks sector and 19.12X for the S&P 500 index.

Over the past five years, the stock has traded as high as 11.53X and as low as 7.97X, with a 5-year median of 10.14X. Our Neutral recommendation indicates that the stock will perform in line with the market. Our \$21 price target reflects 11.23X forward earnings.

The table below shows summary valuation data for ARCC

Valuation Multiples - ARCC					
		Stock	Sub-Industry	Sector	S&P 500
P/E F12M	Current	10.25	10.69	14.87	19.12
	5-Year High	11.53	11.4	16.21	19.34
	5-Year Low	7.97	8.6	12.01	15.18
	5-Year Median	10.14	10.46	14.15	17.47
P/TB TTM	Current	1.11	1.14	3.29	12.43
	5-Year High	1.11	1.14	3.98	12.49
	5-Year Low	0.76	0.71	2.44	6.03
	5-Year Median	0.98	0.97	3.46	9.11
P/S F12M	Current	5.1	5.16	6.55	3.53
	5-Year High	7.36	6.24	6.65	3.53
	5-Year Low	3.81	3.95	5.39	2.54
	5-Year Median	5.07	4.8	6.04	3

As of 02/10/2020

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## Industry Analysis Zacks Industry Rank: Bottom 35% (165 out of 255)



## Top Peers

Apollo Investment Corporation (AINV)	Neutral
BlackRock Capital Investment Corporation (BKCC)	Neutral
Gladstone Investment Corporation (GAIN)	Neutral
Gladstone Capital Corporation (GLAD)	Neutral
Hercules Capital, Inc. (HTGC)	Neutral
Prospect Capital Corporation (PSEC)	Neutral
TriplePoint Venture Growth BDC Corp. (TPVG)	Neutral
Saratoga Investment Corp (SAR)	Underperform

Industry Comparison Industry: Financial - Sbic & Commercial Industry				Industry Peers		
	ARCC Neutral	X Industry	S&P 500	GLAD Neutral	HTGC Neutral	SAR Underperform
<b>VGM Score</b>	<b>F</b>	-	-	<b>F</b>	<b>F</b>	<b>F</b>
Market Cap	8.20 B	295.82 M	24.17 B	323.67 M	1.58 B	306.94 M
# of Analysts	7	2	13	3	5	2
Dividend Yield	8.33%	8.26%	1.77%	8.08%	8.47%	8.16%
<b>Value Score</b>	<b>D</b>	-	-	<b>F</b>	<b>D</b>	<b>F</b>
Cash/Price	0.03	0.07	0.04	0.01	0.02	0.27
EV/EBITDA	14.98	11.19	13.89	18.37	17.66	6.92
PEG Ratio	NA	7.59	2.05	NA	NA	NA
Price/Book (P/B)	1.11	0.96	3.27	1.26	1.46	0.95
Price/Cash Flow (P/CF)	11.13	10.56	13.60	21.12	12.71	10.48
P/E (F1)	10.32	10.19	19.00	12.32	10.44	11.37
Price/Sales (P/S)	5.52	4.95	2.66	6.44	6.22	5.70
Earnings Yield	9.69%	9.83%	5.26%	8.08%	9.60%	8.78%
Debt/Equity	0.89	0.61	0.71	0.36	1.09	0.00
Cash Flow (\$/share)	1.73	1.09	6.89	0.49	1.19	2.62
<b>Growth Score</b>	<b>F</b>	-	-	<b>F</b>	<b>D</b>	<b>F</b>
Hist. EPS Growth (3-5 yrs)	2.64%	0.15%	10.85%	0.39%	4.60%	9.09%
Proj. EPS Growth (F1/F0)	-1.97%	-0.53%	7.22%	0.40%	3.13%	-8.17%
Curr. Cash Flow Growth	20.61%	8.52%	8.88%	516.65%	10.46%	34.83%
Hist. Cash Flow Growth (3-5 yrs)	9.32%	8.27%	8.36%	3.59%	8.26%	14.52%
Current Ratio	1.05	0.57	1.22	0.08	1.49	0.29
Debt/Capital	47.23%	38.19%	42.90%	26.62%	52.13%	0.00%
Net Margin	49.90%	33.64%	11.81%	48.28%	44.00%	68.38%
Return on Equity	10.97%	9.45%	16.98%	10.20%	12.94%	9.77%
Sales/Assets	0.11	0.11	0.54	0.12	0.12	0.11
Proj. Sales Growth (F1/F0)	5.22%	7.58%	4.06%	3.75%	10.19%	15.05%
<b>Momentum Score</b>	<b>B</b>	-	-	<b>C</b>	<b>C</b>	<b>B</b>
Daily Price Chg	-0.16%	0.00%	0.45%	0.58%	0.33%	0.99%
1 Week Price Chg	2.18%	1.77%	2.47%	2.38%	4.51%	2.33%
4 Week Price Chg	2.45%	1.36%	0.95%	2.77%	6.78%	-0.22%
12 Week Price Chg	2.62%	2.85%	5.05%	-0.29%	6.63%	8.50%
52 Week Price Chg	15.66%	2.46%	16.18%	19.15%	16.77%	18.58%
20 Day Average Volume	1,651,435	109,771	1,999,386	135,750	632,183	107,749
(F1) EPS Est 1 week change	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
(F1) EPS Est 4 week change	0.34%	0.00%	0.00%	0.00%	0.00%	-0.89%
(F1) EPS Est 12 week change	1.28%	0.00%	-0.18%	-1.17%	0.00%	-1.43%
(Q1) EPS Est Mthly Chg	0.22%	0.00%	0.00%	0.00%	0.00%	-7.63%

## Zacks Style Scores

The Zacks Style Score is as a complementary indicator to the Zacks rating system, giving investors a way to focus on the highest rated stocks that best fit their own stock picking preferences.

Academic research has proven that stocks with the best Value, Growth and Momentum characteristics outperform the market. The Zacks Style Scores rate stocks on each of these individual styles and assigns a rating of A, B, C, D and F. We also produce the VGM Score (V for Value, G for Growth and M for Momentum), which combines the weighted average of the individual Style Scores into one score. This is perfectly suited for those who want their stocks to have the best scores across the board.

Value Score	<b>D</b>
Growth Score	<b>F</b>
Momentum Score	<b>B</b>
VGM Score	<b>F</b>

As an investor, you want to buy stocks with the highest probability of success. That means buying stocks with a Zacks Recommendation of Outperform, which also has a Style Score of an A or a B.

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