

## Ares Capital Corp. (ARCC)

**\$14.70** (As of 06/11/20)

Price Target (6-12 Months): **\$15.00**

Long Term: 6-12 Months

**Zacks Recommendation:**

**Neutral**

(Since: 08/22/19)

Prior Recommendation: Outperform

Short Term: 1-3 Months

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

**4-Sell**

Zacks Style Scores:

VGM:D

Value: F

Growth: D

Momentum: A

### Summary

Shares of Ares Capital have outperformed the industry over the past year. Its earnings have surpassed the Zacks Consensus Estimate in two and matched in one of the trailing four quarters. First quarter 2020 results were adversely impacted by fall in total investment income. Driven by regulatory changes and rise in demand for customized financing, the company's investment income growth is expected to continue. Moreover, rise in investment commitments will likely continue to support revenues. Further, the company is expected to continue enhancing shareholder value through efficient capital deployments. However, continuously rising expenses (mainly resulting from its expansion strategy) are expected to hurt the bottom line in the near term to some extent. The company's higher debt levels make us apprehensive and might hamper financials.

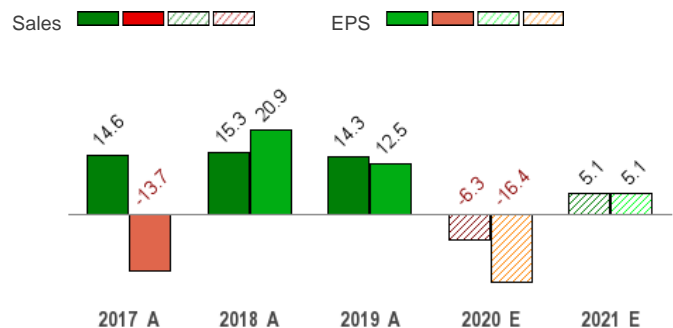
### Price, Consensus & Surprise



### Data Overview

52 Week High-Low	\$19.33 - \$7.90
20 Day Average Volume (sh)	2,671,466
Market Cap	\$6.2 B
YTD Price Change	-21.2%
Beta	1.17
Dividend / Div Yld	\$1.60 / 10.9%
Industry	<a href="#">Financial - SBIC &amp; Commercial Industry</a>
Zacks Industry Rank	Bottom 8% (231 out of 252)

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



Last EPS Surprise	-4.7%
Last Sales Surprise	-3.4%
EPS F1 Est- 4 week change	1.6%
Expected Report Date	08/04/2020
Earnings ESP	-3.3%

### Sales Estimates (millions of \$)

	Q1	Q2	Q3	Q4	Annual*
2021	366 E	374 E	380 E	385 E	1,505 E
2020	369 A	349 E	355 E	359 E	1,432 E
2019	373 A	382 A	387 A	386 A	1,528 A

### EPS Estimates

	Q1	Q2	Q3	Q4	Annual*
2021	\$0.40 E	\$0.41 E	\$0.43 E	\$0.43 E	\$1.66 E
2020	\$0.41 A	\$0.38 E	\$0.39 E	\$0.39 E	\$1.58 E
2019	\$0.47 A	\$0.49 A	\$0.48 A	\$0.45 A	\$1.89 A

\*Quarterly figures may not add up to annual.

P/E TTM	8.0
P/E F1	9.3
PEG F1	NA
P/S TTM	4.1

The data in the charts and tables, including the Zacks Consensus EPS and Sales estimates, is as of 06/11/2020. The reports text is as of 06/12/2020.

## 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.

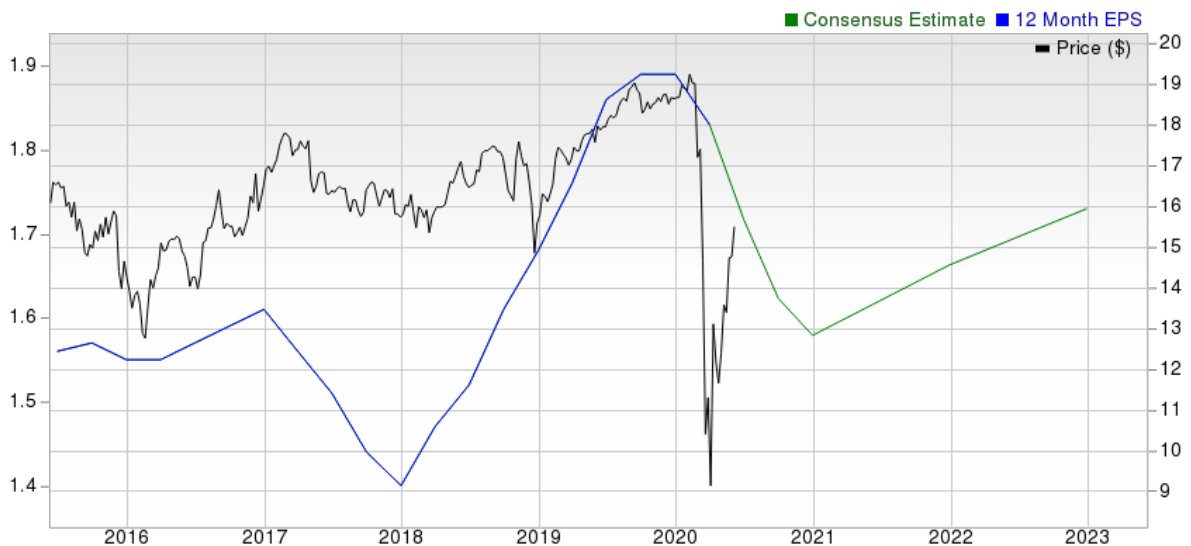
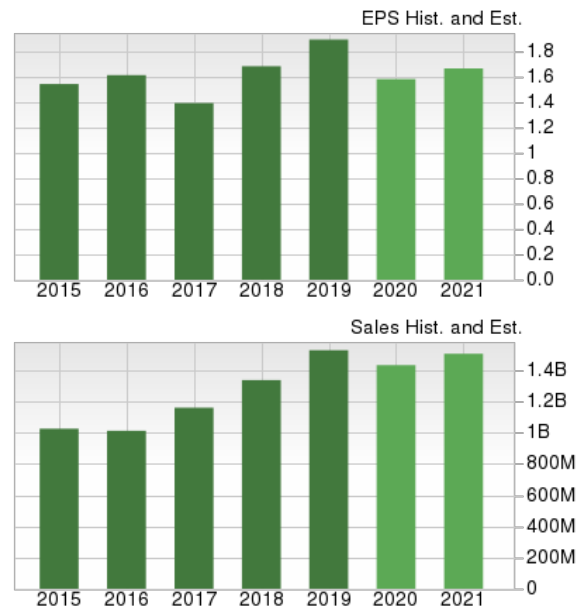
Ares Capital's investments in corporate borrowers generally range from \$30 to \$500 million while investment in power generation projects ranges from \$10 to \$200 million. The company offers customized financing solutions, ranging from senior-debt instruments to equity capital, with a focus on senior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

As of Mar 31, 2020, Ares Capital had 18.9% of its investment portfolio in healthcare services and 14.4% in software & services. Other major investment areas were commercial & professional services (9.3%), power generation (6.9%), and consumer services (6.5%).

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 Mar 31, 2020, Ares Capital had total investment (fair value) of \$14.4 billion, total assets of \$15.8 billion and net asset value of \$15.58 per share.



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## Reasons To Buy:

- ▲ Ares Capital witnessed growth in total investment income over the last five years (2015-2019) and saw a CAGR of 10.5%. The increase was mainly driven by the acquisition of American Capital in 2017, which boosted investment income greatly. Though total investment income declined in the first quarter 2020, the company is expected to witness a rise in the same in the quarters ahead, given the regulatory changes and rising demand for customized financing. Further, the company maintains a decent liquidity position. As of Mar 31, 2020, the company had \$1.1 billion in cash and cash equivalents, and \$2.1 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 first quarter 2020, the company originated \$1.3 billion of gross investment commitments to new and existing portfolio companies. This followed gross investment commitments of \$7.3 billion to new and existing portfolio companies in 2019. Further, since the end of first quarter through Apr 29, it made new investment commitments of roughly \$169 million to new and existing portfolio companies. Driven by the rise in demand for customized financing and near-zero interest rates, 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, it hiked its quarterly dividend by 2.6%. Also, it has a share repurchase program worth \$500 million in place, with an expiration date of Feb 15, 2021. As of Mar 31, 2020, approximately \$393 million remained available for repurchases under the program. Given the earnings strength, the company will likely be able to sustain the current capital deployment plan and enhance shareholder value.
- ▲ Shares of Ares Capital have outperformed the industry over the past year. Also, the company's 2020 earnings estimates have moved 1.9% upward over the past 30 days. Therefore, given the strong fundamentals and positive estimate revisions, the stock has upside potential.

Solid 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:

- ▼ Ares Capital has been witnessing a continued rise in expenses over the past few years. Over the last four years (2016-2019), expenses have seen a CAGR of 12.1%. The increase was mainly due to rise in interest and credit facility fees, and income-based fees. Though the expenses fell in the first quarter 2020, the same 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. 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.
  - ▼ Further, Ares Capital seems to be overvalued when compared with the broader industry as its current price-to-book and price-earnings (F1) ratios are above the respective industry averages.
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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 Q1 Earnings Miss on Lower Investment Income

Ares Capital's first-quarter 2020 core earnings of 41 cents per share missed the Zacks Consensus Estimate of 43 cents. Also, the bottom line declined 14.6% year over year.

The results were adversely impacted by a decline in total investment income. However, lower expenses and decent portfolio activity acted as tailwinds.

GAAP net loss was \$612 million or \$1.42 per share versus GAAP net income of \$214 million or 50 cents per share in the prior-year quarter.

Quarter Ending **03/2020**

Report Date	May 05, 2020
Sales Surprise	-3.35%
EPS Surprise	-4.65%
Quarterly EPS	0.41
Annual EPS (TTM)	1.83

### Total Investment Income & Expenses Down

Total investment income was \$369 million, down 1.1% year over year. The fall was mainly due to lower capital structuring service fees. Also, the figure lagged the Zacks Consensus Estimate of \$381.8 million.

Total expenses declined 25.8% year over year to \$132 million.

Net investment income grew 16.4% year over year to \$234 million.

### Strong Balance Sheet

As of Mar 31, 2020, the company's cash and cash equivalents (including restricted cash) totaled \$1.12 billion, up significantly from \$176 million on Dec 31, 2019.

During the first quarter, the company enhanced its liquidity profile by issuing \$750 million in unsecured investment grade notes at a record low coupon, increasing bank borrowing capacity by \$565 million and extending the maturity on \$5 billion of revolving facilities to 2025.

Moreover, Ares Capital had roughly \$2.1 billion available for additional borrowings under the existing credit facilities as of March 31, 2020. Total outstanding debt was \$8.18 billion, up from \$6.97 billion as of Dec 31, 2019.

As of Mar 31, 2020, Ares Capital's total assets amounted to \$15.81 billion and stockholders' equity was \$6.58 billion.

Further, net asset value was \$15.58 per share, down from \$17.32 as of Dec 31, 2019.

### Robust Portfolio Activities

Gross commitments worth \$1.27 billion were made during the first quarter to 17 new and 20 existing portfolio companies. This compares with \$1.95 billion worth of gross commitments in the prior-year quarter.

Further, during the quarter, the company exited \$918 million of commitments compared with \$1.35 billion a year ago.

The fair value of Ares Capital's portfolio investments as of Mar 31, 2020 was \$14.4 billion, which included \$13.0 billion in accruing debt and other income producing securities.

### Share Repurchase Update

In March, Ares Capital repurchased nearly 8.5 million shares at an average price of \$11.83 per share.

## Recent News

### Moody's Downgrades Outlook of Ares Capital, Affirms Ratings – Apr 7, 2020

Ares Capital's outlook has been downgraded to stable from positive by Moody's Investors Service, the rating arm of Moody's Corporation. Nonetheless, the company's issuer and senior unsecured ratings have been affirmed at Baa3.

The rapidly spreading coronavirus along with falling oil prices has resulted in a severe credit shock across most of the sectors and markets. Moody's believes that business development companies ("BDCs") will likely be the most affected by the credit shock.

Per Moody's, the crisis is expected to lead to a deterioration of asset quality, profitability and capital of Ares Capital. This is the main reason for Moody's to lower the outlook of the company.

However, positives like Ares Capital's history of strong operating performance, effective liquidity management and balanced investment portfolio risk characteristics are reasons behind the ratings affirmation.

Ares Capital has diverse funding sources and maintains adequate availability under its multi-year committed borrowing facilities. It has no senior unsecured term notes maturing until January 2022 and this aids its liquidity profile.

### Dividend Update

On May 5, Ares Capital declared a quarterly cash dividend of 40 cents per share. The dividend will be paid out on Jun 30 to shareholders of record as of Jun 15.

## Valuation

Ares Capital's shares are down 16.9% over the trailing 12-month period. Stocks in the Zacks sub-industry and the Zacks Finance sector are down 27.2% and 9.2% over the past year, respectively.

The S&P 500 index is up 10.3% in the past year.

The stock is currently trading at 9.10X forward 12 months earnings, which compares to 8.56X for the Zacks sub-industry, 17.23X for the Zacks sector and 23.03X for the S&P 500 index.

Over the past five years, the stock has traded as high as 11.53X and as low as 4.38X, with a 5-year median of 10.11X. Our Neutral recommendation indicates that the stock will perform in line with the market. Our \$15 price target reflects 9.26X 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	9.1	8.56	17.23	23.03
	5-Year High	11.53	11.44	17.23	23.03
	5-Year Low	4.38	5.67	11.58	15.23
	5-Year Median	10.11	10.35	13.98	17.49
P/TB TTM	Current	0.96	0.93	3.42	12.54
	5-Year High	1.11	1.16	4	12.76
	5-Year Low	0.46	0.47	2	5.96
	5-Year Median	0.98	0.97	3.48	9.31
P/S F12M	Current	4.24	3.84	6	3.58
	5-Year High	7.36	6.28	6.65	3.58
	5-Year Low	2.16	2.62	4.95	2.53
	5-Year Median	5.07	4.81	6.06	3.02

As of 06/11/2020

## Industry Analysis Zacks Industry Rank: Bottom 8% (231 out of 252)



## Top Peers

Company (Ticker)	Rec	Rank
Prospect Capital Corporation (PSEC)	Outperform	2
Apollo Investment Corporation (AINV)	Neutral	3
BlackRock Capital Investment Corporation (BKCC)	Neutral	3
Gladstone Investment Corporation (GAIN)	Neutral	4
Gladstone Capital Corporation (GLAD)	Neutral	4
Hercules Capital, Inc. (HTGC)	Neutral	3
Saratoga Investment Corp (SAR)	Neutral	3
TriplePoint Venture Growth BDC Corp. (TPVG)	Neutral	4

Industry Comparison Industry: Financial - Sbic & Commercial Industry				Industry Peers		
	ARCC	X Industry	S&P 500	GLAD	HTGC	SAR
Zacks Recommendation (Long Term)	Neutral	-	-	Neutral	Neutral	Neutral
Zacks Rank (Short Term)	4	-	-	4	3	3
VGM Score	D	-	-	A	F	B
Market Cap	6.21 B	198.18 M	21.32 B	218.35 M	1.14 B	173.43 M
# of Analysts	7	3	14	3	5	3
Dividend Yield	10.88%	11.14%	1.99%	11.14%	12.44%	0.00%
Value Score	F	-	-	B	D	A
Cash/Price	0.17	0.12	0.06	0.01	0.04	0.21
EV/EBITDA	11.61	10.32	12.31	13.74	11.16	4.57
PEG Ratio	NA	NA	2.88	NA	NA	NA
Price/Book (P/B)	0.94	0.75	2.92	1.00	1.04	0.57
Price/Cash Flow (P/CF)	7.50	6.72	11.24	14.23	7.21	7.06
P/E (F1)	9.35	7.70	20.84	8.47	7.70	7.08
Price/Sales (P/S)	4.08	3.17	2.24	4.43	4.03	2.97
Earnings Yield	10.75%	12.76%	4.64%	11.86%	13.02%	14.12%
Debt/Equity	1.24	0.73	0.76	0.42	1.09	0.00
Cash Flow (\$/share)	1.96	1.28	7.01	0.49	1.43	2.20
Growth Score	D	-	-	B	F	C
Hist. EPS Growth (3-5 yrs)	4.00%	0.19%	10.87%	0.18%	5.51%	9.13%
Proj. EPS Growth (F1/F0)	-16.48%	-15.66%	-10.81%	-1.59%	-5.25%	-12.05%
Curr. Cash Flow Growth	13.04%	0.71%	5.46%	516.65%	29.90%	24.42%
Hist. Cash Flow Growth (3-5 yrs)	10.57%	10.31%	8.55%	3.59%	14.10%	18.32%
Current Ratio	1.35	1.14	1.29	0.06	2.25	0.20
Debt/Capital	55.41%	45.89%	44.75%	29.71%	52.13%	0.00%
Net Margin	-2.17%	-33.37%	10.54%	-26.05%	29.46%	95.36%
Return on Equity	10.81%	9.37%	16.08%	10.60%	14.01%	9.31%
Sales/Assets	0.10	0.10	0.55	0.12	0.12	0.11
Proj. Sales Growth (F1/F0)	-6.27%	-2.48%	-2.60%	-2.83%	5.02%	-5.75%
Momentum Score	A	-	-	A	A	C
Daily Price Chg	-5.83%	-6.39%	-6.44%	-8.38%	-7.63%	-7.51%
1 Week Price Chg	5.02%	5.93%	7.51%	10.41%	3.23%	10.01%
4 Week Price Chg	12.21%	13.59%	8.40%	14.01%	-0.39%	14.38%
12 Week Price Chg	38.42%	27.27%	25.04%	20.69%	29.43%	17.06%
52 Week Price Chg	-16.86%	-34.26%	-6.33%	-25.53%	-19.80%	-35.91%
20 Day Average Volume	2,671,466	190,197	2,634,935	204,560	973,853	89,798
(F1) EPS Est 1 week change	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
(F1) EPS Est 4 week change	1.56%	0.00%	0.00%	0.00%	0.00%	-3.31%
(F1) EPS Est 12 week change	-13.80%	-13.24%	-15.86%	-1.98%	-7.54%	-7.89%
(Q1) EPS Est Mthly Chg	0.09%	0.00%	0.00%	0.00%	-1.52%	0.00%

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## Zacks Stock Rating System

We offer two rating systems that take into account investors' holding horizons: Zacks Rank and Zacks Recommendation. Each provides valuable insights into the future profitability of the stock and can be used separately or in combination with each other depending on your investment style.

### Zacks Recommendation

The Zacks Recommendation aims to predict performance over the next 6 to 12 months. The foundation for the quantitatively determined Zacks Recommendation is trends in the company's estimate revisions and earnings outlook. The Zacks Recommendation is broken down into 3 Levels; Outperform, Neutral and Underperform. Unlike many Wall Street firms, we have an excellent balance between the number of Outperform and Neutral recommendations. Our team of 70 analysts are fully versed in the benefits of earnings estimate revisions and how that is harnessed through the Zacks quantitative rating system. But we have given our analysts the ability to override the Zacks Recommendation for the 1200 stocks that they follow. The reason for the analyst over-rides is that there are often factors such as valuation, industry conditions and management effectiveness that a trained investment professional can spot better than a quantitative model.

### Zacks Rank

The Zacks Rank is our short-term rating system that is most effective over the one- to three-month holding horizon. The underlying driver for the quantitatively-determined Zacks Rank is the same as the Zacks Recommendation, and reflects trends in earnings estimate revisions.

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### 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	F
Growth Score	D
Momentum Score	A
VGM Score	D

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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