

## Ares Capital Corp. (ARCC)

**\$12.93** (As of 04/13/20)

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)

**2-Buy**

Zacks Style Scores:

VGM:C

Value: B

Growth: C

Momentum: C

### Summary

Shares of Ares Capital have outperformed the industry over the past year. The company has an impressive earnings surprise history. Its earnings have surpassed the Zacks Consensus Estimate in three and matched in one of the trailing four quarters. The company's investment income growth is expected to continue, driven by regulatory changes and rise in demand for customized financing. Moreover, rise in investment commitments will likely continue to support revenues. Further, given a solid liquidity position, 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.

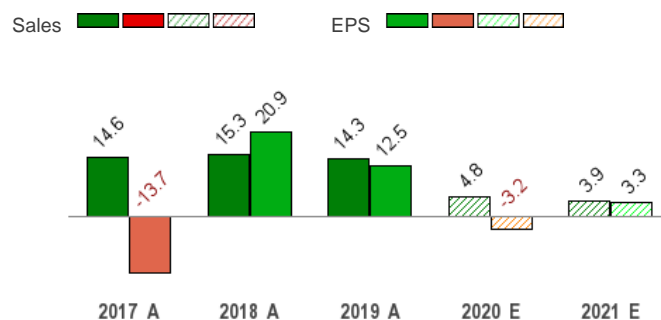
### Price, Consensus & Surprise



### Data Overview

52 Week High-Low	\$19.33 - \$7.90
20 Day Average Volume (sh)	7,603,911
Market Cap	\$5.5 B
YTD Price Change	-30.7%
Beta	1.06
Dividend / Div Yld	\$1.60 / 12.4%
Industry	<a href="#">Financial - SBIC &amp; Commercial Industry</a>
Zacks Industry Rank	Top 13% (32 out of 253)

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



Last EPS Surprise	0.0%
Last Sales Surprise	-0.4%
EPS F1 Est- 4 week change	0.0%
Expected Report Date	05/05/2020
Earnings ESP	0.0%
P/E TTM	6.8
P/E F1	7.1
PEG F1	NA
P/S TTM	3.6

### Sales Estimates (millions of \$)

	Q1	Q2	Q3	Q4	Annual*
2021	410 E	413 E	419 E	424 E	1,664 E
2020	391 E	396 E	404 E	409 E	1,601 E
2019	373 A	382 A	387 A	386 A	1,528 A

### EPS Estimates

	Q1	Q2	Q3	Q4	Annual*
2021	\$0.46 E	\$0.47 E	\$0.47 E	\$0.48 E	\$1.89 E
2020	\$0.45 E	\$0.45 E	\$0.47 E	\$0.47 E	\$1.83 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.

The data in the charts and tables, including the Zacks Consensus EPS and Sales estimates, is as of 04/13/2020. The reports text is as of 04/14/2020.

## 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.

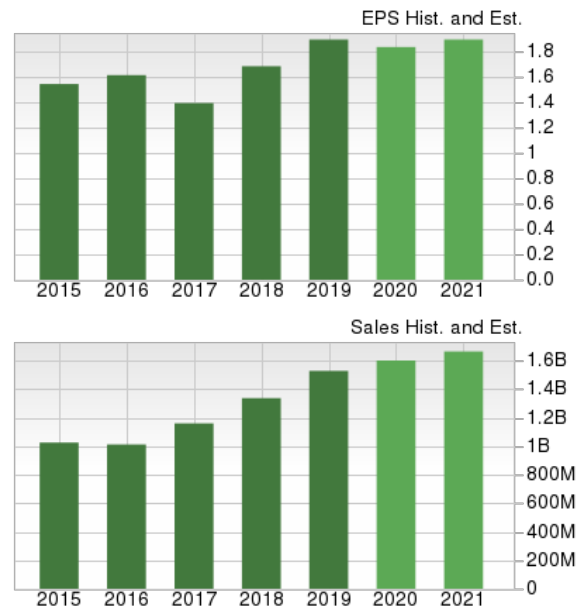
Ares Capital's investments in corporate borrowers generally range from \$30 to \$500 million while investment in power generation projects ranges from \$10 to \$200 million. The company offers customized financing solutions, ranging from senior-debt instruments to equity capital, with a focus on senior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

As of Dec 31, 2019, Ares Capital had 20.3% of its investment portfolio in healthcare services and 12.9% in software & services. Other major investment areas were commercial & professional services (8.5%), utilities (7.1%), and investment funds and vehicles (7%).

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 Dec 31, 2019, Ares Capital had total investment (fair value) of \$14.4 billion, total assets of \$14.9 billion and net asset value of \$17.32 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. 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.
- ▲ Ares Capital is expected to witness growing demand for customized financing from private equity firms and venture capitalists in the coming quarters. The company maintains a robust liquidity position. As of Dec 31, 2019, the company had \$176 million in cash and cash equivalents, and \$2 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 2019, the company originated \$7.3 billion of gross investment commitments to new and existing portfolio companies (down from \$8 billion in the prior year). Since the end of 2019 through Feb 6, it made new investment commitments of roughly \$453 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, 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 Dec 31, 2019, \$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:

- ▼ 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. 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. 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 impacted the company's results as debt constituted more than 46% of its total assets as of Dec 31, 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 outperformed the industry over the past year. However, the company's 2020 earnings estimates have been unchanged 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 Q4 Earnings Meet Estimates, Expenses Rise

Ares Capital's fourth-quarter 2019 core earnings of 45 cents per share met the Zacks Consensus Estimate and were on par with the year-ago quarter figure.

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

GAAP net income was \$204 million or 48 cents per share, up from \$153 million or 36 cents per share in the prior-year quarter.

In 2019, core earnings per share of \$1.89 lagged the consensus estimate by a penny but improved 12.5% year over year. GAAP net income was \$793 million or \$1.86 per share, down from \$858 million or \$2.01 per share in 2018.

### Total Investment Income & Expenses Rise

Total investment income in the quarter was \$386 million, up 11.9% year over year. The rise reflected an increase in interest income from investments and dividend income. However, the figure lagged the Zacks Consensus Estimate of \$393.2 million.

In 2019, total investment income grew 14.3% to \$1.53 billion. The figure was relatively in line with the consensus estimate.

Total expenses jumped 28.7% year over year to \$193 million. The increase was primarily due to rise in almost all expense components.

Net investment income declined 6.4% year over year to \$193 million.

### Strong Balance Sheet

As of Dec 31, 2019, the company's cash and cash equivalents totaled \$176 million, down from \$296 million as of Dec 31, 2018. Total outstanding debt was \$7 billion, up from \$5.2 billion as of Dec 31, 2018.

As of Dec 31, 2019, Ares Capital's total assets amounted to \$14.9 billion and stockholders' equity was \$7.5 billion.

Further, net asset value was \$17.32 per share, up from \$17.12.

### Portfolio Activities

New gross commitments worth \$1.6 billion were made during the quarter, down from \$2.7 billion in the prior-year quarter. The company exited \$1.2 billion of commitments compared with \$1 billion a year ago.

Quarter Ending **12/2019**

Report Date	<b>Feb 12, 2020</b>
Sales Surprise	<b>-0.36%</b>
EPS Surprise	<b>0.00%</b>
Quarterly EPS	<b>0.45</b>
Annual EPS (TTM)	<b>1.89</b>

## 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 2022 and this aids its liquidity profile.

### Dividend Update

On Feb 12, Ares Capital declared a quarterly cash dividend of 40 cents per share. The dividend was paid out on Mar 31 to shareholders of record as of Mar 16.

## Valuation

Ares Capital's shares are down 25.2% over the trailing 12-month period. Stocks in the Zacks sub-industry and the Zacks Finance sector are down 34.4% and 17.6% over the past year, respectively.

The S&P 500 index is down 4.6% in the past year.

The stock is currently trading at 7.00X forward 12 months earnings, which compares to 6.56X for the Zacks sub-industry, 13.29X for the Zacks sector and 18.10X for the S&P 500 index.

Over the past five years, the stock has traded as high as 11.53X and as low as 4.88X, with a 5-year median of 10.13X. Our Neutral recommendation indicates that the stock will perform in line with the market. Our \$15 price target reflects 8.11X 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	7	6.56	13.29	18.1
	5-Year High	11.53	11.4	16.19	19.34
	5-Year Low	4.88	5.63	11.23	15.19
	5-Year Median	10.13	10.39	13.95	17.45
P/B	Current	0.74	0.68	2.13	3.69
	5-Year High	1.47	1.28	2.89	4.55
	5-Year Low	0.46	0.46	1.69	2.84
	5-Year Median	0.98	0.97	2.51	3.63
P/S F12M	Current	3.44	3.02	4.93	3.07
	5-Year High	7.36	6.24	6.65	3.44
	5-Year Low	2.4	2.63	4.93	2.54
	5-Year Median	5.08	4.8	6.03	3.01

As of 04/13/2020

## Industry Analysis Zacks Industry Rank: Top 13% (32 out of 253)



## Top Peers

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

Industry Comparison Industry: Financial - Sbic & Commercial Industry				Industry Peers		
	ARCC Neutral	X Industry	S&P 500	GLAD Neutral	HTGC Neutral	SAR Neutral
<b>VGM Score</b>	<b>C</b>	-	-	<b>F</b>	<b>F</b>	<b>F</b>
Market Cap	5.50 B	186.52 M	19.08 B	193.14 M	1.01 B	161.69 M
# of Analysts	8	2	14	3	5	1
Dividend Yield	12.37%	12.78%	2.19%	13.55%	13.99%	15.49%
<b>Value Score</b>	<b>B</b>	-	-	<b>F</b>	<b>D</b>	<b>C</b>
Cash/Price	0.03	0.11	0.06	0.01	0.11	0.52
EV/EBITDA	10.74	10.19	11.58	12.56	10.19	2.47
PEG Ratio	NA	NA	2.06	NA	NA	NA
Price/Book (P/B)	0.74	0.55	2.58	0.75	0.84	0.50
Price/Cash Flow (P/CF)	6.60	5.62	10.19	12.60	6.41	5.52
P/E (F1)	7.07	6.31	17.15	7.35	6.45	6.31
Price/Sales (P/S)	3.60	2.90	2.07	3.84	3.78	3.00
Earnings Yield	14.15%	15.77%	5.67%	13.55%	15.52%	15.84%
Debt/Equity	0.93	0.65	0.70	0.36	1.04	0.00
Cash Flow (\$/share)	1.96	1.27	7.01	0.49	1.43	2.62
<b>Growth Score</b>	<b>C</b>	-	-	<b>F</b>	<b>F</b>	<b>F</b>
Hist. EPS Growth (3-5 yrs)	3.50%	-0.05%	10.92%	0.39%	5.29%	9.09%
Proj. EPS Growth (F1/F0)	-3.11%	-2.06%	-1.91%	0.40%	0.57%	-5.07%
Curr. Cash Flow Growth	13.04%	0.00%	5.93%	516.65%	29.90%	34.83%
Hist. Cash Flow Growth (3-5 yrs)	10.57%	10.31%	8.55%	3.59%	14.10%	14.52%
Current Ratio	0.89	0.89	1.24	0.08	3.23	0.29
Debt/Capital	48.28%	41.85%	42.36%	26.62%	51.08%	0.00%
Net Margin	51.90%	40.71%	11.64%	48.28%	64.81%	68.38%
Return on Equity	10.89%	9.65%	16.74%	10.20%	13.28%	9.77%
Sales/Assets	0.11	0.10	0.54	0.12	0.12	0.11
Proj. Sales Growth (F1/F0)	4.77%	3.75%	0.45%	3.75%	5.76%	4.48%
<b>Momentum Score</b>	<b>C</b>	-	-	<b>B</b>	<b>A</b>	<b>D</b>
Daily Price Chg	-1.30%	1.28%	-2.62%	-3.13%	0.66%	3.95%
1 Week Price Chg	43.48%	30.79%	16.01%	35.02%	36.90%	46.27%
4 Week Price Chg	4.53%	2.10%	14.48%	-3.88%	5.90%	9.88%
12 Week Price Chg	-31.80%	-45.12%	-21.69%	-40.27%	-36.50%	-48.61%
52 Week Price Chg	-25.22%	-41.84%	-14.14%	-33.33%	-27.73%	-41.05%
20 Day Average Volume	7,603,911	396,260	3,634,618	427,751	2,007,861	194,122
(F1) EPS Est 1 week change	0.00%	0.00%	0.00%	0.00%	0.81%	0.00%
(F1) EPS Est 4 week change	0.00%	0.00%	-5.74%	0.00%	-1.87%	-3.58%
(F1) EPS Est 12 week change	-1.28%	-2.73%	-8.41%	0.00%	-2.07%	-3.58%
(Q1) EPS Est Mthly Chg	0.00%	0.00%	-10.28%	0.00%	-2.39%	-6.09%

## 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>B</b>
Growth Score	<b>C</b>
Momentum Score	<b>C</b>
VGM Score	<b>C</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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