

## Ares Capital Corp. (ARCC)

**\$14.35** (As of 08/17/20)

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)

**3-Hold**

Zacks Style Scores:

VGM:F

Value: D

Growth: F

Momentum: A

### Summary

Shares of Ares Capital have outperformed the industry so far this year. Its earnings have surpassed the Zacks Consensus Estimate in two and matched in one of the trailing four quarters. The company's second-quarter 2020 results benefited from decent portfolio activity and stable expenses. Owing to the rise in demand for customized financing, investment income is expected to continue improving in the quarters ahead. 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 increasing expenses (primarily resulting from its expansion strategy) are expected to hamper bottom-line growth to some extent in the near term. Further, a stretched valuation limits the upside potential of the stock.

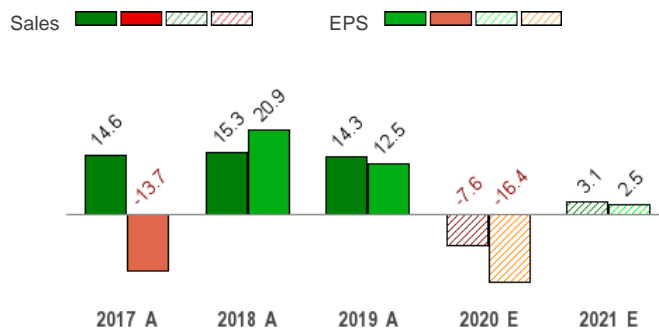
### Price, Consensus & Surprise



### Data Overview

|                            |  |
|----------------------------|--|
| 52 Week High-Low           | \$19.33 - \$7.90   |
| 20 Day Average Volume (sh) | 2,167,038  |
| Market Cap                 | \$6.1 B  |
| YTD Price Change           | -23.1%   |
| Beta                       | 1.14   |
| Dividend / Div Yld         | \$1.60 / 11.1%   |
| Industry                   | <a href="#">Financial - SBIC &amp; Commercial Industry</a> |
| Zacks Industry Rank        | Bottom 17% (210 out of 252)                                |

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



|                           |            |
|---------------------------|------------|
| Last EPS Surprise         | 2.6%       |
| Last Sales Surprise       | 0.3%       |
| EPS F1 Est- 4 week change | 0.0%       |
| Expected Report Date      | 11/04/2020 |
| Earnings ESP              | 0.3%       |
| P/E TTM                   | 8.3        |
| P/E F1                    | 9.1        |
| PEG F1                    | NA         |
| P/S TTM                   | 4.1        |

### Sales Estimates (millions of \$)

|      | Q1    | Q2    | Q3    | Q4    | Annual* |
|------|-------|-------|-------|-------|---------|
| 2021 | 352 E | 359 E | 369 E | 375 E | 1,456 E |
| 2020 | 369 A | 350 A | 345 E | 348 E | 1,412 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 | \$0.42 E | \$0.42 E | \$1.62 E |
| 2020 | \$0.41 A | \$0.39 A | \$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.

The data in the charts and tables, including the Zacks Consensus EPS and Sales estimates, is as of 08/17/2020. The reports text is as of 08/18/2020.

## 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.

Ares Capital, founded in April 2004, completed its initial public offering in October 2004.

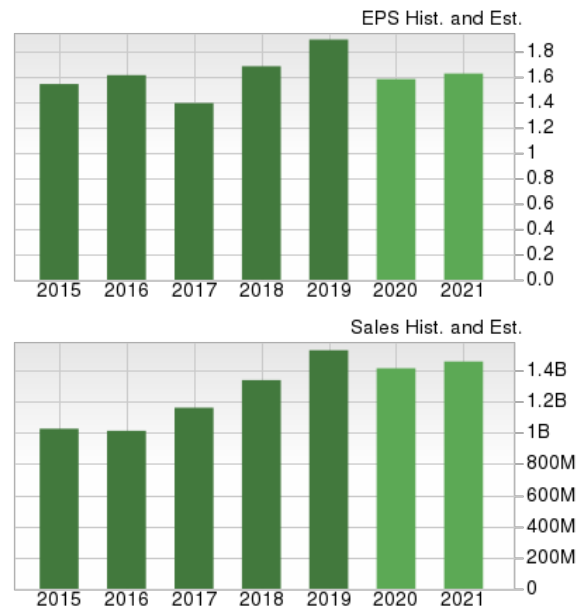
Ares Capital's investments in corporate borrowers generally range from \$30 to \$500 million while investment in power generation projects ranges from \$10 to \$200 million. The company offers customized financing solutions, ranging from senior-debt instruments to equity capital, with a focus on senior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

As of Jun 30, 2020, Ares Capital had 19.5% of its investment portfolio in healthcare services and 13.6% in software & services. Other major investment areas were commercial & professional services (8.5%), investment funds and vehicles (6.9%), and diversified financials (6.9%).

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 Jun 30, 2020, Ares Capital had total investment (fair value) of \$13.8 billion, total assets of \$14.5 billion and net asset value of \$15.83 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 six months of 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.
- ▲ 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 second quarter of 2020, the company originated \$867 million of gross investment commitments to new and existing portfolio companies. Further, since the end of the second quarter through Jul 29, it made new investment commitments of roughly \$63 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.
- ▲ As of Jun 30, 2020, the company had total debt worth \$7.4 billion, while its cash and cash equivalents (including restricted cash) totaled \$301 million. The company has \$3.2 billion available under its existing credit facilities. Its second-quarter 2020 total debt to total capital of 52.5% declined sequentially. In fact, despite being highly leveraged, the company does not have any debt maturities before 2022. This shows that there is a lesser likelihood that it will default in repayment of debt in the near term even if the economic situation worsens.
- ▲ 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 Jun 30, 2020, approximately \$393 million remained available for repurchase under the program. Given its earnings strength, the company will likely be able to sustain the current capital deployment plan and enhance shareholder value.

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 expenses fell in the first half of 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 too be limited to support its overall financials.
- ▼ Shares of Ares Capital have outperformed the industry so far this year. However, the company's 2020 earnings estimates have been unchanged over the past 30 days. Further, the stock 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. Therefore, given the concerns and lack of positive estimate revisions, the stock has limited upside potential.

Elevated expenses mainly due to Ares Capital's expansion strategy will likely hurt the bottom-line growth. Also, a stretched valuation limits the stock's upside potential.

## Last Earnings Report

### Ares Capital Q2 Earnings & Revenues Beat, Expenses Stable Y/Y

Ares Capital's second-quarter 2020 core earnings of 39 cents per share beat the Zacks Consensus Estimate by a penny. However, the bottom line declined 20.4% year over year.

The results benefited from stable expenses and decent portfolio activity. Further, the company's liquidity position remained strong during the quarter. However, a decline in total investment income was an undermining factor.

GAAP net income was \$277 million or 65 cents per share, up from \$200 million or 47 cents per share in the prior-year quarter.

Quarter Ending 06/2020

| Report Date      | Aug 04, 2020 |
|------------------|--------------|
| Sales Surprise   | 0.30%        |
| EPS Surprise     | 2.63%        |
| Quarterly EPS    | 0.39         |
| Annual EPS (TTM) | 1.73         |

### Total Investment Income Down, Expenses Stable

Total investment income was \$350 million, down 8.4% year over year. The fall was mainly due to lower capital structuring service fees and interest income from investments. Nonetheless, the figure marginally surpassed the Zacks Consensus Estimate of \$349 million.

Total expenses were \$180 million, on par with the prior-year level.

Net investment income declined 20.7% year over year to \$165 million.

### Strong Balance Sheet

As of Jun 30, 2020, the company's cash and cash equivalents (including restricted cash) totaled \$301 million, up significantly from \$176 million on Dec 31, 2019.

Moreover, Ares Capital had roughly \$3.2 billion available for additional borrowings under the existing credit facilities as of Jun 30, 2020. Total outstanding debt was \$7.40 billion, up from \$6.97 billion as of Dec 31, 2019.

As of Jun 30, 2020, Ares Capital's total assets amounted to \$14.52 billion and stockholders' equity was \$6.69 billion.

Further, net asset value was \$15.83 per share, down from \$17.32 as of Dec 31, 2019.

### Decent Portfolio Activities

Gross commitments worth \$867 million were made during the second quarter to five new and 17 existing portfolio companies. This compares with \$1.31 billion worth of gross commitments in the prior-year quarter.

Further, during the quarter, the company exited \$1.48 billion of commitments compared with \$1.35 billion a year ago.

The fair value of Ares Capital's portfolio investments as of Jun 30, 2020 was \$13.8 billion, which included \$12.3 billion in accruing debt and other income producing securities.

## 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 Aug 4, Ares Capital declared a quarterly cash dividend of 40 cents per share. The dividend will be paid out on Sep 30 to shareholders of record as of Sep 15.

## Valuation

Ares Capital's shares are down 23.1% in the year-to-date period and 24.3% over the trailing 12-month period. Stocks in the Zacks sub-industry and the Zacks Finance sector are down 28.1% and 15.6% in the year-to-date period, respectively. Over the past year, the Zacks sub-industry and the sector are down 26.7% and 6.7%, respectively.

The S&P 500 index is up 4.5% in the year-to-date period and 15.4% in the past year.

The stock is currently trading at 8.93X forward 12 months earnings, which compares to 8.87X for the Zacks sub-industry, 16.81X for the Zacks sector and 22.85X 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 10.08X. Our Neutral recommendation indicates that the stock will perform in line with the market. Our \$15 price target reflects 9.33X 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       | 8.93  | 8.87         | 16.81  | 22.85   |
|                            | 5-Year High   | 11.53 | 11.4         | 16.81  | 22.85   |
|                            | 5-Year Low    | 4.38  | 5.65         | 11.6   | 15.25   |
|                            | 5-Year Median | 10.08 | 10.3         | 14.26  | 17.58   |
| P/TB TTM                   | Current       | 0.91  | 0.78         | 3.37   | 13.18   |
|                            | 5-Year High   | 1.11  | 1.06         | 4      | 13.2    |
|                            | 5-Year Low    | 0.46  | 0.39         | 2.01   | 5.96    |
|                            | 5-Year Median | 0.98  | 0.93         | 3.48   | 9.57    |
| P/S F12M                   | Current       | 4.21  | 3.44         | 6.22   | 3.7     |
|                            | 5-Year High   | 7.36  | 5.95         | 6.67   | 3.7     |
|                            | 5-Year Low    | 2.16  | 2.17         | 4.97   | 2.53    |
|                            | 5-Year Median | 5.07  | 4.41         | 6.06   | 3.05    |

As of 08/17/2020

## Industry Analysis Zacks Industry Rank: Bottom 17% (210 out of 252)



## Top Peers

| Company (Ticker)                            | Rec          | Rank |
|---|--------------|------|
| Bain Capital Specialty Finance, Inc. (BCSF) | Neutral      | 3    |
| FS KKR Capital Corp. (FSK)                  | Neutral      | 3    |
| Golub Capital BDC, Inc. (GBDC)              | Neutral      | 3    |
| Hercules Capital, Inc. (HTGC)               | Neutral      | 4    |
| Main Street Capital Corporation (MAIN)      | Neutral      | 3    |
| New Mountain Finance Corporation (NMFC)     | Neutral      | 3    |
| BLACKROCK TCP CAPITAL CORP. (TCPC)          | Neutral      | 3    |
| Apollo Investment Corporation (AINV)        | Underperform | 5    |

| Industry Comparison Industry: Financial - Sbic & Commercial Industry |           |            |           | Industry Peers |          |          |
|--|-----------|------------|-----------|----------------|----------|----------|
|  | ARCC      | X Industry | S&P 500   | AINV           | FSK      | NMFC     |
| Zacks Recommendation (Long Term)                                     | Neutral   | -          | -         | Underperform   | Neutral  | Neutral  |
| Zacks Rank (Short Term)  | 3         | -          | -         | 5              | 3        | 3        |
| VGM Score  | F         | -          | -         | D              | B        | D        |
| Market Cap   | 6.06 B    | 220.35 M   | 23.75 B   | 626.49 M       | 1.99 B   | 981.83 M |
| # of Analysts  | 7         | 2          | 14        | 5              | 4        | 4        |
| Dividend Yield   | 11.15%    | 10.13%     | 1.62%     | 18.75%         | 14.95%   | 11.83%   |
| Value Score  | D         | -          | -         | D              | B        | D        |
| Cash/Price   | 0.05      | 0.10       | 0.07      | 0.06           | 0.04     | 0.06     |
| EV/EBITDA  | 11.50     | 7.67       | 13.49     | 11.29          | 13.75    | 22.30    |
| PEG Ratio  | NA        | NA         | 3.03      | NA             | NA       | NA       |
| Price/Book (P/B)   | 0.91      | 0.76       | 3.18      | 0.63           | 0.69     | 0.86     |
| Price/Cash Flow (P/CF)   | 7.32      | 7.17       | 12.85     | 1.61           | 4.85     | 7.94     |
| P/E (F1)   | 9.00      | 8.83       | 22.17     | 6.15           | 6.17     | 8.33     |
| Price/Sales (P/S)  | 4.06      | 3.47       | 2.49      | 2.35           | 2.78     | 3.43     |
| Earnings Yield   | 11.01%    | 11.26%     | 4.32%     | 16.25%         | 16.20%   | 12.03%   |
| Debt/Equity  | 1.11      | 0.60       | 0.77      | 1.76           | 1.35     | 1.52     |
| Cash Flow (\$/share)   | 1.96      | 1.35       | 6.94      | 5.95           | 3.31     | 1.28     |
| Growth Score   | F         | -          | -         | B              | A        | C        |
| Hist. EPS Growth (3-5 yrs)   | 4.18%     | -0.79%     | 10.44%    | -5.32%         | -4.80%   | -0.20%   |
| Proj. EPS Growth (F1/F0)   | -16.48%   | -15.56%    | -5.97%    | -27.78%        | -18.67%  | -4.13%   |
| Curr. Cash Flow Growth   | 13.04%    | 0.71%      | 5.22%     | 200.04%        | 99.62%   | -5.12%   |
| Hist. Cash Flow Growth (3-5 yrs)                                     | 10.57%    | 10.31%     | 8.52%     | 1.78%          | 10.61%   | 1.24%    |
| Current Ratio  | 1.54      | 1.09       | 1.33      | 2.34           | 2.03     | 1.23     |
| Debt/Capital   | 52.51%    | 39.31%     | 44.59%    | 63.75%         | 57.45%   | 60.36%   |
| Net Margin   | 2.95%     | -18.87%    | 10.13%    | -51.26%        | -100.00% | -17.83%  |
| Return on Equity   | 10.45%    | 8.92%      | 14.51%    | 12.38%         | 11.44%   | 10.54%   |
| Sales/Assets   | 0.10      | 0.09       | 0.51      | 0.09           | 0.09     | 0.09     |
| Proj. Sales Growth (F1/F0)   | -7.57%    | -5.77%     | -1.67%    | -19.94%        | -20.19%  | -2.05%   |
| Momentum Score   | A         | -          | -         | D              | F        | C        |
| Daily Price Chg  | -1.51%    | -0.44%     | -0.02%    | -1.84%         | -0.56%   | -0.39%   |
| 1 Week Price Chg   | -2.02%    | 0.57%      | 1.09%     | 1.66%          | -1.94%   | 2.00%    |
| 4 Week Price Chg   | 2.57%     | 5.34%      | 4.83%     | 2.45%          | 6.86%    | 10.58%   |
| 12 Week Price Chg  | -2.51%    | 10.50%     | 13.09%    | 1.37%          | 18.36%   | 11.31%   |
| 52 Week Price Chg  | -24.27%   | -27.47%    | 2.77%     | -41.14%        | -31.29%  | -26.36%  |
| 20 Day Average Volume  | 2,167,038 | 138,753    | 1,932,479 | 446,453        | 608,607  | 454,390  |
| (F1) EPS Est 1 week change   | 0.00%     | 0.00%      | 0.00%     | -0.76%         | -1.54%   | 0.00%    |
| (F1) EPS Est 4 week change   | 0.00%     | -0.14%     | 1.80%     | -9.93%         | -1.54%   | 1.25%    |
| (F1) EPS Est 12 week change  | 0.00%     | -1.16%     | 2.88%     | -5.11%         | -1.79%   | 1.25%    |
| (Q1) EPS Est Mthly Chg   | 0.37%     | 0.00%      | 0.80%     | -10.35%        | -6.56%   | 2.27%    |

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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    | D |
| Growth Score   | F |
| Momentum Score | A |
| VGM Score      | F |

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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