CONSORTIUM EQUITY RESEARCH

Initiating Coverage:

# Ares Capital Corporation

## The War Chest of Middle-Market Lending

Consortium Equity Research
FIG | BDC
August 22nd, 2024

| | |
|---|---|
| Stock Rating: | Overweight |
| Price Target: | USD $22.14 |
| Price: | $21.08 |
| Potential Upside: | 4.78% |
| Ticker(s): | $ARCC |
| Market Cap: | $13.22b |
| Shares Outstanding: | 630.39m |
| Free Float (%): | 2.7% |
| Dividend Yield: | 9.11% |


FIG Coverage Team

FIG Head
Will Situ
Rice University
ws56@rice.edu

**Key Takeaway:** In the rapidly evolving middle-market lending landscape, Ares Capital Corporation (ARCC) is strategically positioned to seize significant opportunities as commercial and investment banks continue to pivot away from middle-market financing. As the largest publicly traded Business Development Company (BDC), ARCC is bolstered by its affiliation with Ares Management Corporation (NYSE: ARES) and its investment adviser, Ares Capital Management. ARCC utilizes ARES's investment platform and relationships with sponsors & hedge funds to source attractive investment opportunities and strengthen its market insights. Confidence is high as the company's exited investments have resulted in a gross IRR of approximately 14% since its IPO on October 8th, 2004.

Yet, it is important to note that leverage remains high, with debt over $13 Billion and cash at $601 Million. ARCC's success also depends on variables such as maintaining its federal corporate income tax exemption as an RIC (Regulated Investment Company) and mitigating impacts of interest rate fluctuation.

**Financial Development:** ARCC reported impressive financials in Q2 2024. Adjusted earnings per share of $0.61, a 5.1% increase YoY. Net Asset Value (NAV) per share was $19.61, up 6% YoY, leading all externally managed BDCs with over $1 billion of Market Cap. Quarterly revenue came in at $755 Million, up 19.1 % YoY. Revenue for the 12 months ending Jun. 2024 was an industry leading 3.2 billion, up 12.0% YoY. Assets rose to $26.1 B from $23. 8 B and stockholder's equity increased to $12.4 B from $ 11.2 B. Debt to Equity ratio remained stable at 1.06x, indicating a well-managed balance sheet.

**Interest Rates and Funding:** With the Federal Reserve set to cut interest rates by at least 0.25 bps in September and possibly 0.5 bps, macroeconomic tailwinds are on the side of ARCC as the cost of debt is set to decrease when interest rates decrease. Since ARCC's net investment income depends on the difference between the rate at which it borrows funds and the rate at which it invests those funds, lower borrowing will enhance profitability. Lower rates allow ARCC to increase its net investment income, supporting growth and strengthening its financial position. So far this year, ARCC has completed three debt refinancing deals totaling $7.04 billion through bonds and its own revolving credit facility, which allows ARCC to borrow up to $4.8 billion at any one time outstanding

**Valuation:** We initiate coverage with a $22 PT.

## Peer Comparisons

| Companies | Stock Price | Market Cap | Enterprise Value (Daily) | EBITDA LTM | Net Income after Non-Controlling/Minority Interests (TTM) | Total Revenue (TTM) | EV/EBITDA | Price(Daily)/Earnings |
|---|---|---|---|---|---|---|---|---|
| Ares Capital (NAS: ARCC) | $21.07 | 13,288,549.00 | 25,694,549.00 | 2,038,000.00 | 1,684,000.00 | 3,199,000.00 | 12.61x | 7.39x |
| Prospect Capital Corporation BDC | $5.23 | 2,243,608.00 | 2,243,608.00 | 423,330.00 | 262,834.00 | 704,908.00 | 5.30x | 15.37x |
| Main Street Capital (NYS: MAIN) | $49.40 | 4,301,450.00 | 6,469,046.00 | 460,000.00 | 452,177.00 | 646,944.00 | 14.06x | 9.22x |
| Gladstone Capital Corp BDC (NA: | $22.73 | 494,479.00 | 818,612.00 | 47,000.00 | 75,885.00 | 126,457.00 | 17.42x | 11.84x |
| BlackRock (NYSE: BLK) | $901.89 | 133,580,000.00 | 135,219,743.00 | 7,153,000.00 | 6,047,000.00 | 18,686,000.00 | 18.90x | 22.39x |
| Blue Owl Capital BDC (NYS: OBD | $15.16 | 5,915,694.00 | 13,054,734.00 | 1,191,000.00 | 700,642.00 | 1,548,174.00 | 10.96x | 8.47x |
| Goldman Sachs BDC (NYS: GBD | $14.13 | 1,650,000.00 | 3,533,446.00 | 387,000.00 | 90,386.00 | 283,290.00 | 9.13x | 16.73x |
| Blackstone Secured Lending Fund | $30.15 | 6,059,121.00 | 11,852,090.00 | 893,000.00 | 708,244.00 | 1,255,876.00 | 13.27x | 7.79x |
| Franklin BSP Lending Corporation | $9.75 | 2,268,856.00 | 3,361,198.00 | N/A | 114,093.00 | 298,954.00 | N/A | 19.90x |
| Low | $5.23 | $494,479.00 | $818,612.00 | $47,000.00 | $75,885.00 | $126,457.00 | 5.30x | 7.39x |
| 25th Percentile | $11.94 | $1,946,804.00 | $2,802,403.00 | $396,082.50 | $102,239.50 | $291,122.00 | 10.08x | 8.45x |
| Median | $18.12 | $3,285,153.00 | $5,001,246.00 | $676,500.00 | $357,505.50 | $675,926.00 | 12.94x | 10.53x |
| Mean | $107.93 | $17,207,061.30 | $20,560,822.40 | $1,574,041.25 | $1,024,935.40 | $2,704,855.70 | 12.71x | 12.40x |
| 75th Percentile | $39.78 | $9,673,835.00 | $19,374,641.50 | $1,826,250.00 | $1,196,122.00 | $2,373,587.00 | 15.67x | 15.16x |
| High | $901.89 | $133,580,000.00 | $135,219,743.00 | $7,153,000.00 | $6,047,000.00 | $18,686,000.00 | 18.90x | 22.39x |

Compared amongst its 8 competitors, ARCC holds strong margins, stable revenue growth, and below-industry P/E & EV/ EBITDA valuations. The implied share price can thus be calculated using the implied EV/EBITDA multiple of the 25th percentile, mean, and 75th percentile.

| Case 1: 25th Percentile | |
|---|---|
| Implied Multiple | 10.08x |
| LTM EBITDA | $2,038 |
| Enterprise Value | $20,547.87 |
| Less: Debt | ($13,007) |
| Plus: Cash | $601 |
| Equity Value | $8,141.87 |
| Diluted Shares Outstanding | 630.3866 |
| Implied Share Price | $12.92 |
| *Upside/Downside* | -38.73% |

| Case 2: Mean | |
|---|---|
| Implied Multiple | 12.71x |
| LTM EBITDA | $2,038 |
| Enterprise Value | $25,896.79 |
| Less: Debt | ($13,007) |
| Plus: Cash | $601 |
| Equity Value | $13,490.79 |
| Diluted Shares Outstanding | 630.3866 |
| Implied Share Price | $21.40 |
| *Upside/Downside* | 1.52% |

| Case 3: 75th Percentile | |
|---|---|
| Implied Multiple | 15.67x |
| LTM EBITDA | $2,038 |
| Enterprise Value | $31,941.83 |
| Less: Debt | ($13,007) |
| Plus: Cash | $601 |
| Equity Value | $19,535.83 |
| Diluted Shares Outstan | 630.3866 |
| Implied Share Price | $30.99 |
| *Upside/Downside* | 47.01% |

## Industry Overview

Business Development Companies (BDCs) play a vital role in the U.S. financial system by providing capital to small and middle-market companies that are often underserved by traditional banks. Established under the Investment Company Act of 1940 and given their current structure by Congress in 1980, BDCs are closed-end investment funds that offer public investors exposure to private companies' debt and equity investments, typically reserved for institutional investors.

BDCs primarily invest in the debt and equity of small to mid-sized businesses, typically those with annual EBITDA between $10 million and $250 million. These companies' market capitalization is too large to qualify for small business loans yet too small to access the public equity markets, creating a significant demand for the flexible financing BDCs provide. The types of debt instruments BDCs invest in often include senior secured loans, subordinated debt, mezzanine financing, and equity, with a strong emphasis on providing tailored, non-dilutive capital solutions.

**Growth and Opportunities**: The BDC industry has grown substantially over the past decade, driven by several key factors. Firstly, traditional banks retreated from middle-market lending due to increased regulatory scrutiny and capital requirements following the 2008 financial crisis. This has created a financing gap that BDCs have been well-positioned to fill. Second, the rising demand for alternative financing solutions. As companies seek more customized and strategic financing, BDCs provide non-bank lending that allows these companies to finance acquisitions, expansions, and recapitalizations without resorting to public equity markets or dilutive financing options. Since 2020, assets under management by private BDCs have increased from $34 billion to $118 billion, representing a CAGR of more than 35%. Furthermore, BDCs are sensitive to interest rate fluctuations, as many of their investments are in floating-rate loans, and their profitability can be affected by changes in borrowing costs. The looming rate cuts pose yet another opportunity for industry.

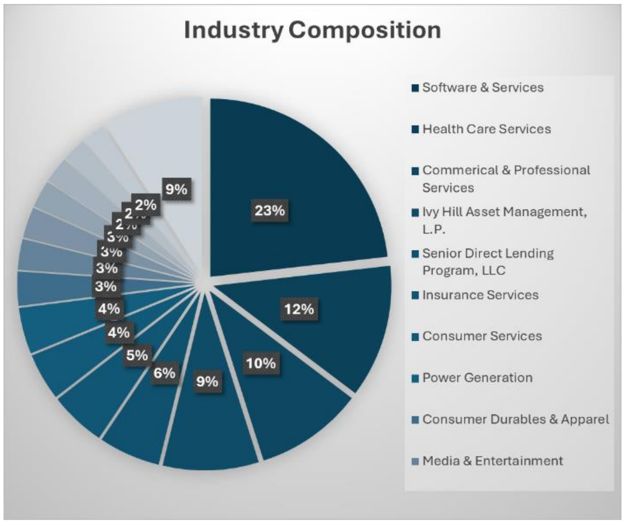
**Strong Competition:** The direct lending space is highly competitive, with numerous players, including private credit funds, traditional banks, and other alternative lenders, all vying for the same investment opportunities. This competition can put pressure on pricing and deal terms, potentially squeezing margins. Major players in the BDC space include Ares Capital Corporation (ARCC), Main Street Capital Corporation (MAIN), and Golub Capital BDC, Inc. (GBDC). These companies have established themselves as leaders by leveraging extensive networks of private equity sponsors, robust origination platforms, and deep industry expertise to capture market share in the middle-market lending space.

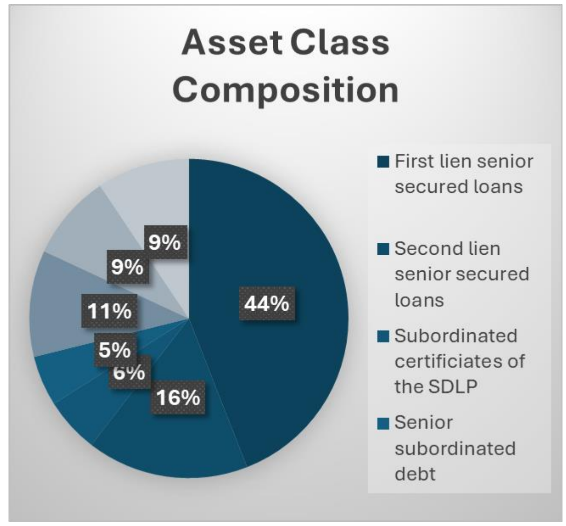
## Company Overview

**Company Description:** ARCC is one of the largest direct lenders in the U.S. ARCC's global platform combines powerful origination capabilities and extensive knowledge to deliver comprehensive solutions to meet the distinct and underserved financing needs of private middle-market companies across a wide range of industries. As a patient, long-term investor with permanent capital, ARCC can hold large positions and offer sponsors and management teams enhanced certainty of execution. The company is managed by a subsidiary of Ares Management Corporation (NYSE: ARES), one of the largest global alternative investment managers. This external management by ARES equips ARCC with profound market insights, access to a wider network, and enhanced operational capabilities that are critical in navigating the competitive landscape of business development and direct lending. Under the

ARCC's investment portfolio is designed to target U.S. middle-market companies, or companies with EBITDA ranging from $10 million to $250 million. ARCC's focus on the middle market centralizes its revenue streams in a segment of the economy in which it has developed expertise. The firm then minimizes risks by spreading investments across broad industry compositions. As of the last fiscal report, ARCC's portfolio holds a fair value of $22.9 billion, comprising 505 companies. This expansive portfolio is not only diversified but also reinforced by partnerships with 232 distinct private equity sponsors.

## Industry and Asset Class Composition:




ARCC's portfolio is well diversified across industry and asset classes, with Health Care (12.5%) and Software (23%) being the leading industry. However, the firm does focus on first lien senior secured loans and second lien senior secured loans, at 44% and 16% respectively. First lien and second lien senior secured loans are both secured by collateral, with first lien loans having the highest repayment priority, making them less risky, while second lien loans are subordinate, offering higher returns but with increased risk. Ares Capital Corporation (ARCC) invests in these asset classes to balance risk and return, leveraging the security of collateral-backed loans while capitalizing on the potential for higher yields from second lien loans in a diversified portfolio.

## ARCC's Highlighted Financial Information:

| USD (MM) | FY 2021 | FY 2022 | FY 2023 |
|---|---|---|---|
| Revenue | $1,820 | $2,096 | $2,614 |
| EBITDA | $1,173 | $1,628 | $1,894 |
| EBITDA Margin | 64.45% | 77.67% | 72.46% |
| Net Income | $1,567 | $600 | $1,522 |
| Net Income Margin | 32.03% | 28.63% | 58.22% |
| D/E | 1.35 | 1.34 | 1.13 |

## Investment Theses

**Ares platform:** ARCC gains significant competitive advantages over its peers from its relationship with Ares Management Corporation and its investment advisor, Ares Capital Management.

Ares Capital Management leverages the extensive investment platform, resources, and established relationships of Ares Management with financial sponsors, financial institutions, hedge funds, and other investment firms to enhance ARCC's accessibility to valuable deals. As of December 31, 2020, Ares Managment had over 525 investment professionals and more than 925 administrative professionals, providing comprehensive support in areas such as accounting, finance, legal, compliance, operations, information technology, and investor relations. The Ares platform not only generates a strong deal flow but also enhances the investment evaluation process. Additionally, Ares' asset management platform supplies crucial market information, company knowledge, and industry insights that significantly benefit ARCC's investment and due diligence processes. The extensive financial sponsor and intermediary relationships maintained by Ares professionals further provide ARCC with valuable insights and access to transactions and information.

Strong track record and seasoned investment team: Since ARCC's IPO on October 8th, 2004, the company's exited investments resulted in an asset level realized gross IRR of 14% and realized gains have exceeded realized losses by more than $753 Million. Approximately 58% of these said investments have exceeded an asset level realized gross IRR of 10% or more. Investors should feel confident that ARCC's continued excellent returns are a testament to the firm's investment selection in the middle market and intensive due diligence process.

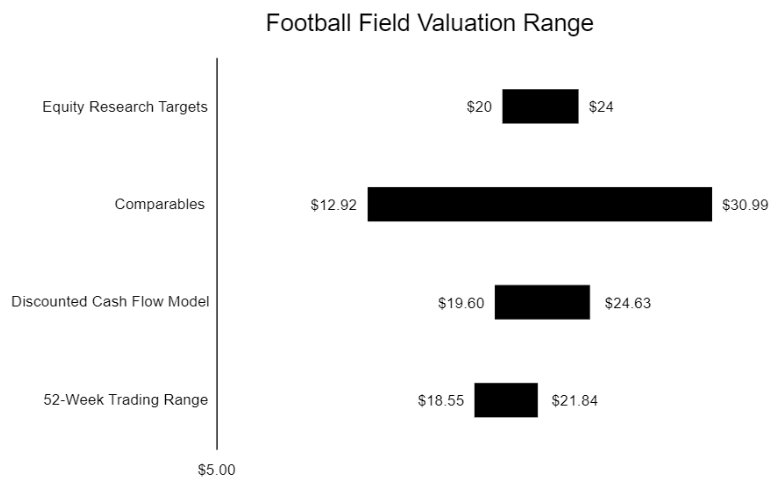
The investment professionals in the Ares Credit Group and the investment committee, led by seasoned CEO Kipp deVeer, have significant experiences investing across marketing cycles. Their expertise is also supported by partners at Ares Managment, who has an average of approximately 25 years of experience in leveraged finance, private equity, distressed debt, commercial real estate finance, investment banking, and capital markets.

RIC Status and consistent dividend yield: ARCC declared a Q3 2024 dividend of $0.48 per share, yielding 9.11%, more than double the financial sector average of 4.17%. As a Regulated Investment Company (RIC), ARCC must distribute at least 90% of its taxable income to shareholders, allowing it to avoid federal corporate income taxes. This has resulted in 15 consecutive years of stable or increasing dividends. It's important to note that in some cases, a high dividend yield can indicate a company in distress and that the yield is only high because the company's shares have fallen in response to financial troubles. In such a case, the high yield may not last for much longer. A company under financial stress could reduce or scrap its dividend to conserve cash. This in turn could send the company's share price even lower.

For example, suppose Company XYZ trades at $50 and pays a $2.50 annual dividend for a 5% yield. A negative external shock sends the stock to $25. The company may not cut its dividend immediately. Therefore, at a superficial glance, Company XYZ appears to now be paying a 10% dividend yield. Despite these risks, ARCC has maintained its dividend and stock price stability, indicating its dividends are well-supported by earnings and prudent portfolio management.

## Price Target & Valuation

Our analysis gives (ARCC) a price target of $22.14 and an overweight rating.




## Potential Downsides to Our Rating

**Taxes and RIC Status:** ARCC’s status as an RIC exempts it from U.S. federal corporate-level income taxes on income and net capital gains distributed to stockholders. However, maintaining RIC status requires ARCC to meet stringent income, asset diversification, and annual distribution requirements, including distributing at least 90% of its taxable income to shareholders. Failure to comply could result in the loss of RIC status, subjecting ARCC to corporate-level income tax, which would significantly reduce net assets and distributions.

**Debt financing challenge:** ARCC’s reliance on debt financing introduces additional complexity, as it must adhere to asset coverage ratio requirements that could restrict its ability to make necessary distributions. Additionally, ARCC often recognizes income before receiving cash, such as from original issue discount or PIK (payment-in-kind) interest, which challenges its ability to meet distribution requirements. If ARCC is unable to generate sufficient cash flow, it may be forced to sell investments at disadvantageous prices, raise additional capital, or reduce new investment originations to meet the required distributions. The complexity of RIC qualification rules adds further risk, and losing RIC status would have a material adverse effect on ARCC and its investors.

Our Price Target: $22.14

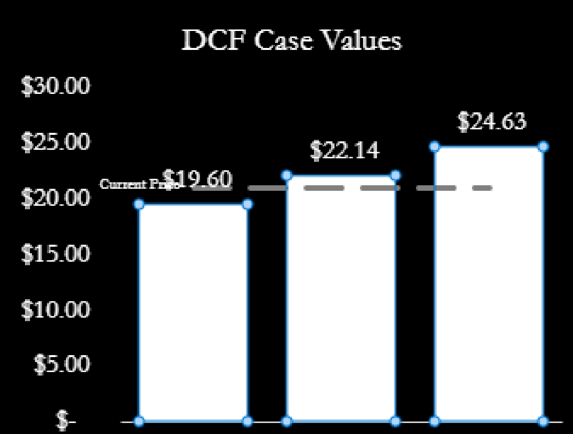
Our PT is based on the assumption that ARCC successfully manages its leverage, maintaining a debt-to-equity ratio at or below 1.0x by 2025. We expect total investment income to grow steadily, reaching $775 million by 2025, supported by strong loan originations and a diversified portfolio. This stable income growth, along with consistent dividend payouts, should drive the stock price to our target level.

Our Upside Case: $24.63

Our upside case assumes a rate cut of 50 basis points (0.5%), leading to a reduction in ARCC's borrowing costs. As a result, total investment income is expected to jump, surpassing $800 million by 2025 due to increased interest income from ARCC’s floating-rate investments. This scenario also assumes strong performance from portfolio companies, leading to equity gains and minimal credit losses, which would further boost ARCC’s profitability and stock price.

Our Downside Case: $19.60

In our downside case, we consider the risk of ARCC's management failing to control leverage, leading to a debt-to-equity ratio exceeding 1.3x. If leverage continues to increase, ARCC may struggle to distribute sufficient taxable income to shareholders, risking the loss of its RIC (Regulated Investment Company) status, which would subject the company to a 21% corporate tax rate. However, the anticipated interest rate cuts could mitigate some of these setbacks by reducing borrowing costs, though this may not be enough to fully offset the potential negative impacts.



**Rates stay higher for longer:** ARCC provides debt financing to middle-market companies, and the company also relies on debt refinancing as part of its portfolio management. As a result, the cost of borrowing is crucial to both the valuation of its portfolio companies and its ability to originate new funds. If interest rates remain elevated for a prolonged period—over the next 12-18 months—ARCC's net investment income could be negatively impacted, as higher borrowing costs may compress margins and decrease the attractiveness of refinancing options. Elevated rates could also lead to lower portfolio company valuations, adversely affecting ARCC's overall performance.

This concern is somewhat mitigated by the Federal Reserve's recent economic indicators. July's unemployment rate rose to 4.3%, up significantly from the historic low of 3.5% just 12 months ago, while the Consumer Price Index (CPI) decreased to 2.9%. With increasing recessionary pressures and inflation cooling, it is likely that the Fed will consider cutting rates. According to CME Fed Watch, traders currently predict a 69% probability of a 25-bps rate cut and 31% 50-bps in the Fed's September meeting. Such a cut could alleviate some of the pressure on ARCC by lowering borrowing costs, thereby supporting portfolio company valuations and improving profitability through more favorable refinancing conditions.

## Projections

| Income Statement ($mm) | 2023A | 2024E | 2025E | 2026E | 2027E | CAGR% |
|---|---|---|---|---|---|---|
| Revenue | 2,870,000 | 3,199,000 | 3,586,079 | 4,023,581 | 4,518,481 | 3.9% |
| EBITDA | 1,894,000 | 2,038,000 | 2,281,974 | 2,561,977 | 2,879,487 | 3.5% |
| EBIT | 1,542,000 | 1,744,000 | 1,948,089 | 2,182,485 | 2,447,802 | 4.0% |
| EBIAT | 793,000 | 484,000 | 1,567,000 | 600,000 | 1,522,000 | 7.1% |

| Margin & Growth Data | 2023A | 2024E | 2025E | 2026E | 2027E | AVG% |
|---|---|---|---|---|---|---|
| EBITDA Margin | 53.1% | 62.6% | 55.2% | 54.5% | 53.8% | 54.1% |
| EBIT Margin | 53.7% | 54.5% | 56.7% | 56.9% | 57.1% | 55.8% |
| Revenue Growth | 73.7% | 11.5% | 12.1% | 12.2% | 12.3% | 24.4% |
| EBIT Growth | 135.4% | 13.1% | 11.7% | 12.0% | 12.2% | 36.9% |

| Valuation Metrics | 2023A | 2024E | 2025E | 2026E | 2027E | AVG% |
|---|---|---|---|---|---|---|
| P/FCF | 11.5x | 23.1x | 15.9x | 11.5x | 8.6x | 14.1x |
| EV/Sales | 9.0x | 8.0x | 7.2x | 6.4x | 5.7x | 7.2x |
| EV/EBITDA | 13.6x | 12.6x | 11.3x | 10.0x | 8.9x | 11.3x |
| FCF Yield | 8.7% | 4.3% | 6.3% | 8.7% | 11.6% | 7.9% |

## About $ARCC

Ares Capital Corporation (ARCC) is a leading business development company (BDC) that focuses on providing debt and equity financing solutions to middle-market companies in the United States. As one of the largest BDCs by market capitalization, ARCC plays a pivotal role in offering capital to companies that are typically underserved by traditional banks. ARCC invests primarily in first and second lien senior secured loans, as well as subordinated debt and preferred equity, targeting businesses with annual EBITDA ranging from $10 million to $250 million. The company leverages its strong relationship with Ares Management Corporation, a global alternative asset manager, to access a vast network of private equity sponsors and investment opportunities. ARCC's diversified portfolio spans a variety of industries, including software and services, healthcare, and commercial and professional services, making it a robust and versatile player in the direct lending market.

## Disclosures & Ratings

Consortium Equity Research does not hold any professional relationships with any reported equities. **Overweight** means the analyst team believes the stock price will outperform the coverage industry (TMT, Healthcare, Industrial, Consumer, FIG) in the next 6-12 months. **Equal Weight** means the team expects performance in line with the industry. **Underweight** means the team expects underperformance relative to the industry.