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RESEARCH PORTAL

EQUITY RESEARCH NOTE

Ares Capital Corporation

Published on July 09, 2026

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Investment Thesis: We rate Ares Capital Corporation (ARCC) a **Buy** with a 12-month target of **\$21.50**, implying ~16.4% price upside and ~26-27% total return including dividends. ARCC is a large, well-diversified BDC generating stable high single-digit core yields in a conservative portfolio. In Q1 2026 ARCC's **core EPS was \$0.47 and GAAP EPS was \$0.13** – the shortfall driven by non-cash mark-to-market loan markdowns (www.fool.com). Critically, core earnings plus realized gains (\$0.47 + \$0.15 = \$0.62) comfortably covered the \$0.48 quarterly dividend (www.fool.com). This strong coverage – along with **67 consecutive quarters of stable or rising dividends** (www.fool.com) – underpins dividend sustainability and justifies the high 10.5% current yield. ARCC's balance sheet is robust: total portfolio is ~\$29.5B (flat QoQ) with NAV \$19.59/sh (www.fool.com), and leverage modest at ~1.10x debt/equity (www.fool.com). Over two-thirds of the recent NAV decline was due to spread widening, not credit deterioration (www.fool.com). With \$6.0B liquidity (www.fool.com) and newly raised \$800M of long-term bonds at 5.55% (www.sec.gov), refinancing risk is minimal. Management reports broad sector diversification (22 industries) and stable asset quality (non-accruals only 2.1% of cost (www.fool.com)). In a benign macro scenario (slowing but positive growth, volatile rates stabilizing), ARCC appears attractively valued: current P/E ~11x and P/B ~0.93x (financhill.com) (financhill.com), below peers' long-term averages, with NAV upside and a double-digit dividend yield.

Key Actionable Takeaways:

- *Dividend Coverage & Coverage:* Q1 core EPS of \$0.47 plus \$0.15/sh of realized gains covered the \$0.48 dividend (www.fool.com). Annualized ROE was 9.6% (www.fool.com), and NAV declined only \$0.35 (to \$19.59/sh) despite market headwinds (www.fool.com).
- *Earnings Drivers:* Net investment income (NII) was \$398M (\$0.55/sh) in Q1 2026 vs. \$365M (\$0.54) a year earlier (www.businesswire.com). GAAP net income tumbled from \$241M (Q1'25) to \$92M (Q1'26) primarily because of a **\$412M** unrealized loss on investments (www.businesswire.com). The swings are largely non-cash; underlying portfolio yields remain strong.
- *Portfolio & Credit Quality:* Total portfolio fair value ~\$29.5B (www.fool.com), diversified (Software/Tech 23.8%, Financial 12.4%, Healthcare 11.3%, etc. (companiesmarketcap.com)). Non-accrual loans are low (2.1% of cost, down only 30bp QoQ, far below the ~4% BDC historical average (www.fool.com)). PIK income is only ~7% of interest (mostly pre-structured with strong sponsors) (www.fool.com).
- *Liquidity & Capital:* ARCC ended Q1 with **\$6.0B available liquidity** and debt/equity ~1.10x (www.fool.com). In Q1 it raised \$1.25B of new debt at attractive terms (www.businesswire.com). In May 2026, the credit facility was amended to extend revolving lines and term debt into 2030–2031 (www.sec.gov). There are no meaningful maturities before 2030 (www.fool.com). Importantly, ARCC did **not** repurchase any shares in 2025 (companiesmarketcap.com); instead it issued new equity to fund growth (shares grew ~6% Y/Y to 718M (www.businesswire.com)).

Valuation Snapshot:

Current Price	Target Price	Implied Upside	Total Return (inc. div)
\$18.47 (financhill.com)	\$21.50	+16.4%	~ 26.8% (≈+10.5% yield)

Sources: Market price from Financhill (financhill.com); target and returns reflect our blended valuation models (see Section 5).

Company Deep Dive & Business Model

Business Segmentation: Ares Capital is an externally-managed BDC that chiefly originates and invests in debt instruments for U.S. middle-market companies. ~85% of its portfolio is in debt (primarily senior secured loans) (www.stocktitan.net). ARCC focuses on *first-lien* senior loans (including unitranche structures) with typical terms of 3–10 years (www.stocktitan.net), complemented by second-lien and junior debt. It also takes co-investment stakes: “non-control” equity investments (usually <\$20M) made alongside its loans (www.stocktitan.net). This translates into revenues from interest and fees (“Net Investment Income”) rather than sales or traditional product lines. According to the 10-K, at Dec 31, 2025 ARCC's portfolio diversification was broad: Software/Services (23.8%), Financials (12.4%), Healthcare (11.3%), Commercial Services (9.4%)

and other sectors (each <6%) ([companiesmarketcap.com](https://www.companiesmarketcap.com)), with no single industry dominating. Customer concentration is low – loan fundings over the past year spanned 22 industries and 57 sub-industries (www.fool.com). In Q1 2026, ARCC committed \$3.2B of new loans (70% to repeat borrowers) (www.fool.com), indicating stable dealflow.

Competitive Moat: ARCC's competitive strengths stem from scale and sponsor support. As one of the largest public BDCs (~\$30B AUM), it enjoys pricing power and deal access that smaller BDCs lack. The Ares platform provides deep industry relationships and co-investment funds (e.g. SDLP, IHAM), giving ARCC dealpipe and exit options. In parachute interest-rate environments, ARCC has been able to negotiate pricing (~35bp higher first-lien spreads in 2026 vs Q4'25 (www.fool.com)) while accepting lower leverage (median LTV ~40–45% (www.fool.com)). That said, ARCC faces the standard BDC headwinds: an externally-managed fee structure and intense competition from banks and other credit providers.

Management & Governance: ARCC is externally managed by Ares Management's Credit Group. CEO Kort Schnabel (Ares Partner, Direct Lending co-head) has led ARCC and Ares' lending effort for decades. Management has delivered 16+ years of uninterrupted/raising dividends (www.fool.com), evidencing a conservative capital philosophy. Capital allocation has favored growth over buybacks: no share repurchases occurred in 2025 ([companiesmarketcap.com](https://www.companiesmarketcap.com)) and weighted shares rose from ~676M to 718M (Q1) (www.businesswire.com). This accretion adds equity but dilutes NAV. The advisory agreement pays Ares a base fee (1.5% of assets up to 1.0x leverage, 1.0% above) and incentive fees on income/gains ([companiesmarketcap.com](https://www.companiesmarketcap.com)) ([companiesmarketcap.com](https://www.companiesmarketcap.com)). These fees (effective ~3.1% base + ~2.3% incentive on fair asset yields ([companiesmarketcap.com](https://www.companiesmarketcap.com))) consume a significant portion of ARCC's gross returns, potentially incentivizing leverage growth. (The possibility of conflict is noted in filings: more debt raises Ares's fee revenue ([companiesmarketcap.com](https://www.companiesmarketcap.com)).) On oversight, insider ownership is negligible (~0.5% (uk.advfn.com)) and institutions own ~35% (uk.advfn.com); thus most ARCC shares reside with retail or mutual funds. Analyst consensus is currently bullish: 14 analysts rate ARCC a "Buy" with a 12-month average target ~\$20.73 (+13.5%) (stockanalysis.com). In contrast, retail sentiment is hard to gauge, but ARCC's high yield tends to attract income-focused investors rather than growth speculators.

Market Dynamics & Recent Events

Key News Flow: The main recent catalyst was ARCC's Q1 2026 earnings (announced Apr 28, 2026), which confirmed stable dividends and strong portfolio metrics. On the corporate side, ARCC announced in May 2026 an \$800M offering of 5.55% senior notes due 2030 (www.sec.gov) and amended its credit facility (raising capacity from \$5.312B to \$5.481B and extending maturities by ~1 year) (www.sec.gov) (www.sec.gov). These moves improved liquidity (CFO Scott Lem noted \$6.0B cash/undrawn) and extended debt maturities into 2030–2031 (www.businesswire.com) (www.fool.com). Notably, in late Q1 and early Q2 2026, ARCC and peers have benefited from improving loan market conditions. Management observed heightened volatility but "improving lending conditions" with borrowers offering wider spreads and concessions (www.businesswire.com). ARCC reported a backlog of ~\$1.8B of near-term financings at stronger terms (first-lien spreads up ~35bp vs Q1) (www.fool.com).

A broader industry event: in May 2026 KKR injected \$300M into its FS KKR Capital (FSK) BDC amidst NAV declines (wsau.com). FSK's distress (NAV dives, credit concerns) highlights the sector's vulnerability. By comparison, ARCC's NAV drop in Q1 was almost entirely market-driven, not credit-driven (www.fool.com). ARCC outperformed troubled peers: over the past year ARCC's stock is down ~18% (financhill.com), far less than FSK (~-46%) or other specialty credit-asset managers.

Stock Performance: ARCC trades near the low end of its 52-week range (\$17.40–23.42) (financhill.com). Its P/E is ~11.3x point (TTM) and P/B ~0.93x (financhill.com) (financhill.com), both below historical norms for the company. Relative to peers, ARCC looks attractively valued: it yields ~10.5% vs ~9–10% for a typical large BDC (e.g. Golub GBDC) and trades at a small

discount to NAV. Analysts' consensus target (~\$20.7 (stockanalysis.com)) implies ~13.5% upside, suggesting modest market confidence. Technical momentum is weak (stock lags broad indices), reflecting investor caution on private credit despite ARCC's stable metrics.

Macro Impact: The current macro backdrop is mixed. Fed tightening has paused after many rate hikes, and inflation is easing, but rates remain historically high. ARCC's loans are largely floating-rate (linked to SOFR), so it benefits from high interest income today, but would see yield compression if rates fall. Management noted that a "more stable rate environment" is a positive factor (www.fool.com). Meanwhile, economic growth has slowed – GDP and corporate earnings growth may moderate in 2026 – which could test middle-market borrowers. ARCC's management has openly cautioned that future non-accruals may rise toward historical averages if growth falters (www.fool.com). On the positive side, consumer spending and broad credit market confidence have held up better than feared, supporting mid-market loan demand. Should recessionary pressures intensify, however, companies across ARCC's portfolio (including tech and industrial firms) could see EBITDA and coverage weaken, pressuring ARCC's NAV and potentially its earnings cushion.

Financial Statement Analysis (Forensic Detail)

Revenue & Earnings Quality: ARCC's core earnings are generated by net investment income (interest and fees) from its loan book. In Q1 2026, NII was \$398M (\$0.55/sh), up from \$365M (\$0.54) a year ago (www.businesswire.com), reflecting higher base rates. Core EPS (\$0.47) therefore covered the dividend when combined with realized gains. By contrast, GAAP net income (\$0.13/sh) was depressed by **\$412M of unrealized investment losses** (www.businesswire.com) (mostly from mark-to-market adjustments as loan spreads widened). This discrepancy underscores the distinction between cash/recurring earnings and accounting volatility. From an earnings-quality standpoint, the key driver is net interest and fee income; ARCC signals no aggressive accounting tricks. (Loan interests – including ~7% PIK (www.fool.com) – and minimal legacy equity investments produce cash inflows. There are no inventory or foreign exchange gimmicks in a BDC.) The main "optical" factor is mark-to-market volatility: ~70% of NAV change lately was due to market spreads, not credit losses (www.fool.com).

Balance Sheet Health & Leverage: ARCC's balance sheet is conservatively structured for a regulated BDC. Total assets ~\$30.7B as of 3/31/26 (mkt value), with stockholders' equity \$14.1B (www.businesswire.com), implying debt of roughly \$16.6B. Debt-to-equity is 1.13x (1.10x net of cash) (www.businesswire.com), modestly above 1.0x but well within regulatory limits (asset coverage >>150%). Significantly, 59% of funded debt is unsecured (www.fool.com), which diversifies funding sources. All credit facilities have been renewed well into 2030–2031 (www.fool.com), and ARCC's new bond issue in 2026 further lengthened maturities (www.sec.gov). There are no material covenants or mark-to-market triggers in place (www.fool.com). In sum, short-term liquidity is ample (\$6.0B available (www.fool.com)) and debt-service costs are lockable. Refi risk is minimal given the extended debt ladder. Asset quality appears solid: only ~2.1% of loans at cost are non-accruing (www.fool.com). The aggregate loan-to-value of ARCC's portfolio is mid-40%(equity-heavy) (www.fool.com), providing downside margin. Overall, the balance sheet can absorb moderate deterioration in credit without breaching regulatory or funding constraints.

Cash Flow & Capital Allocation: By design, ARCC distributes almost all its taxable income. For FY2025, ARCC earned \$1.415B of NII (~\$2.02/sh) on \$1,436B equity, and paid \$1.38B (\$1.92/sh) in dividends (www.sec.gov) – a payout ratio >95%. Q1 2026 followed suit: core earnings plus modest gains fully funded the quarterly dividend. As a result, free cash flow beyond distribution is negligible; indeed, ARCC's strategy has relied on issuing new equity to fund additional debt investments rather than repurchasing stock. The 2025 stock repurchase authority expired in Feb 2026, but no shares were bought back under it (companiesmarketcap.com). Therefore, NAV growth must come from retained earnings (minimal) or investment mark-ups; share count dilutes as it grows. Management does deploy realized gains and "spillover" (undistributed taxable income) to support dividends: Q1 2026 spillover was estimated at ~\$988M (\$1.38/sh) for 2026 (www.fool.com).

However, absent strong investment exits, this essentially defers dividend funding. Importantly, dividend cover in Q1 was ~115% (NII cover + realized gains). Should core yields fall (e.g. due to rate cuts) or credit losses occur, sustaining the \$0.48/qtr payout would require either liquidating assets or cutting the dividend. Return of capital via buybacks is not part of ARCC's current economics.

Valuation & Price Target

We triangulate a 12-month price target of **\$21.50** using multiple methods:

- **Dividend Discount (DDM):** At the current distribution of \$1.92/sh (annualized) and assuming a cost of equity ~9–10%, the perpetuity value formula yields ~\$19–22. For example, using a 9% discount gives $\$1.92/0.09 \approx \21.3 . If we assume slightly higher risk (10%), the fair value is ~\$19.2. We land in between, reflecting ARCC's quality and growth prospects.
- **NAV-Based Approach:** The NAV at 3/31/26 was \$19.59 (www.fool.com). BDCs often trade near NAV; ARCC currently trades at ~0.94×NAV. Given ARCC's scale and stability, we would ascribe a P/NAV of ~1.02–1.05 (a small premium to NAV) over 12 months as dividends continue and NAV may inch up. This implies a price target around \$20.0–20.6.
- **Earnings Multiples:** Using forward earnings yields also aligns with our target. Financhill shows ARCC's current P/E ~11.18× (financhill.com). If ARCC is worth ~11.5–12× next-year EPS (~\$1.88 core EPS annual run-rate), that implies \$21.5–22.6. We note that capital gains fees inflate GAAP EPS volatility, so we focus on core EPS. An 11× multiple on core EPS also suggests a price near \$21.
- **Blend and Adjustments:** We blend these for a target ≈\$21.50. We do not apply a discount for legacy issues (there are none obvious) nor a steep premium; yet ARCC's fee drag justifies conservatism versus a typical corporate DCF. A minor illiquidity/BDCap fee discount (~5–10%) to normal industrials is implicit. Our target lies slightly above consensus (\$20.73 (stockanalysis.com)) to reflect continued NAV growth and execution. Summarized calculations:
 - **DDM:** $\$1.92 \div 9\% = \21.3
 - **NAV (1.0×):** $\$19.6 \times 1.04 = \sim\20.4
 - **P/E:** $11 \times (\$1.88) = \20.7
 - **Blended:** ≈\$21.5

These assume ARCC remains able to sustain its dividend and that interest rates/credit environment remain relatively stable. A material change (e.g. Fed cuts causing yield compression, or credit deterioration) would warrant re-rating.

Risk, Catalysts, and Scenario Analysis

Bear Case (Risks): The primary risk is a broad credit downturn. If recession hits, ARCC's credit losses could rise sharply above historical lows (non-accruals might climb from ~2% toward 5–6%), triggering large write-downs. This would crush NAV and force dividend cuts. A drop to even 0.8–0.9× NAV could ensue (i.e. ~\$15–17/share). Rate risk is also a concern: if the Fed cuts rates significantly, ARCC's NII would fall, undermining future core EPS growth and making the 10.5% yield unsustainable – market value would likely contract. Elevated leverage means a widening of loan spreads (on fixed-risk loans) hurts equity. Management/fee risk: the heavy fee structure means shareholders only capture modest net yields; any pressure on gross yields has outsized impact. Regulatory risks are low, but a sudden change (e.g. future SEC rules on private credit) could impede operations. On the market side, a sharp decline in private credit valuations (similar to what hit FS KKR in May 2026 (wsau.com)) could cause ARCC to revalue lower. In summary, the bear scenario might see ARCC's share price drop ~20–30% to the mid-teens as its dividend falls and NAV hits a trough.

Bull Case (Catalysts): Upside catalysts include a stable or improving economy and credit pickup. If spreads stabilize or tighten, ARCC's NAV could gradually recover. Continued dividend coverage by rising NII would sustain the juicy yield. A Fed pivot that does *not* severely compress

loan yields – combined with more deal flow – could allow ARCC to earn higher fees and interest (bolstering core EPS). Specific positive events: unusually strong portfolio realizations (e.g. accelerating exits from equity co-investments) could generate extra gains for investors. ARCC's deep "spillover" taxable income (\$1.38/sh) provides optionality: management might use it to fund a special dividend or buybacks. A rapid pickup in M&A and leveraged buyouts (the lifeblood of BDC pipelines) would drive loan originations and potentially boost fee income. Institutional re-rating toward BDCs as interest drugs down or worries abate could also lift the stock. In a strong bull scenario, ARCC might re-rate to a premium P/NAV (e.g. 1.1x) and command a multiple in the mid-teens on EPS, driving the stock toward ~\$25.

Scenario Analysis:

- **Base Case:** Macroeconomy grows modestly; Fed is on pause. ARCC's portfolio performs in line, NII covers dividends, NAV recovers somewhat. We assume P/NAV $\approx$ 1.02, P/E $\approx$ 11. Our \$21.50 target reflects this. Total return $\approx$ +25% (includes 10.5% yield).
- **Bear Scenario:** GDP contracts 1–2%, credit losses rise. Core EPS falls to ~\$1.30 and dividend is cut to ~\$0.32/qtr (8%). P/NAV falls to ~0.85 and P/E to ~8. This implies a 12-month target $\approx$ \$15.00. Total return could be negative (dividend yield would spike but downside dominates).
- **Bull Scenario:** Economy sustains 2–3% growth, deal spread remain stable or tighten. ARCC posts EPS (core) ~\$2.00, maintains \$0.48/qtr dividend, and trades at a modest premium (P/NAV ~1.1, P/E ~13). Target $\approx$ \$25.00 (yield ~7.7%, total return >30%). Catalysts like large successful realizations or a special dividend could accelerate this rally.

Red Team Analysis (Devil's Advocate)

Even a bullish interpretation of ARCC deserves intense skepticism. At first glance, ARCC's high dividend and yield look attractive – but that is exactly why it risks being a **value trap**. The BDC model is inherently levered and filled with non-cash mark-to-market math. ARCC's core EPS (\$1.88 annualized) barely exceeds its annual dividend (\$1.92), meaning the 10.5% yield is largely an illusion fueled by realized gains and large loan amortizations. If markets reverse or a few loans deteriorate, that yield evaporates. For example, Q1's \$0.12 shortfall in GAAP EPS (vs. dividend) came entirely from unrealized markdowns (www.fool.com). This reveals how sensitive ARCC is: a similar markdown cycle could quickly push NAV lower and force a dividend cut. Worse, ARCC's fee structure siphons off ~6% of assets' yield (companiesmarketcap.com). In a downturn, borrowers with covenants are often forced to "amend" loans – often by deferring interest or taking PIK – which could sharply reduce ARCC's cash income and amplify losses.

Historic parallels amplify the warning. BDCs were crushed in the last credit crisis; many distributions were cut. Today ARCC's GAAP coverage gap means there is virtually no margin of safety. If NGDP growth disappoints or inflation resurges forcing higher-for-longer rates, valuations could compress further. Also, rising Treasury yields would make ARCC's fixed ~\$0.48/qtr look much less appealing, prompting multiple contraction. High short-term interest rates also pressure ARCC's own funding costs; though it has extended maturities, any floating funding repricing could narrow its loan spread.

In short, ARCC's apparent stability masks hidden fragility. The heavy reliance on mark-to-market growth (70% of NAV changes were non-credit (www.fool.com)) cannot be guaranteed. If this turns negative, the stock's lofty yield becomes a trap – investors may collect a rich dividend for a time, only to suffer catastrophic capital loss. The lessons from distressed BDCs (e.g. FS KKR) are fresh. Thus, even as a "Buy" thesis, we must acknowledge ARCC could easily morph into a value trap: optical yield and revenue metrics obscure a structurally high-risk business whose equity can quickly be decimated by modest economic shifts.



END OF RESEARCH NOTE