

NEW RISK ALERT: (ARCC)

Ares Capital Appears to Lower Its Standards For Selecting Investment Opportunities

New language in latest 10-K reveals investment opportunities receiving due diligence have risen at least 28%.

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This alert compares the language used in the company's latest filing with the period before. [Research](#) suggests changes in language, particularly in the risk factor section, is a powerful indicator of future performance. Companies that change filing language, according to research, underperform those that don't by 30-50 basis points per month for the following year.

Ares Capital Increases the Pool of Potential Investment Opportunities

Ares Capital is a business development company that specializes in acquisition, recapitalization, mezzanine debt, restructurings, rescue financing, and leveraged buyout transactions of middle market companies. In the current environment, it appears Ares has been forced to broaden its pool of investment candidates—ultimately investing in and lending to companies it might not have in the past.

Like always, Ares describes its due diligence process in detail in its annual reports. However, in its 2020 [10-K](#), Ares provides an update that suggests it may be lowering its standards by increasing the number of firms on which it conducts due diligence and in which it ultimately invests.

In the 2019 report, Ares revealed the percentage of investment opportunities selected for preliminary due diligence:

*“Approximately **30-40%** of the investments initially reviewed by us proceed to this phase.”*

In the 2020 report, Ares reveals it's doing diligence more often:

*“Approximately **40-50%** of the investments initially reviewed by us proceed to this phase.”*

Next, a report is created and reviewed by senior investment professionals. If they're in favor of a potential investment, another round of due diligence is performed.

In 2019, Ares revealed the percentage of investment opportunities— after undergoing a second round of diligence— that are ultimately sent to its investment committee for a final investment decision:

*“Approximately **7-10%** of all investments initially reviewed by us will be presented to the investment committee.”*

In 2020, Ares acknowledges it's sending a greater percentage of opportunities to the investment committee:

*“Approximately **10-15%** of all investments initially reviewed by us will be presented to the investment committee.”*

Total assets at the company grew just 8.7% in 2020. Yet at the midpoint of the new estimates presented in the latest annual report:

- The number of investment opportunities receiving due diligence increased 28%.
- The investment opportunities presented to the investment committee for a final investment decision increased 47%

Unless the quality of investment opportunities suddenly increased commensurate with the increase in the diligence Ares conducts, the company has loosened its standards.

We're certain Ares Capital would disagree with our characterization. We're also sure Ares would acknowledge that competition for investment opportunities is elevated. With the U.S. money supply ballooning by approximately 25%, more stimulus on the way, and the Federal Reserve purchasing junk bond ETFs, making senior loans that also top internal hurdle rates is as challenging as ever.