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Q4 2019 TCG BDC Inc Earnings Call

EVENT DATE/TIME: FEBRUARY 26, 2020 / 1:30PM GMT

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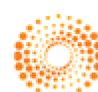

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the TCG BDC, Inc. Fourth Quarter 2019 Earnings Conference Call. (Operator Instructions)

Please be advised that today's conference may be recorded. (Operator Instructions)

I would now like to hand the conference over to your speaker today, Mr. Daniel Harris, Head of Investor Relations. Thank you. Please go ahead, sir.

Daniel F. Harris ***TCG BDC, Inc. - Head of Investor Relations***

Thank you, Daniel. Good morning then, and welcome to TCG BDC's Fourth Quarter 2019 Earnings Call. Last night, we issued an earnings press release and detailed earnings presentation with our quarterly results, a copy of which is available on TCG BDC's Investor Relations website. Following our remarks today, we will hold a question-and-answer session for analysts and institutional investors.

This call is being webcast, and replay will be available on our website. Any forward-looking statements made today do not guarantee future performance and undue reliance should not be placed on them. These statements are based on concurrent management expectations and involve inherent risks and uncertainties, including those identified in the Risk Factors section of our annual report on Form 10-K that could cause actual results to differ materially from those indicated. TCG BDC assumes no obligation to update any forward-looking statements at any time.

And with that, I'll turn the call over to our Chief Executive Officer, Linda Pace.

Linda Pace ***TCG BDC, Inc. - Chief Executive Officer***

Thanks, Dan. Good morning, everyone, and thank you for joining us on our call this morning to discuss our fourth quarter 2019 results. Joining me on me on the call today is our Chief Investment Officer, Taylor Boswell; and our Chief Financial Officer, Tom Hennigan.

I'd like to focus my remarks today across three areas. First, highlighting the strength and momentum of our business as we exit 2019 and begin 2020. Second, summarizing our financial results for the quarter and third, a brief discussion on our capital position and dividend.

I'll start by discussing the strength of our platform. 2019 was a year of change for our company. And as we enter 2020, we are well positioned to capitalize on the opportunities ahead of us. While I formally assumed the role of Chief Executive Officer of our BDC on January 1, our company's entire senior leadership team has been extremely active over the past few quarters, working to optimize our portfolio, ensure that we have the right team in place to drive our investment process and continue to wisely manage our capital position.

Taylor and I, along with our entire team have evaluated every part of our investment process. Taylor will go into more detail, but we quickly identified a small piece of our loan portfolio that has been accounted for an outsized amount of our losses, and we move rapidly to minimize that risk. We sit here today having largely eliminated that exposure in a relatively short period of time.

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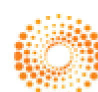

Our goal is to deliver stable NAV and sustainable earnings coverage for our regular dividend. Disciplined underwriting standards, prudent usage of portfolio leverage and active portfolio management will help us achieve that goal. Our investment for philosophy is anchored three core tenants: Directly originating investment opportunities from sponsors with whom we have deep and meaningful relationships; maintaining a strong bias towards senior debt and determined industry exposures and utilizing the full breadth of Carlyle's capabilities, scale of our capital and depth of our expertise to deliver differentiated investment opportunities and create better outcomes for our shareholders.

Let me move on to an overview of our results for the fourth quarter. We generated net investment income of $0.43 per share, and we declared our regular $0.37 dividend as well as a special dividend of $0.18 per share. As we have done in every quarter since our IPO, our company generated net investment income in excess of our regular quarterly dividend. While lower LIBOR continues to be a headwind for overall portfolio yield, we are confident in our ability to pay our standard quarterly dividend going forward.

Our net asset value per share declined $0.02 to $16.56 from $16.58 last quarter, which includes the impact of our special dividend. Excluding this, net asset value per share would have been $16.74, up 1% quarter-over-quarter. Our portfolio experienced a $0.02 gain in net realized and unrealized depreciation and ongoing share repurchases were $0.06 per share accretive to NAV.

Let me conclude with a discussion of our dividend and capital position. At the end of 2019, we took advantage of receptive market and Carlyle's strong distribution team to privately place a $115 million unsecured bond. We're pleased with our initial execution in the unsecured market, which Tom will touch upon further during his remarks. We have also been active repurchasing shares as we continue to see great value in our company at current levels. During the fourth quarter, we repurchased over $17 million in shares. And as of today, we have approximately $22 million remaining on our current authorization. Over the next quarter or two, we intend to seek board approval to authorize additional repurchases. Since we initiated the program at the end of 2018, the repurchases have added approximately $0.20 to our NAV. We feel confident about the quality of our portfolio today, and expect to take advantage of our deeply discounted low relative valuation and remain active buyers of our stock.

At our currently deep discounted share price of approximately $12.80 per share, our regular quarterly dividend represents an attractive yield to shareholders of approximately 12%. In 2019, we announced $0.26 per share of special dividends compared to $0.20 in 2018. That said, as we've previously noted, we intend to balance future special dividends with capital preservation.

So to reiterate, we remain extremely focused on portfolio performance and stabilizing NAV. We believe CGBD shares offer investors a high-quality recurring dividend stream and an attractive valuation.

Let me now hand the call over to our Chief Investment Officer, Taylor Boswell.

Taylor Boswell ***The Carlyle Group Inc. - Chief Investment Officer of Direct Lending***

Thank you, Linda, and thanks to everyone on the call this morning for their interest in, and support of CGBD. As usual, I'll start by briefly sharing an update on Carlyle's current read of economic and credit market conditions. I will spend most of my time on the topic of credit performance, and the reasons why we expect it to improve in the coming quarters as compared to the experience of 2019.

On the economic front, at the time of our last report, there was concern, which Carlyle did not share, of entering a recessionary environment. Since then, Carlyle has seen clear signs of stabilization in the global economy and continued growth in our portfolio companies. The easing of trade tensions should provide further support in 2020. As everyone here knows, the emerging economic risk is coronavirus, the impact of which we are closely monitoring across our global footprint. While early, our view is that this is likely to flatten or postpone but not reverse the pickup we expected this year. That said, we expect impacts from coronavirus on our portfolio will be relatively limited due to our strong overweight in noncyclical domestic demand driven activities. All in all, we judge the current environment to be supportive of the continued performance of CGBD's portfolio.

Meanwhile, levered corporate credit markets are currently experiencing a period of strong technical demand. As fixed income asset classes suffer yield compression alongside rates markets. The dislocated condition [headwinds] (added by company after the call) in traditional leveraged finance markets of the fall of 2019, feel like a distant memory. And repricing activity has been heavy over the past

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several months.

In private credit markets, where nearly all of our investing is conducted, competition remains stiff, putting a premium on breadth and quality of one's direct origination footprint. Our broad platform positions us well in this respect, and we are able to generate attractive investments across market cycles. Regardless, this is a moment for relative caution as the relationship between financing execution outcomes and quality of underlying investment is tight.

Turning to credit. Over the last 12 months, credit migration has been a detractor from our results. And in our opinion, the principal driver of our otherwise unwarranted discounted valuation relative to book value. We have not been pleased, and our team has been actively working on strategic initiatives to improve credit performance as well as tactical actions to maximize value at the position level. Due to those efforts, we reported strong results this quarter. With NAV up, excluding special dividends. Importantly, we stand here today more confident, we will deliver go forward performance in line with our investors and our own expectations. There are 3 reasons for that increased confidence.

First, our losses have been highly concentrated in a single strategy exposure, the Carlyle Unitranche Program, otherwise known as CUP. As a result of our efforts and market activity, CUP is now largely exited. To refresh, CUP was an origination partnership we ran from 2015 to 2017, where CGBD took last out exposure in unitranche financings offered to small borrowers. Since our IPO, CUP has generated over half of CGBD's net realized and unrealized losses, and nearly 2/3 of the same figure in the last 12 months, despite representing only 8% of our portfolio. We have now reduced CUP exposure to a single sub-1% position. Further, this position, which had been on our watch list was recently upgraded as a result of improved performance. CUP can no longer produce the outsized negative results, which weighed on our performance in the past.

Second, as we analyze prospects for our portfolio's performance away from CUP, we take comfort from the structural positioning of our investments. We run a senior heavy portfolio with historically around 70% of assets in true first dollar risk positions. This allows us to exert more control on workouts, experienced less ongoing volatility and sustain less permanent earnings erosion in the case of losses. Consequentially, essentially all of the fair value of our watch list credits today are first dollar exposures, limiting the prospect of more of the high severity outcomes, which characterized our weak credit performance in recent periods.

Dermatology associates, a recent addition to our nonaccrual list is in this first dollar category and is a name from which we ultimately expect to receive significant recoveries and restore income generation to CGBD. So while we are by no means immune to future credit losses, the first dollar orientation of our portfolio and watch list leaves us in better positioned to perform going;

And third, where we do have junior debt exposure, namely the 11% of our portfolio and second lien instruments, we are comfortable with our risk position and track record. We focus our second lien investing on larger borrowers, currently averaging over $100 million of EBITDA. This compares to an average EBITDA of $20 million for the CUP program. For obvious reasons, larger borrowers make for sounder credit profile. And we have benefited from an exceedingly strong track record in true second lien investing with positive realized and unrealized performance since inception for CGBD in these loans.

Shifting from credit to income generation, you should expect us to replace legacy CUP exposures with a combination of large borrower second lien, which we are well positioned to source in an increasingly privately placed market and additive yield-enhancing strategies offered by the Carlyle platform, such as our ABL business, which generate, on average, 150 to 200 basis points of incremental spread as compared to our overall portfolio. By integrating these capabilities, we have the opportunity to concurrently drive incremental yield and diversify our risk factors. In the fourth quarter, we had significant success doing exactly this. Sourcing from Europe to compelling second lien opportunities that are expected to close in the first quarter. These and other recently made investments will significantly offset the temporary yield compression experienced in Q4 from CUP exits.

To conclude, our initiatives of the last 9 months to improve portfolio performance are off to a strong start. With these efforts and CUP effectively behind us, we are confident in our ability to deliver improved performance and continue to meet our core investment objective, the delivery of sustainable yield to our shareholders.

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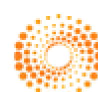

I'll now turn the call over to our Chief Financial Officer, Tom Hennigan.

Thomas M. Hennigan ***TCG BDC, Inc. - Chief Financial Officer of TCG BDC***

Thank you, Taylor. As Linda previewed, we had another solid quarter of total income generation. Total investment income for the fourth quarter was $53 million, down from $56 million in the prior quarter. The decrease was primarily due to lower interest income on the core investment book, driven by repayments of higher-yielding investments, the decline in LIBOR and one addition to nonaccrual. This was partially offset by higher OID acceleration from an elevated level of repayments during the fourth quarter and higher total income from the JV.

Total expenses were $28 million in the quarter, down from $29 million last quarter, driven by lower interest expense, primarily from lower LIBOR and lower management and incentive fees. This resulted in net investment income for the quarter of $25 million or $0.43 per share, which is in line with the average since our June 2017 IPO. On February 24, our Board of Directors declared the regular dividend for the first quarter of 2020 at the same $0.37 per share and is payable to shareholders of record as of the close of business on March 31.

Expanding on some of our earlier on yield compression. As of 12/31, the yield on our core loan portfolio based on cost was 8.2%, down about 65 basis points from the prior quarter. The largest component was repayments of higher price assets. But as Taylor noted, we have a strong pipeline of second lien investments that will allow us to recapture about 20 basis points of that decline.

As we look forward to the impact of lower yields on 2020 earnings, LIBOR continues to be a headwind. But no surprise to us as we've highlighted this in the past few quarters. When combined with lower OID acceleration in the first quarter of 2020, we see NII closer to the $0.40 range. And even though we see some earnings pressure in coming quarters, we still anticipate consistently covering our regular $0.37 dividend.

Moving onto the JV's performance, the dividend yield on our equity the JV remained consistent at 13% for the fourth quarter. Repayments again outpaced deployment at the JV during the quarter, but we're focused on reversing this trend in early 2020, with increased resources dedicated to the JV origination effort.

Shifting to the financing front. Total debt outstanding was about $1.2 billion, and statutory leverage was 1.23x, both consistent with prior quarter. We mentioned on last quarter's call that given the more favorable rate environment for issuers, we were continuing to evaluate alternate financing solutions. To that end, we successfully closed a $115 million unsecured note offering in December, our first issuance of unsecured debt. To note as a standard 5-year maturity and a 4.75% fixed rate, which we think is quite attractive, given the private execution, flexible covenant package and the all-in cost savings from leveraging our internal business development team for distribution. The offering provides us the financial flexibility and risk management tool to comfortably run leverage within our target range of 1.0 to 1.4x. Proceeds from the offering were used to repay debt under our revolving facilities.

Regarding the overall portfolio, the weighted average internal risk rating remained 2.3%, and we had a modest increase in the watch list based on fair value.

On the valuations, our total aggregate realized and unrealized net gain was about $1.5 million for the quarter, with no position accounting for an outsized gain or loss. The sizable realized loss in the fourth quarter is related to writing off our investment in Product Quest, but that investment has been at zero fair value since September 2018, and we had an equal reversal of prior period unrealized losses. And although we placed our investment in Dermatology Associates on nonaccrual this quarter, our valuation was flat, given we're seeing signs of credit stabilization at the company.

Regarding other realizations in the fourth quarter, we successfully exited our investment in Twenty Eighty. This was a loan we restructured back in early 2017. And given our first dollar risk position, we were able to maximize recovery during a prolonged workout, resulting in a return in excess of 100% of our original loan investment. So all in all, we would characterize this quarter as one of stability and overall credit quality.

With that, let me turn the call back over to Linda for some closing remarks.

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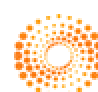

Linda Pace ***TCG BDC, Inc. - Chief Executive Officer***

Thank you, Tom. Before turning to your questions, I'd like to conclude by reinforcing that 2019 was a year of considerable changes and progress we've made. We have taken advantage of being part of the Carlyle Group to grow and enhance our underwriting team, our investment process and our origination capabilities. At this point, we have the resources firmly in place, to execute on delivering attractive returns for our shareholders in 2020 and beyond.

With that, I'll turn the call back over to Daniel, our operator for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Our first question comes from Finian O'Shea with Wells Fargo Securities.

Finian Patrick O'Shea ***Wells Fargo Securities, LLC, Research Division - Associate Analyst***

Congratulations on the quarter. First one on Derm Associates. I appreciate your commentary on the hopeful recovery. But can you help reconcile that it was placed on nonaccrual, implying that you don't expect full recovery, but the valuation was up. So I would think that either it should have been on nonaccrual last quarter or the valuation would be down. Just any context you could give to those conflating movements?

Thomas M. Hennigan ***TCG BDC, Inc. - Chief Financial Officer of TCG BDC***

Finian, it's Tom. What I do is I bifurcate to do different discrete decisions is what the right valuation is in a nonaccrual valuation. Again, mark-to-market based on our view at the particular point in time, not necessarily indicative of what we ultimately think we're going to recover, but what we think the right fair value is at any point in time. Non-accrual relates to getting our interest income payable at the current moment in time. So really, one is cash flow based, one is fair value market-based. So that's where you see one, I would say, valuation stable and obviously, the nonaccrual, what we consider the negative viewpoint in fourth quarter versus third quarter on current income receipts.

Finian Patrick O'Shea ***Wells Fargo Securities, LLC, Research Division - Associate Analyst***

Okay. That's helpful. And also, Tom will -- have you on just a question on the unitranche program, appreciating that you all identified that as a source of stress, and it looks like there's a major rotation out of that this quarter. The first thing that comes to mind is, I assume that was a good source of your top line, given it's effectively second lien, although the loan yields are harder for us to read and they move quarter-to-quarter, but I assume you get what I'm asking. On replacing that income, do you have another similar strategy? Or will this kind of just migrate to first lien through a more conservative posture?

Taylor Boswell ***The Carlyle Group Inc. - Chief Investment Officer of Direct Lending***

Sure. Fin, it's Taylor speaking. I think that what you should expect is for that CUP exposure to be replaced with two things: one, incremental investments in our large borrower second lien portfolio, which we've conducted for a long time and have a good track record in. In fact, we've already booked a couple assets in the fourth quarter that closed in the first quarter, which will help us drive some incremental yield in the portfolio. And then secondly, I think you've heard from us over the course of the last couple of quarters that we're more proactively using some of the other strategies available to us around the platform, which do offer us incremental yield versus that core U.S. middle market sponsor finance asset class.

So between those two levers, we think we're pretty well positioned to replace the income that we rotated out of CUP and are well on our way to doing that already.

Finian Patrick O'Shea ***Wells Fargo Securities, LLC, Research Division - Associate Analyst***

Okay. And just one more on the -- to a similar regard. The credit funds, that's been a very good return, top and bottom line, for you, but pretty stable I think, 10-ish percent of the portfolio.

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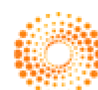

Can you remind me us if -- was that the target? Or are you trying to make this more of a 15%, 20% item or higher?

Thomas M. Hennigan ***TCG BDC, Inc. - Chief Financial Officer of TCG BDC***

It's Tom. We've always stated that our target return is in the mid-teens. So I put that 13% to 15%. So we're certainly towards the bottom end of that range where we've been historically. But I'd say we see that 13% at a relatively stable level right now. We're -- our aspirations right now are that, that will not be a 15% to 20% number.

Finian Patrick O'Shea ***Wells Fargo Securities, LLC, Research Division - Associate Analyst***

Sorry, sorry, Tom, I meant to say, size of the portfolio, will you have more-- will you grow the fund?

Thomas M. Hennigan ***TCG BDC, Inc. - Chief Financial Officer of TCG BDC***

I think we're looking at it, relative stability there, too.

Finian Patrick O'Shea ***Wells Fargo Securities, LLC, Research Division - Associate Analyst***

Okay.

Thomas M. Hennigan ***TCG BDC, Inc. - Chief Financial Officer of TCG BDC***

[Income in] size.

Finian Patrick O'Shea ***Wells Fargo Securities, LLC, Research Division - Associate Analyst***

Okay.

Thomas M. Hennigan ***TCG BDC, Inc. - Chief Financial Officer of TCG BDC***

Thanks, Fin.

Operator

Our next question comes from Ryan Lynch with KBW.

Ryan Patrick Lynch ***Keefe, Bruyette, & Woods, Inc., Research Division - MD***

The first one had to do with the exit of the CUP loans, the last out loans this quarter. There was a significant exiting of that portfolio. Was that normal course runoff? Or were you guys selling those loans to other parties to kind of accelerate that -- those exits this quarter?

Taylor Boswell ***The Carlyle Group Inc. - Chief Investment Officer of Direct Lending***

It's Taylor again. It was two actions. It was sort of normal market activity, M&A activity and then some proactive refinancing work by us but no sales of the positions.

Ryan Patrick Lynch ***Keefe, Bruyette, & Woods, Inc., Research Division - MD***

Okay. And then on that, I was very interested in your comments, you mentioned that the CUP -- the decision to exit the CUP loans because they generate half your realized losses that you had, which I think can make sense. But I was interested that you said some of the CUP loans are higher-yielding loads given that they're last out, that you were going to replace those with large borrower second liens as well as some other yield-enhancing strategies, but specifically on the large borrower second liens. I mean, I view last out unitranche loans as basically synthetic second lien loans, and those are loans that you said have caused you meaningful realized losses over the last several years. And now as your reasoning for exiting those, but then you're going to replace them with just larger borrower standard, second lien loans. So it seems like you're not really changing your risk profile from exiting the last out Unitranche CUP loans and then replacing those with standard second lien loans and can you help me reconcile both those?

Taylor Boswell ***The Carlyle Group Inc. - Chief Investment Officer of Direct Lending***

Yes. The primary difference is the size of borrowers. So we think one of the key problems with CUP's historical performance was the smaller borrower orientation of that junior debt investment, about $20 million average EBITDA size. When we talk about larger borrowers, second liens, we've been doing that in these portfolios since inception and have a really strong track record up in that

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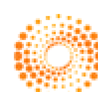

marketplace, which is about a $100 million of average EBITDA in our positions today. It's also coming at a time in the marketplace, where there's some structural changes in the way the market is working, where there is a technical gap in demand for second lien assets. So it's actually a nice place to be right now from a technical demand perspective, risk reward perspective. And on the pure risk point, the scale of the borrowers and our proven track record in that space, leave us a lot more confidence that, that will drive better performance out of that junior debt exposure.

Linda Pace ***TCG BDC, Inc. - Chief Executive Officer***

Yes. And Ryan, this is Linda. I would just add to that. When you talk about a small borrower that has $20 million of EBITDA, like we saw in the CUP program, inherently, you're talking about borrowers that have less proven business plans and less tested management teams than you would with companies that have already been in existence and have grown and have a $100 million plus of EBITDA. And so you can have any view you want as to where we are in the cycle or what some headwinds might be ahead of us, but we feel much more comfortable going through any periods of economic volatility or other types of risk with just larger companies that have more access to capital, more optionality within their business models and more proven management teams.

Ryan Patrick Lynch ***Keefe, Bruyette, & Woods, Inc., Research Division - MD***

Okay. And then over -- around the last 12 months, there's been pretty significant management and high [investment] (corrected by company after the call) professional turnover at the BDC. Started with the President, CEO, Head of Originations, Head of West Coast Originations. That's more than I can remember in other BDCs and quite a bit. So can you just comment on that level of management turnover that the BDC has experienced over the last year and how investors can get comfortable with the current team running it and how they should feel about that level of turnover?

Linda Pace ***TCG BDC, Inc. - Chief Executive Officer***

Sure. Sure, Ryan, no problem. As you kind of heard all of us over the recent quarters and Taylor today. We really weren't pleased with the performance of the underlying portfolio for the BDC. And this is a very important business for us, obviously, and for the Carlyle Group overall. And we want to make sure that we're putting the right resources and the right number of resources towards this business. So on that end, it's not so much necessarily to change, but we're really adding more senior investment professionals, both at the investment committee level, the underwriting level, the origination level.

So really putting what Carlyle views as our best and most experienced investment professionals at work on this BDC to make sure that our performance does not repeat itself as it did in 2019, but really goes in the right direction for -- both for Carlyle, but really more importantly, for our shareholders.

Ryan Patrick Lynch ***Keefe, Bruyette, & Woods, Inc., Research Division - MD***

Okay. Understood.

Daniel F. Harris ***TCG BDC, Inc. - Head of Investor Relations***

Thanks, Ryan.

Operator

Our next question comes from Arren Cyganovich with Citi.

Arren Saul Cyganovich ***Citigroup Inc, Research Division - VP & Senior Analyst***

I just wanted to ask about the -- had another question on the CUP. What I guess, strikes me is that I would assume that you had decision-making ability in terms of approving loans, and it's -- the severity issues are what they are based on in the capital stack. But nonetheless, you chose to invest in those loans. And what's to give investors a better feel that the default frequency is going to be better going forward?

Linda Pace ***TCG BDC, Inc. - Chief Executive Officer***

Sure, Arren. Thanks for your question. I think it harks back really to the answer to Ryan's question in that we put additional resources across the platform in place. We have more personnel, very highly skilled, qualified, experienced, investment professionals in place to really make sure that we're not making decisions like that again. And you heard from Taylor that where our strategy lies. The strength of

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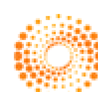

what we bring to the table and the -- one of the main keys to our success going forward will be in utilizing what we have across the Carlyle global platform to help us source differentiated investments that don't look like the ones we had in the CUP program, but have a much a better risk profile to them.

So we've -- the proof will be in the pudding, obviously, and you can judge just that over the next number of quarters. But we feel very confident in the team we have in place, the process we have in place and the fact that we've learned from our mistakes.

Operator

Thank you. Ladies and gentlemen, this concludes today's question-and-answer session. I would now like to turn the call back over to Daniel Harris for any further remarks.

Daniel F. Harris ***TCG BDC, Inc. - Head of Investor Relations***

Thank you for your time and attention this morning. If you have any follow-up questions, feel free to reach out to Investor Relations after the call. And we look forward to speaking with you again next quarter.

Operator

Ladies and gentlemen, and this concludes today's conference call. Thank you for participating. You may now disconnect.

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