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TCG BDC, Inc. (CGBD)

Q1 2019 Earnings Call

CORPORATE PARTICIPANTS

Daniel Harris
Head of Investor Relations, TCG BDC, Inc.

Michael Anthony Hart
Director and Chairman of the Board & Chief Executive Officer, TCG BDC, Inc.

Grishma Parekh
Head of Origination, TCG BDC, Inc.

Thomas M. Hennigan
Chief Financial Officer & Chief Risk Officer, TCG BDC, Inc.

OTHER PARTICIPANTS

Richard Shane
Analyst, JPMorgan Securities LLC

Finian O'Shea
Analyst, Wells Fargo Securities LLC

Ryan Lynch
Analyst, Keefe, Bruyette & Woods, Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Good day, ladies and gentlemen, and welcome to the TCG BDC First Quarter 2019 Earnings Call. At this time, all participants are in listen-only mode. Later, we will conduct a question-and-answer session and instructions will follow at that time. [Operator Instructions] As a reminder, this conference call may be recorded.

I would now like to introduce your host for today's conference, Mr. Daniel Harris, Head of Investor Relations. Mr. Harris, you may begin.

Daniel Harris
Head of Investor Relations, TCG BDC, Inc.

Thank you, Sherry. Good morning and welcome to TCG BDC's first 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 a replay will be available on our website.

Any forward-looking statements made today does not guarantee future performance, and undue reliance should not be placed on them. These statements are based on current 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. Lastly, past performance does not guarantee future results.

With that, I'll turn it over to our Chief Executive Officer, Michael Hart.

Michael Anthony Hart

Director and Chairman of the Board & Chief Executive Officer, TCG BDC, Inc.

Thanks, Dan. Good morning, everyone, and thank you for joining us for our first quarter earnings call. I'm joined today by our Head of Originations, Grishma Parekh; and our CFO, Tom Hennigan. I'll begin this morning with a brief look at our financial results and also share some thoughts on the development of our business. Yesterday, we released our first quarter earnings for the year. By every metric whether it's earnings, originations, portfolio growth, or NAV improvement the business delivered strong results. Most important from my vantage point are four key drivers of this performance.

First is our core portfolio, first lien oriented, fully scaled and highly diversified. Second is the continued strong performance of the Middle Market Credit Fund which is our joint venture with PSP. Third are the capabilities and efforts of our direct lending professionals across originations, capital markets and underwriting who combines his source evaluate a record number of potential investment opportunities. And finally, the significant resources that we leverage from the broader firm including a Global Credit platform and the Carlyle Group more generally.

Global Credit now has assets under management of nearly $46 billion and firm-wide AUM totaling $216 billion. Carlyle Direct Lending has originated roughly $600 million in gross new loan commitments this quarter and approximately $2.4 billion over the last 12 months.

Looking at some of the specific numbers, net investment income was $0.45 per share, comfortably covering our first quarter dividend of $0.37, a result that has been achieved in every reporting period in our company's history. This quarter's results are representative of core interest income contributing the vast majority of total income versus any one-time fee-related items.

As of March 31, we've generated undistributed surplus income of approximately $0.20 per share. With this surplus, we'll be considering the payment of a special dividend during the second quarter of 2019; and given the consistency of our NII performance, we'll be considering an increase to our stated quarterly dividend as well.

Record first quarter originations led to a near 10% increase in our investment portfolio, which reached approximately $2.2 billion at the end of the quarter. What was most satisfying was the quality and composition of the origination activity. As Grishma will expand on in a moment, the investments made this quarter continued to reflect the strength and versatility of the platform and the ability to directly originate a variety of opportunities.

Our investments spanned various industry verticals, were made across the capital structure and in newer areas such as the ABL space. This investment activity was against the backdrop of lower overall market volumes, which we believe highlights the differentiated performance of our platform and the ability to deliver strong results across the cycle.

Net asset value per share increased $0.21 quarter-over-quarter from $17.09 per share to $17.30, primarily driven by NII in excess of our dividend contributing $0.08; portfolio appreciation adding $0.09; and the impact of our share repurchase program adding another $0.04. Our debt-to-equity at the end of the first quarter was just over 1 to 1. The increase from prior quarter was the result of strong net originations and represented the execution of our stated strategy regarding the intended use of leverage to fund growth.

As I mentioned last year when we adopted the lower asset coverage requirement, we'll look to operate in a leverage range of 1 to 1.4 times. We haven't altered our investment strategy in any way since inception. We'll continue to invest where we see best relative value and any increase in leverage will likely be through the organic growth in our asset base when market opportunities present themselves, as was the case during this quarter.

Regarding our liabilities, we continue to benefit from the association with one of the premier CLO platforms in the world. This quarter we priced our fourth middle market CLO, further diversifying our sources of financing and reducing our overall cost of debt. We continue to be one of the few BDCs that has an investment portfolio anchored in first lien senior secured loans, with the scale and diversification necessary to support the issuance of CLOs.

This not only provides our BDC and our shareholders with lower cost of debt relative to our peers, but perhaps more importantly it provides us with non-mark-to-market term financing, which we feel is highly valuable in markets with increased volatility. Regarding the broader direct lending platform leveraged by our BDCs, we continue to enjoy the support of a 19-member bank group, which supplies over $2.4 billion in capital across a variety of financing facilities.

We also continue to actively utilize our share repurchase program. During the quarter, we repurchased nearly 1 million shares at an average cost of $14.70, which resulted in accretion to NAV per share of $0.04 quarter-over-quarter. This first quarter repurchase activity represented over $14 million in proceeds deployed, which is nearly a threefold increase in the amount repurchased by the program in the fourth quarter of 2018.

To-date, our total repurchase activity is up to nearly $29 million and has represented approximately $0.08 in NAV accretion for our shareholders. And while our stock has advanced over 20% since year end, we would expect to continue repurchasing shares as we feel these trading levels do not in any way reflect the intrinsic value of our company. Based on a recent share price of $15, we have a trailing 12-month dividend yield of over 11%, a level that we think is extremely attractive given the quality of our portfolio and all of the other positive attributes related to our business that I've mentioned earlier.

Additionally, we believe it represents an excellent relative value versus other companies trading today in the BDC space at yields significantly below 11%. Relatedly, we've also accelerated the final release of the lock-up on our pre-IPO shares to May 13. This will allow us to remove one of the last contractual features of the IPO transaction, which limited overall liquidity. It also provides us a greater window to utilize our repurchase program on a discretionary basis, which we intend to do at market levels recently experienced. We view the repurchase program as another very visible commitment to shareholder alignment and the confidence we have in the value of our portfolio.

With that, let me turn it over to Grishma, to provide some additional color on our origination activity this quarter.

Grishma Parekh

Head of Origination, TCG BDC, Inc.

Thanks, Mike. Let me begin by providing some additional context around the market environment, how we approached it, and how it ultimately translated into the investing activity we produced in Q1. The credit markets have rebounded from the volatility of the fourth quarter and are in fairly firm footing. However, the sudden steep volatility in Q4 despite being short lived did have some residual impact. While the middle market remains somewhat inflated to the pressures experienced in the broadly syndicated market, we have felt our private equity sponsor clients prioritized uncertainty and working with lenders who have stable, scalable capital basis versus simply driving the most aggressive terms.

The market dislocation in Q4 also allowed us to get more involved in parts of the market this quarter that we had previously shied away from because we didn't find the risk adjusted returns to be particularly compelling. Specifically, I'm referring to the upper middle market companies with greater than $60 million of EBITDA as well as second lien term loans.

As the markets capitulated, private equity firms and banks turn to lenders like Carlyle, large nimble platforms of flexible pools of capital that are able to structure and execute complex transactions quickly. Let me give an example of what I mean. We were approached by one of our top private equity sponsor client who is looking to preempt a process to acquire an upper middle market company in the industrial storage space. Their priorities were: scale, speed, certainty and confidentiality. We were mandated co-lead on a $710 million financing including holding the entire $150 million second lien term loan.

It's important to note that our platform committed significantly more capital to this financing than what is held in TCG BDC. The continued expansion of Carlyle's Direct Lending pools and capabilities across our Global Credit platform are a direct benefit to the BDC. We can now speak for larger positions in individual transactions, win lead manage roles and influence terms while maintaining prudent diversification levels. So, I'd say our Q1 investment activity was a combination of business as usual and capitalizing on dislocation and volatility to generate enhanced returns for our shareholders.

As Mike mentioned, leverage loan volume was down meaningfully in Q1, partially due to muted M&A activity and virtually no opportunistic activity, but we are seeing a pickup thus far in Q2. During the quarter, we originated a solid $295 million of commitments across 29 transactions with 21 private equity firms. Our ability to be a complete capital solution provider led us to have a lead role in the vast majority of our transactions. The weighted average yield at cost of our new investments was about 10.4%. This quarter, 83% of our new commitments were first lien and 100% were in senior secured position. 75% of our investments were to repeat sponsors, and about a quarter of our investments were to existing borrowers.

Many of the key metrics we monitor for our new investments remain largely intact with the broader portfolio and with prior quarters. The loan-to-value of our investments is about 45%. The average leverage multiple was 5.4 times and the interest coverage ratio was in excess of 2 times. The one area that did deviate a bit from my earlier comments was the average EBITDA of our new investments was about $58 million versus the $40 million median EBITDA across the portfolio.

This is a reflection of a scaling platform that has been designed to be responsive to changing market conditions. Our portfolio companies are in good shape and demonstrating healthy top line and EBITDA growth year-over-year. As anticipated, core sales and repayments were relatively new to this quarter, $51 million at the BDC and $22 million at the JV. This resulted in good quarter-over-quarter portfolio growth at both the BDC and the JV. The weighted average yield at cost of our repayments was about 12%.

Lastly, we entered the asset-based lending space through a senior hire last fall as previously discussed. Our thesis was and remains that an ABL strategy is complementary to our core cash flow middle market sponsor finance business. Asset-based loan performance and recovery rates have been strong and consistent across market cycles. ABLs have better structural protection in the borrowing bases and covenants and cash flow loans, and adding an ABL underwriting capability creates more defensive and diversified company across more asset classes with potentially lower correlation.

This quarter we made two investments in the strategy at attractive yields. We expect to grow this strategy meaningfully which should drive higher ROE for the BDC. We are acutely aware that we're investing in what could be late cycle and therefore we remain ultra-selective. Carlyle's credit investment platform has over 100 investment professionals that have the expertise to evaluate opportunities across the capital stacks, company sizes, sectors and market cycles, all with the lens on relative value and fundamental credit investing.

I'll now turn the call over to Tom Hennigan, to review our financial results.

Thomas M. Hennigan
Chief Financial Officer & Chief Risk Officer, TCG BDC, Inc.

Thanks, Grishma. Today I'll discuss three main topics: our first quarter financial results; performance of the portfolio; and valuations and impact of mark-to-market on our results for the quarter. Total investment income for the first quarter was $55 million, which is down about $1 million compared to the fourth quarter. The modest decrease largely was due to lower income from OID acceleration and prepayment fees, given that repayments were elevated in the fourth quarter than unusually low in the first quarter. A partial offset during the first quarter was an increase in core interest income from the growing portfolio.

Total expenses were $28 million in the quarter compared to $27 million in the prior quarter. The largest component of the increase was higher interest expense, driven primarily by higher average outstanding debt which increased in line with growth in net originations. The end result was net investment income for the quarter of about $28 million or $0.45 per share and that compares to an average of $0.43 over the last six quarters since our IPO, and our regular dividend declared of $0.37 per share.

Mike and I have both made reference to term core interest income. By this we mean regular interest income on the investment portfolio, excluding any one-time OID acceleration, prepayment fees or transaction fees. We're able to achieve this level of earnings in the first quarter despite a relatively low level of one-time income. In fact, this core interest income alone is now able to cover our regular dividend. Of note, on May 6, our board of directors declared a regular dividend for the second quarter of 2019 at the same $0.37 per share and is payable to shareholders of record as the close of business on June 28.

On the financing front, we finished the first quarter with total debt outstanding of about $1.1 billion, that's up almost $150 million on the quarter driven by the strong net deployment we discussed earlier. During the quarter, we increased commitments under our revolving credit facility by $100 million. So as of 3/31, we still had about $250 million of total unused commitments under our credit facility.

As Mike noted, statutory leverage increased from 0.9x to 1.04x. You may recall, we foreshadowed this increase on last quarter's call based on our view of the pipeline at that time. Today, as we look forward and expect a new deal activity as well as line of sight in some heavy repayments over the next couple of quarters, we think further portfolio growth and leverage increases should be relatively muted in the near term.

Regarding the portfolio, overall credit performance remained stable. The weighted average internal risk rating remained at 2.3. The level of non-accruals remained largely unchanged based on fair value. You'll note that watch list deals rated in the 4 category increased this quarter. This was driven primarily by the addition of two borrowers. One of these companies has experienced some temporary operating issues, but we're already seeing a rebound in performance this year.

The other position has some more pronounced and likely longer-term operating and reporting challenges. However, the private equity sponsors pledged additional equity capital to support the business and we're finalizing an amendment that could pave the way to repayment in full of our position hopefully within the next 9 to 12 months.

Regarding valuations and mark-to-market, our total aggregate realized and unrealized net gain was about $6 million for the quarter. Overall movement in valuations based on credit alone was a slight positive. The largest contributor to the gain was a partial bounce back in yields in the large cap market. However, the middle market index we track rebounded only modestly from 12/31 levels, which is pretty common in that we often see the middle market experiencing both less volatility, but also a lag in terms of timing when there are sharp movements in the broader markets.

I'll note that so far through April, we've seen improvement in both the large cap and middle market indices. So at the current market yield levels, we'll potentially see further recapture of some of that purely market-based valuation decline that we experienced in the fourth quarter.

Regarding the JV's performance, the dividend yield on our equity in the JV was about 14% for the first quarter, in line with our mid-teens target. We expect the JV yield to remain stable in this 13% to 15% range and these levels will be supported by the targeted closing in late May of our second CLO at the JV, which priced in late April and will result in an overall reduction in the JV's cost of capital of about 20 basis points.

Similar to when we closed the first JV CLO back in late 2017, we'll repay about half of the JV mezzanine loan. So while the CLO enhances the JV's equity return to the BDC, we expect a modest decline in our total income from the JV when considering both our equity and mezzanine loan investments when we report next quarter's results.

With that, let me turn it back to Mike, for some concluding remarks.

Michael Anthony Hart
Director and Chairman of the Board & Chief Executive Officer, TCG BDC, Inc.

Thank you, Tom. In closing, we're very pleased with our first quarter results. While the market continues to present challenges from a competitive standpoint, we believe our company is well-positioned to compete in today's market and deliver consistent results for our shareholders.

That concludes our prepared remarks. We'd like to thank you all for dialing in this morning and would be happy to open the line for questions at this time.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] We do have a question from Rick Shane with JPMorgan.

Richard Shane
Analyst, JPMorgan Securities LLC

Q

Good morning, guys. Can you hear me?

Michael Anthony Hart
Director and Chairman of the Board & Chief Executive Officer, TCG BDC, Inc.

A

Sure, Rick. Yes.

Grishma Parekh
Head of Origination, TCG BDC, Inc.

A

Yes.

Richard Shane
Analyst, JPMorgan Securities LLC

Q

Sorry, I dropped off the line and I want to make sure I got queued back in. In terms of the transaction that's being restructured where the sponsors coming back in, do you expect that you'll have an ongoing investment thereafter your repaid in 9 to 12 months?

Thomas M. Hennigan
Chief Financial Officer & Chief Risk Officer, TCG BDC, Inc.

A

Hey. Morning, Rick. This is Tom. In that particular transaction, we expect that will be a sale of the business and we'll be repaid in full and we'll not have a continuing position in the borrower.

Richard Shane
Analyst, JPMorgan Securities LLC

Q

Okay, great. And is your expectation that you'll get the full principal recovery on that or will there be any principal write-down?

Thomas M. Hennigan
Chief Financial Officer & Chief Risk Officer, TCG BDC, Inc.

A

We're anticipating full recovery.

Richard Shane
Analyst, JPMorgan Securities LLC

Q

Okay, great. That's it from me. Thank you, guys.

Michael Anthony Hart
Director and Chairman of the Board & Chief Executive Officer, TCG BDC, Inc.

A

Thanks, Rick.

Operator: Thank you. Our next question comes from Finian O'Shea with Wells Fargo Securities.

Finian O'Shea
Analyst, Wells Fargo Securities LLC

Q

Hi, guys. Good morning. Thank you. Grishma, hearing some of your remarks on the asset-based strategy, you talked about how this deal flow started this quarter, given the more recent senior hire. Can you kind of talk about internal resources and beyond the BDC how you're able to assemble asset-based lending given it's, from my understanding, a more labor-intensive endeavor? Is this something that you're able to bring in outside of the BDC Group or is this something you've been building beyond the announced senior hire?

Grishma Parekh
Head of Origination, TCG BDC, Inc.

A

Sure. Good question. Thanks, Fin. So, there are kind of two important components to the strategy, and the way that we're thinking about it, the first is on the origination side. And a big part of our thesis when we were exploring the space and then made the decision to enter it was – and you've heard this from us in the past – is we're part of obviously the broader credit platform and to get the benefits of that and then the broader firm.

And so, the thesis is that we're generating a tremendous amount of origination activity, and sourcing across the platform in the firm, particularly in certain industry silos where ABL is – Stretch ABL is really relevant, consumer and retail in particular. So, the thesis is that we're going to be seeing a fair amount of deal flow within everything that we do in direct lending as well as away from direct lending across the firm.

As we continue to see more opportunities in the space, we are going to be building out the team. So, there are a couple of new hires that will be supporting [ph] David Store (00:22:58) who is the executive that we brought over about six to nine months ago, to continue to build out the effort. And they'll be focused on the underwriting, the investing and the execution side of the business.

Michael Anthony Hart
Director and Chairman of the Board & Chief Executive Officer, TCG BDC, Inc.

A

And Fin, this is Mike. One thing that I would add to that is that the intended part of the ABL market that we're targeting is, as Grishma mentioned, the Stretch ABL sitting behind what you traditionally think of as regular way of ABL that's highly intensive with respect to collateral analysis and the like. So, that element isn't necessary with our approach, but certainly the resources with respect to the people that we'll be bringing on to execute the broader Stretch ABL strategy will be where our focus is.

Finian O'Shea
Analyst, Wells Fargo Securities LLC

Q

Sure. That's helpful. Thank you. Then just one more on sort of the growth in sponsor group. I think going back through the earnings release, as you've had a pretty consistent group of sponsors and you've grown in this time obviously on an asset level. So the question would be, how much more can you grow share with your sponsor base? Is there still runway there or are you making a more acute effort to more meaningfully expand that?

Grishma Parekh
Head of Origination, TCG BDC, Inc.

A

Particularly over the last couple of years, what we've been focused on is identifying probably 40 to 50 middle market private equity sponsors that we have spent a lot of time with. We understand their track record, how they invest, how they behave during good times and in bad times and really deepening our relationship with them and capturing as much market share, with the goal being that we see virtually all of the opportunities that they're looking at. We play a very active role in all the opportunities that they are focused on, securing and winning, and have a real shot if we want it in leading the financing.

And so, in many ways, especially given where we are in the cycle, we've really sort of double down on a group of sponsors that we've identified as particularly important and core to our business strategically. With that said, we capture a really wide origination net and we have broad, deep relationships with a lot of private equity sponsors. And so, it comes down to fundamental credit investing as well.

So, I'd say there's plenty of white space that exists within our core sponsors and you see that 75%-plus investment rates with the repeat sponsors. But we have plenty of white space outside of them as well, and we have really good deep relationships with them. So, I'd say it's a combination of both with a focus on kind of our top Tier 1 sponsors.

Finian O'Shea
Analyst, Wells Fargo Securities LLC

Q

Sure. That's helpful. Thank you.

Operator: Thank you. Our next question comes from Ryan Lynch with KBW.

Ryan Lynch
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Hey. Good morning. Thanks for taking my questions. The first one has to do with the comment regarding the $0.20 of spillover income as well as the special dividend you guys are considering. Is it the thought process that you guys are potentially going to payout that full $0.20 of spillover that you currently have, or do you guys want to always maintain some level of spillover income going forward?

Michael Anthony Hart
Director and Chairman of the Board & Chief Executive Officer, TCG BDC, Inc.

A

Good morning, Ryan; and thanks for the question. As we look at that, traditionally we've accumulated the undistributed surplus over the course of the year and paid that out in the fourth quarter. This year it's accumulated more rapidly into a reasonable size that we would expect to size that amount, not necessarily the full $0.20, but a portion of that and pay that as a special dividend declaring it in June timeframe. Very similar to how we've approached it in the past declaring in the fourth quarter for that surplus that has been generated over the year.

In that last year it reached at year-end a $0.20 number; and at this point in the year we're at $0.20. We wanted to be cognizant and responsive to getting that money back to the shareholders. So, that's in the coming weeks we'll size exactly how much of that $0.20 we'll be paying out and we'll declare that in the June timeframe.

Ryan Lynch
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. And then as far as you guys mentioned, [indiscernible] (00:28:16) leverage target of 1 to 1.4 times debt-to-equity, which is unchanged. You guys are now within that targeted range at the end of the first quarter. The market backdrop [audio gap] (00:28:30) current environment we're at, that leverage range it's a pretty wide range.

Do you guys foresee yourself trying to continue to move up and run at the upper end of that range? Or where do you kind of see your target today, given the market environment that we're in?

Michael Anthony Hart
Director and Chairman of the Board & Chief Executive Officer, TCG BDC, Inc.

A

Another good question, Ryan. Much like – I think this quarter is a good representation of how we think about it and how we utilize it. We had a quarter with what we thought, I thought, were exceptional origination investment opportunities. The other dynamic was lower repayments and so that leverage was utilized to fund that growth and that was exactly what we'd look to do. And we think that's the highest and best use of that leverage and that is identifying good opportunities and move – and allowing that to move our leverage into that 1 to 1.4 times.

I don't really view the operating anywhere within that 1 to 1.4 times as being dramatically different. Given the preponderance of our assets being in the first lien space we think that's a very comfortable range. And then you have the added cushion up to [ph] 2.0 (00:30:02) that we look at is simply being available there in the event of high market volatility where you'd have pressure on valuations and sort of unforeseen at this time.

So, I don't again – I'd just reiterate that we really don't change our investment process or approach. If there are good opportunities and we have a very high standard at this point, we have targets with respect to the cyclicality of businesses that we'll accept or won't accept and in various sectors. So, all of that's going in to frame our view with respect to the bar which we're looking to make sure our investments meet. But as long as that growth is comfortably covered and allowed for within the context of the increased leverage from 1 to 1.4, we're comfortable to operate within that band.

Ryan Lynch
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay, understood. Those are all my questions. I appreciate the time today.

Michael Anthony Hart
Director and Chairman of the Board & Chief Executive Officer, TCG BDC, Inc.

A

Thank you.

Operator: Speakers, I'm showing no further questions in the queue at this time. I'd like to turn the call back over to management for any closing remarks.

Daniel Harris
Head of Investor Relations, TCG BDC, Inc.

Thanks for your time and attention today. If you have any follow-ups, feel free to call Investor Relations throughout the day, otherwise we look forward to speaking with you again in next quarter.

Operator: Ladies and gentlemen, thank you for participating in today's conference. This concludes the program. You may all disconnect, and have a wonderful day.