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CGBD - Q2 2021 TCG BDC Inc Earnings Call

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PRESENTATION

Operator

Thank you for standing by, and welcome to TCG BDC's Second Quarter 2021 Earnings 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 host, Head of Investor Relations, Allison Rudary.

L. Allison Taylor Rudary - TCG BDC, Inc. - Head, Investor Relations

Good morning, and welcome to TCG BDC's second quarter 2021 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 do not guarantee future performance, and undue reliance should not be placed on them. These statements are based on current management expectations and they 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 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. - Chairperson, CEO & President

Thank you, Allison. Good morning, everyone, and thank you for joining us on our call this morning to discuss our second quarter 2021 results. Joining me on the call today is our Chief Investment Officer, Taylor Boswell; and our Chief Financial Officer, Tom Hennigan.

I want to focus my remarks on 3 areas. First, I'll touch on a few portfolio highlights. Second, I'll provide a review of our second quarter results. And third, I'll share some thoughts on the current market environment.

Let me start by highlighting our portfolio activity and current credit position for the quarter. As we previewed last quarter, our deal activity in the second quarter was extremely robust, outpacing even the volume of the fourth quarter. We originated over $213 million of loans across a diverse array of new borrowers and add-ons for existing portfolio companies. Overall, the portfolio is sitting at just under $1.9 billion, and we continue to find ample attractive new deployment opportunities in today's market.

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We're pleased to report that credit performance continues to strengthen alongside the macroeconomic recovery. Over the past several quarters, we've seen tangible evidence of cyclical recovery across the portfolio, including those names most impacted by COVID.

Fundamental performance is solid, our watch list continues to trend down as a percent of the portfolio, and our portfolio internal risk ratings continue to improve. Importantly, we have seen no new nonaccruals in the last year, and we are confident in the trajectory and progress we are making in each of our 4 nonaccrual names.

We're proud of the performance of the portfolio through COVID. And most importantly, we see the current trajectory of improving performance and solid credit continuing on its current upward path.

I'd like to turn now to the financial highlights of the quarter. We generated net investment income of $0.38 per common share and declared a total dividend of $0.38. This includes a base dividend of $0.32 and a $0.06 supplemental dividend, in line with our policy of regularly distributing substantially all of the excess income earned over our base dividend.

As Tom will detail later, we see earnings continuing in the context of $0.36 to $0.37, as we've reported over the last several quarters, which remains comfortably in excess of our $0.32 base dividend.

Net asset value per share increased 2.8% or $0.44 from $15.70 to $16.14. While improving market yields drove some of this increase, NAV was substantially bolstered by stronger overall credit performance, particularly in those names impacted by COVID. We've taken an appropriately conservative approach to valuation through this cycle, and we expect continued underlying fundamental improvement to drive positive NAV migration in the coming quarters.

Additionally, we repurchased $8 million of our common stock, resulting in $0.02 of accretion to net asset value. We care deeply about our shareholders' total return experience, and at our stock's current valuation, we will continue to be consistent, active repurchasers of our shares.

Turning to the investment environment. Investment activity across our business footprint in the second quarter was amongst the highest on record, reflective of the active transaction environment and consistent with the trends in private equity and broadly syndicated loan markets. We view the investment opportunity set in our market as highly attractive, especially on a relative risk-reward basis and are actively deploying capital into those transactions we regard as most compelling.

At the same time, as you would expect, we remain highly selective investors, vigilant on risk and thoughtful in portfolio construction. With this backdrop, we are confident in our ability to continue to generate and sustain attractive and stable income for our shareholders.

Finally, I'd like to take a moment to welcome Aren LeeKong, who joined our Board of Directors in June as an Independent Director. Aren brings a great deal of expertise in both the leverage finance and middle market private equity to our Board. We are pleased to have the benefit of his counsel and experience.

I'd like to now hand the call over to our Chief Investment Officer, Taylor Boswell.

Taylor Boswell - TCG BDC, Inc. - CIO

Thanks, Linda. As usual, I'll begin with Carlyle's macroeconomic perspectives, and then I'll share thoughts on our investment approach to today's highly active and competitive market.

Global growth accelerated in the second quarter, as vaccine distribution progressed, health restrictions eased and economies reopened. U.S. GDP grew at an annualized 6.5% from the first quarter, while the Eurozone and Chinese economies expanded at 8% and 5%, respectively.

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Most strikingly, households in the U.S. continue to spend freely, and we have seen a 20% year-to-date increase in our discretionary spending index relative to 2019. This year's acceleration in economic activity, paired with the pandemic-related disruptions in the last year, caused headline Q2 inflation to reach levels not seen in over a decade.

Recently, realized inflation remains concentrated in certain supply-constrained sectors, such as autos, materials and energy. We expect many of these pressures to ease in coming quarters, as capacity expands and consumer spending patterns revert.

One place we are keeping a close eye on is the labor market, where we see more risk as the year progresses given continued tight labor availability. Despite these pressures, corporate profits are expanding across many sectors, thanks to significant productivity improvements, including a broad-based increase in the adoption of technology.

In total, we judge the macro backdrop to be highly supportive of continued credit performance, both generally and in CGBD's portfolio. The velocity with which our markets have recovered after 2020 severe shock is remarkable. Like 2019, we are again in a very robust transaction environment, and the key metrics in our industry, spreads, fees, leverage and the like are now broadly in line with the pre-COVID period.

We've come full circle, and the operative question for today's market is the same one as 2019, how will you drive outperformance in a competitive environment. Across our platform, we have windows into the vast majority of credit risk markets, and we can report with high confidence that there is no avoiding competition, not in sponsored finance, not in technology lending, not in ABL, not in liquid markets, not in any investment market of reasonable depth or scale.

Yes, there are varying degrees of competition for any given deal. But as it relates to building diversified credit portfolios, the last decade Central Bank policies have made obsolete the question of how do you avoid competition. Rather, the right question is, how do you win in the face of competition. Here's how we do it at Carlyle.

First, we leverage our leadership position in middle-market sponsor finance to win the deals we want to win, and in so doing, avoid adverse credit selection. We accomplish this by maintaining a heavy investment in direct origination, offering a complete leverage finance product set at scale, possessing underwriting and execution expertise to move with speed and conviction, and delivering value to borrowers beyond our capital in as many ways as possible.

In short, we used Carlyle's platform to create an extremely broad investment funnel, and we pair it with a highly relevant solution set for potential borrowers, allowing us to be both highly credit selective and trusted partners for financial sponsors.

It's critical to remember, we're operating in a market where demand for capital is growing at least as strongly as the supply of capital and a market with an extremely fragmented competitive set. Our platform's competitive advantages are real and sustainable and stand in stark contrast to the average player in the market, where deal sourcing and relevance of offering may be more constrained. We're comfortably on the right side of the competitive landscape and fortunate to operate in a market, which offers extremely strong relative investment value.

Second, we complement our first dollar sponsor finance business with additive private credit assets where Carlyle possesses similarly deep expertise, such as asset-backed, non-sponsor and recurring revenue lending. The value in this exercise is not that these markets are categorically better or worse than our core market. Rather, the value is that they are fundamentally different than our core assets, allowing us to diversify risk factors in our book, tactically assess relative value deal by deal and be even more credit selective. We are confident that complementing our core with these other safe and defensive private credit profiles will result in better portfolio construction and investment results on a through-cycle basis.

Finally, we are intensely focused on deploying the advantages of the Carlyle platform against every investment opportunity in every aspect of our operations. From origination to diligence to execution to portfolio management, we understand our edge, apply it with rigor and seek to extend it in all possible ways. At Carlyle, we sit alongside hundreds of talented investment professionals with specific expertise across sectors, geographies and asset classes from which we can derive investment insights to both capture opportunities and avoid mistakes.

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In addition, we leverage fully staffed and highly capable teams in capital markets workout, liability management and ESG, to name just a few. When properly applied, it's hard to overstate the extent to which these capabilities create and sustain edge for CGBD.

In summary, our market offers a highly attractive investment opportunity characterized by growing demand for capital, high current income and significant downside protection. It makes all the sense in the world that people want exposure to it and that there would be ample competition.

At Carlyle, our platform equips us to win the business we want to win in competitive markets and across cycles. Harnessing these competitive advantages has been exactly what Linda, Tom and I have been focused on these past 2 years, and we are confident that it will continue to produce strong investment results.

As always, thank you for your continuing support. I'll now hand the call over to our CFO, Tom Hennigan.

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

Thank you, Taylor. Today, I'll begin with a review of our second quarter earnings, then I'll provide further detail on the portfolio and our balance sheet positioning.

As Linda previewed, we had another very solid quarter on the earnings front. Total investment income for the second quarter was $43 million, that's up from $41 million in the prior quarter, primarily due to 2 main factors: first, higher core interest income on our investment book; and second, higher amendment and underwriting fees. Both OID accretion from repayments and income from the 2 JVs were flat versus prior quarter.

Total expenses were $21 million in the quarter, up modestly from $20 million last quarter. The result was net investment income for the quarter of $21 million or $0.38 per common share, exceeding the general guidance we've been providing during recent earnings calls.

On August 2, our Board of Directors declared the dividends for the third quarter of 2021 at a total level of $0.38 per share that comprises the $0.32 base dividend plus a $0.06 supplemental, which is payable to shareholders of record as of the close of business on September 30.

Similar to prior quarters, as we look forward to the rest of 2021 and beyond, we remain very confident in our ability to comfortably deliver the $0.32 base dividend, plus continue the sizable supplemental dividends, in line with the $0.04 to $0.05 we've been paying the last few quarters.

Moving on to the performance of our 2 JVs. Total dividend income was $7.5 million, in line with last quarter. On a combined basis, our dividend yield from the JVs inched up from 10% closer to 11% given we're able to make a return of capital at MMCF 1 following a recent favorable amendment under our primary credit facility.

Total assets at the JVs increased from $1.2 billion to $1.3 billion, reversing the recent trend of declines that have been driven by repayment headwinds. Linda noted robust new originations across our direct lending platform. This was particularly evident in the MMCF 1 portfolio, with fair value increasing by over 10% in the second quarter. Going forward, we continue to expect stable dividend generation from the 2 JVs, similar to this quarter's results.

On the valuations, our total aggregate realized and unrealized net gain was $21 million for the quarter, the fifth consecutive quarter of positive performance following the drop in March 2020. Using the same buckets I've outlined in prior quarters, we again saw improvement across the board.

First, performing lower COVID-impacted names, plus our equity investments in the JVs, which accounts for a combined 70% of the portfolio, increase in value about $8 million compared to 3/31.

Second, the assets that have been underperforming pre-pandemic, some of which have COVID exposure, were up $4 million, marking the fifth consecutive quarter of stability or improvement. This included an exit at par of our investment in Plano Molding.

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The final category is the moderate to heavier COVID-impacted names. We continue to see improvement in fundamentals and recovery prospects for these investments. Collectively, they experienced a net $9 million increase in value.

I'll turn next to the portfolio and related activity. We continue to see overall stability and improvement across the book. Total nonaccruals were flat at 3.3% based on fair value, and this was the fourth consecutive quarter with no new additional nonaccruals. Similar to last quarter, we don't see any additional loans at risk of nonaccrual. As Linda noted, we also see potential for improvement in the level of nonaccruals over the next 12 months.

The total fair value of transactions risk-rated 3 to 5, indicating some level of downgrades since we made the investment, improved again this quarter by $14 million in the aggregate, while over $50 million in transactions experienced some level of upgrade. While there remains some unfinished work, we're very pleased with the continued positive momentum in the performance of the overall portfolio.

I'll finish with a review of our financing facilities and leverage. We continue to be very well positioned with the right side of our balance sheet. Statutory leverage was again stable at about 1.2x, while net financial leverage, which assumes the preferred is converted and the risk metric we use to manage the business, was again right around 1 turn of leverage. So we're sitting close to the lower end of our target range of 1.0 and 1.4x, giving us flexibility to invest prudently in the current robust deal environment.

And regarding the preferred equity issuance from May 2020, I'll reiterate again, this instrument was a strong sign of support by Carlyle during the darkest days of the global pandemic, and it continues to be a long-term investment by Carlyle in our BDC. So currently, there is no intention to convert.

With that, back over to Linda for some closing remarks.

Linda Pace - TCG BDC, Inc. - Chairperson, CEO & President

Thanks, Tom. Before turning to your questions, I'd like to conclude by noting that we are very pleased with the current momentum embedded in our business. The engines we have in place, namely the talent and hard work of our team here and throughout Carlyle, are driving attractive and sustainable returns for our shareholders.

We hope you and your families enjoy the remaining weeks of summer. And with that, I'd like to now turn the call back over to the operator to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Ryan Lynch of KBW.

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

The first one, you were talking about the competitive environment that's out there today in the direct lending market, which has been very clear to us. And you talked about how you guys are coming to the market and how you guys can hopefully win deals.

What I was hoping to get is to get a little more background on where you guys stand as a direct lending platform. I'd love to hear what sort of AUM you guys can currently come to the market that's currently dedicated to the direct lending space across the Carlyle platform that, obviously, CGBD can participate with and what sort of commitment sizes you all can make across the platform because that's obviously one way to help win deals is to be able to commit to larger hold sizes, to be able to offer fuller solutions.

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And as we've seen the direct lending market grow and grow, we've seen larger solutions becoming a competitive advantage. So I just love to hear an update on where you guys stand there from a platform standpoint.

Taylor Boswell - TCG BDC, Inc. - CIO

Yes. Sure thing, Ryan. It's Taylor, and happy to pick up that question. So just to provide a couple of points of context around that, Carlyle's overall global credit business is about $60 billion of AUM. And so while CGBD is a really important vehicle and flagship vehicle for us at $1.9 billion of AUM, it does represent a small portion of our total capital base aligned against these markets.

And what I would say also about that $60 billion of AUM at Carlyle is we really have built a credit business that focuses down on core corporate leverage finance markets. So the vast majority of that AUM is targeted right in the places where you think Carlyle would be good, corporate levered credit, private transactional levered credit and the like.

And so collectively, that does give us a very full product suite to deliver to the marketplace, which really enhances our relevance in the marketplace as well as our hold sizes to get specifically into illiquid credit, which you can kind of shorthand as a direct lending business or the relevant private corporate credit markets. We manage about $15 billion in capital across the platform in those strategies. And -- so we have a very material footprint.

Specifically around hold sizes, we've done transactions on our platform as large as $750 million in total commitment size. Obviously, individual positions that flow into CGBD end up being smaller, but it's a material market presence.

One thing I will call out for you, though, is unlike some players in the market, we really remain focused on the core middle market, that $20 million to $75 million EBITDA business. And a lot of the very large transactions that are printing in the unitranche market and appropriately getting significant headlines, those are far larger borrowers where the competitive set is competing with traditional leveraged finance markets, broadly syndicated loans and high-yield markets and the like.

So our capital base is very relevant, very scaled, but you're less likely to see us competing head-to-head in large cap markets against broadly syndicated and high-yield and more likely to see us kind of sticking to that middle-market knitting where you don't have to go head-to-head with both private credit and traditional liquid market financing sources.

So sorry for the long answer. I hope that's broadly responsive to the question.

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

No. That's very helpful, very good context and color on your overall platform. Good to hear.

The other question that I had, which you guys have kind of talked about in the past and reiterated it, but you talked about the convertible preferred stock being kind of a long-term financing solution that you guys intend to hold. And I think you said you viewed that as an attractive source today.

I mean, you guys have been able to issue liabilities, unsecured notes recently at 4.5%. I wouldn't be surprised if you could do something less than that in today's market. So why is paying 7% cash on a convertible preferred an attractive source of financing when you're able to tap unsecured notes at 4.5%?

And then depending on your answer to that, when you get into converting that, what does that look like? How does that look like from the manager converting at a sizable discount, the external manager converting and having -- and making a sizable profit from supporting the BDC?

I don't know if that's a great look either, but I just don't understand the comment why paid 7% is attractive source when you guys are issuing debt for significantly below that.

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Linda Pace - TCG BDC, Inc. - Chairperson, CEO & President

Yes. Ryan, it's Linda. I'll start and then maybe turn it over to Tom. So just to kind of reiterate, if you recall, when we put the convert in place, life was pretty dire, right? The -- our stock price was half of what it is today. We're in the middle of the pandemic. Our -- we're looking at really how to make sure our balance sheet was strong and defensible during a time that was -- had just an enormous amount of uncertainty.

And Carlyle coming in and doing the preferred was a really great testament not only to their support of our business, but also to just really help us achieve the goals that we wanted to achieve at that point in time.

So I'd like really our people to kind of just put all of this in context. For Carlyle, it's a great show of support, but let's not forget, it is $50 million for Carlyle, and it's $50 million for our balance sheet, so it's relatively small. And Carlyle, this is strategic, right? They're not looking to convert this anytime soon. It's here to support the business, and we really look at this as equity.

So compared to our dividend yield on our common stock, this is paying 7%, which is, we think, actually a pretty attractive piece of equity for our balance sheet, and converting it is just not really in the cards.

So I would just encourage people to think of this really as permanent equity, which you may view as expensive, but we actually view as pretty cheap, and know that this is not something that is going to dilute our current shareholders really any -- in the foreseeable future that we can tell.

So -- and we're pretty conscious of that. When -- back -- when we issued this, we didn't want to dilute shareholders, especially back in the spring of 2020, and that's still our view now. There's no reason to dilute current shareholders, not when Carlyle is standing behind the business like it is.

Tom, maybe you could kind of talk about our unsecureds and kind of just the rest of the balance sheet and how we're thinking about that.

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

Yes. Sure. What I'd just add is I think we have the best both words. We have the financial flexibility. It's effectively equity. We manage the business as if it's equity. We get credit under our leverage facilities as if it's equity. So certainly from a financial flexibility perspective, we think it's well-priced equity. So managing the business, we were very happy to have this in the capital structure.

When we look at our broader capital structure, we've got diversified funding sources with our traditional corporate revolver, with a very attractive CLO vehicle that's got north of 2 years left under for investment period, and that's obviously well suited for our primarily first-lien book.

And then, of course, we have 2 tranches of unsecured notes, and what I'll note to those unsecured notes priced a little bit high compared to current market standards, but there's a couple of tranches. They mature in a few years. They're actually very favorable call features as well.

So we look down the road in terms of a traditional bond deal that has effectively a full make whole. We've got some flexibility in the capital structure with those bonds depending on anything you want to do down the road.

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

I mean, the only thing that I would just add, though, is one of the issues with looking at the preferred as equity is that as it sits here today from a regulatory standpoint, it counts as leverage. So it's counting towards your leverage calculation as it sits here today, not as an equity tranche. And so that's one of the issues from fully divest point.

And I would just say if it does convert at its current price, I mean, one of the things that CGBD is now important having a large, successful, big platform backing it in Carlyle through the external manager. And so I don't know if it's a great look. When it does convert, to have the manager

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making a large profit from -- via -- from the BDC shareholders from making an investment into it at a rough time in the market. And then, again, I don't think necessarily having a 7% cost of capital out there, which, right now, counts as leverage is a great option either.

Linda Pace - TCG BDC, Inc. - Chairperson, CEO & President

Yes. Ryan, I think we'll be conscious of that, how that could look and would look. But what I would tell you now is 2 things, and Tom, correct me if I'm wrong on this. But just also keep in mind that our financing facilities do not look at this as leverage, right? They -- so it's not restraining our flexibility, vis-a-vis the rest of the liabilities on the balance sheet.

And just -- I know you're keeping it in the back of your mind and ask what happens when and if this converts. But again, I would just reiterate, there's no plan to convert it. And sometimes, I think the focus on this $50 million preferred gets lost and overshadows, I think, what -- what we would like people to really feel like what is the focus of our story, which is over the past 2 years, this -- the management team, particularly Taylor and Tom and the rest of the team have just really been working super hard to get us through COVID, get us out of the CUP program, put in place processes and procedures that strengthen the balance sheet, that strengthen the portfolio, and we've made such great progress over the past couple of years that I cringe a little bit that the $50 million preferred that is support from our parent kind of overshadows that message.

So maybe a little bit of advertisement here from me, but I guess as CEO, that is part of my job. But -- so listen, we're happy to keep talking about it each quarter, but I would just ask, let's not lose sight of also, I think, kind of the bigger picture that we're trying to show to you and to our investors. And keep in mind that Carlyle has -- I think has -- Carlyle and our parent, CGBD, we pride ourselves on having a really strong reputation for taking care of our shareholders. And it would -- it's not our intent to change that way of operating.

Operator

(Operator Instructions) Our next question comes from Finian O'Shea of Wells Fargo.

Finian Patrick O'Shea - Wells Fargo Securities, LLC, Research Division - VP and Senior Equity Analyst

Just a follow-up on Ryan's question. Sorry to do that. I was listening to some of your comments, Linda. I agree that life was pretty dire when the parents stepped up during COVID, but it was also rather bright and sunny in, say, 2018 when the BDC lost a lot of money and was paying the parent a full incentive fee.

So I guess, the question is against your opening remarks about caring deeply about the shareholders' total return, do you perhaps care more deeply about the adviser? Or should something give? Like should there be sort of a pick one between the convert and not having a credit look back?

Linda Pace - TCG BDC, Inc. - Chairperson, CEO & President

Thanks, Fin, for that question. I think I've kind of addressed the convert issue. In talking about our look back and our management fees, we do believe that Carlyle has a very fair and balanced management fee structure. We think that -- and the shareholders are getting a lot of value for that.

Keep in mind that we do manage the JVs and don't take a fee for that. So I'm -- sometimes, I think that gets a little bit lost when people look at our overall fee structure. So you're kind of getting the management of the JVs at a very nice discount on the management fee.

And one of the other kind of topics, I think, that Taylor really discussed on the call and one that we'd like to further emphasize is all of the resources that Carlyle brings to the table just away from just the core team that's supporting the CGBD and the rest of direct lending is there for investors as well.

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So our management fee and not having a look back, I'm not really sure that, that is what is going to be driving our stock price higher. It's really -- we've got to continue on the straightforward, consistent performance, get our nonaccruals down, which is looking better and better and really keep our shareholders satisfied by knowing that we can generate our dividends, perform well on credit. And ultimately, we think that will get our stock price up. I'm not sure our management fee is really the issue.

Operator

And there appear to be no further questions in queue from the phone lines at this time. At this time, I'd like to turn it back over for closing remarks.

Linda Pace - TCG BDC, Inc. - Chairperson, CEO & President

This is Linda. I want to thank everybody for joining us on our call today.

Operator

This concludes today's conference call. Thank you for participating. You may now disconnect.

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