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CGBD - Q1 2021 TCG BDC Inc Earnings Call

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Melissa Marie Wedel JPMorgan Chase & Co, Research Division - Analyst

Paul Conrad Johnson Keefe, Bruyette, & Woods, Inc., Research Division - Associate

PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to TCG BDC First Quarter 2021 Earnings Conference Call. (Operator Instructions)

I would now like to hand the conference over to your speaker host, Allison Rudary. Please go ahead.

Allison Taylor Rudary TCG BDC, Inc. – Investor Relations

Good morning, and welcome to TCG BDC's first 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 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.

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 first quarter 2021 results. Joining me on the call today is our Chief Investment Officer, Taylor Boswell, and our Chief Financial Officer, Tom Hennigan.

I'd like to start by highlighting the continued strong momentum we've established in our business. Our financial results for the quarter, which Tom and I will detail later, were solid and importantly our portfolio's credit profile continues to improve. Going forward we expect that credit will continue to strengthen alongside the macroeconomic recovery as we move further away from the depths of the health crisis in the U.S. Overall, we are pleased with our current positioning, and are confident in our ability to generate and sustain attractive income for our shareholders.

I'd like to turn now to the financial highlights of the quarter. We generated net investment income of $0.36 per common share and declared a total dividend of $0.36. This includes a base dividend of $0.32 and a $0.04 supplemental dividend. As we've noted before, we expect earnings to continue to be well in excess of our $0.32 base dividend. We ended the quarter with net asset value per share of $15.70, up $0.31 from last quarter for an increase of 2%. Driving this increase was a combination of improving market yields and more importantly, stronger overall credit performance. This marks our fourth consecutive quarter of NAV growth since the first quarter of 2020, and since then net asset value has increased 11%. Additionally,

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we repurchased almost $6 million of our common stock at an average discount of 22% of our net asset value. This resulted in $0.03 of accretion to net asset value. We continue to be consistent active re-purchasers of our shares.

Turning to the investment environment as we look forward. The markets in which we operate continue to be very active and broadly speaking, the economic environment is recovering rapidly from last year's sharp contraction. As Taylor will detail later broadly syndicated markets experienced an exceptionally strong quarter. But our focus area in the middle markets still provide compelling relative value, and we continue to close on attractive investment opportunities. Despite a competitive landscape, our deal pipeline is robust, both in our core markets and those adjacent areas of the credit markets where we have deep expertise.

We remain focused on leveraging the competitive advantages that accrue to us from the breadth of the Carlyle platform to originate differentiated new business. Our broad sourcing funnel allows us to be highly selective, and as always we construct our portfolio to be defensive, high quality and diverse, the aim of which is predictable, stable income generation throughout all market cycles. I'd also like to take a moment to welcome Billie Wright who joined our Board of Directors last quarter as an Independent Director. Billie brings a great deal of experience in credit to our Board, and we are glad to have the benefit of his expertise as we continue to deliver on our key objectives for our shareholders.

I'll now hand it over to our Chief Investment Officer, Taylor Boswell.

Taylor Boswell - TCG BDC, Inc. - CIO

Thank you, Linda. As usual, I'll begin with some quick comments on Carlyle's current macroeconomic perspectives, which we develop based on inputs from across our global footprint. Keeping with the themes of the last year, our proprietary data again show sharp divergence across economies. China, which grew 3% in 2020, is evidencing signs of decelerating but still solidly positive growth as its post-pandemic catch up phases out.

Conversely, European lockdowns generated a second quarter of economic contraction. In the U.S., as we expected, the economy is accelerating significantly on the back of improved confidence in vaccine distribution, reopening and massive fiscal stimulus, the latter of which is expected to boost household income by 5% of GDP this year. Our data suggests significant growth versus both 2020 and 2019 in the most income-sensitive spending categories. Of course, with a 91% U.S. based investment portfolio, this establishes a strong fundamental operating backdrop for the vast majority of our borrowers.

As the year has progressed we have seen increased incidences of inflation globally, often the result of understandable but ultimately overly conservative management decisions to take capacity offline in 2020. These capacity constraints are combining with pent-up demand to generate pockets of price spikes and shortages, especially in the industrial sector. However, at this time like policy makers, we also view most of these increases as transitory with a low likelihood of long-term runaway inflation. In the portfolio, we are monitoring for the effectiveness of price pass-through mechanisms, input substitution and other management actions, which we expect will support continued strong credit performance.

Liquid leveraged finance markets have remained extremely active year-to-date with both the broadly syndicated loans and high-yield markets posting their busiest new issue quarters on record, an astonishing fact. The reason is obvious to all here. In today's low-interest rate environment, the execution offered by these asset classes is extremely attractive to both borrowers and investors alike. While we do not see a near-term catalyst for these market conditions to change, we are not concerned about operating effectively if they prove persistent. In fact, we are pleased that our business is demonstrating sustainable performance through this period.

In this environment repayments across credit markets have picked up and will continue to occur as transaction velocity increases. This has been especially true in our MMCF I JV whose larger EBITDA borrowers are more susceptible to rotation into liquid markets. However, our core middle market borrower base has seen a slower pace of repayment activity year-to-date. Many of these assets were priced in higher LIBOR environments, and do not offer significant spread savings as well as often possessing strong fundamental reasons to remain in private credit markets.

Meanwhile, we are, as a business, finding ample attractive new opportunities to deploy capital. After the remarkable return of deal activity in the fourth quarter where pent up transaction demand from COVID matched with owner's desires to sell ahead of potential tax or regulatory changes, one might have expected a material slowdown in Q1. But in fact, we were extremely active on the originations front in the first quarter deploying

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$151 million across 10 borrowers at an 8.4% average yield. This activity, again comfortably outpaced $73 million of repayments in the period. The remainder of our portfolio exits were tactical sales taking advantage of robust secondary market prices as part of our active portfolio management strategy.

All in, the yield on our sales and repayments was approximately 7.8%. The core secular drivers of our asset class remain intact while the breadth and quality of origination available to us in the Carlyle platform allow us to maintain and grow our portfolio as may be required across the investment side. At the same time you will see we posted another solid quarter of credit improvement and earnings generation. Whether from an asset base, income or credit perspective, we feel our business is on sound footing to deliver for shareholders in 2021.

As always, thank you for your time and support. Tom?

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

Thank you, Taylor. Today, I'll begin with a review of our first quarter earnings then I'll provide further detail on the portfolio and our balance sheet position. As Linda previewed, we had another stable quarter on the earnings front. Total investment income for the first quarter was $41 million. That's down from $44 million in the prior quarter primarily due to 2 main factors. First, a full quarter impact of lower average loan balance following the closing of our second JV in November. And second, lower OID accretion and prepayment fees due to lower loan repayments in the first quarter. This was partially offset by an increase in total dividend income from the 2 JVs, which increased due to a full quarter impact from MMCF II.

Total expenses were $20 million in the quarter down from $22 million last quarter. The largest component of the decrease was lower credit facility fees. The result was net investment income for the quarter of $0.36 per common share or $20 million right in line with the guidance we provided during last quarter's earnings call. On May 3, our Board of Directors declared the dividends for the second quarter of 2021 at a total level of $0.36 per share that comprises the $0.32 regular dividend plus a $0.04 supplemental, which is payable to shareholders of record as of the close of business on June 30. Similar to last quarter, as we look forward to the rest of 2021, we remain very confident in our ability to comfortably deliver the $0.32 regular 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, up from $6.5 million last quarter. The increase was due to a full quarter impact of MMCF II. On a combined basis, our dividend yield in the JVs was about 10% in line with the prior quarter. Total assets of the JVs were down from $1.3 billion to $1.2 billion due to another wave of repayments that occurred at MMCF I later in the quarter. However, we've had positive momentum with new originations for that vehicle early in the second quarter. So going forward we expect stable aggregate assets, yield, and dividend generation from the 2 JVs similar to the first quarter's results.

On the valuations, our total aggregate realized and unrealized net gain was $15 million for the quarter, the fourth consecutive quarter of positive performance following the drop in March of 2020. Similar to the last 3 quarters, we saw valuations increase based on the continued rebound in market yields plus improving fundamental credit. Using the same buckets I've outlined in prior quarters, we again saw improvement across the board. First, performing lower COVID impacted borrowers plus our equity investments in the JVs, which accounts for a combined 70% of the portfolio, increased in value about $4 million compared to 12/31. Second, the assets that have been underperforming pre-pandemic, some of which have COVID exposure, were up $5 million marking the fourth consecutive quarter of stability or improvement for this group.

The final category is the moderate-to-heavier COVID impacted names. We continue to see a rebound in actual results and improvement in recovery prospects for these investments. Collectively, they also experienced a net $5 million increase in value. Given we're still in the early days of a sustained recovery for some of these borrowers, we continue to be appropriately conservative in our assessment of these credits.

I'll turn next to the portfolio and related activity. We continue to see overall stability and improvement across the book. Total non-accruals were flat at 3.3% based on fair value, and as we sit here today, we don't see any additional loans at risk of non-accrual. The total fair value of positions risk rated 3 to 5 indicating some level of downgrade since we made the original investment, is down again this quarter by about $33 million in the aggregate.

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Total amendment activity slowed down meaningfully in the first quarter, as we expected. We had 2 material amendments that closed for borrowers specifically impacted by COVID. The important point to note is that in exchange for covenant relief, the sponsors injected significant incremental dollars to support the liquidity needs of each business.

I'll finish with a review of our financing facilities and liquidity. We continue to be very well positioned with the right side of our balance sheet. That said, we're always exploring various alternatives in both the private and public markets particularly given the current issuer friendly financing environment. Regarding 3/31 results, statutory leverage was 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 new attractive opportunities. And regarding the preferred equity issuance from May 2020, our stock continues to trade well above the conversion price, but as we previously noted this instrument remains a long-term investment by Carlyle in our BDC. So there currently is no intention to convert.

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

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

Thank you, Tom. I'll finish where I started and note the strong momentum and performance in our company that will continue to drive attractive and sustainable income generation for our shareholders. We appreciate your support and thank you for your time this morning.

I'd like to now turn the call over to the operator to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question coming from the line Melissa Wedel with JPMorgan.

Melissa Marie Wedel - JPMorgan Chase & Co, Research Division - Analyst

A couple of interesting things this quarter. First of all, I was noticing that there are some second lien issuance that was a little bit elevated compared to prior quarters, just wondering if you could elaborate on sort of the relative value that you're seeing up and down the capital structure?

Taylor Boswell - TCG BDC, Inc. - CIO

Thank you so much, Melissa. It's Taylor picking that one up. I think that that doesn't represent any significant change in terms of our approach to originations and balance of the portfolio over time, and maybe it's just more reflective of the opportunities that we saw and liked in this particular period. But what I would say to you is that in our business whether it's a sub-asset class or product category or a sector even when portions of the market might comprehensively offer better or worse real val. We're always really kind of looking for the individual credit investment and tend to find those that we like even those verticals. So interestingly, while we have a little more second lien origination and we really like those credits that we booked, I think the second lien market right now is probably comprehensively not as much of a source of relative value of other aspects of the market. And so, yes, I wouldn't read into that, that we're doing deals we don't like rather we're finding investment conviction and in credits we know and like very much within those markets, even if the whole market has less of a relative value construct right now for large second lien borrowers. At the same time, I think the core middle market senior product continues to offer great relative value across that entire asset base. So again, deals we liked out of a very big origination funnel, not necessarily a reflection of a view that that's where the best relative value is comprehensively in the market today. Is that responsive?

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Melissa Marie Wedel - JPMorgan Chase & Co, Research Division - Analyst

That's really helpful. Follow-up question on the repurchase activity, which obviously did continue in the March quarter, but it was a bit lower from 4Q levels of repurchase. And I'm just wondering if you could help us understand the framework that you use to think about the sizing and pace of repurchase from quarter-to-quarter.

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

Sure, Melissa. It's Linda. Thanks for the question. I think the first thing to state and -- excuse me, allergies are kicking in here, is that we are -- we do think there is a lot of value in our stock and we continue to be consistent repurchasers of it. But we'll obviously scale those repurchases based on how accretive they are overall, and that will fluctuate as our stock price fluctuates. So it shouldn't be a surprise that we purchased a bit less this quarter. Repurchasing our shares was a bit less accretive this quarter than it had been in prior quarters. But nevertheless, again, we continue to see great value in our shares. So you should continue to see repurchases at least in the near future. And we have -- just as a side note, we have plenty of room and plenty of time left on our repurchase authorization that the Board gives us each year.

Operator

Our next question coming from the line of Paul Johnson with KBW.

Paul Conrad Johnson - Keefe, Bruyette, & Woods, Inc., Research Division - Associate

I realize you mentioned this at the end of your prepared remarks, and this has also been asked on previous calls as well but I'm just wondering on the preferred equity piece in your capital structure, have you guys assessed any of the dilutive impact from a potential conversion or even just a pay-off of that investment. And then also on that investment, I'm just also curious, is this -- is the preferred equity essentially controlled by the advisor itself, its discretion over the prepayment of that investment or is this something that's in a fund that's maybe outside of the control of the advisor?

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

Paul, it's Tom. To hit the second point or the last part in terms of the actual investment who holds it, it's held by Carlyle, the advisor. So it is obviously part of Carlyle, we look at it is clearly friendly money and any decisions will certainly be made with our management team as well as broader Carlyle, noting that whatever the -- sometime down the road the ultimate realization of that product. There's certain requirements for Board approval as well in terms of, let's say, where the liquidity will come from. So we think it certainly is very much friendly paper. It's going to be long-term Carlyle's investment, it's a portion of this business, and when the time is right sometime down the road a collective decision across both the BDC, the BDC Board and Carlyle, the manager. In terms of the accretive effect you can see we report the fully diluted shares. It's something to the tune of 5 million shares, if and when converted, and that would have the commensurate impact on earnings. Obviously, we would not be paying the pref dividend, which is roughly $900,000 the cash rate per quarter, which is 7% rate but then we'd be paying the common dividend. So the net impact would be $0.02 or so per share per quarter.

Paul Conrad Johnson - Keefe, Bruyette, & Woods, Inc., Research Division - Associate

Okay. Okay. And not to prolong that topic anymore I guess, but as you say, it's a part of your long-term financing plan for the BDC, I'm just curious how you balance that out in context of today's capital markets where obviously we've seen BDC's issue unsecured debt at much lower rates 3%, 4% handle some even lower than that. How do you balance that out in terms of viewing a 7% piece of financing when you can issue potentially lower in the unsecured markets?

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

Sure. From a broader capital structure perspective, we're very comfortable with our current balance sheet, well positioned with our flexible corporate revolver, we have an attractive long-term CLO that's well suited for our heavy first lien portfolio, and of course the unsecured debt that we raised in the last 2 years. So very well positioned. We're certainly looking at the current hot market whether it'd be for unsecured, whether it'd be the CLO market. Obviously a lot of moving pieces and we are certainly factoring in the impact of a bond offering at a lower interest rate, but then offsetting what would certainly be the dilutive impact of, let's say, a conversion or repayment of the pref. So I think -- but I think that our analysis would suggest that and certainly Carlyle is a long-term holder with that perf is that, that will remain a long-term part of the capital structure. No intention right now to convert, no intention to repay it.

Taylor Boswell - TCG BDC, Inc. - CIO

And Paul, it's Taylor. I do think it's important in the context of the convert to go back to the circumstances in which it was put in the capital structure, which was sort of in the depths of the coronavirus crisis last year. And so the firm really thought that, that was a strong statement of support for the company at the time. And that execution was done on terms that probably wouldn't have been available in the market at those times. And then if you flash forward to today, I do think it's also important to call out that many of the attributes of that security are not replicable in other respects for the company, meaning its perpetual duration, its PIK toggle option. There is a bunch of attractive features of that security still today for that instrument. And so we don't have any intention to convert in the near term, as Tom said, but we don't feel like it is an appropriate portion of our overall capital structure at $50 million of size.

Paul Conrad Johnson - Keefe, Bruyette, & Woods, Inc., Research Division - Associate

Okay. Yes. Then my last question is just on the JVs. The -- I know you've been deleveraging slightly over -- well, quite a bit over the last couple of years in the Middle Market Credit Fund #1, yield has been declining obviously as kind of a result of that, I calculate roughly like a 9.3% yield or so annualized yield for that JV this quarter. I'm curious, is that kind of the yield that we should expect going forward just given all the deleveraging that's taken place there or could we expect maybe potentially a higher return if you're going to be placing more investments into the fund?

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

Paul, yes. It's Tom again. I think when you compare the current status of that JV lower leverage and certainly, as we look at new investments now perhaps slightly higher yields from a spread perspective relative to historically you had high leverage in the vehicle but perhaps much lower yielding assets, more broadly syndicated assets, let's say, had a delta plus 400 handle. You will see some of those legacy investments still in the portfolio. So as we look going forward, the leverage will certainly be I think in the ballpark of where it is now perhaps a bit higher. We'll be looking for higher-yielding assets relative to where the portfolio is right now. So I think that right now, I'd say that, that 9% is a range of let's say, 9% to 10% or 11% is at the bottom end of our range. I think we'll live comfortably in that range based on some recent enhancements to our main credit facility. We potentially have an ability to achieve some higher yields. But I think we feel really comfortable with the 9%, and based on both on the asset side and the liability side, a little bit of movement -- potential to move that up. I think we're comfortable with kind of a 9% to 10% target and again some potential upside. Based on our current assets, targets and also, our -- some recent developments we are going to then also close our main credit facility.

Operator

I'm showing no further questions at this time. I would now like to turn the call back over to the speakers for closing remarks.

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

This is Linda. I want to thank everyone for joining us on our call today, and please follow up with Allison if you have any other further questions. Have a great day. Thanks.

Operator

Ladies and gentlemen, that does conclude our conference for today. Thank you for your participation. You may now disconnect.

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