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TCG BDC, Inc. (CGBD)

Q2 2019 Earnings Call

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Analyst, Wells Fargo Securities LLC

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MANAGEMENT DISCUSSION SECTION

Operator: Good day, ladies and gentlemen, and welcome to the TCG BDC Second Quarter 2019 Earnings Conference Call. At this time, all participants are in a listen-only mode. Later, we'll conduct a question-and-answer session and instructions will be given at that time. [Operator Instructions]

It is now my pleasure to introduce Daniel Harris, Head of Investor Relations.

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

Thank you, operator. Good morning and welcome to TCG BDC's second 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 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 any forward-looking statements at any time.

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

Michael Anthony Hart

Chief Executive Officer, Director & Chairman, TCG BDC, Inc.

Thanks, Dan. Good morning everyone and thank you for joining us on our call this morning to discuss our second quarter results. Joining me on the call today is our new President, Linda Pace, who will become the CEO of TCG BDC on January 1. In addition we have our Chief Financial Officer, Tom Hennigan; our Head of Originations Grishma Parekh; and the new Chief Investment Officer of Direct Lending, Taylor Boswell.

Let me spend a moment on the CEO transition we announced during the second quarter. As I mentioned, effective January 1 of next year, I'll be stepping down and Linda will become the new CEO of TCG BDC. And until then, I'll continue to operate in that capacity. Linda has an exceptional track record at Carlyle having led our broadly syndicated loan business for the past 10 years, a business today that manages over $25 billion in AUM. Linda has actually been with Carlyle for more than 20 years in different investment capacities and I've had the pleasure of working closely with Linda as she's been involved with our BDC since our inception, serving as an important member of our Investment Committee. She's an exceptional risk and investment manager and her skill and experience in global credit markets are a perfect addition to our direct lending team. Today, our business is well-positioned to take advantage of changing opportunities within the industry and the combination of our experienced investment team and our new leadership team is a powerful combination to move our business forward.

With that, let me now turn the call over to Linda Pace. Linda?

Linda Pace

President, TCG BDC, Inc.

Thank you, Mike. It's been a wonderful experience working closely with you over the past few years. Let me begin today by reiterating a key message, the BDC remains an important flagship vehicle for Carlyle, which is why I'm excited to take on these new management responsibilities. Our BDC and direct lending more broadly is a business which is core to Carlyle's global credit development and a business which has market leading capabilities.

With that said, I'd like to focus my remarks today across three areas: our underwriting strategy focused on achieving optimal risk-adjusted returns, our financial results for the quarter, and our capital management and financial strategy at the BDC.

First, our underwriting and portfolio strategy remains focused on creating and managing a diversified loan portfolio to achieve the best risk-adjusted outcome. Our expectation for the company's performance remains high. The changes we have made highlight Carlyle's aggressive investment into this business.

From an investment perspective, the core tenets of our investment philosophy are unchanged. We will continue to populate the BDC with the best relative value and diverse exposures, maintain a strong bias towards senior debt and defensive industry exposures and directly originate from sponsors with whom we have meaningful relationships. That, however, does not mean that we will stand still. In fact whether responding to dynamic markets or in our continuous improvement efforts we will constantly evolve to extend our competitive advantage. For instance, in recent years, that evolution resulted in the development of new capabilities, such as our software lending and ABL practices. Going forward, the thrust of our evolution will be integrating across the Carlyle platform.

Specifically, we will intensify efforts to utilize the scale of our capital base, the breadth of our investing capabilities and the depth of our expertise to mitigate competition. We regard these assets as true structural advantages, which few of our competitors can match and which we expect will yield differentiated investment outcomes for our shareholders. We are already seeing the benefits of these efforts and Grishma will give you some specific examples momentarily.

Second, let me give an overview of our results for the second quarter. We generated net investment income of $28 million or $0.46 per share, $0.01 higher than the $0.45 we produced in the first quarter. We declared a regular $0.37 dividend and as we previewed last quarter we also declared an $0.08 special dividend for a total of $0.45 in dividends declared in the quarter.

Our company has consistently produced net investment income in excess of our quarterly dividend and we expect to continue this trend going forward. Our net asset value per share declined to $17.06 from $17.30 last quarter as net investment income was generally in line with total dividends paid and was reduced by realized and unrealized losses of approximately $0.30 per share. During the quarter, we repurchased 1.1 million shares of stock for over $16 million which was $0.04 per share accretive to NAV. Stabilizing and growing our NAV via our integrated platform approach will be the major focus area for me and the team over the next few years. And finally, I'd like to focus my last remarks on my view of our capital plans. We remain highly confident in our ability to generate recurring core earnings in excess of our $0.37 dividend and we believe that this stability is an attractive investment opportunity for shareholders.

We will consider additional future special dividends with some regularity as appropriate and as our core earnings allow. At the end of the second quarter, we had approximately $0.21 per share and spillover income to fund special dividends in future periods. As of today we have $58 million remaining on our $100 million repurchase authorization implemented during the fourth quarter of 2018. We will continue to repurchase shares at or near our current valuation as we do not believe our current share price accurately reflects the strength of our investment platform.

With that, let me hand that call over to Taylor who will discuss the health and direction of our business.

Taylor P. Boswell

Managing Director-Carlyle Direct Lending, The Carlyle Group LP

Thanks, Linda. I'll begin by expressing my excitement to join this important investment effort. I'm here today having recently assumed the role of Chief Investment Officer for Carlyle Direct Lending. In this role I'll work closely with Linda, Grishma, Tom and the rest of our talented team across our BDC's investment and operating activities. One of the many resources available to us at Carlyle is our economic research team which closely tracks the health of global economies by analyzing information ranging from macro data to proprietary leading indicators across hundreds of portfolio companies.

Going forward, we expect to regularly share with you the insights of these efforts and how we position ourselves around their findings. Looking across our global portfolios today, Carlyle does not see a near term U.S. or global recession. The signs of emerging economic weakness we do see are largely contained to global trade driven sectors and certain foreign geographies. That said, this deceleration while not evidenced in real U.S. economic data, is to an extent impacting business sentiment and leading to more conservative approaches by management teams. Carlyle expects a vigorous response from global central banks that we believe is likely to mitigate both the depth and duration of real economic weakness as well as result in stable or increasing liquidity in global credit markets. This pending response has led to, one, less favorable macro development for our business and all of our BDC peers, the abrupt downward shift in forward interest rate expectations over the last six months. As a reminder, 99% of our portfolio is comprised of floating rate loans and all else being equal every 25 basis points change in LIBOR will impact annual net investment income by $0.03 per share. Most importantly, we consider our BDC's portfolio to be extremely well positioned fundamentally against this macroeconomic backdrop. We have 70% of our portfolio in true first lien instruments, a high degree of investment diversification and significant underweights to more cyclical industry exposures, all of which we believe will be long term benefits to our shareholders.

In the current period, while we are pleased with most aspects of our financial performance. There remains room for improvement. The one controllable area which fell short of expectations in Q2 was the progression of our NAV, which was impacted by higher realized and unrealized losses than we would expect to see in normal course. We have dug into each situation and ascertained they represent idiosyncratic credit issues not indications of either thematic risk concentrations in our portfolio or broad economic weakness. As you would expect, these loans are a significant focus for our team and we have committed the necessary resources to maximize shareholder value.

All in all, we are comfortable with the profile of our business and optimistic about our prospects. To echo Linda's comments, we will maintain an appropriately diversified defensively positioned portfolio while also integrating our broad platform capabilities to dynamically respond to changing market conditions.

Our investment process remains rigorous focused on a high quality recession resilient businesses, deep relationships with our borrower clients and investment opportunities where we have a differentiated diligence advantage.

I'll now hand the call over to Grishma to take you through our origination activity in the quarter.

Grishma Parekh

Head of Origination, TCG BDC, Inc.

Thanks, Taylor. In terms of the market, the general backdrop remains characterized by high leverage multiples and private equity firms paying full purchase prices. The substantial dry powder held by both private credit and private equity managers coupled with generally stable economic conditions continues to drive this dynamic. Loan volume was sluggish this quarter due to muted M&A activity, although we did see an uptick in opportunistic activity. Competition for new origination remains intense and our response has been to focus our investments in areas that play to our strengths. We are harnessing our platform-wide credit capabilities in a greater way than we have done in the past. For example that means taking an idea generated by our aerospace credit research analyst in the broadly syndicated loan business, leveraging the long-term expertise of Carlyle's private equity professionals investing in aerospace companies and bring that transaction to a sponsor with whom we have a strong relationship to offer accretive one-stop solution across several parts of the capital stack. This is exactly what occurred with our recent investment in Wencor, an aerospace aftermarket components manufacturer owned by Warburg Pincus.

We are also aligning around industries not only across credit, but firm-wide in order to develop more expertise. We found that by doing this, we can move quicker with greater conviction resulting in better outcomes. For example, medical device contract manufacturing is a niche sector we have spent a significant amount of time developing a thesis around by leveraging our healthcare bio team, regulatory affairs group and other Carlyle advisors. Our knowledge and conviction in this space lead us to secure the lead for [ph] Altera's acquisition of Pyramid (00:13:58) a designer manufacturer of complex electronic medical devices. Moving to the numbers, during the quarter we originated $291 million of commitments essentially in line with Q1 across 33 transactions with 25 private equity firms. Much of this capital was in support of existing private equity clients to our business and about half was to existing portfolio companies. As we said in the past, we believe investing behind repeat borrowers and PE clients is an important risk management tool and offers some of the best risk adjusted return opportunities.

This quarter, the vast majority about 88%, of our new commitments were first lien and 100% were in senior secured positions. The weighted average yield at amortized cost of these new investments was 8.83% compared to 8.97% for the debt portfolio overall. Many of the key metrics we monitor for our new investments remain largely in line with our broader portfolio and with prior quarters. The loan to value of our new investments was 41%. The average leverage multiple was 5.3 times and the interest coverage ratio was in excess of 2 times.

The average EBITDA of our new investments was $50 million versus the $40 million median EBITDA across the portfolio. Repayments were high this quarter at $240 million which excludes $64 million repayment of the mezzanine loan for our JV with PSP. This is in contrast with Q1 which had de minimis payments due to the market volatility of that quarter. However when you look at our repayments for the first half of 2019, they were in line with prior years. As a result, we experienced a net reduction in our BDC portfolio of 4% and net growth in the JV of 6%.

I will 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. Jumping right into the financials, total investment income for the second quarter was $57 million which was up about $2 million compared to the first quarter. The increase was primarily due to higher OID accretion and prepayment fees from the elevated level of repayments this quarter and also higher average investment balance. This was offset by some negative pressure from lower LIBOR, an increase in non-accruals, and lower total income from our JV.

Total expenses were $29 million in the quarter compared to $28 million last quarter. The largest component of the increase was higher interest expense driven primarily by higher average debt outstanding. This resulted in net investment income for the quarter of $28 million or $0.46 per share. And that compares to an average of $0.43 over the last seven quarters since our IPO and our regular dividend of $0.37 per share.

Last quarter, we referenced the term core interest income which we define as regular interest income on the investment portfolio excluding any OID acceleration, prepayment fees or transaction fees. This quarter, if you back out the elevated level of transaction related income streams, we still would've comfortably covered the regular dividend. And on August 5, our board of directors declared the regular dividend for the third quarter of 2019 at the same $0.37 per share and that's payable to shareholders of record as of the close of business on September 30. On the financing front, we finished the second quarter with total debt outstanding of about $1.1 billion. That's flat compared to prior quarter. During the quarter, we increased commitments under our revolving credit facility by another $80 million. So as of 6/30 we had about $340 million of total unused commitments under our credit facilities. Statutory leverage was 1.07 generally in line with prior quarter given muted growth in the portfolio. However, we do see this level increasing more meaningfully by the end of the third quarter due to a steady originations pipeline combined with more modest repayments expected this quarter. And given the more favorable rate environment for issuers, we anticipate exploring additional financing transactions in the near term. To increase our operational flexibility, we'll be looking at all areas of the market including the private and public capital markets.

Moving on to the JV's performance, the dividend yield on our equity in the JV was about 13% for the second quarter. As previewed on last quarter's call, in late May we closed our second CLO at the JV which resulted in an overall reduction in the J's cost of capital by about 20 basis points.

Regarding the portfolio, we had an increase in overall activity this quarter. The weighted average Internal Risk Rating remained 2.3. However, total [indiscernible] (00:18:28) loans again increased this quarter with a net addition of three borrowers. What the overall theme is that in most cases we believe these are temporary performance issues. Sponsors have been supportive with additional capital, we've closed or negotiated credit enhancing amendments, and our goal remains full recovery. The level of nonaccruals increased this quarter from 0.8% to 2% based on fair value with the addition of two borrowers.

We exited one of these positions, [ph] Totes (00:18:56), post quarter end at a level a bit lower than our [ph] 630 (00:18:59) mark driven by our developing view on the potential downside to our recovery in that investment. For the other nonaccrual transactions, these continue to be fluid and developing situations. Given the status of ongoing negotiations between the various parties we're limited in providing additional color but we hope to have updates over the next couple quarters. Regarding valuations in NAV, our total aggregate realized and unrealized net loss was about $18 million for the quarter. Credit related markdowns were the primary driver of this loss. The continued rebound in market yields aided valuations by about $2 million on the quarter while reversals of prior unrealized gains on exited positions was a negative $2 million.

The roughly $8 million of realized loss this quarter has two primary components, first a $9 million of realized loss from our recapitalization of SolAero and that was primarily a reversal of prior period unrealized losses. And second, a $2 million gain on our equity co-investment in Imperial Dade.

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

Linda Pace

President, TCG BDC, Inc.

Thank you Tom. Again, I'm very excited to have the opportunity to lead our direct lending business moving forward. As I mentioned earlier, delivering strong risk adjusted returns to our shareholders, and stabilizing and growing our NAV will be among my major focus areas as we further leverage the diverse resources of Carlyle.

Thank you for your time and attention this morning and I'll now turn the call back over to the operator for Q&A.

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] And our first question comes from the line of Rick Shane with JPMorgan. Your line is now open.

Richard Shane
Analyst, JPMorgan Securities LLC

Q

Hey guys. Thanks for taking my question this morning and Linda congratulations. I wanted to talk about two things. First of all, given the current interest rate outlook, could you guys give us a sense of the distribution of floors on investments in your portfolio and your ability to negotiate floors in the current environment.

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

A

Sure, Rick, this is Tom. Our portfolio for the most part, most transactions have LIBOR floors and in particular are directly originated middle market deals. We continue to have LIBOR floors in those transactions and it's typically 1%.

Richard Shane
Analyst, JPMorgan Securities LLC

Q

They're typically 1% and that's regardless of sort of the interest rate environment? You're not getting higher floor – you haven't gotten higher floors in the last year when rate curve was suggesting rates were headed higher and the curve was – rates were higher, base rates were higher.

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

A

1% has really been the standard for the last number of years.

Richard Shane
Analyst, JPMorgan Securities LLC

Q

Got it. Okay. Great. Second question, Grishma, you talked about sort of a new approach in terms of integrating the resources from Carlyle. Historically there's been this notion of One Carlyle goes all the way back really to the beginning or the inception of the company. Curious what specifically we should be looking at that's different. You [ph] said at a specific (00:22:24) transaction, would love to understand the nuance there.

Grishma Parekh
Head of Origination, TCG BDC, Inc.

A

Yeah sure. It's a good question, Rick. So integration and the utilization of our credit-wide and firm-wide frankly capabilities is something that has been core to our investment strategy and really just the ethos of our business. So in that way fundamentally not a lot has changed. Tactically when we're approaching opportunities now, we are spending a lot more time collaborating with other groups within credit and within the firm. We're continuing to develop deeper sector expertise and so that includes our credit research analysts, that includes members of our direct lending team, that will include members of the private equity business, so that we can formulate a thesis around certain sectors and then within certain sectors, niche areas, that we think are really interesting so that we're more proactively generating ideas and not necessarily just waiting for the call – the phone to ring on an opportunity from a sponsor. And we've been seeing a big shift in the way that we're sourcing ideas and our success rates for those deals that we really want to invest in just becoming much more impactful by taking an even deeper approach to the One Carlyle effort that we've been focused on from the very beginning.

Richard Shane Q
Analyst, JPMorgan Securities LLC

Is it fair to characterize that as sort of more of a push strategy from using the resources of Carlyle, pushing up ideas as opposed to the pull strategy of tapping into the experts when you've been looking at transactions in the past?

Grishma Parekh A
Head of Origination, TCG BDC, Inc.

Yeah, that's well said. So I think in the past, we would reach out when there was an opportunity. And now we're spending a lot of time almost in a think-tank capacity and looking at the market, looking at what we're seeing in various sectors and saying, what sort of ideas can we generate from investments that we've already invested in in various other parts of the organization, what ideas can we bring to our private equity clients in a way that we just haven't done before and that we don't think that a lot of other direct lenders are doing. And again, we found that when we do that, a lot of our clients are looking at us as not just a provider of capital, but now also a provider of really unique ideas.

Richard Shane Q
Analyst, JPMorgan Securities LLC

Got it. Okay, terrific. Thank you so much.

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

Thanks, Rick.

Operator: Thank you. And our next question comes from the line of Finian O'Shea with Wells Fargo Securities. Your line is now open.

Finian O'Shea Q
Analyst, Wells Fargo Securities LLC

Hi, guys. Good morning and welcome, Linda and Taylor. First question on the portfolio side, it looks like some of the valuation, some of the negative marks this quarter were related to healthcare services names. So I want to ask, appreciating you can't get into specifics on a company, is there any acute pressure on this line of – on this industry maybe employee retention issues or reimbursement issues? Are there any challenges to these practices, which frankly are seen across your portfolio and many BDC portfolios? So it'd be helpful for any color you could provide there.

Linda Pace A
President, TCG BDC, Inc.

Sure. Thanks, Fin. This is Linda. I'll take your question and nice to meet you on the phone. Hope to meet you in person pretty soon. And then other folks in the team can jump in with more comments, but I think that's a really poignant observation that you're making because it's one that we've made ourselves in looking at not just within our BDC, but really across the global credit platform as to are there any themes regarding what we're seeing as far as stress in the portfolio. And for the most part, for the names that are on our watch list around nonaccrual they're idiosyncratic situations. But one thing we can point to is that within the healthcare services space where we're seeing companies do more aggressive types of roll up transactions that those come with more challenges. And you have not only reimbursement challenges but you've got personnel challenges and systems challenges things like that, which we are seeing that sponsors are having a bit more of a challenge in dealing with.

So, yeah, I think that's something that we've noticed. We're becoming more aware of those things and looking at kind of our lessons learned on some of the things that we have in the portfolio as we see more of these deals come to the market.

Finian O'Shea
Analyst, Wells Fargo Securities LLC
Q

I sure appreciate the color and just a follow-up question on allocation, when – Carlyle, when the advisor originates a new loan does it receive any upfront economics before allocation to the BDC?

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

Hey Fin, it's Tom. The answer is no. The manager receives zero fees outside of what the BDC is receiving. So we have full pass throughs to the BDCs in all of our funds and the manager to the extent it's underwriting a discrete excess of our funds demand, then there may be fees on that underwriting. But certainly there's no fee that the manager is taking for the ultimate [ph] hold (00:28:23) for our fund.

Finian O'Shea
Analyst, Wells Fargo Securities LLC
Q

Thank you for taking my question.

Operator: Thank you. [Operator Instructions] Our next question comes from the line of Ryan Lynch with KBW. Your line is now open.

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

Hey, good morning and thanks for taking my questions. Linda first question is for you. Obviously the resignation of Jeff Levin earlier this year and then Mike Hart announced a few months ago, that's a significant amount of turnover at the executive level at the BDC. So can you maybe just comment on how investors can get comfortable with that level of executive turnover?

Linda Pace
President, TCG BDC, Inc.
A

Sure, Ryan. Thanks for your question. So what I would tell you is yes, acknowledging Jeff's departure and Mike's retirement at the end of the year, that's two people out of a team of 35 people. And we still have folks like Grishma and Tom and all the people underneath them that are still here and still working very hard. I am – even though I've assumed kind of the new role of President, I've been a consistent member of the team since the beginning having been on the investment committee. And we're taking the opportunity because of the importance of the BDC to the Carlyle overall global credit platform not just to put me into the President role but really to add more people and more focus and more resources to the BDC platform. So we are – it's business as usual and we continue to work really hard. And I think the shareholders can feel confident that we have a ton of focus with a lot of senior and highly experienced professionals from Carlyle's credit platform focused on the BDC.

Michael Anthony Hart
Chief Executive Officer, Director & Chairman, TCG BDC, Inc.

A

And Linda and Ryan, if I may just add, I think Linda's relationship – our relationship I think has allowed for Linda to have an immediate impact on the business and my decision is a personal one. But I have never felt better about where our business stands and have never had more confidence in the people that are involved and the people that are or will be contemplated to be involved and where our business stands within the context of the overall global credit platform. So while business turnover is inevitable in businesses like this, I think our business is at a unique point that will benefit greatly from further integration with the global credit platform, the focus that the firm has on it, and having talented individuals join the team like Linda and Taylor. I personally can say that there has never been a time that we have been better resourced.

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

Q

Okay, that's helpful commentary. Next question on the Middle Market Credit Fund, the yield was a bit lower this quarter. I know you guys said you had the CLO or securitization was issued this quarter. I just want to know was that 12.7% yield in Q2 is that sort of a trough yield given that the securitization was issued this quarter and you guys expect that to kind of bump back up into that 13% or 14% type range?

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

A

Hey, Ryan, it's Tom. I think you'll see the JV yield on our equity kind of ebb and flow in that general range of low to mid-teens just based on prepayment OID yields repaying one-time fees, to the extent that there are any one-time fees for transactions in the JV. So I think you'll see ebb and flow in that general range.

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

Q

Okay. And then Grishma I believe you were talking about this quarter very strong repayments given the kind of muted fourth – or muted Q1. How is the outlook looking for 3Q from the repayment side to – should we expect it to kind of normalize in the what you guys have been kind of running at the $200 million, $250 million area?

Grishma Parekh
Head of Origination, TCG BDC, Inc.

A

Hey, Ryan. Yeah, I would say that – which is why we sort of pointed to a repayment for across the first half because we did feel like there was a little bit of a pull forward in Q2 from the fact that there was very little in the way of repayments in Q1. And so Q3 and sort of the balance of the year, we're expecting a much more normalized repayment environment. And I think we feel pretty good as we sit here today as it relates to both our pipeline and our backlog in the context of the repayment outlook.

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

Q

Okay. Those are all my questions. I appreciate your time today.

Operator: Thank you. And I'm showing no further questions at this time. So with that I'll turn the call back over to Head of Investor Relations, Daniel Harris, for closing remarks.

Daniel Harris

Head of Investor Relations, TCG BDC, Inc.

Thank you operator and thank you all for your time and attention this morning. If you do have any further questions, feel free to reach out to Investor Relations after the call. We look forward to speaking with you again next quarter and enjoy the end of the summer.

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