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TCG BDC, Inc. (CGBD)

Q4 2020 Earnings Call

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Melissa Wedel
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MANAGEMENT DISCUSSION SECTION

Operator: Ladies and gentlemen, thank you for standing by and welcome to the TCG BDC, Inc. Fourth Quarter 2020 Earnings Conference Call. At this time, all participants are in a listen-only mode. After the speaker's presentation, there will be a question-and-answer session. [Operator Instructions] Please be advised that today's conference maybe recorded. [Operator Instructions]

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

L. Allison Taylor Rudary
Head of CGBD Shareholder Relations, The Carlyle Group

Good morning and welcome to TCG BDC's fourth quarter 2020 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 the TCG BDC 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.

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

Linda Pace
Chief Executive Officer & Director, TCG BDC, Inc.

Thank you, Allison. Good morning everyone and thank you for joining us on this call to discuss our fourth quarter 2020 results. Joining me today are Chief Investment Officer Taylor Boswell and our Chief Financial Officer, Tom Hennigan. Overall we had another very solid quarter and throughout a volatile year we were successful in managing the performance of our portfolio, fortifying our balance sheet and leveraging our origination capabilities. We exit 2020 with a high degree of confidence in the fundamental credit trajectory of our portfolio and our prospects for sustained income generation.

I'll focus my detailed remarks today on three areas: first, our quarterly results and our positive momentum entering 2021; second, our approach to the current investment environment; and finally, how our company and shareholders benefit from our relationship with Carlyle. We generated net investment income of $0.38 per common share and declared a total dividend of $0.37 per share.

You will recall our dividend policy provides for a base amount of $0.32 per share in fixed quarterly dividends combined with recurring supplemental dividends of excess earnings each quarter, which this quarter was $0.05 per share for a total of $0.37. As Tom will detail later, we continue to forecast earnings well in excess of our base dividend in the coming quarters.

Net asset value per share increased 2.5% quarter-over-quarter from $15.01 to $15.39. Loan valuations again improved driven not just by rebounding market yields, but more importantly improving credit performance. We also resumed our share repurchase program last quarter repurchasing 1 million shares of our common stock. This resulted in $0.08 of accretion to net asset value. While we have always approached our repurchase strategy with an eye towards consistency, at our stock's recent valuation we remain active acquirers of our shares.

With an underlying macroeconomic recovery underway and positive credit performance in our portfolio, we expect 2021 to offer opportunity for continued positive NAV migration. As we previewed in our last call, the fourth quarter proved to be an extremely robust origination environment with M&A demand rebounding briskly from the depths of the crisis.

Much of our market has recovered quickly in a short period of time and we're pleased that our proactive portfolio and capital actions in 2020 position CGBD to access the attractive new deal market in the back half of last year. We have maintained the same momentum and activity thus far in the New Year and are excited about both the quantity and quality of transactions in front of us.

Currently, we're seeing attractive first-lien opportunities in our core markets and are well-positioned to be opportunistic in other areas where we see favorable risk adjusted returns. As always, we remain focused on our defensive approach to both asset selection and portfolio construction in pursuit of our core investment objective: the generation of sustainable income for our shareholders.

Finally, I want to highlight just a few of the competitive advantages that accrue to us and our shareholders from being part of the broader Carlyle platform. First, our platform offers a highly differentiated origination proposition as the coordination of our wide sourcing funnel, our scale's capital base and our breadth of product offerings allow us to be highly selective in our investments while also diversifying risk factors in our portfolios.

Additionally, our platform utilizes the deep embedded expertise at Carlyle, which improves our due diligence, negotiation and investment structuring. Whether it is a specific company, industry, geography or asset type, our platform consistently delivers us valuable insights and execution advantages that form the foundation of our investment performance.

And now, quickly allow me, here, to introduce Allison Rudary, who joined us as Head of CGBD Shareholder Relations late last year. Many of you will know Allison from her time covering BDCs on the sell side and we're excited to have her working with our team, including Dan Harris, on providing a best-in-class investor experience for our shareholders. Please do not hesitate to reach out to Allison should you have any questions regarding our company.

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

Taylor P. Boswell

Chief Investment Officer, TCG BDC, Inc.

Thank you, Linda. I'll begin with a quick comment on Carlyle's current macroeconomic perspectives, which we developed based upon inputs from across our global footprint. After that, having discussed portfolio and credit evolution at length in past calls, I'll focus my comments today on our origination activity in recent quarters. Overall, global economic activity continues to be characterized by substantial dispersion across industries and geographies. While no downturn affects spending categories equally, the pandemic-induced recession has been unprecedented in that it has created far wider than usual gaps between winners and losers.

Our preliminary data year-to-date suggests that US GDP growth has slowed somewhat in the first quarter of 2021, but most economists see a strong rebound thanks to larger than expected fiscal stimulus and broader reopening facilitated by vaccinations. Stimulus prospects have aroused some concerns about inflation risk, but thus far, we see scant evidence of overall price pressures with prices paid across the US economy consistent with overall inflation of just 1.4%.

A constructive macro backdrop and buoyant liquidity conditions have fueled leveraged finance markets out of the box this year with increasingly aggressive execution in high yield and broadly syndicated loans where demand for paper is outstripping supply.

In private credit markets, which have certainly recovered meaningfully since the beginning of the crisis, we continue to see more balanced conditions. That said, as always, individual credit selection remains paramount with opportunities for both wins and mistakes in all markets.

As Linda mentioned, the fourth quarter was an extremely active originations environment in which we deployed $205 million across 26 transactions at an 8.1% average yield. This activity comfortably outpaced repayments in the same period, which totaled $133 million at an approximate 7.8% yield.

Notably, our deployment in the fourth quarter heavily capitalized on the unique strengths of our platform. We were active leading new investments in our core sponsor finance strategy, executing attractive add-ons for existing borrowers, closing complex asset-backed transactions as well as stepping into the dislocated syndicated market prior to the presidential election.

Our expansive origination footprint and broad execution capabilities allow us to be more credit selective while concurrently diversifying the portfolio's underlying risk factors. We expect both to accrue to the material benefit of our shareholders over time. We continue to leverage those same strengths this year, looking to tactically allocate our capital into the best individual investments across the wide swath of private credit subsectors in which we operate.

Currently, we are seeing the most attractive opportunity set in core middle market investing as robust technical conditions in syndicated markets constrain the upper middle market relative value proposition. However, as has always been the case in leveraged finance markets, we expect the location of credit relative value to be dynamic. With access to the benefits of our highly capable platform, we remain confident in our ability to deliver regardless of the direction in which opportunity migrates.

Turning to repayments, in an active M&A environment one would normally expect them to increase, and they have, particularly in our MMCF I portfolio where total assets decreased from the prior quarter. That said, from a portfolio management perspective, we focus on cumulative exposures to MMCF I and MMCF II; and on that basis, we remain comfortable in the sustainability of distributions from those vehicles.

Finally, I should make a quick comment on credit which we have discussed in depth each of the last several quarters. The fourth quarter played out favorably and as expected. While we remain vigilant on risk, we continue to feel that our COVID impacted borrowers have largely addressed their problems and have sufficient liquidity to bridge to demand recovery.

Again this quarter we had no new non-accruals, experienced positive valuation migration and accounting for the MMCF II transaction constructive risk ratings progression in our portfolio. We believe the portfolio's fundamentals combined with our appropriately conservative valuation approach leave us well-positioned to continue to deliver solid credit performance in the coming quarters. As always thanks for your time and support. Tom?

Thomas M. Hennigan

Chief Financial Officer & Chief Risk Officer, TCG BDC, Inc.

Thank you, Taylor. I'll begin with a review of our fourth quarter earnings, then I'll provide further detail on the portfolio and our balance sheet positioning. As Linda previewed we had another impressive quarter of income generation. Total investment income for the fourth quarter was $44 million up from $43 million in the prior quarter. The increase was driven by a few factors, an increase in OID accretion and prepayment fees from a normalized level of loan repayments, higher fee income stemming from new originations and an increase in total dividends from the two JVs. This was partially offset by a decrease in interest income from a lower average invested loan balance primarily due to the contribution of assets to the new JV.

Total expenses were flat versus prior quarter at $22 million. This resulted in net investment income for the quarter of $0.38 per common share or $22 million, exceeding the general guidance we've provided the last couple quarters.

On February 22nd, our board of directors declared the dividends for the first quarter of 2021 at a total level of $0.37 per share comprising the $0.32 regular dividend plus a $0.05 supplemental, which is payable to shareholders of record as of the close of business on March 31st. 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 to pay sizable supplementals in line with the $0.04 we've been able to pay in the last few quarters.

Moving on to the performance of our two JVs, total dividend income was $6.5 million, up over 10% versus prior quarter while total assets of the JVs were flat at about $1.3 billion. The earnings increase was driven by the addition of MMCF II while total asset growth was muted by heavy repayment activity at MMCF I. On a combined basis, our dividend yield was about 10%. Looking forward, we see aggregate assets, yield and dividend generation from the two JVs as stable in the coming quarters adjusted for a full quarter of contribution from the MMCF II.

On valuations, our total aggregate realized and unrealized net gain was $16 million for the quarter, the third consecutive quarter of positive momentum following the drop in March of 2020. Similar to the last two quarters, we saw valuations increase based on the continued rebound in market benchmark yields, plus improving credit. Using the same buckets as outlined in prior quarters we 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 $5 million compared to 9/30. The assets that had been underperforming pre-pandemic, some of which have COVID exposure, were also up $5 million, marking the third consecutive quarter of stability or improvement.

Our successful exit at par of our investment in Hydrofarm valued in the mid-70s in last quarter was a key driver. The final category is the moderate to heavier COVID impacted names. Well we believe it's prudent to be somewhat conservative in our assessment of these credits, particularly given some second wave impact is to experience the net $6 million increase in value driven primarily by investments in the aerospace and business services segments.

I'll turn next to the portfolio and related activity. Building on Taylor's comments, we continue to see positive momentum across the book. Total nonaccruals decreased from 3.5% to 3.2% based on fair value. The total fair value of transactions risk rated 3 to 5 indicating some level of downgrades since we made the investment inch down by about $30 million in the aggregate.

The flood of amendments from the third quarter is largely behind us with relatively limited activity during the fourth quarter and into early 2021. You'll see in the cases of direct travel and central security that we closed successful restructurings and now hold both debt and equity instruments. In both cases, we think with lenders now holding majority of the equity, we're better positioned to achieve superior recoveries.

I'll finish with a review of our financing facilities and liquidity. Total debt outstanding was approximately $1 billion at quarter end. That's down from $1.1 billion as of 9/30. The reduction in debt was primarily due to the net proceeds from the closing of the second JV in November.

Statutory leverage was down from 1.3 to 1.2 times, while net financial leverage which assumes the preferred is converted and is the risk metric we use to manage the business, was down from 1.2 to under 1.1 times. So, we're sitting close to the lower end of our target range of 1.0 to 1.4 times. This provides us comfort in the case of any unexpected twist in the macro environment, like we experienced last year, and also offers us flexibility to invest prudently in attractive new opportunities.

In the fourth quarter, we also closed on an incremental $75 million of unsecured notes with a coupon of 4.5%. We used those proceeds to repay and retire one of our legacy secure financing facilities; so, we both simplified and fortified our financing structure during the quarter. And regarding the preferred equity issuance from May of 2020, our stock is now trading well above the conversion price. But as we've noted previously, 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

Chief Executive Officer & Director, TCG BDC, Inc.

Thanks, Tom. 2020 was a year like no other. Taylor, Tom and I are extraordinarily proud of how the team navigated through such a high risk and volatile market environment. As we begin 2021, we are confident in the positioning of our portfolio, balance sheet and our earnings outlook. Thank you all for your time and support today.

And I'd like to ask the operator to open the line for questions.

Operator: Thank you. Before we began our Q&A process, TCG BDC's CFO, Tom Hennigan, would like to add a few quick comments.

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

Thank you, operator. Yeah, one quick note; as you may have seen on page 6 of our earnings presentation, we published an increase in all-in yields on investments on both our cost and fair value basis. I just want to highlight the 12/31 figures. Those include our two JVs. If you were to exclude the two JVs, that would be consistent with the prior method. The quarter-over-quarter increase is actually closer to 10 basis points. Just want to highlight that. We expect to issue comparable figures in the near term.

Now, we can move to questions. Thank you, operator.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] And our first question coming from the line of Finian O'Shea with Wells Fargo. Your line is open.

Finian O'Shea
Analyst, Wells Fargo Securities LLC

Q

Hi, everyone. Thanks and good morning. First question on the amendments, I think one of you said that that chapter is concluding on the need for amendments in your portfolio. Can you expand – or give us some color, now, with hopefully that chapter behind us – with COVID behind us, how this batch of portfolio companies – presumably they mostly tripped EBITDA maintenance covenants or something like that, how they are rebounding to-date, any color there?

Taylor P. Boswell
Chief Investment Officer, TCG BDC, Inc.

A

Hey, Fin. You've got Taylor on the line. As you'd expect across a diversified portfolio, there's a wide range of answers to that question. I think that, generally, what we see across the portfolio is not that the crisis is over, but rather that the outcomes can be pretty confidently bounded at this point and that the borrowers in our portfolio have generally addressed their liquidity issues.

I think that [ph] to peel in (19:33) some of the subsectors around how things are recovering, I think that it feels to us as if a number of the consumer-oriented sectors and the like have sort of found more stable footing where there has been demand recovery and continued progression, but remains well below prior periods; but, the businesses, generally, have recovered a fair amount.

I think we are hopeful in the last couple of months that exposures more in spaces like travel and aerospace are finding the bottom in this period. And we've seen a couple of those borrowers sort of start to inflect upward again from a profitability perspective. But those are still more severely demand impacted sectors.

Again, all in the context of many of these borrowers having sufficient liquidity to bridge a long period of time back to that recovery. But hopefully that gives you a little feel for what we're seeing both generally. And then as you come down into some of the more impacted sectors, if you will. Is that helpful?

Finian O'Shea
Analyst, Wells Fargo Securities LLC

Q

Very much so. And a follow-up on the converts, again appreciate you – again outline that that's a longer-term instrument although it's now in the money. What happens at maturity of the converts, does – do you pay it back like that or does it automatically convert or are there a range of outcomes?

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

A

Hey, Fin. It's Tom. On the convert, there is no maturity date. So there are various time frames in which both the issuer or the investor are able to redeem. But those are optional as well as obviously the option to convert. So there is really no maturity date in terms of a forced action on the instrument.

Finian O'Shea
Analyst, Wells Fargo Securities LLC

Q

Great. Thank you. Forgot about that and just a final small question on the special dividends. Tom, I think you outlined that you'll expect to continue to earn a healthy clip of supplemental. Now the portfolio is stabilized, we're through COVID and so forth. It sounds like you plan to keep the current core and supplemental payout or are you considering perhaps restoring or partially restoring your core dividend?

Taylor P. Boswell
Chief Investment Officer, TCG BDC, Inc.

A

Right now, we feel very good about delivering very consistent results as we have the last couple of quarters in that we've been $0.36, $0.37 the last couple of quarters. We feel very confident in that level and for now certainly anticipate continuing with the $0.32 regular plus the additional being paid as a supplement each quarter.

Linda Pace
Chief Executive Officer & Director, TCG BDC, Inc.

A

Yeah, Fin...

Finian O'Shea
Analyst, Wells Fargo Securities LLC

Q

Okay. That's it for me. Thank you, everybody.

Linda Pace
Chief Executive Officer & Director, TCG BDC, Inc.

A

Fin, just to jump in and remind you. So this is our new policy and just in the intent on being as transparent and consistent with investors as possible, we don't really want to change the policy back, if you will. So, I think you should expect us to stay like this for quite some time.

Finian O'Shea
Analyst, Wells Fargo Securities LLC

Q

Okay. Thanks so much and congratulations on the quarter.

Linda Pace
Chief Executive Officer & Director, TCG BDC, Inc.

A

Thank you.

Operator: Our next question is coming from the line of Paul Johnson with KBW. Your line is open.

Paul Johnson
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Hey, good morning. Thanks for taking my questions and congratulations on making progress with the portfolio. I just have a few I just have a few questions, I'm wondering as we move forward in the cycle, how do you expect the average size of your borrower to change if at all. And also, in addition to that, do you potentially see any sort of increased demand for second lien or, potentially, junior debt in your portfolio?

Taylor P. Boswell
Chief Investment Officer, TCG BDC, Inc.

A

Hey, Paul. It's Taylor. How are you? Yeah, I think from a borrower size perspective, we're fortunate to have a significant platform that lets us actively participate across a bunch of different elements in the marketplace. Really, our platform is aligned to participate kind of from $20 million of EBITDA north all the way through into the upmarket, broadly syndicated in the high yield world when that's appropriate.

So in any given quarter, depending on where we see the relative value, we may tack ourselves on the margin in or out of different sub-segments from an EBITDA perspective, but I think that the core of the portfolio and the averages over time will probably live about where they are. So I don't think we see a significant change, but rather see ourselves tacking around the market when the rel val moves in the marketplace.

As regards your question around second lien, we're comfortable with the general construction of our book right now from a high-level allocation perspective. Same comment applies: you may see a bump around a little bit a percent or two here or there as relative value opportunities migrate in the market.

What I would tell you is in this market environment the second lien structure, which tends to be more prevalent up market, bigger borrowers is not a place where we see extraordinary relative value in markets because that product is being served by larger liquid markets quite aggressively right now. So in this moment, the trend is probably going a little bit the other way, but big picture, we'll see stability and participate across these markets over time.

Paul Johnson
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. Thanks for that. It's very good color. And then, as yields have declined and spreads have tightened over the last several months or so, and this is kind of what we've seen in the middle market, but I'm just curious – as I'm looking at your scheduled investments and some of your new investments in the previous quarter, it doesn't appear to be the case, but I'm just curious if you're experiencing any sort of pressure on the LIBOR floors terms in any of your – in any of the loans that you are sourcing?

Taylor P. Boswell
Chief Investment Officer, TCG BDC, Inc.

A

In our core middle market book, we really are not. In the upmarket world, again, the $100 million plus EBITDA borrower, you are seeing a migration down and some pressure on floors in particularly hot transactions, maybe to 75 basis points, rarely to 50 basis points, but general stability from a floor perspective in the core middle market.

Paul Johnson
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. Thanks for that. Congrats, again, on a good quarter and that's all for me.

Taylor P. Boswell
Chief Investment Officer, TCG BDC, Inc.

A

Thanks.

Operator: And our next question coming from the line of Melissa Wedel with JPMorgan. Your line is open.

Melissa Wedel
Analyst, JPMorgan Securities LLC

Q

Good morning, everyone. Thanks for taking my questions today. I'd like to tap on to the last question to start with. Actually. Could you remind us what your current average floor is on your debt investments right now?

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

A

Hey. It's Tom. Most of our loans, large portion, the typical floor is 1%. And when you look at our first lien book, I'd say it's – vast majority of the loans, it's really those second lien loans where we're going more upmarket. And those are the transactions where we'll more likely than not have a LIBOR floor or lower LIBOR floor. But on average, it's probably 80 or 90 basis points.

Melissa Wedel
Analyst, JPMorgan Securities LLC

Q

Okay. So 80, 90 across the second lien component or across the total portfolio?

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

A

Across the total portfolio.

Melissa Wedel
Analyst, JPMorgan Securities LLC

Q

Got it.

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

A

And that's assuming – that's with the zeroes weighted in there. That's why it's not 1%. We have a handful of floors at 75 basis points, but the vast majority are 1%.

Melissa Wedel
Analyst, JPMorgan Securities LLC

Q

Okay.

Taylor P. Boswell
Chief Investment Officer, TCG BDC, Inc.

A

There was a – just for clarification, there was a moment in the market a couple years ago when LIBOR was north of two, where borrowers were able to drop their floors meaningfully, and we haven't seen as much of that since then. And so, there's a couple of legacy positions from that environment still on the book.

Melissa Wedel
Analyst, JPMorgan Securities LLC

Q

Got it. Okay, that's helpful. Thank you. In terms of activity, I think you were pretty clear that you remain active in this environment; you're seeing some attractive risk-adjusted opportunities. On the repayment side, how are you – do you anticipate any sizable repayments in the near term? And then, how are you thinking about that, generally, throughout the remainder of 2021?

Taylor P. Boswell
Chief Investment Officer, TCG BDC, Inc.

A

Melissa, on the repayments front, it's interesting. When you look back at second quarter, third quarter, I think our normalized repayments [ph] from regular way repayments (29:13) was practically zero. In the fourth quarter, we went back to I'd say a more normalized – M&A activity picked up, our regular cadence and level of repayments came back in the fourth quarter.

And I think we anticipate that in the first quarter and going forward. To-date in the first quarter we've had relatively limited repayments, there's a couple of deals in the portfolio that we know are up for sale or the sponsor may be looking for refinancing that we have on our perspective potential repayment list. I think we anticipate first quarter and the rest of 2021 will be that more normalized level of repayments. Certainly an increase from what we were in 2020.

Q

Sure. Okay thank you.

Operator: And I'm showing no further questions at this time. I would like to turn the call back over to Linda Pace for any closing remarks.

Linda Pace
Chief Executive Officer & Director, TCG BDC, Inc.

Thank you, operator and thank you all for your good wishes for us. And I hope everyone is well. And we'll talk to you next quarter. Thanks again.

Operator: Ladies and gentlemen that does conclude the conference for today. Thank you for your participation. You may all disconnect.