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CGBD.OQ - Q1 2018 TCG BDC Inc Earnings Call

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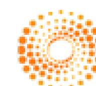

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the TCG BDC First Quarter 2018 Earnings Call. (Operator Instructions) .

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

Daniel Harris

Thank you, Sandra. Good morning, and welcome to TCG BDC's First Quarter 2018 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. This call and webcast is the property of TCG BDC, and any unauthorized broadcast in any form is strictly prohibited.

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 10-K that could cause actual results to differ materially from those indicated. TCG BDC assumes no obligation to update any forward-looking statements at any time. Lastly, past performance does not guarantee future results.

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

Michael A. Hart - *TCG BDC, Inc. - Chairman & CEO*

Thank you, Dan. Good morning, everyone, and thank you for joining us for our first quarter earnings call. I'm joined today by our management team, including our President, Jeff Levin; our CFO, Tom Hennigan; and our Head of Originations, Grishma Parekh.

I'll begin this morning with a brief look at our financial results. My colleagues will provide some further color on the activity in the quarter and then I'll conclude with some comments on one of the more noteworthy developments in the BDC space, and that's the passage of the Small Business Credit Availability Act, and more specifically, the new leverage limits, which allow for BDC leverage to move from 1:1 debt to equity to 2:1. I'll discuss our approach to its adoption and how we're thinking about potential utilization.

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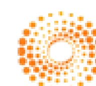

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Turning to financial results. Yesterday, we released our first quarter earnings for the year. It was a very straightforward quarter, with all components of our business delivering solid and consistent results. We had continued strong credit performance at our loan portfolio. We had another quarter of high-quality origination activity. And our senior loan joint venture continued to scale and generate strong equity returns. These factors contributed to a solid quarter of performance with net investment income of $0.40 per share, comfortably covering our first quarter regular dividend of $0.37, which represents an annualized yield of 8.3%.

Net asset value per share declined modestly quarter-over-quarter from $18.12 per share to $18.09, driven primarily by some unrealized valuation changes, which Tom will provide more details on in a moment.

With that, I'll turn it over to Jeff who will provide some additional color on the overall state of the market, specifically as it relates to our origination activity this quarter and how this has influenced our investment selection. Jeff?

Jeff Levin

Thanks, Mike. The trends of 2017 generally continued into the first quarter of 2018 with leverage multiples robust, largely driven by record-high purchase prices being paid by private equity firms. Additionally, the technical supply-demand balance for new deal flow was challenging, as middle market loan volumes declined due to slowing LBO and M&A activity. LBO volume was down approximately 50% compared to the fourth quarter of 2017. This lack of supply of new deal flow across the middle market, coupled with significant dry powder among middle market lenders, resulted in modest further spread compression and sponsors continued to seek repricings, refinancings and dividend recaps.

That being said, due to our differentiated origination capabilities and sponsor relationships, we sourced several high-quality investments, offering strong risk-adjusted returns. Consistent with our core investment strategy of capital preservation and principal protection, we invested extremely carefully this quarter given the state of the market, with the vast majority of our investments being in first lien senior secured term loans.

We continued to scale our JV portfolio with PSP, which, as a reminder, is comprised of almost entirely first lien loans and are the tightest-priced assets in our portfolio, reflective of the lower risk profile and lower loan to value.

As it relates to the frothy state of the market, we passed on several deals where other middle market lenders were extremely aggressive and seeking to buy market share with sponsors. This included other lenders offering higher leverage, tighter pricing and looser terms than we believe was prudent.

In terms of the yield environment, we continue to benefit from rising LIBOR, resulting in our average asset-level yield across our portfolio increasing over 40 basis points over the fourth quarter of 2017.

With that, I will hand it over to Grishma to cover the details of our origination activity over this quarter.

Grishma Parekh - *The Carlyle Group L.P. - Partner and Head of Carlyle Mezzanine Partners*

Thanks, Jeff. I'll spend a few minutes reviewing our origination approach in the current market, our first quarter investment activity and our outlook. Our market coverage allows us to originate a broad set of middle market opportunities with a goal of investing in the best credit and most attractive risk-adjusted returns.

During the first quarter, we made 24 new commitments, totaling $239 million, which included investments with 20 private equity sponsors, approximately 80% of which are repeat clients to our business. The majority of our investments for the quarter were in support of buyouts and acquisitions, although there continues to be market momentum for opportunistic financing. As Jeff mentioned, we continued to be focused on more conservative first lien debt investments, which accounted for almost 90% of these new commitments.

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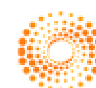

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This dynamic also channeled our origination activity towards our JV, which represented about 2/3 of new origination. The loan to value of our new investments was 43%, flat from prior quarter and in line with the overall portfolio. We believe this metric is well below average for the industry and highlights the significant enterprise value cushion and downside protection that exists in our business.

Our industry mix continues to highlight a deliberate focus on defensive sectors, such as health care, business and financial services, software and technology. We are underweight in sectors that are prone to greater volatility, such as oil and gas, retail and other cyclicals.

The JV currently stands at $1.1 billion, including our equity and mezz loans and comprises 10.5% of the BDC. Net portfolio growth was 11% quarter-over-quarter. When including the JV, our total investment portfolio was flat to prior quarter at $2.8 billion.

And finally, loan sales and repayments were $184 million, heavily weighted towards the BDC, which experienced modest portfolio contractions as inflows into the asset class exacerbated the borrower from the environment resulting in greater refinancing.

With that said, given the flexibility of our capital base, in many instances we do have the ability to retain an asset. However, we're choosing an exit as oftentimes some combination of leverage, spread and term makes the opportunity no longer attractive to us. One such instance occurred post quarter with our portfolio company in a sector where Carlyle has a real competitive edge. Another market participant offered a substantial return of capital to the sponsor for almost 10.5 more leverage and 150 basis point tighter pricing, along with meaningfully looser terms than we as the incumbent believed was prudent. While our sponsor relationships and incumbency gave us a last look, we chose to exit. You may see more of that from us.

I'll now turn the call over to Tom.

Thomas M. Hennigan - *TCG BDC, Inc. - CFO, Chief Risk Officer and Head of Underwriting & Portfolio Management*

Thanks, Grishma. Overall, credit performance of the portfolio was again stable this quarter. The weighted average internal risk rating remained at around 2.25. Total watch list transactions, those rated 4 or worse on our internal risk rating scale, ticked up by a net $27 million as 3 borrowers were added and 2 repaid in full during the quarter. Product Quest remained our sole loan on nonaccrual status.

In terms of credit metrics, our portfolio continues to experience annualized LTM revenue and EBITDA growth of over 10% on a year-over-year basis. And our portfolio weighted average net leverage for the quarter remained stable in the mid 5x range.

In regards to valuations, total aggregate realized and unrealized net loss was $4 million for the quarter. Valuations again benefited modestly from continued tightening in market spreads. We had an additional markdown on Product Quest, while the rest of the portfolio was roughly flat in the aggregate.

On the financing front, our debt-to-equity ratio was 0.71x and total debt outstanding was about $800 million as of 3/31, both down slightly from 12/31 given the net repayment activity highlighted by Grishma. And as of 3/31, we had approximately $285 million of total unused commitments under our credit facilities.

Turning to the financial results for the first quarter. Total investment income was $47 million, down about $2 million versus the fourth quarter. Core investment income plus total income from the JV was flat quarter-over-quarter. The primary driver of the modest decline was lower other income from prepayment, syndication and amendment fees. Net expenses were $22 million for the quarter compared to $23 million in the fourth quarter, with the decrease largely driven by lower management fees and incentive fees based on lower average investments and lower preincentive fee income.

Interest expense was flat as the decrease in average outstanding borrowings during the quarter was offset by the increase in LIBOR. The end result was net investment income for the quarter of about $25 million or $0.40 per share. That compares to our regular declared dividend of $0.37 per share for the first quarter.

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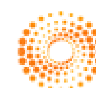

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Of note, on May 2, our Board of Directors declared the regular dividend for the second quarter at the same $0.37 per share payable to shareholders of record as of the close of business on June 29.

Regarding JV returns, the first quarter dividend yield on our equity in the JV was over 19%, up from the 14% achieved in the fourth quarter. As we highlighted last quarter, the closing of the first CLO at the JV in December significantly reduced the JV's overall cost of capital, which contributed to the strong first quarter results. But the JV's first quarter results also were aided by higher-than-normal accelerated OID. So we expect the JV yield to normalize in the mid-teens in future quarters.

I'll now turn it back to Mike to further discuss our views on recent BDC leverage legislation.

Michael A. Hart - *TCG BDC, Inc. - Chairman & CEO*

Thanks, Tom. As I mentioned, I wanted to conclude our call with a few comments on the recent regulatory change affecting BDC leverage. This is obviously a significant event for our industry. And while a potential change in leverage has been discussed for years, the manner in which it was passed and the timing was a bit of a surprise, with a narrower version of the reform bill being included in the recent omnibus spending bill and signed into law on March 29.

When the passage of the BDC leverage bill was announced, we carefully considered what the new law provided for in terms of increased flexibility and increased disclosure requirements. The new legislation mechanically provides for the potential increased leverage by reducing the asset coverage ratio that governs BDCs. That ratio was reduced from 200% to 150%, or put in another way, allowing BDCs to potentially increase their debt-to-equity ratio from 1:1 to a maximum of 2:1.

The bill provided 2 avenues for approval and adoption, either going the board route and receiving an affirmative vote by a majority of the independent directors, in which case the new leverage parameters would go into effect 1 year from the date of approval, or take it to a shareholder vote and receive approval to the leverage provision by a quorum of those shareholders with greater than 50% of the vote at either a special or annual meeting of the shareholders.

In evaluating the provisions of the bill and the potential impact, not only on our business but on the industry as a whole, we concluded as a management team that the correct path and the right thing to do was to seek the approval of both our board and our shareholders. It's a decision that we feel is too important not to have those 2 constituencies weigh in.

At a meeting held on April 9, our Board of Directors unanimously approved the adoption of the new BDC leverage bill as being in the best interest of the company and its shareholders. And as a result, the 2:1 leverage ratio will become effective on April 9, 2019.

Additionally, since that time, we worked closely with our legal counsel and the SEC in developing a proxy statement that we feel provides our shareholders with a complete and transparent perspective on the benefits as well as the potential risks associated with the new legislation. That proxy statement was filed with the SEC and mailed to our shareholders on April 27, 2018 for their consideration in advance of our annual shareholders meeting on June 6.

We would encourage you to review the proxy statement, which is now available on EDGAR, as we feel it provides a very comprehensive look at the many factors that we considered in light of the new regulation. It analyzes the risks relative to the benefits associated with the use of increased leverage, and we believe it provides a balanced look at the opportunity.

Since we began the company, we have consistently applied an investment thesis that is focused on opportunities in stable, healthy businesses with strong cash flows in noncyclical sectors. We've built out an infrastructure that supports the sourcing and monitoring of high-quality assets. In addition, we constructed a highly diversified portfolio of over 100 investments across 28 industries and 57 unique sponsors, with 77% of the investments in first lien debt. We believe the overall quality of our portfolio to be among the best in the industry.

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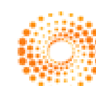

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We've invested where we saw best relative value, and our portfolio construct and historical deployment reflects a prudent and careful approach with our investors' capital. We've never deployed capital outside of our thesis for the sake of either yield or AUM growth despite market tendencies to do so. In fact, at the time of our IPO, we returned nearly $300 million in capital to our original shareholders, rather than deploy those dollars in a manner that did not meet our strict underwriting and return parameters.

Our leverage today as a public company is approximately 0.7:1. For many years, as a private company, we were able to effectively manage our leverage at or near 1:1 due to the call structure of our equity commitments. And while no decision has been made as to whether or not to increase leverage, we believe that the outer boundary for our business would be in the area of 1.3 to 1.4:1, which we believe to be a prudent level given the overall risk in our portfolio today.

With respect to the availability of increased credit, were we to choose to increase leverage, we're confident that incremental credit would be available to us, holding current market conditions constant.

We believe the adoption of the new leverage guidelines represents a further opportunity to deliver increased returns to shareholders. However, we also believe the opportunity will be differentiated by manager. And that differentiation will be a function of the quality and composition of the portfolio, the breadth of the origination platform and the track record around the prudent use of leverage. However, even if we do not choose to increase leverage, approval of the reduced asset coverage ratio by the shareholders would provide immediate operational flexibility and additional cushion, which would be invaluable in the event of more volatile markets.

Many aspects of the new bill's impact will play out over time. And many of the decisions to be made in the future will be market dependent. What is certain from our vantage point is that we'll focus on being as thoughtful in our approach to the strategic decision as we have in managing and investing on behalf of our shareholders since the company's inception.

That concludes our prepared remarks. Thank you all for joining us today. And with that, I'll ask Sandra to open the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Jonathan Bock with Wells Fargo.

Finian Patrick O'Shea - *Wells Fargo Securities, LLC, Research Division - Associate Analyst*

Fin O'Shea in for Jonathan. Appreciate the in-depth proxy you put out here and detail involved. Just one follow-up question on the leverage matter. Could you give us a sense of the incremental assets? Would they be -- would it look similar to your current ROE profile in terms of assets onboarded and leverage utilized? You already have very low-cost leverage facilities in place. Would you be going more upmarket lower risk or continuing sort of core CGBD assets?

Michael A. Hart - *TCG BDC, Inc. - Chairman & CEO*

Thanks for the question. The bill itself has provided a lot of flexibility to the industry. It really gives participants a lot of options. It gives them the ability to hold steady and enjoy the benefits of any increased regulatory cushion. It also provided the opportunity for companies to rotate out of their asset mix and perhaps improve the overall quality. And that seems to be the recurring theme that you hear a lot about from industry players in what you're trying to accomplish. Quite frankly, we don't see a great need to reposition the company with respect to risk profile. Today, I think our portfolio composition with 77% of our assets in first lien, we feel good about the noncyclical nature of that. So from a quality standpoint, we don't think that's going to be a significant move. I hesitate to say you can never be -- have too strong or too safe of portfolio, but we feel good

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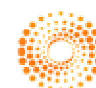

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about that in that respect. And the major rotation and change in asset focus will not -- would, in all likelihood, not be a major impact or major initiative around this new provision for us in any way.

Finian Patrick O'Shea - *Wells Fargo Securities, LLC, Research Division - Associate Analyst*

Appreciate that. And then just one more sort of global question as well. With the private BDCs you're now raising, can you just kind of give us a global view? Are these just simply separate institutional accounts in the BDC format? Or are they perhaps a means to effectively scale your public BDC platform over time with an eventual merger without interrupting your current returns, perhaps similar to NF? If you could just give us a little color there.

Michael A. Hart - *TCG BDC, Inc. - Chairman & CEO*

Sure. Listen, the goal always as we look around growing assets or broadening our platform with respect to our direct lending profiles to build scale. And so the overriding principle when we look at additional pockets of capital is to be highly complementary and at the end of the day, provide positive impact to our BDC and the strategy that, that is trying to execute against. There are no plans at this point for the pockets of capital that we have that would ultimately merge into our existing BDC. But they very much are complementary, both in strategy and in investment thesis.

Operator

And our next question comes from the line of Rick Shane with JPMorgan.

Richard Barry Shane - *JP Morgan Chase & Co, Research Division - Senior Equity Analyst*

I just wanted to talk a little bit about funding strategy in terms of the idea of potentially trimming out some of your financing in the unsecured market. Whether that makes sense where we are in terms of the rate cycle and also as you consider the possibility of increasing leverage?

Thomas M. Hennigan - *TCG BDC, Inc. - CFO, Chief Risk Officer and Head of Underwriting & Portfolio Management*

Rick, it's Tom. I'll take that. Based on our asset mix, we have quite a bit of flexibility in our funding strategy. We've got multiple credit facilities. We anticipate continuing to grow those over time. And we also have successful CLO, and I think that we can -- with some changes in risk retention recently, that market has now reopened to us. In terms of the unsecured market, we're certainly also investigating that market as well, whether it be a traditional bond offering. S&P is making that a little bit difficult based on their view on the leverage legislation as well as convertible offering. So we have all the options on the table, and we're investigating all those simultaneously here and getting the right longer-term capital structure here.

Richard Barry Shane - *JP Morgan Chase & Co, Research Division - Senior Equity Analyst*

Got it. That makes sense. It is interesting when you think about the different constituencies that you need to satisfy related to the higher leverage limits, whether it's shareholders, board, your bank lenders, and the rating agencies. It does seem like the rating agencies thus far have been the biggest gating issue.

Thomas M. Hennigan - *TCG BDC, Inc. - CFO, Chief Risk Officer and Head of Underwriting & Portfolio Management*

I can say, they are simply in terms of the unsecured bond market, but I think that we've got the flexibility, if we need to, to maintain our current capital structure or continue to grow the business without that market.

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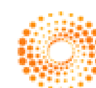

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Michael A. Hart - *TCG BDC, Inc. - Chairman & CEO*

Rick, this is Mike. The only thing that I would add to that is that I would agree with you, I'm little surprised on the position that S&P took, particularly in providing really no differentiation. But we do benefit greatly from sort of where we sit today In terms of -- the sources of liability funding that we have are sort of nonrating dependent. But our hopes clearly over time is that the rating agencies would take a different view for the benefit of all constituencies because it's hard to imagine that all should be created equal -- or all should be treated equally. In analysis, they can be quite specific and bespoke.

Operator

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

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

First one has to do with the covenants on your credit facilities. I believe you guys, both your credit facilities on your balance sheet have a 1:1 debt-to-equity limitation. One, I guess, is that correct? And then two, have you guys had any sort of preliminary discussions with your credit facility providers on whether they would be comfortable amending those facilities if this 2:1 does pass your shareholder vote?

Thomas M. Hennigan - *TCG BDC, Inc. - CFO, Chief Risk Officer and Head of Underwriting & Portfolio Management*

Yes, correct. Both our credit facilities do have 1:1 leverage covenants, and we have been in very active and positive dialogue with our lenders to date. So we anticipate a positive outcome there.

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

Okay. And then on the Middle Market Credit Fund, that yield jumped to about 19.4% from 13.9% in the quarter. I know you guys closed on a CLO financing. Was that the primary reason driving the 19% yield? Was there any onetime items? Or should we kind of expect that 19%-ish run rate going forward in the fund?

Thomas M. Hennigan - *TCG BDC, Inc. - CFO, Chief Risk Officer and Head of Underwriting & Portfolio Management*

Ryan, what I say is for the current quarter roughly 5-point increase, half was related to just growth in the business and certainly, we had very attractive CLO, half was onetime based on some OID fee accretion. So if we back that out, we think that normalized, you'll be in the mid-teens. So we think that the 19% was -- we don't expect to see that next quarter.

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

Okay, it makes sense. And then just one question kind of on the dividend policy, just kind of what you guys are thinking. Obviously, you guys have done a good job overearning the dividend, particularly also 2:1, if you guys pass that, there is going to be further upside. Do you guys foresee kind of keeping the dividend steady -- the core dividend steady at the $0.37 level and then maybe paying out special dividends like you did in the fourth quarter? Or if you continue to earn $0.40 and above going forward, which we anticipate you guys can do, do you think there is a possibility that you guys would raise the core dividend?

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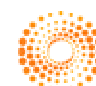

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Michael A. Hart - *TCG BDC, Inc. - Chairman & CEO*

Thanks, Ryan, for the question. Listen, I think what we really want to do with our dividend over time is to make sure that there is a comfort level within our investor base as to the predictability of it and the achievability of it. And I think we feel comfortable that we're there. I would -- and we generally looked at special dividends at the end of the year, it's a sort of catch up, if you will, and pay out that excess. Once we get to a point where, and perhaps the adoption of the leverage -- the new leverage guidance will provide this, that we're at a consistent earnings level that provides that cushion that we feel comfortable with and we can then convey that to our investors. That's when we would look to make a move. So the other point that I'm tying in here about the leverage policy and the leverage legislation is that, we view it as something that's obviously helpful day 1 in the absence of doing anything. There is -- the positive benefits of having regulatory cushion versus mark-to-market is a positive thing. It's hard to argue otherwise. We do, though, feel that implementation of it and the taking on of incremental leverage will be slower than -- it certainly won't be an overnight event. And either it won't be available to certain participants or it will be something that's brought on and taken onboard in a very measured fashion. That's certainly our approach to it. So while we would hope that, that drives returns and we've certainly analyzed it as such. it's something that would hopefully accrue to us over time, and I would see a consistent dividend policy through the balance of this year for sure.

Operator

And our next question comes from the line of Arren Cyganovich with Citi.

Arren Saul Cyganovich - *Citigroup Inc, Research Division - VP & Senior Analyst*

You mentioned the frothy state of the market and kind of looser terms, higher leverage developing. So we've be kind of hearing about, is this intensifying? Is it more kind of similar to how we were towards the end of the year? Could you just talk a little bit more color about how you're seeing that part of the market go and for middle market finance?

Jeff Levin

Sure, Arren. Thanks for the question. It's Jeff. The market's been in a tight state over the past couple of years. At certain points over the past couple of years, it's been slightly tighter than others as it relates to spreads as well as terms. Generally speaking, in Q1, in the core middle market where we're focused, which is $15 million of EBITDA in the low end up through $60 million or so in the higher end, we saw a pickup in aggressiveness in terms of repricing refi and dividend activity. LBO and M&A activity, as I alluded to earlier, declined quite a bit over Q4. But in general, we continue to see really good opportunities to deploy capital. And as we noted, the vast majority of the money that we put out in this quarter was in first lien, and we continued to scale the JV, which, as I noted, is really the lowest risk assets in the portfolio, that's at LIBOR + 350 to LIBOR + 450 generally speaking asset class. So we continue to feel really good about the money we're investing and the health of the portfolio. We think our strategy, combination of the diversification, avoiding the more cyclical sectors and where we invest in the capital stack really keeps us well positioned given the frothy state of the market relative to BDCs in general.

Operator

And that does conclude today's Q&A session. And I would like to return the call to Mr. Daniel Harris for any closing remarks.

Daniel Harris

Thank you for your time today. If you have any further questions, feel free to follow up with Investor Relations after the call. Otherwise, we look forward to talking with you again next quarter.

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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 great day.

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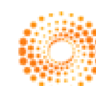

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