TCG BDC(Q3 2018 Earnings)

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Corporate Speakers:

- Daniel Harris; TCG BDC, Inc.; Head of IR
- Michael Hart; TCG BDC, Inc.; Chairman & CEO
- Grishma Parekh; The Carlyle Group L.P.; Partner and Head of Carlyle Mezzanine Partners
- Thomas Hennigan; TCG BDC, Inc.; CFO, Chief Risk Officer and Head of Underwriting & Portfolio Management
- Jeffrey Levin; TCG BDC, Inc.; President

Participants:

- Richard Shane; JP Morgan Chase & Co; Research Division, Senior Equity Analyst
- Ryan Lynch; Keefe, Bruyette, & Woods, Inc.; Research Division, MD
- Finian O'Shea; Wells Fargo Securities, LLC; Research Division, Associate Analyst

PRESENTATION

Operator: Good day, ladies and gentlemen, and welcome to the TCG BDC Third Quarter 2018 Earnings Call.

(Operator Instructions)

As a reminder, this conference is being recorded for replay purposes. I would now like to turn the conference over to Daniel Harris. Please go ahead.

Daniel Harris: Thank you, James. Good morning, and welcome to TCG BDC's Third 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 place 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. Lastly, past performance does not guarantee future results. With that, I'll turn it over to our Chief Executive Officer, Michael Hart.

Michael Hart: Thanks, Dan. Good morning, everyone, and thank you for joining us for our third 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 and also touch on a few of the strategic initiatives that we have underway as we continue to invest in our direct lending platform.

Turning to our results, yesterday, we released third quarter earnings for the year. Our business continued to deliver consistent results, including our core portfolio, our joint venture and our strategic partnerships.

All of which contributed to a solid quarter performance with net investment income of $0.41 per share, comfortably covering our third quarter dividend of $0.37 per share which represents about a 9% yield on a trailing 12-month book basis.

In every reporting period since our IPO, our NII has exceeded our regular dividend and as of 9/30 we had approximately $12.5 million in undistributed net investment income which equates to $0.20 per share on our current shares outstanding.

Accordingly, it would be our intention to declare a special dividend before yearend. We had a solid quarter of origination activity, both at the BDC and at the Middle Market Credit Fund. Repayment activity continues to be prevalent in the market.

However, our new investment fundings outstripped repayments in each of those vehicles, leading the portfolio growth of 4% at the BDC and 5% at the Credit Fund quarter-over-quarter. We continue to see heightened levels of competition in the market which has placed even greater emphasis on the importance of scale and direct origination.

We found that the scale that we've achieved and the investments we've made across the platform has served us very well as this competitive dynamic persists. Net asset value per share declined by $0.27 quarter-over-quarter from $17.93 per share to $17.66, primarily driven by valuation changes in some selected investments.

We view the issues on these names to be idiosyncratic in nature and within the broader portfolio, we don't currently see any real indication of systemic economic weakness. Our portfolio companies have grown revenues by 10% of the least 12-month period and Tom will provide more details on this topic in a moment.

Our debt-to-equity at the end of the third quarter was 0.91:1. The increase from 0.76:1 at the end of the second quarter was the result of solid net originations and some drawings under our credit facilities at quarter end to provide for investments that were closing in early October.

As I mentioned last quarter when we discussed our adoption of the lower asset coverage requirement, we haven't altered our investment strategy in any way.

We'll continue to invest where we see best relative value and any increase in leverage will likely be through the organic growth in our asset base when market opportunities present themselves as was the case during this quarter.

On the strategic front, we're very excited to announced the expansion of our product capabilities in the asset-based lending space with the hire of a senior executive who joined us in September and will be leading that effort for us. The ABL and Stretch ABL market is a terrific complement to our existing strategy.

It further diversifies our investment opportunity set and we like the risk/return profile of this asset class, particularly as you consider potential shifts in the credit market. This is an asset class that has performed consistently well through the cycle.

We have also received approval for and will be instituting a company-sponsored share repurchase program. Under the new program, we can repurchase up to $100 million of our outstanding common stock in the open market. This plan will be initially administered under Rule 10b-18.

The plan is effective and purchases can commence upon the opening of the trading window which typically occurs 48 hours after our earnings call. Of course, purchases will also be subject to the terms of the plan.

We view the program as another very visible commitment to shareholder alignment and the confidence we have in the value of our portfolio. A number of factors will influence the decision to repurchase shares, including our share price, the current investment opportunity set and our leverage.

However, we feel repurchasing shares at levels where the stock has recently traded represents a compelling opportunity as we feel these trading levels do not reflect the intrinsic value of our company.

With that, let me turn it over to Grishma to provide some additional color on our origination activity this quarter.

Grishma Parekh: Thanks, Mike. This quarter we saw a continuation of several market themes. There is strong demand for credit from middle market private equity firms. That demand is being met by significant private capital resulting in competitive pressures.

And while leverage levels have been elevated, yields tight, and terms loosened, we haven't seen meaningful more degradation. Finally, a healthy economic backdrop is resulting in revenue and earnings growth at our underlying portfolio companies.

In the face of these dynamic market conditions, our investment approach remained consistent on first lien senior secured loans in defensive industries supporting repeat sponsor clients.

During the third quarter, we made 22 new commitments totaling $280 million with 22 private equity firms. Of these, 96% were first lien loans.

While our asset mix has always been predominantly first liens, we have migrated the portfolio even more towards this lower risk part of the capital stack which now represents 80% of the overall portfolio.

The loan-to-value of our new investments was 40%, and that figure has continued to trend lower as enterprise value of our borrowers has increased. The weighted average net debt to EBITDA of our new investments was 5.5x, flat with prior quarter.

The weighted average interest coverage this quarter was 2.4x, also in line with the prior quarter. And while we continue to maintain strong industry diversification, we have deliberately focused on technology and software which currently represents our largest industry vertical.

Shifting to the Middle Market Credit Fund, the JV currently stands at $1.2 billion and comprises 11% of the BDC's total investments. The unlevered weighted average yield of investments in the JV was 7.1% and is producing a healthy return on equity of 15.7% to TCG BDC.

Sales and repayment activity totaled $125 million during the third quarter. This resulted in modest quarter-over-quarter portfolio growth at both TCG BDC and the JV of 3.7% and 5.3% respectively.

On a combined basis, the total investment portfolio of TCG BDC and the JV increased to about $3 billion. I'll now turn the call over to Tom Hennigan to walk through our financial results.

Thomas Hennigan: Thanks, Grishma. Today I'll discuss our third quarter financial performance, recent successes with our financing facilities and the current portfolio. Total investment income for the third quarter was $51 million, down about $1 million versus the second quarter.

This modest decline was driven primarily by lower one-time fees partially offset by solid growth at our JV. Interest income from the core loan portfolio was roughly flat quarter-

over-quarter. Net expenses were $26 million in the third quarter compared to $24 million in the second quarter.

Similar to last quarter, the largest component of the increase was higher interest expense, driven by both higher average debt outstanding and an increase in LIBOR as well as a one-time charge of about $700,000 for amortization of deferred financing costs related to our CLO reset.

The end result was net investment income for the quarter of about $26 million or $0.41 per share which compares to our regular declared dividend of $0.37 per share.

Of note, on November 5th, our Board of Directors declared the regular dividend for the fourth quarter at the same $0.37 per share payable to shareholders of record as of the close of business on December 28th.

Next, I'll turn to a discussion of our financing facilities given we achieved some important milestones in the third quarter related to the previously approved increase to our statutory leverage limit.

On last quarter's call, we reported the pricing of a reset of our on-balance sheet CLO. In late August, we successfully closed that transaction resulting in $176 million of increased debt at a very attractive average cost of capital.

In the third quarter, as previously targeted, we also closed amendments under our other credit facilities that not only extended the reinvestment periods at attractive interest rates, but importantly, relaxed our asset coverage test covenants from 200% to 150%. So we now have all requisite lender approvals to benefit from the flexibility afforded by the new regulatory leverage limit.

On that note, we finished the third quarter with total debt outstanding of approximately $1 billion, up about $140 million from 6/30 driven by both the net deployment for the third quarter as well as transactions that closed in early fourth quarter.

As of 9/30, we had approximately $260 million of total unused commitments under our credit facilities, and over $100 million of cash which should provide adequate dry powder for new investment opportunities in future quarters.

Regarding the portfolio, the weighted average internal risk rating remained at 2.3. Total watchlist transactions ticked up by a net $13 million, while the total number of borrowers on the watchlist remained flat.

Total nonaccruals decreased modestly to 0.8% of total fair value. In regards to valuations, our total aggregate realized and unrealized net loss was about $20 million for the quarter.

The largest contributor to this loss was Product Quest which accounted for over half the loss as we marked our last out investment down to 0. Product Quest is a manufacturer of topical over-the-counter drugs and cosmetic products as well as some animal health products.

This is a situation that quickly eroded after new management joined the company in July of 2018 and it became evident that the company's Florida facility had widespread quality control issues that had not previously been disclosed by prior management.

As a result of the ensuing deterioration in operations, the company filed Chapter 11 in early September and the case was recently converted to a Chapter 7.

Based on liquidation of the company's assets, we expect little to no recovery on our last out investment. But we do expect full recovery on our priority revolver position. The majority of the realized loss in the third quarter was related to our investment in Tweddle. Tweddle develops and authors user and service manuals for automotive OEMs.

Based on the loss of a major customer in early 2018, the company's projected cash flows were no longer adequate to service its debt level, so a restructuring was completed in the third quarter that resulted in senior lenders haircutting their debt in exchange for the equity of the company.

Despite the realized loss, this is an example of our prudent and proactive portfolio management as we sold down from an initial hold of $18 million to about $7 million at a price close to par prior to the customer loss. Now I'll turn it back to Mike for some concluding remarks.

Michael Hart: Thanks, Tom. I'd like to close with some summary comments on how we as a management team are looking at the quarter taken as a whole.

As you just heard from Tom, the NAV decline is an important focus for us and we've committed all appropriate resources to the relevant situations in an effort to maximize our value there. Away from that, we're very pleased with all other activity in the quarter, and I'd like to highlight several elements of that performance.

We delivered another quarter of consistent net investment income which reflects the strong earnings engine of a broad platform. We had high-quality origination activity and this was against the backdrop of a challenging market environment which contributed to both NII performance and AUM growth.

We continued our strong dividend coverage which will provide for a supplemental dividend payment in the coming quarter. We prudently used our incremental leverage capacity through high-quality organic growth, and we further diversified our investment opportunity set with the expansion into the ABL space.

And finally, we implemented a significant stock repurchase program, a further demonstration of our belief in the value of our business and our commitment to shareholder alignment.

That concludes our prepared remarks. I'd like to thank you all again for joining us today and for your continued support. I'll hand it back to the Operator and we'll be happy to take Q&A.

QUESTIONS AND ANSWERS

Operator: (Operator Instructions)

Our first question comes from Rick Shane with JPMorgan.

Richard Shane: One of the concerns in the space over the last several years has been erosion of deal terms and covenants. When you look at the write-downs this quarter, would better covenants and protections have avoided this? Or is this the consequence of the symptom that we've been concerned about over the years?

Thomas Hennigan: Thanks for the question. In looking at those two particular situations I outlined, those were covenant transactions that actually had a good structure, good package of covenants and other negative covenants. Those two situations, not symptomatic of loosening of covenants in the market in general.

What I'd say broadly on our portfolio is, we are very focused on covenants, over 90% of the loans in our BDC have financial covenants. Certainly, there's been some softening deterioration in covenants across the market.

We haven't been hesitant to decline transactions because there may be a transaction where we think the transaction needs a covenant, competitors may pitch a couple of deals. We've declined deals based on covenants.

So it's something we're certainly very focused on. It's not just the financial covenants, it's the broader package of negative covenants, something we're very focused on in our new business efforts.

Operator: Our next question comes from Ryan Lynch with KBW.

Ryan Lynch: The first one has to do with the comment about the special dividend in the fourth quarter. Obviously, you guys have well over the dividend from an NII perspective and so I just wanted to get a little more detail you can provide on how you guys foresee spillover in special dividends.

Do you guys anticipate paying out all of the -- paying out a special dividend to the size where you guys don't carry over any spillover income? We know some BDCs have done

that. Or do you just intend to pay out a special just to reduce the spillover income but still carry some amount of spillover income going forward?

Michael Hart: Thanks for the call, or for the question. Here's -- our approach to that has been to identify the surplus. Last year we paid out significantly all of the surplus leaving a minor cushion.

I'd expect that to be the similar approach that we'd take this year. To date through 3 quarters, we've accumulated $0.20.

Obviously, activity in the fourth quarter will dictate whether that number goes up or down. But the expectation would be that $0.20 plus the impact of the fourth quarter, some significant portion of that will be paid out and when significant, I'd say 90% plus.

Ryan Lynch: Okay, that's helpful. And then I wonder if you could just provide a little more detail on the senior executive you hired in the ABL market. I was curious, did Carlyle have any sort of, broadly in the Carlyle platform, did you guys have any sort of resources already in kind of the ABL space?

Or is this kind of a brand new vertical that you guys are starting up? And I would anticipate that you guys intend to kind of build out a team around him. How big do you think this strategy can get, etc.? Any sort of additional color on that would be great.

Jeffrey Levin: Sure, Ryan, it's Jeff. Thanks for the question. We spent a lot of time meeting with people within the core ABL space as well as what we call the stretch ABL space. And we hired someone that's been in the business for about 20 years.

He's worked at a few different leading institutions within the ABL industry. And the core thesis is that the product has proved to be very defensive over multiple credit cycles, as a nice complement to our core sponsored finance business as well.

The sponsor finance business as we all know has become increasingly competitive over the years, we think prudent to diversify the asset mix across our portfolio.

And the thing about Carlyle more broadly, both within credit as well as across the firm, we have so much sourcing across the various industry sectors that provide deal flow within the ABL space.

Leveraging the credit research that we have, the operating executives across the buyout side of the firm, and just overall sourcing across the platform, notably consumer retail as well where the firm has invested over $13 billion over the past decade or so.

So the thesis was, leverage all that sourcing and investment experience and success frankly, and develop a new credit product within our direct lending platform that we think will continue to provide really good risk-adjusted returns for shareholders.

Michael Hart: Ryan, I was just going to finish up on what I thought was a very complete answer by Jeff. With respect to looking forward, you had mentioned about the team, the expectation is that a team would be hired and further built out and the size of that will really be dictated by the opportunity set as it evolves.

Ryan Lynch: Picking up on the opportunity set, are you guys going to be investing all across all sectors as far as ABL? Or is this focused in on healthcare or retail? Does he have any sort of like niche focus or is this going to be across all sectors basically?

Michael Hart: It will be diversified, again, leveraging the sourcing that we have across the sponsor side of the business as well as the non-sponsored side across Carlyle.

Within credit, we invest across all the industry sectors appropriate as well as the buyout side. Generally speaking, the stretch ABL business has tended to skew more consumer retail. That's just the nature of the product frankly.

And over multiple cycles, despite that industry sector being prevalent, the returns have been really good just given the profile of the product. And so the portfolio within ABL tends to skew that way, but I think what the market should expect from us in terms of ABL is to be diversified across industry sectors.

Ryan Lynch: Okay, that makes sense. And then I guess the last thing is just more a comment than a question. But I guess I'm happy to hear you guys put in the $100 million repurchase agreement and based on your comments, I know you said you guys would evaluate share price, opportunity set and leverage levels.

And I believe you mentioned that based on where all those are today, you guys find your guys' shares a compelling spot to point capital and repurchasing shares, is that correct?

Thomas Hennigan: Yeah, that's the comment that I made Ryan. Again, it's a lot of factors influence that on a day to day basis. But it was implemented because there was trading performance over the last several weeks that we feel fairly captured the value, and it would certainly represent at discounts in the range that it was trading at a week or so ago, compelling. But again, putting the, wrapping the qualifiers around there as you have to do of course.

Operator: (Operator Instructions)

Our next question comes from Fin O'Shea with Wells Fargo Securities.

Finian O'Shea: First, just a small one on Twiddle. Tweddle, sorry. Appreciating you guys sold that down before the fact, but the -- just curious as to the difference in where the restructuring landed you versus the previous mark. Can you break that down roughly between further deterioration in the name and restructuring administrative related fees?

Thomas Hennigan: It’s Tom. Where we had this marked last quarter in anticipation of a potential restructuring was in the low 40s.

And the restructuring turned out to be right in line with the prior mark. So you'll see all in quarter-over-quarter not too much change in the realized/unrealized on Tweddle. Essentially unrealized switching to realized.

Finian O’Shea: Okay. And then just to touch on the buyback and Ryan's questions, is there sort of -- I know you have your parameters on price to NAV leverage, etc.

Do you sort of have a tier of what level, the level you will buy back nominally from your program at say price to NAV is lower or higher? Should we -- like if the stock hangs out at $85 or $90, will you just continually do your portion or will you kind of have a reserve? That's a bit longwinded.

Michael Hart: No problem, it's a complex issue, right? As a fundamental matter, our buyers of our stock internally when we feel it's accretive to NAV and it's accretive to ROE relative to what else we may invest in, and those other factors that we discussed, at those levels it is.

And we would expect to be buyers, again, having to hold all those other elements constant. We put the program in place because we intend to use the program but we intend to use the program when it meets those terms where it's accretive for our shareholders.

And so it's almost entirely dependent, future use is almost entirely dependent in terms of where the stock is at a given point in time. And then once it's at those levels, we have to make sure we're working within the context of the 10b-18 requirements.

Finian O’Shea: Sure. One last one, seeing Madison a bit less active in the market, is this, do you anticipate sort of a decline or a bit of runoff as those loans amortize for the interim? Or are you -- just I guess any outlook on this program.

Jeffrey Levin: Sure, this is Jeff. That's a good question. That program we structured a few years ago, and what we would tell you is, the market has evolved in terms of the unitranche business.

Three or four years ago, the first out/last out product was one that was quite prevalent in the marketplace. And we saw a fair amount of deal flow for bifurcated unitranche where we took the last out, Madison took the first out.

Our business, as well as others across the marketplace, as you know, have raised a lot of capital for direct lending. And a lot of that money has been raised at the price point where unitranche loans typically come, LIBOR plus 525 to LIBOR plus 700 or so, that being the goalpost typically.

And so given the size of the lending community that's grown at that price point, ourselves and others, typically, those deals are being clubbed up among a few different lenders and not being bifurcated.

And so when you look at our portfolio, what you'll find is that there's a fair amount of dollar one unitranches, we call it exposure in the book, and increasingly less of it is bifurcated.

We also like that it skews, it's lower risk for us versus a last out. Given where the market has gone, becoming more expensive, leverage multiples creeping up over the past few years, the dollar one unitranche we view as a more defensive play than last out risk.

Operator: Thank you. I show no further questions in queue, so I'd like to turn it back over to Mr. Harris for some closing remarks.

Daniel Harris: Thank you for your time and focus today. We do look forward to speaking with you again next quarter. If you have any questions throughout the rest of the day, feel free to call Investor Relations at any time. Thank you

Operator: Thank you. Ladies and gentlemen, this does conclude today's conference. Thank you very much for your participation. You may all disconnect. Have a wonderful day.