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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the TCG BDC Third Quarter 2019 Earnings Conference Call. (Operator Instructions) Please be advised that today's conference call is being recorded. (Operator Instructions) I would now like to hand the conference over to one of your speakers today, Mr. Daniel Harris. Sir, please begin.

Daniel F. Harris ***TCG BDC, Inc. - Head of Investor Relations***

Thank you, [Howard]. Good morning, and welcome to TCG BDC's Third 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 guidance at any time.

With that, I'll turn it over to our President, Linda Pace.

Linda Pace ***TCG BDC, Inc. - President***

Thank you, Dan. Good morning, everyone, and thank you for joining us on our call this morning to discuss our third quarter results. Joining me on the call today is our Chief Investment Officer, Taylor Boswell; and our Chief Financial Officer, Tom Hennigan. Before handing the call over to Taylor and Tom, I'd like to focus my remarks today across 3 areas: summarizing our financial results for the quarter; a closer look at our portfolio and the change in NAV this quarter, and a brief discussion on our dividend and capital position. Let me start with an overview of our results for the third quarter.

We generated net investment income of $27 million or $0.45 per share, and we declared our regular $0.37 dividend. Our company has consistently produced net investment income well in excess of our quarterly dividend, and we expect to continue this going forward. Our net asset value per share declined to $16.58 from $17.06 last quarter. Net investment income substantially exceeded the dividend but was offset by realized and unrealized losses of approximately $0.60 per share while share repurchases were $0.04 per share accretive to NAV.

Let me shift to a slightly deeper discussion on our portfolio and change in NAV this quarter. Our BDC's portfolio is highly diversified and heavily weighted with first lien positions, which represent about 70% of our portfolio as of the third quarter. We have over 140 investments in the portfolio diversified by size and sector. No single sector accounts for more than 12% of the portfolio. This portfolio construction represents our defensive approach to sustainable dividend creation, which is our investment objective.

However, portfolio construction alone does not immunize a portfolio from idiosyncratic risk. While we expect to outperform the industry over the long term, our results this quarter were negatively impacted by a couple of investments that drove the vast majority of the 2.8%

quarter-over-quarter decline in NAV per share this quarter. We have aggressively moved to manage our remaining risk, leveraging the broader Carlyle Global Credit workout team and other platform capabilities. As I mentioned last quarter, our team is focused on stabilizing NAV through prudent underwriting standards and active portfolio management. We are confident we can deliver strong long-term credit performance and drive shareholder value, though any individual quarter may exhibit some level of volatility.

The core tenets of our investment philosophy are unchanged. We continue to invest in the best relative value opportunities, maintain a strong bias towards senior debt and defensive industry exposures and directly originate from sponsors with whom we have meaningful relationships.

Let me conclude with a discussion of our dividend and capital position. Dividend stability remains an important feature of our BDC and represents an attractive yield to shareholders. At today's price, this equates to a dividend yield greater than 10% without factoring in the impact of any special dividends. Last quarter, we paid a special dividend and are positioned to declare a further significant special dividend in the fourth quarter. At the end of the third quarter, our spillover income was approximately $0.31 per share, and we intend to balance the future special dividends with capital preservation.

We continued to be active in share repurchases during the third quarter, as we do not believe our valuation reflects the intrinsic value of our company with the broad capabilities of the Carlyle platform. We repurchased $17 million of shares during the quarter, an inception-to-date to $52 million in repurchase activity has led to $0.14 in accretion to NAV. We have approximately $48 million remaining on our $100 million repurchase authorization, which earlier this week, our Board extended for another year. It is our intent to continue repurchasing shares at or near our current valuation.

To reiterate, we remain extremely focused on portfolio performance and stabilizing NAV. Let me now hand the call over to our Chief Investment Officer, Taylor Boswell.

Taylor Boswell ***Carlyle Group L.P. - Chief Investment Officer of Direct Lending***

Thank you, Linda. Allow me to begin by sharing Carlyle's read on the macroeconomic environment. If you recall, last quarter, we said our firm's proprietary research is not pointing towards an imminent recession. Today, while we continue to see weakness in trade-linked activities as well as certain categories of short-cycle industrial demand, and we acknowledge the data has softened somewhat in the last few months, our house view remains unchanged. That is, we still do not expect a recession through year-end 2020.

That said, we're neither macro investors nor market timers. Rather, we are fundamental investors building portfolios designed to perform across cycles. This is certainly the case with CGBD, where our investment objective is the delivery of defensive sustainable income to our shareholders. In this pursuit, as Linda mentioned, we've constructed a portfolio, which is heavily anchored in first dollar senior secured instruments and is highly diversified by borrower. It also possesses less than half the exposure to cyclical industries of broader leveraged finance markets. As such, we're happy to report that any economic weakness Carlyle see is emerging is not evidencing itself in CGBD's portfolio. We remain confident in our ability to outperform through the cycle.

We spoke last quarter about our portfolio sensitivity to movements in LIBOR, the progression of which continues to be unfavorable for us and our peers. As our market navigates this transition, we're focused on maintaining price discipline and seeking to maintain yield by increasing spreads. Our progress in this respect has been solid, especially in light of the highly competitive environment in which we are operating. You can see the same with our book yields roughly flat on a quarter-over-quarter basis. While the private markets rarely see immediate transition of public market signals, we do see initial signs, our competitors are taking similar approaches, and we have confidence in this market's ability to deliver absolute return across macro environments.

But at Carlyle, we're not going to be passive and rely on this competitive market to deliver us what we need. Instead, as you would expect, we continuously evolve our business to adjust to changing market conditions. The core thrust of that evolution today is driving deeper integration of our efforts across Carlyle. This means a widening of our funnel to source from across the firm's broad capabilities as well as the use of our scaled capital base and deep sector expertise to allow us to control transactions and move faster with conviction. We're pleased to begin to show early results of this effort in the quarter, booking both large and lead sponsor finance transactions as well as transactions leveraging our software, asset-backed, European and non-sponsored lending capabilities. In the coming quarters, you will see us build upon these efforts as we believe the yield and diversification benefits of these differentiated strategies are compelling for our shareholders.

Our platform also opens up very interesting opportunities to compete with traditionally syndicated financing markets, which are currently experiencing meaningful technical dislocations. We've been actively stepping in with bespoke private capital solutions, namely in privately placed second liens, large-scale unit tranches and taking advantage of a bifurcated first lien market. For example, in the third quarter, we worked with one of our top sponsors to privately structure incremental first lien and second lien loans for a well-regarded seasoned leverage loan issuer in the aerospace sector. The sponsor did not want to take execution risk in liquid markets and needed a trusted partner that could invest with scale in multiple parts of the capital stack. We worked together with them to design a bespoke financing package that facilitated a partial monetization, delivered critical dry powder for M&A and integrated, without issue, into their existing capital structure. As we, and a small number of other direct lenders, have achieved significant scale, we expect to continue to open up new opportunities by taking share from traditionally syndicated leveraged finance markets.

Stepping back, we had another strong quarter of origination activity, both in quantity and quality, with $284 million of commitments, over 75% of which were in first lien instruments. A similar percentage of this capital was deployed in support of repeat sponsors. While we served as lead arranger on approximately 80% of our transactions, demonstrating our significant influence in the marketplace. From a credit perspective, the key metrics for new originations remain largely in line with our broader portfolio in prior quarters. The loan-to-value is under 50%, the average leverage multiple was roughly 5.5x. Average EBITDA was $90 million, significantly higher than our average portfolio EBITDA, reflecting progress both deploying our scale capital more effectively as well as inroads made displacing syndicated markets.

I'll now turn the call over to Tom Hennigan to discuss our financial results.

Thomas M. Hennigan ***Carlyle Group L.P. - Chief Financial Officer***

Thanks, Taylor. We had another solid quarter in terms of core income generation. Total investment income for the third quarter was $56 million, down slightly from $57 million in the second quarter. The decrease was primarily due to lower OID accretion and prepayment fees, given the elevated level of repayments experienced last quarter. However, this was offset by growth in core interest income from a higher average investment balance.

Total expenses were flat for the quarter at $29 million, as higher interest expense from an increase in the average debt outstanding was offset by a decline in incentive fees. This resulted in net investment income for the quarter of $27 million or $0.45 per share, and that compares to an average of $0.43 over the prior 8 quarters dating back to our IPO. On November 4, our Board of Directors declared the regular dividend for the fourth quarter of 2019 at the same $0.37 per share, and that's payable to shareholders of record as the close of business on December 31.

Shifting to the financing front. We finished the third quarter with total debt outstanding of about $1.2 billion. That's up from $1.1 billion as of 6/30. The increase was driven primarily by funding the net growth in the investment portfolio. We recently increased our revolving credit facility by about another $100 million. So we still have about $330 million of total unused commitments under our credit facilities.

Statutory leverage was 1.23 as of 9/30, which is right in the middle of our stated target range of 1.0 to 1.4x, and that's up from 1.07 at the end of the prior quarter. And as we highlighted on last quarter's call, given a more favorable rate environment for issuers, we continue to evaluate alternative financing solutions with a primary goal to further optimize our liability structure.

Moving on to the JV's performance. The dividend yield on our equity in the JV was again about 13% for the third quarter. Repayments outpaced new originations at the JV during the quarter, a trend we see continuing through year-end. So this could weigh on the JV's dividend yields in 2020.

Regarding valuations in NAV, our total aggregate realized and unrealized net loss was about $36 million for the quarter. One borrower, Dimensional Dental, contributed to over half of this loss and over 2/3 of our NAV decline as we marked our position down to almost 0. This company's financial prospects have deteriorated materially over the last quarter. Given we hold the junior debt tranche, we expect minimal recovery on our investment. This is one of the remaining credits from a legacy last out program that has not made any new investments since 2017. And I'll note, we're making a conscious effort to reduce exposure in that program over the next few quarters.

Regarding exits. We noted on last quarter's call that we sold our investment in Totes. The realized loss of $11 million for the quarter, primarily represents a reversal of prior period unrealized losses on this position. On the positive front, in September, we received repayment in full on our debt investment in [20-80]. And in the last week, we received equity proceeds from the sale of the remaining business lines. This was a loan we restructured back in early 2017 and with the right combination of capital, corporate governance and patients, we expect to recover over 100% of our original loan investment.

Regarding the overall portfolio, the weighted average internal risk rating remained 2.3, and the total watch list was flat quarter-over-quarter, with no new additions.

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

Linda Pace ***TCG BDC, Inc. - President***

Thank you, Tom. Delivering strong risk-adjusted returns to our shareholders remains our top priority and getting to a place where we have stabilized NAV is a focus area for all of us on this call. We are on the right track.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from the line of Fin O'Shea with Wells Fargo Securities.

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

First question is for Linda. You had some extended remarks on the dividend this quarter. But you seem to be saying that it's attractive going forward essentially. Are you communicating anything in your view as to the long-term sustainability of the regular dividend?

Linda Pace ***TCG BDC, Inc. - President***

Yes, Fin. Thanks for dialing in and for the question. Yes, I think our message to you and to our investors is that we're very comfortable with the long-term sustainability of the dividend. Our net interest income is well in excess of the $0.37 that we declared this quarter and in the prior quarters. And we're not going to give any guidance on the special for Q4 yet, it's a bit too early. But you can see by the level of the spillover income that we'll be in a position to declare one. And we do expect that the special dividend, which was $0.20 last year, we've already declared $0.08 last quarter, will be in excess of the combined $0.20 from last year.

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

Appreciate. Sure. And as a follow, just looking at -- with marks this quarter. It looks like a couple of your more severe experiences have come from the Madison Capital joint venture, the last out program. Is there any thread there in hindsight, whether it be industry or structure? And is there a change on how you look at this avenue going forward?

Linda Pace ***TCG BDC, Inc. - President***

Yes. Something that we've talked a lot about as a team here. So when we started out, we had a program with Madison Capital that essentially was a first out last out program where Carlyle took the last out. We've stopped investing through that program back in 2017. We're still working through some of the legacy issues that came through that program. And you saw it mainly in Dimensional Dental this quarter.

I think one thing -- I'm not sure, I would blame it on necessarily on industry, but there is a little bit of that, but it's more so the structure, a last out position when a company gets into trouble and has to restructure its balance sheet, the recoveries there are tend to be relatively poor. And -- so yes, so that's the main driver for us wanting to not continue to invest in that program. And I think more importantly, going forward, we've got some exposure, residual exposure that came from that program, but we've got a really good line of sight to -- fully exiting, whether it's through just getting repayments or sales or just general portfolio management.

Taylor Boswell ***Carlyle Group L.P. - Chief Investment Officer of Direct Lending***

And then -- sorry, it's Taylor. Just one point I would add on to that, which is that Madison program we were running, which generally in smaller issuers. And so as you see us taking incremental exposure in junior debt/second liens in this environment, what you see us doing is further upmarket with larger companies, is another way that we're sort of responding to the experience of that program, which Linda mentioned, we're winding down.

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

I appreciate the color on that. And one also -- third question, if I may. Looks like a couple of the names, I think, legacy.com, Superior Health linens, you add a pick component. Is that a borrower concession of any form? Or do they trip a covenant and the rate picks up or anything to read into on those names?

Thomas M. Hennigan ***Carlyle Group L.P. - Chief Financial Officer***

Yes, it's Tom. In both those scenarios, we had covenant issues and in the negotiations with the sponsor in inking an amendment, we're able to increase price, and in both cases, we increased the price in the form of pick.

Operator

Our next question comes from the line of [Rick Shane] (corrected by the company after the call) with JP Morgan.

Melissa Marie Wedel ***JP Morgan Chase & Co, Research Division - Analyst***

It's Melissa on for Rick today. I was hoping you guys could touch on how you're thinking about taking leverage higher at this stage of the cycle and whether or not -- the extent to which you have even more ability to kind of move leverage up if we were to see any kind of dislocation in the market?

Thomas M. Hennigan ***Carlyle Group L.P. - Chief Financial Officer***

Melissa, It's Tom. Thanks for the question. When we received approval from our Board and shareholders last year, our view always was that we could comfortably run leverage in that 1.0 to 1.4 range, keeping the same investment mix and that being a relatively conservative mix weighted more heavily towards first lien than you see in the broader markets. So as you look at our portfolio, still with roughly 70% true first lien loans, we think that based on that risk exposure in the portfolio weighted towards first liens as well as, as Taylor noted, relatively low level of risk -- of cyclicality in the portfolio, we feel quite comfortable running at the current leverage levels in that stated target range given the risk in the aggregate portfolio.

Melissa Marie Wedel ***JP Morgan Chase & Co, Research Division - Analyst***

Okay. Could you also talk about, I think, Derm Growth Partners III? That's something -- another one that you're carrying at bit of a discount to cost. I'm not sure if there's something incremental that happened this quarter. Or if you could just give an update on the company.

Thomas M. Hennigan ***Carlyle Group L.P. - Chief Financial Officer***

Yes. The update I'd give on that credit is it's -- we're working through some operational and financial performance challenges with the sponsor and the company. But unlike some of the other positions, such as Dimensional, which was the other large markdown this quarter, this is a first lien tranche. So we expect, in this situation, a very different outcome than we had on Dimensional, which obviously being junior debt in an underperforming situation, they were covered prospects and that's one much difference. That's an important distinction I would draw between the 2 borrowers.

Operator

And our next question comes from the line of Paul Johnson with KBW.

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

You guys talked about taking on larger transactions, bigger companies, displacing more syndicated market. Is that a result of what sort of the dislocation in the BDC market that we've heard about this year? Or is that more of an internal shift in your strategy?

Linda Pace ***TCG BDC, Inc. - President***

Yes. Thanks, Paul, this is Linda. Thanks for the question. In large part, it is driven by the dislocation that we're seeing in the broadly syndicated markets. Whereby we're seeing more opportunities come our way and leave the syndicated market. And just, I think, a good way to maybe illustrate that, is to give you an example, kind of in-house here at Carlyle. In talking with kind of our capital markets team that covers our private equity side, we recently did a deal that normally would have gone to the syndicated market, given its size, but decided to come to the more middle-market direct lending space, and that was really -- not because direct lenders don't have the same credit prowess or the way they look at credit is any different. They're still very discriminating. But really, because there's much more execution risk in the broadly syndicated market these days than there is in the direct lending market, and having certainty around execution, having speed around execution is pretty valuable. So the -- so that opportunity is coming to our markets. And we're seeing more and more of that.

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

Great. And then switching a little bit to your middle market credit fund. We noticed that originations slowed slightly during the quarter, repayments were pretty big. Is there anything going on there that's prompted higher repayments during the quarter? Or is that just more of a -- an anomaly?

Thomas M. Hennigan ***Carlyle Group L.P. - Chief Financial Officer***

I'd say that we -- this is Tom. I'd say, even when you look at the broader BDC, the repayments, obviously, difficult to predict. We have some quarters where payments are very heavy, somewhere they're light. I'd say right now, we just happen to be experiencing a very heavy repayment period for the JV, in particular, some larger positions, and that's why you see the -- in particular, the repayments are outpacing the new originations for the third quarter, and we anticipate likely the same for the fourth quarter.

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

Okay. And then one other question on Derm Growth Partners. Just to add on to the question before. Is that particular company -- is that a rollup strategy of health care practices?

Thomas M. Hennigan ***Carlyle Group L.P. - Chief Financial Officer***

Paul, it's Tom. Yes, that's correct.

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

Okay. And lastly, I'm just curious, is Carlyle, the BDC, are you guys undergoing any other additional changes either to your process or other things within the BDC as Linda takes over as CEO, aside from integrating further into the Carlyle platform?

Linda Pace ***TCG BDC, Inc. - President***

Thanks, Paul. The short answer is no. We talked last quarter about the additional resources that we've added to the team, both on the underwriting side and on the senior management side. And as Taylor pointed out earlier on the call, focusing on integrating within the broader Carlyle credit platform and the overall firm, those are the two main points. And they're done and ongoing. So you shouldn't expect anything else.

Operator

Thank you. I'm showing no further questions at this time. I will now turn the call back over to Head of Investor Relations, Daniel Harris for closing remarks.

Daniel F. Harris ***TCG BDC, Inc. - Head of Investor Relations***

Thank you for your time today. We appreciate your interest. If you do have any follow-ups, feel free to contact Investor Relations at any time. Otherwise, we'll look forward to speaking with you again next quarter.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for participating, and you may now disconnect.