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CGBD.OQ - Q4 2017 TCG BDC Inc Earnings Call

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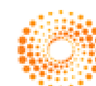

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PRESENTATION

Operator

Good day, ladies and gentleman, and welcome to the TCG BDC Fourth Quarter 2017 Earnings Conference Call. (Operator Instructions) As a reminder, this conference is being recorded.

I would now like to hand the floor over to Daniel Harris, Head of Investor Relations. Please go ahead, sir.

Daniel Harris

Thank you, Karen. Good morning, and welcome to TCG BDC's Fourth Quarter and Full Year 2017 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 Factor section of our 10-K and other SEC filings that could cause actual result 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 joining us for our fourth quarter earnings call. I'm joined today by our management team, including our President, Jeff Levin; our Chief Risk Officer, Tom Hannigan; our Head of Originations, Grishma Parekh; our CFO, Venu Rathi as well as other members of the team.

I'll begin by highlighting some of the accomplishments for the year and then review some of the financial results. Last year was a transformational year for our business. We successfully merged our original entities in a transaction that paved the way for our IPO, the largest IPO for a fully ramped BDC and was the first such offering in over 2 years. We originated more than $2 billion of loans and achieved net portfolio growth in excess of $1

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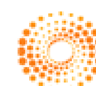

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billion across our vehicles, all achieved without deviating from our original investment thesis or stretching on credit despite an increasingly challenging market.

We continue to scale our senior loan joint venture, which eclipsed the $1 billion mark during the fourth quarter. And most importantly, these efforts resulted in the delivery of strong, consistent investment returns to our investors. I would like to take a moment to thank all of our investment professionals who've continued to work so hard to achieve our goals, and the Carlyle founders who have supported all aspects of this business since inception.

Turning to financial results. Yesterday, we released our fourth quarter and full year 2017 earnings. We once again saw all components of our business deliver solid and consistent results. We had continued strong credit performance in our loan portfolio. We had another quarter of high-quality origination activity, and we benefited from further scaling of our senior loan joint venture with PSP, which is increasing its contribution level to our bottom line. In that regard, I'm pleased to report a solid fourth quarter performance for our shareholders, with net investment income of $0.43 per share compared to $0.41 per share in the previous quarter. The results are straightforward and transparent, with the increase largely coming from organic portfolio growth in the absence of any real movement in overall valuations during the quarter.

For the fourth quarter, we paid a regular dividend of $0.37 per share, and given the continued strong performance of the BDC during the year, we are in a position to pay a special dividend of $0.12 per share. Excluding the special dividend, our net asset value per share would have increased by $0.06 for the quarter as our earning per share of $0.43 exceeded our regular dividend of $0.37 per share. As a result of the special dividend, our NAV per share declined from $18.18 as of September 30 to $18.12 at December 31. The combined dividends represent a 9.7% yield to shareholders for the year.

As I mentioned, we had a benign quarter from a valuation standpoint, and the credit quality of our portfolio remained stable with a weighted average internal risk rating of 2.2, remaining flat quarter-over-quarter. However, the quarter was not without its challenges. The market, as we know, continues to be extremely competitive with that dynamic affecting not only spreads and leverage, but also the structures in EBITDA at backfill investors are being asked to accept. [Mike Hart], who provided additional color on the overall state of the market, specifically as it relates to our origination activity this quarter and what we're doing with our underwriting and investment selection in the face of this competitive dynamic.

With that, I'd like to now turn the call over to Grishma to discuss our origination activity in greater detail.

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

Thanks, Mike. We continued to deploy our capital in a measured, careful manner and delivered another strong origination quarter. We addressed the market challenges by supporting our highest-quality borrowers as they continue to grow and seek additional financing by partnering with proven private-equity sponsors with whom we have long, deep relationships and by leveraging the sector expertise across the Carlyle ecosystem, particularly our operating executives and portfolio company management teams. In short, we step to our knitting fundamental credit investing while leveraging the unique tools we have within the firm.

Portfolio construction remains top of mind, and we focused on maintaining a highly diverse, defensive portfolio branded in first lien loans, which accounted for about 78% of the BDC as of year-end, up slightly from 76% as of 9/30. Our focus on the top part of the capital stack has been consistent and deliberate quarter-over-quarter and is a reflection of where we continue to see the best risk-adjusted opportunities. We believe we have built BDC to withstand market volatility and potential economic pressure, while at the same time, producing attractive return to our shareholders.

During the fourth quarter, we made 25 new commitments totaling approximately $400 million. Our origination activity was split fairly evenly across the BDC and the JV. 87% of these commitments were first lien senior secured loans. The loan-to-value of our investments is also reflective of the significant enterprise value cushion and downside protection that exists in our portfolio.

For these new investments, the loan-to-value is 43%. This is partially a reflection of today's robust purchased multiples, but also underscores the quality of the companies we are lending to. These are businesses that have resilient business model, long track records and generate substantial cash flow.

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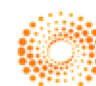

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During the fourth quarter, we closed investments with 20 private equity sponsors, 86% of which were repeat clients to our business. And while dividend recaps, opportunistic financings and covenant light volumes have ballooned. About 90% of our investments for the quarter were in support of buyouts and acquisition financings, and 90% of our portfolio contains the financial maintenance covenant. Our investment portfolio continues to be almost entirely floating rate, and we are benefiting from an increase in LIBOR. As of December 31, the weighted average yield on our first lien and second lien debt investments was 8.9% based on amortized cost, up about 25 basis points from the prior quarter. The overall yield for first lien loans increased from 8.3% to 8.6% due primarily to increasing LIBOR. The overall yield for second lien loans was flat, at about 10.4%, as higher LIBOR was offset by lower yields on the newly booked assets compared to those that we paid during the quarter.

Our industry mix highlights the defensive nature of our portfolio. Health care and insurance brokerage continue to be 2 of the largest sectors, and we are drawn to their noncyclical characteristics. Over the course of the year, we made a concerted focus on technology, tech-enabled services and software companies and added resources to that vertical. Our industry expertise and focus has been a true competitive differentiator.

Shifting gears to our JV will PSP. The portfolio stands at about $1.1 billion and comprises 9% of the BDC as of December 31. Net portfolio growth was a robust 19% quarter-over-quarter. We continue to have substantial room to scale the JV, and as we do, we believe it'll be highly accretive to our dividend yield. When including the JV, our total investment portfolio increased $2.8 billion at December 31, up from $2.6 billion last quarter.

And finally, core loan sales and repayments were $213 million, excluding the repayment of the JV mezzanine loan that Tom will discuss shortly. We saw companies take advantage of the borrower-friendly environment to reprice loans or recapitalize their balance sheet.

I'll turn the call over to Tom Hannigan, our Chief Risk Officer.

Thomas M. Hennigan - *The Carlyle Group L.P. - MD*

Thanks, Grishma. Overall credit performance of the portfolio was again stable this quarter. As Mike noted, the weighted average internal risk rating of the portfolio remained stable at 2.2. Total watch list transactions, those rated 4 or worse on our internal risk rating scale, ticked up modestly this quarter as a percentage of the portfolio, while the number of borrowers on the watch list remained flat. And nonaccruals as a percentage of the total portfolio remained steady at about 1% of fair value, with just one position on nonaccrual stats. In terms of credit metrics, our portfolio experienced annualized revenue and EBITDA growth of over 10% over the course of 2017. And our portfolio net leverage for the quarter remained stable in the mid-5x range. Similar to last quarter, modest improvement in leverage across the existing portfolio was offset by higher leverage from new investments.

In regards to valuations, total aggregate realized, and unrealized net gain was up modestly for the quarter. Valuations again benefited from continued tightening in market spreads. We had an additional markdown on Product Quest, but this was offset by net increases in values across the rest of the portfolio.

On the financing front, our debt-to-equity ratio was 0.74x as of 12/31, down slightly from 9/30. While our debt-to-equity ratio remained at the higher end of our targeted range of 0.65 to 0.75x, we have visibility into about $150 million of repayments in the first quarter, which will provide adequate liquidity for new investments. Last quarter, we highlighted that we held over $200 million of sellable loans priced south of our current yield hurdle. With the current market running its natural course, we expect about half of that amount to be repaid by the end of the first quarter.

Regarding our financing facilities, outstanding debt as of 12/31 was $836 million, a slight reduction versus prior quarter. And as of 12/31, we had approximately $250 million of total unused commitments under our credit facilities.

At the JV level, as highlighted during last quarter's call, we successfully closed our first CLO in December, and those CLO proceeds were used to repay existing debt facilities of the JV, including partial repayment of the mezzanine loan provided by our BDC. The CLO not only provides additional debt capacity to support future growth at the JV, but it should also meaningfully enhance JV equity returns going forward.

Turning to financial results for the fourth quarter. Total investment income was about $50 million, up $7 million versus the third quarter. The drivers of the meaningful increase were threefold. First, higher interest income from loans based primarily on higher average investments outstanding

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over the course of the quarter, higher OID accretion on repaid positions and increase in LIBOR. Second, growth in other income primarily from higher call premiums and amendment fees. And third, growth in interest and dividend income from the JV as we continue to scale that vehicle.

Net expenses were $23 million for the fourth quarter compared to $18 million in the third quarter, with the increase driven largely by higher management fees due to removal of the fee waiver. The management fee waiver ended on 9/30, so the effective management fee increased from 1% to 1.5% of average gross assets. In addition, interest expense increased due to an increase in average outstanding borrowings during the quarter and the increase in the LIBOR. The end result was net investment income for the quarter of about $27 million or $0.43 per share, comfortably covering our regular dividend of $0.37 per share.

On Page 12 of the earnings presentation, you'll find NAV bridge for the quarter. NAV was down $0.06 on the quarter from $18.18 at 9/30 to $18.12 at year-end. But as Mike and I both noted, we had a strong quarter of core earnings. So absent the special dividend of $0.12, NAV otherwise would have increased by $0.06. Excluding the special dividend, the annualized quarterly dividend yield based on NAV was 8.1%. And at year-end, we had approximately $4.3 million in undistributed net investment income, which equates to $0.07 per share.

Regarding JV returns, the fourth quarter dividend yield on our equity of the JV was about 14%, down from north of 15% achieved in the third quarter, which was aided by higher-than-normal fee income and accelerated OID and repayments. With the closing of our first CLO at the JV and a significant reduction in overall JV cost of capital, we expect to see the yield level in the first quarter of '18 back above the 15% level.

Next, Jeff Levin will provide some further color on the current market environment.

Jeff Levin

Thanks, Tom. I wanted to address the overall investment environment and discuss our capital deployment strategy into a very tight credit market. 2017 was an extremely strong year across the broader markets in general, with the leverage finance market be no exception. We saw record loan issuance, increasing leverage multiples despite being at or near all-time highs, driven by record purchase prices being paid by private equity firms, tightening spreads and extremely strong CLO formation in overall credit fundraising. Despite a short period of volatility earlier this month in the equity markets, the leverage finance markets really didn't move much in either direction, and the middle market loan asset class has continued to be as tight as ever. High-quality credits are being repriced or refinanced, and sponsors continue to seek opportunistic dividend recaps wherever possible.

Overall, marketplace liquidity and the entrance of new credit managers have combined to drive looser credit documents with increasingly borrower-friendly terms. This is not to say there aren't good opportunities in the market, there are. They are just harder to originate, and lenders need to find ways to differentiate themselves to create valuable investment opportunities. As Grishma noted, we stuck to our knitting in the fourth quarter as 87% of our investments were in first lien loans. In markets like the current one, exhaustive and differentiated due diligence is critical. Extremely wide and equally deep Carlyle resources help us to navigate the current environment better relative to other middle market lenders to operate with smaller platforms. Most often, the Carlyle network leads to our discovering an issue of [our] particular credit or industry sector dynamic that our competitors may not uncover and results in our passing on a potential investment and avoiding what could be a costly mistake.

Conversely, when our due diligence process supports an investment, we have enhanced levels of conviction, given the vast resources that have been engaged during the process. These broader Carlyle resources will also be a significant asset to our business whenever a market dislocation occurs. While we are in this extremely tight market, we will continue to leverage our scale as a way to optimize origination and influence terms, providing full financing solutions continues to be the optimal way to generate strong risk-adjusted returns and a sponsor-finance asset class. We continue to raise private capital structures strategically across our broader direct lending platform to ensure our business is well equipped with the right capital base. These incremental pools of capital can co-invest alongside TCG BDC, increasing our scale and relevance in the marketplace and maximizing our ability to influence pricing in documentation terms.

As you are aware, our portfolio is already more heavily anchored in first lien loans than most other BDCs, so we are well positioned for capital preservation. The trends of 2017 have continued into the first couple of months of 2018. Thus far, in the first quarter, we have been extremely selective with new investment activity and will not stretch on credit quality for the sake of origination to generate yields. We will increasingly focus

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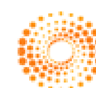

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on partnering with the right sponsors in the right industry sectors and maintain our highly rigorous due diligence process and underwriting standards.

We would like to thank everyone for joining today's call and for the continued support of the company. Operator, will you please open the line for questions?

QUESTIONS AND ANSWERS

Operator

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

Joseph Bernard Mazzoli - *Wells Fargo Securities, LLC, Research Division - Associate Analyst*

Joe Mazzoli filling in for Jonathan this morning. So the first question, we see that you priced the $400 million securitization for the middle market credit funds. So you still have about $378 million under the credit fund sub-facility. So do you expect additional securitizations to the middle market credit fund and -- to replace the revolving facility and then also to kind of support future growth?

Thomas M. Hennigan - *The Carlyle Group L.P. - MD*

It's Tom, I will take that one. The strategy of the JVs continued to use that warehouse facility to ramp up and then do additional securitizations. So you see, overtime, net facility ramped back up to approximately where it was when we did the last CLO, up north of $600 million. We have the adequate number of loans to do the next securitization and then we'll repeat the playbook, repay down both of our existing facilities.

Joseph Bernard Mazzoli - *Wells Fargo Securities, LLC, Research Division - Associate Analyst*

All right. That's very helpful. And I'm curious, is there a -- what is the management fee that -- I assume it's Carlyle, who's -- who charges to manage the credit fund securitization as a percentage of total assets. Because equity holders essentially pay the fees and securitizations structure, so this would reduce CGBD's return on the credit fund. So I'm kind of thinking that we might expect other expenses in the income statement for the credit fund to potentially increase in the coming quarters.

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

Similar to our on-balance-sheet CLO, there are no fees taken either by CG or by CGBD. So it's essentially a no-management-fee CLO. So the returns of the JV through the CLO will continue to be distributed 50-50 between the 2 JV partners. No leakage.

Joseph Bernard Mazzoli - *Wells Fargo Securities, LLC, Research Division - Associate Analyst*

Okay. That's certainly good to know, and that's very helpful. And just one final question about the securitization there. Should we expect the CGBD's mezzanine loan to -- is that used to kind of fund the warehouse? Should we expect that to be paid down again, maybe with the next securitization as it's priced?

Thomas M. Hennigan - *The Carlyle Group L.P. - MD*

We anticipate that much like the other credit facility, that will ramp up and then ramp back down over time as we do additional securitizations.

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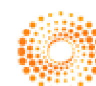

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Operator

Our next question comes from the line of Melissa Wedel with JPMorgan.

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

Melissa on for Rick today. A quick question to clarify some of your prepared comments on repayments in the first quarter. You mentioned about $150 million expected repayments, but then, an additional -- was there an additional $100 million roughly of sellable loans that weren't priced below your hurdle rate now? Or was that $100 million included in the $150 million?

Thomas M. Hennigan - *The Carlyle Group L.P. - MD*

It's Tom. I will clarify. The $200 million was the reference to a comment I made last quarter. So the $150 million is the expected repayments right now in our pipeline for first quarter. What I'm saying is this overlap that the loans that we previously had -- we had anticipated potentially exiting or selling down that, that's -- it's playing out its course as we anticipated. With those loans, R&D is repaying naturally in the first quarter.

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

Got it. And that's already incorporated into the $150 million number?

Thomas M. Hennigan - *The Carlyle Group L.P. - MD*

Correct.

Operator

And our next question comes on the line of Jim Young with West Family Investments.

James Young - *West Family Investments, Inc. - Investment Analyst*

Could you just explain a little bit about the increase in the professional fee that you realized from the September quarter until the December quarter?

Venu Rathi

This is Venu Rathi. So as we -- this was our -- the second full quarter as a public BDC, and we are kind of, like, continuing to get a little bit more clarity in terms of the professional fee. So we did have a couple of one-time professional fees incurred mainly related to the legal fees. The other component of the professional fees are audit fees as well as the tax and internal audit. We are required to comply with the severance obviously (inaudible). So those are the major component of the professional fees. As we, kind of, like, go forward, I would say we look -- we estimate our professional fees to be in line with Q4, Q4 actual expenses.

Operator

And that concludes our question-and-answer session for today. I'd like to turn the call back over to TCG BDC for any closing comments.

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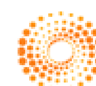

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Michael A. Hart - *TCG BDC, Inc. - Chairman & CEO*

Thank you, Karen. We appreciate your time today. If you do have any follow-up questions, feel free to call Investor Relations after the call. And we look forward to talking with you again next quarter.

Operator

Ladies and gentleman, thank you for your participation in today's conference. This does conclude the program, and you may now disconnect. Everyone, have a great day.

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