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CGBD.OQ - Q2 2018 TCG BDC Inc Earnings Call

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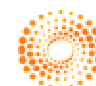

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the TCG BDC Second Quarter 2018 Earnings Call. (Operator Instructions) As a reminder, this conference may be recorded. I would now like to introduce your host for today's call, Mr. Daniel Harris, Head of Investor Relations. Mr. Harris, you may now begin.

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

Thank you, Sherry. Good morning, and welcome to TCG BDC's Second 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 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 and other SEC filings 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 second 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 revisit our discussion from last quarter regarding the adoption of certain provisions of the Small Business Credit Availability Act or as I referred to it, the BDC leverage bill. I'll then provide an update on the implementation of the new leverage limitations, which became effective for us on June 7 of this year.

As you know from our discussion last quarter, TCG BDC was a leader in seeking approval for the new guidelines from both our board and our shareholder base. I'll share with you the results of that outreach and how we're thinking about utilization and talk about an important change to our fee structure as we continue to look for ways to best align our interests with those of our shareholders.

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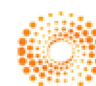

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Turning to our financial results. Yesterday, we released our second quarter earnings for the year. All components of our business continue to deliver consistent results, including our core portfolio, our joint venture and our strategic partnerships. All of which contributed to a solid quarter performance with net investment income of $0.45 per share, an increase of 12.5% from the prior quarter and comfortably covering our second quarter dividend of $0.37 per share, which represented about a 9% yield on trailing 12-month basis.

Net asset value per share declined modestly quarter-over-quarter from $18.09 per share to $17.93 driven primarily by some unrealized valuation changes that Tom will provide more details on in a moment.

Let me shift to our debt-to-equity ratios. It provides a good segue into a broader comments that I want to make on the topic of the BDC leverage bill. Our debt-to-equity at the end of the second quarter was 0.76:1, up modestly from 0.7:1 ratio at the end of the first quarter. We previously provided guidance of the outer boundary for our own business' leverage would be in the area of 1.3 to 1.4:1. Obviously, we're comfortably inside those levels currently but we continue to believe that those are prudent outer boundaries given the overall risk in our portfolio today. Regarding some of the bill's specifics, as you're well aware the bill permits BDCs to reduce the minimum asset coverage ratio from 200% to 150%, which translates into a potential increase in the debt-to-equity ratio from 1:1 to 2:1. When the passage of the bill was announced, we carefully considered what the new law provided for both in terms of increased regulatory cushion and the potential for increased profitability for our company, and so this adoption would be significantly positive for our shareholders.

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 one year from the date of approval or taken to a shareholder vote and receive approval within affirmative vote by a majority of the shareholders in which case the new leverage limitation would go into effect one day after the shareholder meeting. In evaluating the provisions of the bill and the potential impact, not only in our business but also in the industry as a whole, we concluded this the best path forward was to seek the approval of both our board and shareholders. It's a decision that we felt was too important not to have those 2 constituencies weigh in regardless of the timing implications. In April, our Board of Directors unanimously approved the adoption of the new BDC leverage bill and our shareholders overwhelmingly approved this adoption through a proxy process that coincided with our year-end Annual Shareholder Meeting and resulted in a 150% asset coverage ratio becoming effective on June 7 this year.

As we've mentioned previously, we don't anticipate the adoption of the reduced asset coverage requirement to influence or change the investment thesis that we've applied since our company's inception. We'll continue to invest where we see best relative value and our portfolio construct shouldn't change in any material way going forward. We obviously believe the adoption of new leverage guidelines represent an opportunity to deliver increased returns to shareholders. However, even in the absence of increased leverage, the reduced asset coverage ratio provides immediate operational flexibility and increased cushion to the regulatory leverage limit, 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 in the future will be market dependent. However, as a final point of emphasis as it relates to Carlyle ongoing commitment to the alignment of interest with shareholders, effective retroactively to July 1 of this year, our investment adviser has reduced the base management fee from 1.5% to 1% on all assets financed with greater than 1:1 leverage. This reduction in management fee, which as you know has been implemented post the shareholders' approval of the new leverage guidelines is another good example of Carlyle's philosophy around shareholder alignment.

With that, I'll turn it over to Jeff who will provide some additional color on the overall state of the market and how this is influencing our investment selection. Jeff?

Jeff Levin

Thanks, Mike. In the middle market, operating theme remained relatively unchanged during the second quarter as compared to the first quarter, including high-leverage multiples and private equity firms paying full purchase prices. Substantial dry powder held by both private credit and private equity managers, coupled with the strong underlying U.S. economy, continue to drive this dynamic. Loans to finance LBOs continue to have substantial equity value below them, and in the middle market, the average equity contribution was 43% at the end of June, which is significantly higher than it was at the peak of the last credit cycle when it was 32% in 2007. Second quarter sponsored loan volume was roughly flat with the first quarter with approximately 2/3 driven by new money activity. The syndicated loan market experienced some volatility in June with 42 deals flexing pricing wider versus 18 flexing tighter during the month.

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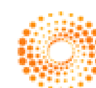

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That said, we have not yet seen this volatility significantly impact the middle market loan asset class. Given the competitive environment that persists, we continue to be focused on optimizing our ability to source as many high-quality investments as possible to generate strong risk-adjusted returns for our shareholders. Several critical elements support our ability to achieve these returns, including having highly flexible capital to invest throughout the capital structure based on where we find the best value, delivering differentiated industry intelligent from the vast Carlyle network to help the sponsors we've partnered create equity value for their portfolio of companies and ensuring our direct lending business has substantial scale and the ability to deliver full financing solutions for middle market borrowers.

Given the importance of scale, one theme we want to address that has become increasingly beneficial to the TCG BDC is the growth across the direct lending business managed by Carlyle Global Credit. In many instances, sponsors show deal flow only to those lenders that can commit large quantums of credit, resulting in scale being a differentiator to optimize investment sourcing.

Given this dynamic, we benefit from Carlyle's platform, which continues to raise capital in both co-mingled and managed account formats to further bolster the whole sizes of middle market loans, which allows us to maximize our origination funnel and have improved influence on terms. The continued expansion of Carlyle Global Credit platform allows us to take larger positions in individual transactions and win lead management roles while maintaining prudent diversification levels, which is a key tenet of our risk management strategy. A couple of recent examples include our investments in [Cole-Mart] and Stacks Sports. In each of these transactions are direct lending platform committed significantly more capital and what is held in TCG BDC. Our scale combined with other funds managed by our investment adviser was critical in winning these co-lead mandates and allowed us to size investment positions that are consistent with our diversification strategy. With that, I will hand it over to Grishma to provide the details of our origination activity this quarter.

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

Thanks, Jeff. Overall, we had a strong capital deployment quarter on a number of fronts. During the second quarter, we made 29 new commitments totaling $394 million with 25 private equity sponsors. In past quarters, I've noted that the vast majority of our investment activity has supported our existing sponsor base. That encompasses over 100 U.S. middle market private equity firms with whom we have closed transactions.

This quarter, we added several new clients. These are firms that we had identified as important to our platform and have known for many years, but for one reason or another, had and not transacted with until now. Continuing to expand our market reach, is an important part of our origination strategy, what we do so with great care, especially in a hypercompetitive market like we have today in order to avoid any adverse selection issues. Our focus remains resolute on the top part of the capital stack. This quarter, more than 95% of our new loans were in a first lien position. Similar to past quarters, our capital is in support of buyouts where substantial fresh equity is coming in and for acquisitions that propelled the growth of our portfolio companies. In the second quarter, LBO and acquisition financings represented 80% of our investment activity. Approximately a third of our investments were in support of our existing portfolio companies as they sought additional debt financing for acquisitions and investments. This is an important benefit of having such a large and diversified portfolio. We view incremental financing as amongst the best risk adjusted deployment of our capital. These are companies we know well and often tend to be our best performing credits. For example, during the second quarter, we have co-led the first lien credit facilities in support of the acquisition of Teaching Strategies. Teaching Strategies had been an existing portfolio company and provides the curriculum, assessment and professional development to the early education market. It's a market leader that should benefit from secular tailwinds in the early education space, irrespective of the economic environment. Based on the information edge we had due to our incumbent position, we are able to provide certainty and speed of execution to the sponsor and were awarded this mandate.

While we've seen a general weakening of credit terms, our new investment and overall portfolio metrics remained highly attractive. The loan-to-value of our new investments was 45%, largely flat from the prior quarter and in line with the overall portfolio. The weighted average net debt to EBITDA this quarter was 5.5x, also in line with the portfolio as a whole.

The weighted average interest coverage per quarter was about 2.5x. Covenant-light volume represented less than 10% of our new investment activity and is less than 10% of our portfolio as well. Shifting to the Middle Market Credit Fund, the JV currently stands at $1.1 billion and comprises 10.7% of TCG BDC's total investments. Net portfolio growth was 4.2% quarter-over-quarter. On a combined basis, the total investment portfolio of TCG BDC and the JV increased to $2.9 billion. The unlevered weighted average yield of investments from the JV is approximately 7.1% from compared

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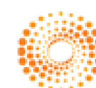

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to 9.3% in TCG BDC. This vehicle highlights our ability to produce a high quality of return with more leverage while investing in lower risk underlying investments. Finally, loan sales and repayments were $209 million, weighted towards TCG BDC.

Despite the heavy repayment activity, TCG BDC experienced modest net portfolio growth of just under 2% quarter-over-quarter. The asset mix also shifted further in favor of first lien as 2 sizable second lien positions were (inaudible). This mix shift is a reflection of our investment approach and the (inaudible) market, where we're seeing more opportunistic transactions and aggressive behavior by market participants. I'll now turn the call over to Tom Hennigan.

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

Thanks, Grishma. Today, I want to discuss our second quarter financial performance, the current portfolio and our financing facilities. I'll begin with a discussion of our financing facilities given we've had a very active last few months in conjunction with the approval by both our board and shareholders of the increase to our statutory leverage limit. Last week, we successfully priced the reset of our 2015 vintage CLO. We are upsizing the CLO from $400 million to $550 million, establishing a new 5-year reinvestment period and increasing total debt issued by $176 million, all while slightly improving our overall cost of capital.

In the next week, we expect to close on an amendment to our SPV financing facility that will reset the 3-year reinvestment period, maintain pricing at [plus 200] and importantly, permit the new statutory leverage level. In addition, we've made great progress with the lenders under our corporate revolver facility on an amendment that would provide us with similar flexibility. Regarding future additions to our debt capacity, we're looking at both upsizing our current secured facilities as well as tapping the unsecured markets. On that note, we finished the second quarter with total debt outstanding of about $860 million, up about $60 million from 3/31 driven by the net deployment activity highlighted by Grishma. As of 6/30, we had approximately $230 million of total unused commitments under our credit facilities, and that will grow to over $400 million following the closing of the CLO upsizing later this month.

Regarding the portfolio, the weighted average internal risk rating ticked up modestly to 2.3 total watch list transactions, those rated 4 or worse on our internal risk rating scale, ticked down by a net $29 million. However, 2 loans migrated to the fixed category, indicating probable loss, while non-accruals increased to 1.7% of total fair value. In terms of credit metrics, our portfolio continues to experience annualized LTM revenue and EBITDA growth of about 10% on a year-over-year basis. Our portfolio weighted average net leverage inched up modestly this quarter, primarily due to repayment of loans that had previously deleveraged since the time of our initial investment. In regards to valuations, total aggregate realized and unrealized net loss was about $15 million for the quarter. Valuations, again, benefited from continued tightening in secondary spreads for the middle market index we track, and we had successful realization on our equity co-investment in global software. Offsetting these were some additional markdowns, notably on Product Quest and [12]. Turning to the financial results for the second quarter. Total investment income was $52 million, up about $5 million versus the first quarter. This increase was split roughly evenly between interest income and other income, which was aided by higher arranger fees. Total income from the JV was roughly flat quarter-over-quarter. Net expenses were $24 million for the second quarter compared to $22 million in the first quarter. The largest component of the increase was higher interest expense driven by both higher average debt outstanding and an increasing LIBOR. The end result was net investment income for the quarter of about $28 million or $0.45 per share, which compares to our regular declared dividend of $0.37 per share. And of note, on August 6, our Board of Directors declared the regular dividend for the third quarter at the same $0.37 per share payable to shareholders of record as of the close of business on September 28.

Regarding JV returns, the second quarter dividend yield on our equity in the JV was about 15%, down from the 19% achieved in the first quarter. But as I mentioned on last quarter's call, we expected this normalization following some one-time items in the first quarter, and we expect to achieve similar mid-teen results in future quarters. That concludes our prepared remarks. Thank you everyone for joining us today. And with that, I'll ask the operator to open the line for questions.

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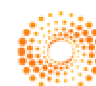

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QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Fin O'Shea with Wells Fargo Securities.

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

I guess, just to start. Broadly, you highlighted in sort of the platform growth in your ability to spread deals around your various funds. The bill origination sizes in CGBD for your larger deals looked roughly similar, so can you give some color on are you winning larger shares of consistent nature deals? Or are you going up to larger EBITDAR enterprise value for example type companies?

Jeff Levin

Sure. Thanks for the question, Fin. It's Jeff Levin. Our origination strategy hasn't changed in terms of the target market, the sponsors and the size of the businesses that we look to finance. The ability, though, to commit to the entire financing anywhere between $100 million and $300 million or so in a single name allows us to drive better terms have more impact on economics and widen the deal funnel as well as I referenced. Sponsors, in certain instances, show deals to only a few different lenders that can provide certainty and can do it quickly, to derisk the liability side of an LBO. And so we, given the growth the platform across co-mingled funds and estimates across our credit platforms here, we're able to commit much larger quantums than we could have even 1 year or 2 years ago and be able to drive better risk-adjusted returns. And the diversification across the various pools of capital, given the size of the balance sheet, we're able to continue to drive typical positions of anywhere between 1% and 2% given the growth of the business.

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

Okay, very well. Makes sense. And on -- is there -- is this intertwined with your higher arranger fees as outlined this quarter? Or was there some sort of one-off? Should we expect that to remain consistent? Or is this kind of a pop quarter?

Jeff Levin

Yes, I think -- I'm sorry, am I good?

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

Hey, Fin, it's Mike. Well, thanks for the question. I would view on the fee income this quarter as a bit of an anomaly. We don't look at that as a primary source of income, although there's clearly opportunities there. But that's not something that we look at in driving the overall strategy.

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

Okay, very well. One more. On the CLO upsizing, is that the credit fund? Or is that the balance sheet CLO? Sorry, I missed that one?

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

Hey, Fin. It's Tom. That's the balance sheet CLO.

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

Okay. So does that mean you refinanced it? And the the SEC issue, I'm sure you're familiar with, I'm less so on the nuances. But in terms of the SEC not allowing the 40 act vehicle, et cetera to run CLO financing, is that solved at this point? Or did your upsize, was that outside of the framework for the SEC rule there?

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

No, that was solved on our end for the risk retention issues that, that previously had, I guess, delayed activity in the market.

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

Okay, very well. Just one more question on -- what's the name? Sorry. Product Quest, it looks like you paid down, if I'm correct, you paid down the front end of the unit tranche financing? Did this hit a buyout trigger type provision? Or is this something that kind of naturally wound down given it's a little bit seasoned here?

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

No, Fin. On that transaction, you see 2 line items. One is a super priority revolver that all the lenders contributed to about a year ago, that's the first out piece. That's independent from the original unit tranche loan that we made back in 2015. The original loan from 2015 where we hold the last outrisk, that remains in place today. That's the position that you see that's just experienced markdown sequentially in the quarter.

Operator

(Operator Instructions) Our next question comes from Rick Shane with JPMorgan.

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

Hey, guys. it's Melissa on for Rick today. Quick question for you about potential impact from increased and allowed leverage? Are you thinking that your average hold size could skew upwards as a result of this, especially given the breadth of the platform across Carlyle that you guys highlighted just few minutes ago?

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

Melissa, it's Mike. Thanks for the question. Melissa, we look at the increased leverage opportunity in a couple of ways. First and foremost, as I mentioned in my comments, a nice cushion to the regulatory leverage limit, and that certainly as we look at potential increased volatile markets impact on valuation, that's a nice thing to have. As we consider putting on additional leverage, we've always considered where we are today, which is about 0.76 debt-to-equity, comfortably moving into the 1.3x to 1.4x. So just mathematically, that creates for us $700 million to $800 million of capacity, if you will, and we look at it in that context. So the capacity, in terms of single holds or individual holds with respect to the BDC, grows in a linear manner relative to that. So if holding all things -- -- holding all other things constant, if you look at just applying a leverage to our portfolio today of about $2 billion, taking it to 2.8 within the constraints of the leverage limits as we looked to apply them would simply allow for that increased commitment size in a linear manner from where we are today based on that sort of 30% increase in overall portfolio size.

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

Okay, okay. And then one follow up, do you guys have any line of sight into any large expected repayments or exits that you're willing to address for 3Q?

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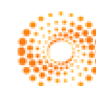

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Thomas M. Hennigan - *TCG BDC, Inc. - CFO, Chief Risk Officer and Head of Underwriting & Portfolio Management*

Hey, Melissa. This is Tom. I'd say that in the regular course, there are expected repayments, but I think our active pipeline should result in net positive deployment for the quarter. Nothing of note to significantly impact our earnings.

Operator

Ladies and gentlemen, thank you for participating in today's question-and-answer portion of the call. I would now like to turn the call back over to management for any closing remarks.

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

Thank you. And thanks, everyone, for joining. We really appreciate your time this morning. If you have further questions, please don't hesitate to reach out to us. We'd be happy to speak with you. But again, thanks. Enjoy the rest of your summer.

Operator

Ladies and gentlemen, thank you for participating in today's call. This does conclude the program. You may all disconnect, and have a wonderful day.

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