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CGBD - Q4 2021 TCG BDC Inc Earnings Call

EVENT DATE/TIME: FEBRUARY 23, 2022 / 4:00PM GMT

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PRESENTATION

Operator

Good day, and thank you for standing by. Welcome to the TCG BDC, Inc. Fourth Quarter 2021 Earnings Call. (Operator Instructions) Please be advised that this call is being recorded. (Operator Instructions)

I'd now like to hand the conference over to your host today, Head of Investor Relations, Allison Rudary. Please go ahead.

Allison Rudary - TCG BDC, Inc. - Head, IR

Good morning, and welcome to TCG BDC's Fourth Quarter 2021 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 they 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 forward-looking statements at any time.

And with that, I'll turn the call over to our Chief Executive Officer, Linda Pace.

Linda Pace - TCG BDC, Inc. - Chairperson, CEO & President

Thank you, Allison, and good morning, everyone, and thank you all for joining us on our call this morning to discuss our fourth quarter and full year 2021 results. Joining me on today's call is our Chief Investment Officer, Taylor Boswell; and our Chief Financial Officer, Tom Hennigan.

I'm going to focus my remarks today on 3 topics. First, I want to touch on this quarter's results. Second, I'll highlight some of the momentum of the last year. And finally, I'll conclude with some thoughts on our positioning for 2022.

Let me begin with this quarter's financial results, which demonstrated continued strength across the board. We again generated solid earnings with net investment income of $0.40 per common share, while declaring $0.40 in total dividends, which represents an annualized yield on our stock of over 11%.

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Net asset value per share of $16.91 saw a positive progression for the 7th consecutive quarter, up 1.6% from Q3 '21. As we will detail later, strengthening credit performance, especially in our nonaccrual and watch list names drove most of this increase.

SolAero, a nonaccrual name we have been invested in for 7 years and been working out for 3 provided the largest impact. In the first quarter, we exited the position and expect another meaningful boost to Q1 '22 performance and a reduction in our nonaccrual rates as a result.

As we have said before, the recovery of our watch list and nonaccrual names remains a significant tailwind for performance. During the fourth quarter, given the continued attractive returns available, we purchased $7.8 million of our common stock, resulting in $0.03 of accretion to net asset value.

Since we launched our program in late 2018, we have repurchased over $125 million of stock, which represents nearly 15% of the total shares outstanding, demonstrating our ongoing commitment to shareholder returns.

On the investment front, we funded $236 million in the fourth quarter, reflecting the robust deal environment in and the deep origination capabilities of Carlyle's platform. We had repayments of strategic sales of $272 million and ended the year with just over $1.9 billion of investments. This is a very comfortable funded position, allowing us to be highly selective and defensively oriented on new investments.

Next, I'd like to reflect for a moment on 2021's full year results. Simply put, it was a great year for our business with strong income delivery, substantial NAV growth and outstanding stock performance. We posted full year net investment income of $1.53, considerably outearning our base dividend each quarter.

We paid a $1.50 in dividends, representing a 9.7% yield on NAV and a 14.6% yield on the stock price as measured from the beginning of 2021. We grew our NAV almost 10% in 2021 and 2.2% since year-end 2019, reflecting excellent results through the COVID cycle.

And our shareholders of January 1, 2021, received a full year return of almost 50%, inclusive of reinvested dividends. We're proud of this performance, which we view as amongst the best in the industry for conservative lending focused BDCs. We're confident it reflects not only the strong macroeconomic backdrop of 2021, but also the resilience of our investing approach, the benefits offered by Carlyle's platform and the hard work of the large and talented team. We thank each of them for their efforts.

As we begin another year, our investment objective, the delivery of sustainable income to our shareholders hasn't changed. But the investment environment is both changing and getting more complicated. We've been investing in leveraged credit for over 2 decades here at Carlyle. And our approach has been tested through many cycles, a focus on senior secured debt, the extraction of illiquidity premium from the true middle market, harnessing our platform to drive competitive advantages at all stages of our process and finally safe and defensive portfolio construction.

All of these position us well to deliver again in 2022 for our shareholders. Thanks for joining us this morning.

I'd like to now hand the call over to Taylor Boswell.

Taylor Boswell - TCG BDC, Inc. - CIO

Thanks, Linda. As usual, I'll begin today by sharing some macroeconomic perspectives derived from our global investment footprint. And after that, I'd like to spend a few moments detailing the investment set up as we see it for CGBD in 2022.

Inflation is understandably our focused topic today. In short, it remains high, and our portfolio data provide little reason to expect price pressures to abate meaningfully anytime soon. Capacity constraints continue to bide from inventories to shipping to labor.

The good news is that we're seeing cost increases largely being passed on to end customers. While this is positive for the portfolio's gross margins, near-term financials and credit performance, it further complicates the inflation outlook and suggests more cumulative Fed tightening may be necessary.

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In markets, we are, of course, seeing a meaningful shift in forward rate expectations. Thus far, floating rate credit, which comprises the vast majority of our portfolio, has been largely unaffected. While the sell-off in high-yield bonds can be almost entirely explained by rate risk rather than credit spreads.

Equity market volatility on the other hand has risen with treasury market volatility. Returns in the most rate-sensitive equity categories, loss-making and long-duration growth stories are down significantly. Conversely, the equity assets most sensitized the near-term economic outlook, companies with more traditional cash flow-based valuations and shorter investment horizons have actually held up quite well.

So despite this volatility, equity markets seemed to be telling us the same thing as credit markets. Liquidity conditions and the valuation environment are shifting. The fears of recession are not yetdriving markets.

Shifting back to CGBD. As Linda noted, 2021 was undeniably a great year for the company, with strong income delivery, good NAV growth and outstanding stock performance. But of course, what's next should always be our focus. Our investment objective remains the delivery of sustainable income. And looking forward, we are equally optimistic about our prospects for both fundamental and stock performance in 2022.

Allow me to fill into the building blocks. First, fundamental corporate performance and credit. 2021 was a year of strong, cyclical recovery for corporates and tremendous liquidity tailwinds across markets, which grew its performance across nearly all investment strategies.

2022 promises to be more complicated and is likely to demonstrate slower but still positive cyclical earnings growth prospects with inflationary pressures across sectors as well as rising rates and the more balanced liquidity conditions they engender.

At Carlyle, we welcome this environment, as it offers substantial opportunity for discerning investors to differentiate their performance. We're confident the sourcing in credit (inaudible) through our competitively advantaged platform will continue to deliver through these cycles.

Second, yield and income. We continue to find attractive absolute yields of strong investment relative value in our strategy through middle markets senior lending. The source of that return is the structural illiquidity premium we access when not forced to compete with traditional broadly syndicated loan and high-yield markets.

Alongside that core, our complementary and opportunistic efforts in junior investing, ABL, recurring revenue finance, non-sponsored lending and other areas offer both yield enhancement and risk diversification benefits.

Of course, with 80% of our loans invested in floating rate instruments, we're significantly insulated from the risk of rising rates. Our borrowers typically have meaningful cash flow to absorb increased financing cost, limiting credit impacts. While all else equal, returns on our assets will increase.

As Tom will detail later, the current path of the forward LIBOR curve implies that we will quickly pass-through any headwind from LIBOR floors sometime in the third quarter after which we would see increasing returns on the portfolio.

We're pleased to have this benefit. But that said it's an important time to reiterate the following. We are conservative investors here at Carlyle. Our shareholders hire us to generate sustainable income, which we do principally by extracting structural illiquidity premium and tightly managing credit performance.

We do not view it as our mandate at CGBD to make macro bets on the interest rate curve. As we have always done, we will continue to appropriately match and balance our funding profile to our assets to ensure overall stability of income through cycles.

Third, our watch list and nonaccruals. As we stated last year, we've been working these assets for a long time, years in most cases. And we are very comfortable they now rest on a strong footing. In fact, as you see in our results today and are likely to see again in the coming quarters, these investments are proving to be net assets, not liabilities for CGBD's performance.

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In this quarter, I'll highlight SolAero, a loan made in 2014 that has been on nonaccrual since the end of the second quarter of 2018. To be sure, this investment did not perform as expected. But due to the strong capabilities and persistent efforts of our workout team, we've been able to manage this underperforming investment to a solid outcome.

In Q4 '21, SolAero accounted for 14% of our nonaccrual investments at fair value after a $6 million markup. In Q1 '22, having now sold the business, this division will deliver an incremental $9 million of gains. Behind SolAero, we continue to work dermatology associates and direct travel, both of which have credible path to outperformance in 2022, offering further potential NAV and earnings upside, all else equal.

Finally, a comment on our stock. We are approaching 3 years since Linda and I joined Tom to lead CGBD's investment effort. Since that time, CGBD's fundamental return, our change in NAV plus our dividends paid has been solid, comfortably in the top path of the industry and top quartile in more recent periods, while we have been delivering against our primary investment objective of generating sustainable income.

Despite this, our stock can still be acquired with over 2% incremental dividend yield or an approximate 15% discount on price to NAV to the industry. We believe this provides a compelling margin and safety for our investors who want the attractive, sustainable income.

We're confident that over time, investors will see the same strong fundamental performance we do and valuation reversion will offer further upside to current shareholders. In the meantime, we expect to continue to be active repurchasers of our shares.

With that, I'd like to turn it over to Tom.

Thomas M. Hennigan - TCG BDC, Inc. - CFO & Chief Risk Officer

Thank you, Taylor. Today, I'll begin with a review of our fourth quarter earnings. Then I'll provide further detail on our balance sheet positioning and conclude with a discussion of our portfolio performance, including some very positive developments in our some of our historically underperforming assets.

As Linda previewed, we had another strong quarter on the earnings front. Total investment income for the fourth quarter was $44 million, up marginally from prior quarter. The primary driver was an increase in prepayment fees and OID accretion from a higher level of repayment activity.

Core interest income on our investment book was down modestly due to a lower average investment balance, while income from the 2 JVs again remained stable versus prior quarter levels. Total expenses were flat at $22 million in the quarter. The result was net investment income for the fourth quarter of $22 million or $0.40 per common share. That's our highest level since March 2020.

On February 18th, our Board of Directors declared the dividends for the first quarter of 2022 at a total level of $0.40 per share. That comprises the $0.32 base dividend plus an $0.08 supplemental, which is payable to shareholders of record as the close of business on March 31.

I may sound like a broken record with this. As we look forward into 2022, we remain highly confident in our ability to comfortably deliver that $0.32 base dividend plus continue the sizeable supplemental dividends.

Taylor noted the impact of rising rates. Given most of our loans have LIBOR floors while our floating rate debt does not, based on the most recent curves, rising rates will result in mild earnings headwinds in the near term. However, the current curves also indicate benchmark rates will quickly become a positive earnings driver.

By the end of 2022, we begin to see a net positive impact. And for every 33 basis points of additional increase in LIBOR, we'll experience a $0.01 increase in NII each quarter. In addition, we also expect a positive earnings impact from the improvement in our level of nonaccruals. I'll touch on that point in more detail later.

Moving on to the performance of our 2 JVs. Total dividend income was again $7.5 million in the quarter, in line with the last few quarters. On a combined basis, our dividend yield from the JVs was again about 11%, so continued stability. Onto valuations, our total aggregate realized and

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unrealized net gain was $12 million for the quarter, the 7th consecutive quarter of positive performance following the drop in the first quarter of 2020.

First, performing lower COVID-impacted names plus our equity investments in the JVs, increased in value of about $2 million compared to 9/30. The largest component was $8 million in gains from our equity book, offset by a $5 million decline in the value of our investment in MMCF I JV. I'll note the decline in the JV's value was driven by lower leverage of the vehicle, not underlying credit.

Next is the moderate to heavier COVID-impacted gains. Valuations for this category were flat for the quarter as we saw overall stability in the underlying fundamentals in this group. The final category, assets that have been underperforming pre-pandemic were up $9 million, marking the 7th consecutive quarter of stability or improvement. This was driven primarily by SolAero and continued positive migration in dermatology associates.

Next, I'll touch briefly on our financing facilities and leverage. We continue to be very well-positioned with the right side of our balance sheet. Statutory leverage was about 1.2x, while net financial leverage was about 1.0. So we're still sitting close to the lower end of our target range, giving us flexibility to invest in attractive new investment opportunities.

I'll finish with a review of the portfolio and related activity. We continue to see overall stability and improvement in credit quality across the book, specifically in some of the positions with more severe historical credit issues. The total fair value of transactions risk-rated 3 to 5, indicating some level of downgrades since we made the investment, improved again this quarter by $15 million in the aggregate.

Total nonaccruals increased to 4% based on fair value, but that's actually a good thing because our valuations for these assets improved during the quarter. Last quarter, we said we saw a path to both NII expansion and increased recovery from our nonaccruals. In the fourth quarter, we had an increase in fair value of our investment in SolAero from a mark of 38 to 90, accounting for a $6 million unrealized gain.

That was based on a potential sale of the business. And we're very pleased to say that sale was consummated earlier this quarter with the incremental gain on our debt and equity above our 12/31 valuation totaling almost $9 million or $0.18 per share.

You'll see that benefit in our results for the first quarter of 2022, including a reduction in nonaccruals of about 60 basis points on both a cost and fair value basis. And as Taylor noted, we continue to work hard on our other watch-list names and see a path for further reduction in nonaccrual levels later in the year as these processes play out.

With that, back to Linda for some closing remarks.

Linda Pace - TCG BDC, Inc. - Chairperson, CEO & President

Thanks, Tom. Before I turn the call over to the operator, I'd like to reiterate that delivering a sustainable and attractive dividend to our shareholders alongside a stable or growing NAV remains our top priority. Since we changed our dividend policy in the third quarter of 2020 to include a base dividend of $0.32 plus a supplemental dividend, we've earned and distributed between $0.36 and $0.40 a share per quarter.

Our shareholders should have a high degree of confidence that future quarterly payments will continue in this range. And that we will continue to pay out the excess earnings over and above our $0.32 base dividend.

Thank you for joining us today. I'd like to now hand the call over to the operator to take your questions.

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QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our next question -- our first question comes from Melissa Wedel from JPMorgan.

Melissa Marie Wedel - JPMorgan Chase & Co, Research Division - Analyst

Lots to digest in this quarter end with the update you provided this morning. Given the conversation you had about the interest rate outlook and given the magnitude of NII performance above the base dividend, thought it would be helpful to kind of explore your thinking around at what point you might revisit the discussion around the level of the base dividend, potentially increasing that over time.

Thomas M. Hennigan - TCG BDC, Inc. - CFO & Chief Risk Officer

Yes. Melissa, Tom Hennigan, thanks for the question. We feel very comfortable with that $0.32 dividend, and we expect to continue to exceed that as we've noted and continue to note. There certainly are some near-term headwinds from the interest rate curve. We think we'll be quickly through that in the next couple of quarters. And then when you look at the curve, it really will be the fourth quarter where we'll start to see a positive impact on earnings for all else equal from the interest rate curve.

We also see upside from our 2 remaining large nonaccrual names. So overall, very positive signs. We feel very comfortable with those levels. And certainly, as the year plays out, it's something we look at. But as of right now, there is no intention to increase that base dividend as we sit here today.

Linda Pace - TCG BDC, Inc. - Chairperson, CEO & President

Yes. Melissa, it's Linda. Let me just chime in because your question is one that obviously we ask ourselves every quarter. And we're never going to have perfect visibility. But I think as Tom said and as Taylor pointed out in his discussion, we think there's going to be a lot going on this year. Some of it's really good in terms of fundamentals in our portfolio, and some of it is unknown vis-a-vis the macro environment and the interest rate environment.

And really we think the best thing for shareholders right now is to just give them a high degree of predictability in a very unpredictable world that we think is where we are in 2022. So we're going to stay with our current dividend policy today, but feel free to keep asking that question as time goes on.

Melissa Marie Wedel - JPMorgan Chase & Co, Research Division - Analyst

Noted. One follow-up. On the repurchase activity as we look at it over the last few quarters, it's been pretty consistently in the $7 million to $8 million range for the last 3 quarters, certainly sounds like you're well aware of the value there given trading levels currently. Given where portfolio leverage is, given the opportunity set right now, is your thinking evolving at all on the level or pace of deployment on repurchases over the next few quarters given the remaining capacity on the existing authorization?

Thomas M. Hennigan - TCG BDC, Inc. - CFO & Chief Risk Officer

Melissa, it's Tom again. I think that based on -- we've been trading in we'll call it the mid-80s range, and we've been stuck there for the last couple of quarters. And we think that at that level, we're comfortable at the current level, so I don't see any change following to the repurchases.

So I think that we certainly would hope that based on looking at the positive this quarter as our price creeps up towards the 90% of NAV range. That's where I think that you may see the decline in those open repurchase. But right now, we're comfortable with that modest level.

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We'll put that modest level we want to be in the market, consistent purchases. That's what we've been in the last number of quarters as we've been in like we call the mid-80s trading range.

Taylor Boswell - TCG BDC, Inc. - CIO

And Melissa, it's Taylor. I mean you'll hear a comments read through the answers to both of your last questions, which is we are just super-focused on stability and consistency.

Those are the things that we think investors want to see out of us. And we think that there's ample room for us to perform both fundamentally and for our stock to perform. If we just keep delivering solid, consistent performance and that's driving a lot of the philosophy and the response to both those questions.

There's more opportunity on both likely. But with where we sit today, we think investors just want to see us deliver, deliver, deliver quarter in, quarter out.

Operator

(Operator Instructions) And our next question comes from Ryan Lynch from KBW.

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

The first one I wanted to touch on was, can you maybe speak to what was the biggest difference in your successful exit of SolAero that you guys accomplished in Q1 of 2022 and kind of a long progress that you guys made of working through that investment and turning that around versus maybe some of the investments that you guys had in the past that haven't had such a positive outcome?

I know several of those were in the Unitranche program. So maybe it's just where -- how you structured those investments. But I would love to just hear what you guys learned and where you guys thought this investment was -- why this investment was a successful exit turnaround versus maybe some in the past that that were so much.

Taylor Boswell - TCG BDC, Inc. - CIO

Ryan, I think you're referencing the sort of 2018 period when we had some underperformance that was very localized on credit in our cup program. And we took a couple of high severity losses. And that really goes back to sort of the strategic decision around that program, which was very focused on small borrowers and junior debt.

And when you look at our current nonaccrual portfolio, it's mostly first lien assets of more scaled businesses at this point. And you've heard us say previously that we have the capabilities to work those assets over long periods of time to drive maximum value creation.

We don't need to punt them or manage around them in a shorter time frame. And so in the first case, 3 years ago, however many years that was -- those were losses that were unavoidable given the strategic choice around them.

In this case, this is more sort of the natural outcome with solid first lien investing and good workout capabilities. Tom, I don't know if you want to pick up any details around SolAero from there.

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Thomas M. Hennigan - TCG BDC, Inc. - CFO & Chief Risk Officer

What I'd add is the similarity SolAero and our other 2 watch-list nonaccrual names is -- were first lien, so the lenders effectively control their destiny. Second is we believe and support these businesses, and we've done so with capital. And third is with the patience point is we're not in a rush. We're maximizing value over time by doing the right thing, getting the right management team, the right Board of Directors using other Carlyle resources and those are similarities with the various credits.

And we used all those for the SolAero investment. We were the largest lender. We are the largest equity holder ultimately, and we help drive the turnaround in that business. But I think patience is providing capital when some other lenders maybe were not willing to provide capital. And there's patience in getting and in exiting we think at the right time.

Linda Pace - TCG BDC, Inc. - Chairperson, CEO & President

And Ryan, even when we're not the biggest, we tend to have a lead role in these workouts, largely because of the resources that Carlyle brings to the table. Obviously, given our private equity background, we're good at determining value. And we have resources to source Board members and management teams and a plethora of other kind of things that we can bring to the table. So given that we have that capability, in the names in SolAero and in the other 2 names, we see value over and above where things are trading, if you will. So we're happy to be patient and work them out.

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

Okay. That's helpful commentary on that. Switching gears a little bit, Taylor, in some of your prepared remarks, you talked about which is no surprise, labor -- or excuse me, inflation, whether it's input cost or labor inflation sort of being probably the biggest headwinds that businesses are managing through today and trying to pass along those costs.

When I look at your year-on-year the current 2 -- the largest nonaccruals in your portfolio grown growth and direct travel, I wouldn't think that those would inflationary pressures would be huge headwinds to that business. But I'd love to hear your comments on how do you think those 2 businesses are in particularly positioned for kind of rising inflation expectations?

And then, also maybe broadly, are there any particular companies or industries or how are you just generally feeling about CGBD's portfolios ability for your underlying portfolio companies to manage through the kind of a high inflationary environment?

Taylor Boswell - TCG BDC, Inc. - CIO

Yes. So on the first question first, those 2 names, just to give you a sense of them. One of them is a diversified set of scaled dermatology practices. The other is a corporate services provider. And neither of them are having notable inflationary impacts on their performance. Both of them, frankly, have far more opportunity from the combination of inherent operational improvement and macroeconomic recovery to overwhelm any marginal impacts they may feel from inflation.

So I think that those 2 businesses are really kind of ride in the curve to recovery pretty comfortably at this point, Ryan. And that's why we are stepping forward and saying that we think we have plenty of opportunity for continued positive performance out of those names as 2022 rolls forward. In the larger conversation about credit, listen, we've got a highly diversified book and to suggest that we aren't seeing the impacts of inflation would be completely disingenuous, and then we always try to be very direct with people here.

Inflation is real, and it's in the portfolios. But we see -- we're not seeing any evolving risk to our forward credit performance from inflation because pass-through is real. And generally speaking, borrowers are achieving pass-through of their increased costs.

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The problem with that for all of us, of course, is that's a loop, right? The fact that in rising costs are being passed through is what's creating inflation. And so I think that a lot of those pressures are flowing into the macro and liquidity environment more than they're flowing into fundamental corporate credit performance right now, Ryan. That's what we're seeing across our portfolios, not just in CGBD, but Carlyle generally.

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

Great. That's helpful details on those specific companies and also broad on your portfolio to definitely understand that we're going to be inpatient issues on all businesses today. That's all for me. I appreciate the time today and again congrats on the nice quarter and more importantly congrats on really the nice 2021.

Linda Pace - TCG BDC, Inc. - Chairperson, CEO & President

Thanks, Ryan.

Operator

And I am showing no further questions. I would now like to turn the call -- actually, pardon me. We have a question from Derek Hewett from Bank of America.

Derek Russell Hewett - BofA Securities, Research Division - VP

Congrats on the good quarter. Could you comment on any updated thoughts on the preferred? And should we expect any sort of either an announcement or any sort of movement on that preferred issuance to give the market a little bit more certainty?

Linda Pace - TCG BDC, Inc. - Chairperson, CEO & President

Sure, Derek. It's Linda. Thanks for your question. And shorter answer is not yet. Just to maybe reiterate and a little bit of background on the preferred. If you recall, it was put in at a very volatile time in the market and it was really a nice show of support from the Carlyle Group.

As we sit here today with the market having recovered as much as it has, we're still pretty comfortable having it in our capital structure. It's just to remind you 7% cash pay. And when you compare that to the yield on our common stock, it's pretty attractive for us and really accretive we think to the overall balance sheet.

And it's $50 million. So it's not something that's kind of moving the needle for us. And as we sit here today, we sort of like where it sits in the capital structure. So obviously it's there. There are some call dates and whatever that will come up eventually and we'll address that.

But at this point in time, you should think that it's just going to be, as Taylor said, and using his words of stability and consistency that applies to the pref too. So it's in our balance sheet, and you should expect it to be there for a bit.

Operator

And I'm showing no further questions. I would now like to turn the call back over to Linda Pace for closing remarks.

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Linda Pace - TCG BDC, Inc. - Chairperson, CEO & President

Thank you, everyone, for joining us today. Appreciate your time and your questions. And we look forward to talking to you in the spring. Have a good day.

Operator

Thank you. This concludes today's conference call. Thank you for participating. You may now disconnect.

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