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PRESENTATION

Operator

Good day, and thank you for standing by. Welcome to the TCG BDC, Inc. Third Quarter 2021 Earnings Call. At this time, all participants are in a listen-only mode. After the speaker's presentation, there will be a question-and-answer session. (Operator Instructions) Please be advised that today's conference is being recorded. (Operator Instructions).

I would now like to hand the conference over to your speaker today, Allison Rudary. Please go ahead.

Allison Rudary - TCG BDC,Inc. - Investor Relations

Good morning, and welcome to TCG BDC's Third 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 third quarter 2021 results. Joining me on today's call is our Chief Investment Officer, Taylor Boswell; and our Chief Financial Officer, Tom Hennigan.

I'd like to focus my remarks today on three areas. First, I'll provide an overview of this quarter's strong financial results; second, I'll touch on the portfolio and credit highlights. And finally, I want to conclude with some thoughts on our current positioning. Let me begin with an overview of this quarter's strong financial results.

We ended the quarter with net asset value per share of $16.65, up $0.51, or 3.2%, from the $16.14 we reported last quarter. Notably, our NAV now sits above what we reported in the fourth quarter of 2019, the final quarter before the onset of the global health crisis.

We took aggressive action to manage our portfolio throughout the pandemic, and we are very pleased to see our team's hard work reflected in our results. We again generated strong earnings this quarter, with net investment income of $0.39 per common share. We've declared a total dividend of $0.39, which represents a trailing 12-month dividend yield of 10.6% on our common stock and 9% on our net asset value. In line with our dividend policy, investors can expect us to distribute substantially all of the excess income earned over our base $0.32 dividend.

This quarter, we repurchased $6.8 million of our common stock, resulting in $0.02 of accretion to net asset value. Recently, our board of directors reapproved our stock repurchase authorization for $150 million, and at our stock's current valuation, we will continue to be purchasers of our common shares.

I'll turn now to this quarter's investment activity in the portfolio. As you might imagine, given the continued strength in our markets, we posted another quarter of robust originations. We funded $270 million of new investments across an array of new and existing borrowers. Currently, the portfolio stands at just under $2 billion, and leverage remains in line with our target. As we look forward, our pipeline is healthy, and we are confident in our ability to source attractive investments in this market.

Credit fundamentals in the portfolio remain solid, and those investments most impacted by COVID continue to demonstrate cyclical recovery. Our internal risk ratings again improved, as did the performance of our watch-list credits. We expect continued positive fundamental performance going forward and see opportunity in 2022 for improvements in our nonaccrual investments.

Finally, allow me to reflect back on the last few years at CGBD. When Taylor, Tom, and I took the helm in the second quarter of 2019, reestablishing strong investment performance was our top priority. On this front, I'm extremely pleased with the results our team has demonstrated. We've passed through a difficult cycle, and our NAV has grown across that period, while our earnings remain comfortably in excess of our base dividend. Our investment objective is the delivery of sustainable income, and we have been consistently delivering against that goal.

Going forward, we're fortunate to operate in attractive markets with both secular growth and strong relative investment value, but the cycle is advancing, and there is ample competition. As you've heard and will continue to hear from us, our strategy to address this is to fully leverage our primary competitive advantage, the Carlyle platform. We focus our efforts on how best to use our platform to drive edge at each step of our investment process, from origination to credit to portfolio management. As we drive and deepen these initiatives, we're confident we can maintain a high degree of investment selectivity and regularly identify conviction investments, all while bringing a safe and defensive approach to portfolio construction. We will continue to focus on the long-term performance of the business, with the goal of delivering attractive dividends and NAV stability to our shareholders.

I'd like to hand the call now over to our Chief Investment Officer, Taylor Boswell.

Taylor Boswell - TCG BDC, Inc. - CIO

Good morning, everyone. It's nice to be with you again, and we're pleased to report another strong quarter of performance at CGBD. Today, we'll touch on macro and markets per usual, then I'd like to spend a few minutes on how we apply the benefits of Carlyle's platform to drive our investment success.

Admittedly, it's a more complicated macro environment than the beginning of the year, when there were fewer observable risks to cyclical recovery. We saw the pace of global growth weaken in the third quarter due to the COVID-19 Delta variant and the persistence of global supply chain disruptions. The late 2020 and early 2021 boom in durable goods spending liquidated global manufacturing inventories, and restocking has proven difficult due to inadequate capacity in complex global production networks. With these conditions, elevated inflation has proven more persistent than previously anticipated. This has been further fueled in Q3 by sharp increases in global energy prices and elevated shipping costs.

Meanwhile, employee shortages persist, as the U.S. labor force participation rate remains approximately 2% below its pre-pandemic peak. In our portfolio, we're seeing certain instances of rising costs. However, generally, our borrowers are showing the ability to pass-through cost increases, and as such, fundamental performance remains strong. This is consistent with the broader backdrop, where U.S. corporate earnings are expected to rise 30% from year-ago levels.

On the new deal front, we continue to see robust activity across corporate transactional markets, and the third quarter was as busy as any in our history. Both the velocity and volume of this market are remarkable. Of course, velocity is a risk, while volume is an opportunity. We're actively using the latter to mitigate the risk of the former by focusing our efforts on those deals where we have both high conviction and appropriate opportunity to conduct rigorous credit work. All in all, our market continues to offer attractive deployment opportunities for discerning investors.

Last quarter, I discussed how we derive our investment advantage, even in competitive markets, which I'd summarize as follows: first, we have a leading position in true middle-market first-lien lending that forms the core of our portfolios. Second, we complement our core with risk factor diversifying specialty lending capabilities. And third, we utilized the Carlyle platform to create edge at all stages of our investment process. Today, I'll spend some time pulling deeper into that third topic, which has been an enormous focus of ours over the last 2 years.

In sourcing, our platform's large direct origination footprint, an integrated approach materially increased deal volumes at the top of our funnel. Today, we source nearly 1/3 of our deals from adjacent investment efforts within Carlyle's global credit platform, who regularly see transactions more appropriate for our mandate than for their own. Over the last 2 years, as we've deployed and deepened our integrated approach, we have seen hit rates for new deals halve, meaning we are roughly twice as credit selective today as we once were. Top-of-the-funnel breadth not only lets us get more selective at the bottom of our funnel, it also allows us to meaningfully reduce investment-specific risk. As an example, you'll see in the quarter, we booked a new junior debt position in AP Plastics. Given the breadth of our origination footprint, we had this deal in-house over an extended period of time from four different highly-engaged sponsors. This is a regular occurrence in our business, and it allows us to significantly enhance our diligence step, compared to more narrow sourcing efforts.

In diligence, our platform is an even more effective risk reducer. Being part of Carlyle allows us access to expertise across a wide variety of markets, sectors, and geographies, and we build our process to seek that edge in each transaction. For instance, in recent quarters, we've seen an uptick in sponsor interest in digital consultancy businesses, as there are strong secular growth trends underlying this sector. We have a historically strong business services practice in Carlyle credit, and seven digital consultancy deals have hit our direct lending desk in the last 9 months alone.

This is a great place to start, but our work doesn't stop there. When we access the Carlyle platform, we leverage the fact that our private equity teams are also focused on this space and, in fact, own an asset in the sector. We leverage the senior leaders of our IT organization, who have deep, direct expertise contracting with these firms, and we leverage our private equity portfolio companies to understand how they use and view these providers. This gives us both more and more direct expertise to inform our investment judgments, as we seek to both minimize risk and capture opportunity.

Finally, in workouts, we combine the deep and relevant experience of our private equity franchise with our platform's dedicated workouts team. We're not afraid to move aggressively to exit assets in which we have lost faith, but we also have competitively advantaged workout capabilities, from staffing management teams and boards to designing and executing new corporate strategies. As such, we are equally unafraid to hold workout assets. In more instances than not, we find the cost of capital demanded by the market to exit assets undergoing transition is far too high, precisely because potential buyers don't have the same capabilities as we do. So one should expect us to remain invested in these assets for longer periods of time so that we can leverage our capabilities to maximize outcomes. Indeed, you'll find that we've held our current nonaccrual investments for an average of 10 quarters. As we look forward, with several years of hard work behind us, we believe these assets now generally stand on sound fundamental footing.

Hopefully, this helps provide color on how we apply our platform to drive investment edge across our process. Over the last 2 years, we've been working hard to deepen these advantages, and we believe the results of those efforts are beginning to evidence themselves plainly in our investment performance. Our portfolio has passed through the severe shock of COVID and exited with higher NAV than we entered. We have consistently generated an attractive dividend. And as we go forward, continued portfolio recovery offers an opportunity for both income and NAV improvement.

Thanks, as always, for your time and support. Tom?

Thomas M. Hennigan - The Carlyle Group Inc. - CFO & Chief Risk Officer

Thank you, Taylor. I'll begin with a review of our third-quarter earnings, then I'll provide further detail on our balance sheet positioning and conclude with a discussion of our portfolio.

As Linda previewed, we had another impressive quarter on the earnings front. Total investment income for the third quarter was $44 million. That's up from $43 million in the prior quarter. The primary driver was an increase in core interest income on our investment book, partially offset by lower other income. OID accretion from repayments experienced a moderate increase, while income from the two JVs again remained stable versus prior-quarter levels.

Total expenses were up modestly at $22 million in the quarter. The result was net investment income for the third quarter of $21 million, or $0.39 per common share, exceeding both recent performance and the general guidance we provided the last few quarters. On November 1, our board of directors declared the dividends for the fourth quarter of 2021 at a total level of $0.39 per share. That comprises the $0.32 base dividend, plus a $0.07 supplemental, which is payable to shareholders of record as of the close of business on December 31. And similar to prior quarters, as we look forward to the fourth quarter and into 2022, we remain very confident in our ability to comfortably deliver the $0.32 base dividend, plus continue the sizable supplemental dividends.

Moving on to the performance of our two JVs, total dividend income was again $7.5 million, in line with the last 2 quarters. On a combined basis, our dividend yield from the JVs was about 11%. Going forward, we continue to expect stable dividend generation from the two JVs, similar to this quarter's results.

On the valuations, our total aggregate realized and unrealized net gain was $26 million for the quarter, the sixth consecutive quarter of positive performance following the drop in March 2020. And as Linda noted, NAV is now back above December 2019 levels. Using the same buckets I've outlined in prior quarters, we again saw broad-based improvement across each category. First, the performing lower COVID-impacted names, plus our equity investments in the JVs, increasing value of about $14 million compared to 6/30. The largest components were an $8 million increase in the value of our investment in MMCF 1, plus $5 million in gains from our equity co-investment book.

Second, the assets that have been underperforming pre-pandemic, some which have COVID exposure, were up $5 million, marking the sixth consecutive quarter of stability or improvement. The final category is the moderate-to-heavier COVID-impacted names. We continue to see improvement in the underlying financial performance of these borrowers. Collectively, they experienced a net $7 million increase in value. Of note, our investment in First Watch Restaurants, which we marked up during the third quarter, repaid in full during October.

Next, I'll touch 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 1.3x, while net financial leverage was about 1.1x. Both increased modestly quarter-over-quarter, given the net positive deployment in the investment book. Yet we're still sitting close to the lower end of our target range of 1.0 to 1.4, giving us flexibility to invest judiciously in the current robust deal environment.

And regarding the preferred equity issuance for May 2020, as I said in prior quarters, it continues to be a long-term investment by Carlyle in our BDC, so there currently is no intention to convert. I'll also note that it accounts for only about 2.5% of our capital structure and is accretive to earnings on an unconverted basis.

I'll finish with a review of our portfolio and related activity. We continue to see overall stability and improvement in credit quality across the book. The total fair value of transactions risk rated 3 to 5, indicating some level of downgrade since we made the investment, approved again this quarter by $16 million in the aggregate. Total nonaccruals were essentially flat at 3.5% based on fair value, and this was the fifth consecutive quarter with no new nonaccruals.

As Taylor detailed, I want to take a moment to reiterate our philosophy on workouts. We have a dedicated workout function and significant resources across Carlyle that we use to maximize recovery when credits turn south. We don't manage our nonaccrual statistics; we manage our nonaccrual assets for maximum value realization. These situations often require the right mix of turnaround experience, incremental capital, and patience, all which we possess. We've used that combination in the past to achieve successful recoveries, and we're following a similar playbook on our current

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nonaccruals: dermatology, direct travel and SolAero. Based on our continued focus and investment over a number of years, all else equal, we see a path to both NII expansion and increased recovery above our 9/30 valuations.

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. We are pleased that we've delivered on this and believe we are very well positioned to continue to do so. Thank you for joining us today, and we here at Carlyle wish you and your families a safe and wonderful start to the holiday season.

I would like to now hand the call over to the operator to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Ryan Lynch from KBW.

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

You gave some commentary in your introduction regarding some supply chain shortages and inflation pressures as being a fairly moderate concern right now in the marketplace, which is understandable. Does that change the specific industries that you guys are focusing on today when you guys are looking to deploy new capital? Or does that just influence the way you guys are due diligence-ing specific companies, making sure that the supply chains are set up well or that they can pass on increasing costs to their end markets.

Taylor Boswell - TCG BDC, Inc. - CIO

Ryan, thanks for the question. It's Taylor. The answer is, absolutely on the latter, maybe a little less so on the former, meaning that it really causes us to focus a lot more on near-term earnings trajectory and proving out the price pass-through mechanisms of the borrowers that we have. That, of course, is a really important part of any underwrite and always will be, and then seeing those demonstrated in the current period, as costs rise, to recapture those and profitability. So I think that it really causes us to kind of double down in those places where you might see those things happening.

And naturally, in an environment like this, you're going to skew a little less towards highly labor-intensive business models, highly energy-intensive business models where you're seeing the most pressure. But it certainly doesn't rule out those sectors, if you have confidence in your ability to underwrite and understand that the pricing capture is happening on the other side of cost pickup.

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

Okay. Understood there. Really, over the last couple of quarters, you guys have had very strong portfolio activity, both on the originations and on the repayment side. It sounds like your pipeline remains pretty strong. I just wanted to know if you could give any color on what you guys are expecting. Are you guys expecting these levels to remain similar in the fourth quarter that we've seen maybe in the third quarter, or to a lesser extent, the second quarter? Or has anything changed as far as market activity or your guys' process that would slow that down?

Taylor Boswell - TCG BDC, Inc. - CIO

Overall, I mean, we're continuing to see very robust levels of activity, and I don't think there's anything that's going to change that. There is a little bit of seasonality in our business, where people kind of try to wrap their transactions before the Christmas holiday season, and then new processes will kind of launch in the new year. But that's very normal and typical, and overall, we don't see anything going on, markets or in our business specifically, that are going to stand in the way right now of this very robust volume environment.

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

Yes. And Ryan, it's Linda. I just would maybe point you to what we look at as sort of a leading indicator in that regard. And we see a lot of capital being raised on the private equity side from folks like Carlyle, all the way down the spectrum to private equity firms that are more focused on the more traditional, middle-market direct lending space as well. So that gives us some confidence that the trajectory of the volumes that we're seeing will have some legs to it.

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

And then, just one more for me. You mentioned you being able to tap into other parts of the Carlyle platform, both from underwriting due diligence, but also, very importantly, to widen the funnel and create better origination opportunities. I think you said, maybe 1/3 of your deal flow is now coming from adjacent strategies across the Carlyle platform. I know the overall credit business is growing at Carlyle, which is benefiting the BDC. I'm just wondering, have there also been investments made, and if you could speak to those made within the direct-lending platform to kind of grow the capabilities and the investment professionals at that platform, in addition to just getting additional deal flow from growth and other strategies across the credit platform?

Taylor Boswell - TCG BDC, Inc. - CIO

Yes. Ryan, it's been an enormous focus of ours over the course of really the last 5 years here at Carlyle, when our credit platform has been significantly investing in private credit markets. And so, if you look across our business, the number of headcount here dedicated to illiquid markets generally has probably doubled over that period of time. And some of that growth falls directly into our narrowly-defined direct lending business. Some of it falls into functional areas that support our business, whether it be our capital markets teams or our research teams or otherwise, and some of it falls in those adjacent businesses. But we really have meaningfully participated as a business in the growth of these industries and shifted our resourcing as a platform dedicated towards these private credit industries over the last 5 years. So the short answer is yes, a lot.

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

Yes. And Ryan, maybe just to give you an anecdote, this morning, I had just a conversational meeting with some of the direct lending team, and there were about a dozen of us in the room. I've been at Carlyle 22 years. I don't think there's been anybody else in that room that's been at Carlyle even 22 months. Everybody had been hired in 2020 and 2021, so really a focus on just growing our resources and growing them in the right way, with people who we think are going to be additive, both on an origination -- from an origination perspective and a credit research perspective.

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

Understood. That's helpful anecdote. Those are all my questions, but I did want to -- before I hopped off, did want to say, congratulations on reaching the milestone of growing your NAV above pre-COVID levels. That's a big accomplishment, certainly, for any lender this environment. So, good work on that, guys.

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

Thanks for recognizing that, Ryan. We really appreciate it.

Operator

Our next question comes from the line of Finian O'Shea from Wells Fargo Securities.

Finian Patrick O'Shea - Wells Fargo Securities, LLC, Research Division - VP and Senior Equity Analyst

Just a question on leverage. Tom, as you pointed out, there's a range of 1 to 1.4, and you're on the lower end. Just any color or context on how willing you are or interested you are in taking advantage of that in today's market, given we're seeing a lot of competition, wage and energy inflation, and so forth? Like how should we think about -- should we think about this runway as a near-term or a longer-term opportunity?

Thomas M. Hennigan - The Carlyle Group Inc. - CFO & Chief Risk Officer

I appreciate the question. It's Tom. You've seen in the last number of quarters we've been running in that right around 1.05, right between 1.0 and 1.1. We're very comfortable at that range right now. Certainly, to the extent we see attractive opportunities in the market, there's room to grow there. But our target right now, for the time being, is remaining right in that current sweet spot where we are now, which certainly gives us the flexibility to increase, if desired, based on the market opportunities.

Operator

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

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

Wanted to touch quickly on the repurchase activity, which seems to have been pretty stable quarter-to-quarter, and it sounds like that certainly, at current levels and a discount to NAV, that's likely to continue in the near term. Curious about how you're thinking about share repurchases headed into '22.

Thomas M. Hennigan - The Carlyle Group Inc. - CFO & Chief Risk Officer

It's Tom. Certainly, we look closely at the level of the discount. And while we've been active buyers over the last number of years, except during the March 2020, the (inaudible) 2020 time frame based on the impact of the pandemic, we've been steady purchases. We anticipate continuing to be steady purchases. But depending on the discount to NAV, you could see that those numbers rightfully -- we think rightly have gone down the last couple of quarters. So we think, based on if we continue to trade in the 80s where we are now, we'll continue at that steady pace, to the extent that NAV, as we anticipate -- as we anticipate that discount should decrease, we should get closer to trading at NAV, you could see those level of repurchases decline.

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

Got it. I appreciate that. And I did have one clarification. I think it was a follow-up on Ryan's question about repayment activity in 4Q. Did you -- I might have missed it. Did you touch on sort of what -- if you expect repayments to continue into the end of the year, similar to what we've seen in the third quarter?

Thomas M. Hennigan - The Carlyle Group Inc. - CFO & Chief Risk Officer

It's Tom. What I'd say is, while the new deal environment, for the reasons Taylor noted, continues to be very robust, we've definitely seen a pickup in repayment activity based on just a really robust M&A environment. Goes to Fin's question about where we are with leverage. As we look at this quarter, as we sit here today, we're probably looking at very robust new deal volume probably being offset by repayments in the book. So we're seeing, I'd say, in the aggregate, steady in terms of overall net-net deployment for the quarter in terms of not looking at too much portfolio growth leverage remaining in the range where we've been.

Taylor Boswell - TCG BDC, Inc. - CIO

It's Taylor, Melissa. I mean, I think that we're feeling very confident, generally, in our ability to originate assets. Our -- frankly, we could take up the funded asset level, I think very comfortably in this environment, if we wanted to. But the focus here, right, is sustainable income generation, and we feel like we're earning at a really nice level right around where we are with the business, and we'll kind of live in this range, as Tom mentioned, as opposed to needing or wanting to drive higher or lower for some other reason.

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

Understood. Very helpful.

Operator

Our next question comes from the line of [Kali Wang] from Citi.

Unidentified Analyst

Wondering if you could talk about how interest rate-sensitive you are, and do you have any thoughts about potential inflationary pressures and how it affects the portfolio that you have?

Thomas M. Hennigan - The Carlyle Group Inc. - CFO & Chief Risk Officer

Yes, sure. [Maureen], it's Tom again. When you look at our portfolio, most of our loans, floating rate and have LIBOR floors. Our debt, on the other hand, we've got our fixed rate tranches of notes. Our notes -- our other -- our revolving credit is floating rate. So, to the extent that LIBOR has been at LIBOR, when it goes to SOFR, is it 10 basis points, is at a low level. To the extent that, that level drifts up to the 1% floor level, you'll see some deterioration in earnings as LIBOR gets closer to that 1% floor. And then, when it goes above the 1%, that's when we start to get some of that back.

So that's where you see the interest rate sensitivity. We have tables in our 10-Q, spelling out the various levels. But in terms of -- we get certainly the benefit of the floors right now. To the extent interest rates go up, our interest expense would increase. We'd have some pressure from that perspective.

Operator

At this time, I'm showing no further questions. I would like to turn the call back over to Linda pace for closing remarks.

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

Well, thanks, everyone, for joining us today. Hope you have a great day, and we'll see you after Q4 earnings. Thank you.

Operator

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