ON24 Operator: 00:05

Good morning and welcome to FS Credit Opportunities Corp.'s first quarter 2023 earnings conference call. Please note that this conference is being recorded. If you would like to ask a question throughout today's conference, please type your question in the ask a question box and click send. At this time, Robert Paun, Head of Investor Relations, will proceed with the introduction. Mr. Paun, you may begin.

Robert Paun: 00:30

Thank you. Good morning and welcome to FS Credit Opportunities Corp.'s first quarter 2023 conference call. Please note that FS Credit Opportunities Corp. may be referred to as “FSCO”, “the fund”, or “the company” throughout the call. Today's conference call is being recorded and an audio replay of the call will be available for 30 days. Replay information is included in a press release that FSCO issued on May 3rd, 2023. In addition, FSCO has posted on its website a presentation containing supplemental financial information with respect to its portfolio and financial performance for the quarter ended March 31st, 2023. A link to today's webcast and the presentation is available on the company's webpage at www.fsinvestments.com under the investor relations tab. Please note that this call is the property of FSCO. Any unauthorized rebroadcast of this call in any form is strictly prohibited.

01:34

Today's conference call includes forward-looking statements with regard to future events, performance, or operations of FSCO. These forward-looking statements are subject to the inherent uncertainties in predicting future results and conditions. Certain factors could cause actual results to differ materially from those projected in these forward looking statements. We ask that you refer to FSCO's most recent filings with the SEC for important factors and risks that could cause actual results or outcomes to differ from these statements. FSCO does not undertake to update its forward looking statements unless required to do so by law. Additionally, information related to past performance, while helpful as an evaluation tool, is not necessarily indicative of future results, the achievement of which cannot be assured. Investors should not view the past performance of FSCO or information about the market as indicative of FSCO's future results.

02:36

In addition, this call will include certain financial measures that have not been prepared in accordance

with generally accepted accounting principles in the U.S., or GAAP. FSCO uses these non-gap financial measures internally in analyzing financial results and believes that the use of these non-GAAP financial measures is useful to investors as an additional tool to evaluate ongoing results and trends, and in comparing FSCO's financial results with other closed-end funds. For such non-gap measures, reconciliations to the most directly comparable GAAP measures can be found in FSCO's Form N-CSR that was filed with SEC on March 1st, 2023. Non-GAAP information should be considered supplemental in nature and should not be considered in isolation or as a substitute for the related financial information prepared in accordance with GAAP. In addition, these non-GAAP measures may not be the same as similarly named measures reported by other companies.

03:44 Speaking on today's call will be Andrew Beckman, Head of Liquid Credit and Special Situations at FS Investments and Portfolio manager for FSCO, and Nick Heilbut, Director of Research for the Liquid Credit and Special Situations Team and Portfolio Manager for FSCO. Also joining us on the phone is Jason Zelesnik, Chief Operating Officer of FSCO. I will now turn the call over to Andrew.

Andrew Beckman: 04:12 Thank you, Robert, and thank you all for joining us today. We are pleased to be with you following our first full quarter as a publicly traded company. FSCO's listing on the New York Stock Exchange last November was a significant milestone for the fund and our stockholders. Next week will mark yet another important milestone as we approach the final stage and completion of the phased listing. As many participants on the call are aware, we implemented a phased approach to listing FSCO's common shares by gradually increasing the supply of shares available for trading in the market. Under the phased approach, one-third of common shares were available for trading last November, an additional one-third of shares were made available for trading 90-days after the listing on February 13th, 2023, and the final one-third of shares will be available for trading next week on May 15th.

05:11 In our view, the discount at which the stock is trading compared to the net asset value is driven by near term selling pressure following the listing, and is not

indicative of the health of the portfolio or the forward return potential of our diversified credit strategy. In fact, the fund's net asset value has increased by approximately 20 basis points during the quarter, after accounting for distributions paid during the quarter. We believe FSCO offers a differentiated value proposition for several key reasons. First, FSCO is one of the largest credit focused closed-end funds in the market. Size and scale matter in credit investing, especially when it comes to maximizing deal flow and achieving economies of scale. Our dynamic strategy provides the flexibility to invest across public and private credit, based on what we believe are the best risk adjusted return opportunities.

06:11

The mix of public and private assets with approximately 60-40 as of quarter end. We believe our origination capabilities within the private markets and focus on providing specialized financing solutions differentiates the fund from other closed-end funds and the BDCs in the market. The fund offers an attractive annualized distribution yield of 9.2%, based on NAV and a current yield of close to 14% based on stock price. It's important to note that the distribution has been fully covered through net investment income since the management of FSCO was brought in-house at FS Investments in January of 2018. Over that time, net investment income has represented 119% of distributions paid to shareholders. The portfolio is weighted to senior secured debt with the focus on first lien debt, which has helped us preserve capital over time. Senior secured debt represented 82% of the portfolio's fair value as of March 31st, 2023. Floating rate assets comprise approximately 62% of the portfolio as of March 31st, 2023, which contributes to the fund's low average duration profile of just under one year.

07:46

Finally, the fund uses a prudent level of leverage to help enhance shareholder returns. Our diversified capital structure provides us with flexibility to invest across asset types and maturities through a mix of revolving term loan and preferred financings. Since many participants joining us today are new to our company and our story, we thought it would be helpful to reintroduce the portfolio management team and reiterate our investment strategy. We will then discuss

the fund's quarterly results before concluding with some perspective on FSCO's outlook.

08:27 To begin, FS Credit Opportunities Corp. is an affiliate of FS Investments, a 35-billion-dollar alternative asset manager headquartered in Philadelphia with offices throughout the U.S., including New York, which is where the FSCO investment team is located. I joined FS Investments in late 2017 to build out the firm's liquid credit and special situations team and manage FSCO. Our team is comprised of 11 dedicated investment professionals with deep expertise in investing in syndicated and private credit, as well as structured products. There's a high degree of continuity across our team with many of us, including Nick and I, working together since our time at Goldman Sachs in the early 2000s. Scott Giardina, our head trader, has been with us since our time at Magnetar and DW Partners. With an average of 16 years' experience, the team has invested across multiple credit cycles, and we draw upon this expertise to source, analyze, and structure a broad universe of investment opportunities.

09:41 A large part of the investment team's DNA is investing in stressed and dislocated markets. While we have a significant amount of distressed experience, distressed investing is not a core focus for FSCO, but we believe our experience and expertise is well suited to assess opportunities and downside risks in today's volatile market. As we think about FSCO's differentiated value proposition, the fund is one of the largest credit focused closed end funds in the market, with over 2 billion in total assets, with access to the infrastructure, relationships, and resources of FS Investments. This allows us to streamline operations, reduce costs, and enhance deal flow and idea generation. For example, the FS Capital Markets Team helps source, negotiate, and structure financing facilities across the entire FS platform, representing over 25 billion in financings. The firm's relationships span across bulge, bracket, and regional banks as well as insurance companies. FS Investments' strong presence in debt and equity capital markets helps drive down borrowing costs and provides FSCO with a broad range of financing options.

11:10 Our reach and scale also helps us source deal flow through these same relationships. Our team can extract significant economies of scale across the legal, finance,

compliance, and operations teams, supporting FSCO and the firm's entire platform of 1940 Act funds.

11:33 While we do not compete for deal flow with the FS BDC franchise, from time to time, it may serve as a source of deal flow for credit profiles that do not fit the more traditional BDC private credit mandate. Most importantly, we benefit from the sharing of collective insights on markets and individual credits, an idea generation that comes with managing over $24 billion of credit as a firm.

12:07 We believe our investment strategy is dynamic and flexible, as we tend to have a differentiated focus than traditional credit funds. We are not constrained by a specific asset class mandate. We can invest across loans, bonds, structured credit, or highly structured equity investments and across fixed and floating rate assets. We look for situations where return premiums exist due to complexity, illiquidity, or as a result of corporate events. These opportunities often require significant expertise and resources to source and analyze due to the complexity of company balance sheets, a lack of publicly available information, or the illiquidity of an asset.

12:56 In private credit, our focus is on financings to unconventional credit profiles outside the focus of banks, traditional BDCs and other conventional lenders. Examples include transitional lending, lending to out of favor industries and companies, and non-sponsored lending. Within public credit, our focus is on event-driven and opportunistic performing credit as opposed to highly liquid credits commonly found in high-yield funds and CLOs.

13:28 In our experience, the opportunities in private and public credit tend to ebb and flow and relative attractiveness can shift meaningfully. Our goal is to dynamically allocate capital to the most attractive opportunities across the credit and business cycle, and we think this leads to enhanced stockholder returns as well as better downside protection to a more confined strategy.

13:58 We believe the flexibility of our strategy and ability to leverage the broader expertise and infrastructure of FS

Investments provides us with a competitive advantage in today's market.

14:10 I'll now turn the call over to Nick to provide thoughts on the markets and discuss our results for the first quarter. Nick.

Nick Heilbut: 14:19 Thanks, Andrew. Macro uncertainties intensified during the quarter, driven by the largest bank failure since the Great Financial Crisis, which led to rapid repricing of fed rate expectations. Despite intra quarter volatility, loan spreads widened just 15 basis points quarter over quarter, while high yield spreads tightened over 30.

14:40 Lower rated credit outperformed in the first quarter. Triple C bonds returned 4.8%, outperforming double B rated bonds by 147 basis points. The divide in performance was more pronounced in the loan market, as triple C rated loans outperformed double B loans by 180 basis points, with triple Cs returning 3.9% and double Bs 2.1% during the quarter.

15:07 Despite stress within the regional bank sector and a more cautious outlook among consumers and businesses, the U.S. economy remains on generally strong footing, with equity markets pricing in a soft landing.

15:19 Looking broadly across the bond and loan markets, leverage and interest coverage metrics are holding steady, yet margin pressure is evident and default rates have ticked up from historically low levels. These metrics are inherently backward looking and the credit worthiness of borrowers will be dictated by future performance, which is difficult to predict in uncertain economic environments such as today.

15:42 As the economic environment evolves, swings in investor sentiment can change quickly, creating market volatility. We remain cautious about the economic outlook and see potential for future volatility, and therefore are less invested than where we would be in a more benign environment. We think maintaining extra buying power is prudent, not only to minimize potential drawdowns, but such volatility often creates dislocations that can create attractive investment opportunities for the fund going forward.

16:13 Turning to the portfolio, net investment activity was nearly flat during the quarter, with sales exits and repayments slightly outpacing purchases. Given the volatility in the broader markets, we selectively rotated out of unsecured debt positions into senior secured debt investments with the capital structures of a few portfolio companies.

16:35 First lien debt investments represented 72% of purchases during the first quarter, while 87% of all investments during the quarter were in senior secured debt. We continue to expect inflation to remain elevated and believe the higher interest rate environment will last longer than some market observers are expecting.

16:57 The rapid rise in base rates over the past year has enhanced the portfolio yield, and we are seeing the benefit of elevated rates passed through to investors as we increase the distribution by approximately 16% in December of last year.

17:12 Floating rate assets comprised 62% of the portfolios fair value as of March 31, 2023. We believe the combination of high current income and low average duration should prove to be an attractive income stream for many investors. Especially during uncertain market environments, our ability to invest across public and private markets allows us to adjust allocations as economic and credit conditions change.

17:38 Private market volume has slowed alongside a decline in M&A activity, as issuers and lenders adjust to an environment of higher rates and falling, yet still elevated inflation. Pricing and terms in the public markets have been quicker to respond to changing investor sentiment compared to the private markets, and we believe some of the most compelling investment opportunities generally skew to the public markets today.

18:04 Given the potential for additional market volatility in the coming months, we continue to prefer senior debt investments with strong documents sourced at attractive discounts and tend to avoid companies that were recent LBOs [leveraged buyouts] because they're often subject to lender versus lender battles for control and tend to be underwritten to aggressive terms with

large EBITDA add-backs that may or may not materialize.

18:28 We believe we are invested in high quality companies with strong fundamentals. Our sector allocations are informed by our bottom up fundamental research and we tend to avoid highly cyclical areas of the economy. We are also invested in credit instruments with appropriate loan to values to ensure ultimate repayment of the obligations even if the environment continues to deteriorate.

18:50 We've constructed the portfolio around these attributes and are confident in the position of the portfolio as well as the opportunity set. We believe the flexibility of our strategy and the expertise of our team have driven strong outperformance versus the loan and high yield bond indices. From January 2018 through March 2023, FSCO outperformed high yield bonds by approximately a hundred basis points per year and loans by 65 basis points per year.

19:21 Performance has been strong on an absolute and risk adjusted basis as demonstrated by our higher sharp ratio compared to the liquid credit benchmarks.

19:29 Turning to FSCOs performance during the quarter, the fund generated net investment income of 18.4 cents per share, driven by the positive impact of rising interest rates and the continued strong performance of the portfolio. Consistent with our distribution policy of delivering a fully funded annualized distribution, the fund's net investment income exceeded the distribution of approximately 15 cents per share paid during the quarter.

19:56 As a result, fund's net asset value increased by approximately 20 basis points quarter over quarter after taking into consideration distributions paid.

20:07 Turning to the liability side of our balance sheet, we believe our cost structure gives us a competitive advantage. It's important to note that the preferred financings are multi-year with the majority of the maturities in 2025 and beyond. Although in the near term, the fund does have $100 million dollars of preferred financings maturing in 2023, we are confident in our ability to address these maturities and

optimize our capital structure. Approximately 52% of drawn leverage is fixed rate and provides us with flexibility in the type of assets that we can borrow against.

[20:45] Finally, the preferred financings provide favorable regulatory treatment versus traditional term or revolving debt facilities. As of March 31, 2023, the fund had approximately $265 million in undrawn debt plus ample cash on hand, which provides us with significant dry powder to deploy in the event that spreads widen further or idiosyncratic opportunities arise driven by short term market dislocations, asset mispricing, or other special situations.

[21:17] I'll now turn the call back to Andrew.

Andrew Beckman: [21:21] Thanks, Nick. Before I begin taking questions, we have one housekeeping note. We expect to reinstate the amended and restated distribution reinvestment plan on May 16th following the listing of the third tranche of shares on the NYSE on May 15th.

[21:38] Once the distribution reinvestment plan is reinstated, registered shareholders who elect to receive cash prior to the listing and still hold their shares with the funds transfer agent will continue to receive cash distributions.

[21:53] In summary, based on our well-positioned portfolio, low average duration, healthy distribution, diversified capital structure, and the flexibility of our strategy, we believe FSCO is a compelling long-term investment opportunity. We will continue to be highly proactive in our efforts to broaden the investor base for FSCO shares in the public markets, with sell-side research analysts, mutual fund managers, private wealth managers, and other private credit and closed-end fund focus managers. Once again, thank you all for joining us today. With that, we will take a brief pause to review the queue before answering your questions.

Robert Paun: [22:46] Thanks, Andrew and Nick. As a reminder, you can submit your questions using the Q&A function on your screen.

And the first question is, where are you seeing the best opportunities in the market right now to deploy capital?

Andrew Beckman: 23:08

Yeah, that's a good question. So, we're seeing opportunities both in the public and private markets. In the private markets, we're seeing some really nice opportunities in non-sponsored private loans. That part of the market has widened significantly and the leverage levels on those deals have come down. Additionally, you can get strong covenants and structural protections. You can also get SOFR floors and have upside to rising rates and protection with declining rates, and also get some nice call protection to lock it in, so in the private markets, that's where we're focused.

23:52

In the public markets, as everyone knows, we invest in both high-yield and syndicated loans. That's generally our universe. High-yield, we're seeing some opportunities in shorter duration event-driven high yield. More generally speaking, we think high yield is a little tight to loans. There continues to be a bid for duration, and if you look at cap structures that have both high-yield bonds and syndicated loans, especially cap structures where they're pari debt-secured bonds, as well as secured loans, the high-yield is often trading tight to loans. So, other than those pockets, we're a bit more focused on loans.

24:34

And in the loan market, it's a tale of two cities. The broadly syndicated loan market, covenants have gotten really bad over the years, leverage levels have also really crept up over the years. The generic deal might be six times levered through its secured part of the capital structure on heavily-adjusted EBITDA. In our view, on average, you're not getting paid for the low credit quality and very weak covenants.

25:10

But there are certain spots within the levered loan market where things are quite dislocated. Loans that CLOs are not willing to own have no home, because as people likely know, CLOs are the major and largest buyer of loans. So, if something doesn't work for a CLO, there's just a significant amount of dispersion, so we've been looking at a lot of credits that just don't work for CLOs that trade really, really wide to the broader oil market.

Robert Paun: 25:49

Great. And just to follow up on the other side of opportunities, what are the biggest areas of risk and

any industries or sectors you're staying away from in today's environment?

Andrew Beckman: 26:02 Sure. So in our view, we think the biggest area of risk right now is the economy, and what happens with the economy. We're at a point where the outlook is very uncertain. Obviously, various investors have different views, but there's a wide difference of opinions in terms of where we could be over the next six to 12 months, and we think that creates a fairly dangerous environment.

26:39 So, we're focused on downside protection and trying to stay away from companies or credits that could really get hurt by a downside cycle. So generally, more defensive industries or companies with lower leverage profiles that can weather an economic slowdown.

Robert Paun: 27:08 Great. And then next question, you mentioned the portfolio is roughly 60% public investments, 40% private. What are the benefits of having both in the portfolio?

Andrew Beckman: 27:21 Sure. So we think the opportunity set ebbs and flows, and one portion of that universe can be much more attractive than other portions of that universe at times, and that allows us to pivot and really to have the best risk-reward in the portfolio. There are times when syndicated credit is just plainly unattractive, and at those times, there could be just tremendous opportunities in private credit and vice versa. So we're not forced to go into investments or sectors or areas of the market that don't have attractive risk-reward profiles by having this larger mandate.

Robert Paun: 28:13 Okay. The next question, are you seeing increased prepayments on loans in the portfolio, and how do you address redeploying excess capital?

Andrew Beckman: 28:24 Sure. So high-level, the market is definitely seeing reduced prepayments on loans, and I think that's because, on average, spreads are likely wider than they were when a company took out its original loan, so just a pure refinancing doesn't make sense unless you have to do that. And M&A activity has fallen very significantly because the cost to finance that M&A has gone up both because of interest rates and spreads, and it's also a difficult economic outlook to kind of underwrite M&A.

So, for that reason, the market's seen a fairly large slowdown in prepayments.

29:12 Oddly, I'd say in the year-to-date period, we've seen a bit of an increase in prepayments in our portfolio. Our strategies tend to be a little bit less traditional, and a lot of what we do on the private side is transitional lending, and that transitional lending has kind of excess spread and excess return associated with it because of something kind of idiosyncratic.

29:43 And we've seen a number of those investments deal with their kind of idiosyncratic risks in a very positive way, which has given them the ability to kind of refi into more traditional capital structures and cause prepayments in our portfolio. But generally, it's a good thing. There's convexity to getting prepaid early, and we've been redeploying that capital into other opportunities that the market is giving us.

Robert Paun: 30:21 Okay. The next question is on interest rates. How has the recent environment of rising interest rates affected the fund and the performance in the portfolio?

Andrew Beckman: 30:32 There's two ways that rising interest rates have affected the fund. One is the individual portfolio companies themselves, and interest coverage is getting tighter for individual businesses that have floating rate capital structures that aren't hedged, which are most businesses.

30:57 Our LTVs are not crazy, and generally speaking, the interest coverage deteriorating has not been a major issue for any of our portfolio companies, but it is something that we're monitoring. Remember, the deterioration is tied to our SOFR moves primarily, and not the curve, and just based on what's priced into the markets, the markets are saying that we've peaked in terms of those short-term rates. So, hopefully kind of things get better from where we are, but no real problems right now.

31:46 The other effect is just our fixed-rate book, so 38% of our portfolio is fixed-rate debt, and generally, when interest rates go up, the value of fixed-rate debt goes down. Our fixed-rate debt tends to have two attributes. One, it's either short-duration stuff where kind of the movement in rates has not been that powerful and the

rolldown of time has generally kind of overpowered that. The other element is there's idiosyncratic spread built into some of our fixed-rate investments, and the performance of those underlying portfolio companies has generally been good enough to kind of offset the moves and rates.

Robert Paun: 32:52 Okay. And then the next question, are you seeing inflationary pressures on portfolio companies today?

Andrew Beckman: 33:00 A bifurcated world. Different answer than a year ago. We are actually seeing margins start to improve in credits that have had raw-material inflationary issues. So, raw materials and shipping was a big issue last year on the inflation side, and companies that have been exposed to those pressures were actually starting to see green shoots as they report.

33:37 The other part of the story is labor, and labor has been a little bit tougher. It's lagged raws and shipping, and is still going in the wrong direction, but we're underwriting those labor pressures in our investments, and we believe we've accounted for them appropriately.

Robert Paun: 34:08 And our next question is on the share price. Any comments on the recent stock-price performance versus the NAV of the fund overall, and do you have plans in place to close the discount to the peer group and versus your NAV?

Andrew Beckman: 34:27 So we think the stock performance is very disconnected from the overall fund's performance last year. Our fund, we believe, really outperformed the vast majority of our competitors, with much more downside protection than the peer set. This year, our performance has been good and NAV has increased. We think a lot of the stock-price performance relates to technicals around the listing and lockup, and our hope and goal is to close that discount as we get past the lockup. We plan to be very proactive: to tell our story to investors to get analyst coverage and just get a lot more exposure.

35:26 What I would also tell people is, as we've been quietly marketing the fund during this period of phased lockups, one thing that was evident is new investors were very hesitant to get involved in the stock ahead of

the stock being fully freely tradable. So, we think getting past this lockup opens up the potential for lots of new investors and also gives us the ability to go out and fully market the fund.

Robert Paun: 36:03 Next question is on the dividend and distribution. Can you address the current distribution coverage of the fund? How are you able to pay out such a high dividend, and what's really driving that?

Andrew Beckman: 36:19 Sure. So distribution coverage since 2018 has been 119%. Recent-quarter distribution coverage was around 124%. So, if you look at our dividend and the high dividend, as one question came in at, it's been fully covered by the portfolio yield. Today, the yield to maturity in our portfolio, so just the unlevered yield to maturity at market prices of our portfolio, is around 14%.

Robert Paun: 37:00 Great. And the next question now: what is the current LTV ratio of the fund?

Andrew Beckman: 37:08 The LTV ratio today is approximately 33%. I'd note that it's a bit lower than it has been in the past because of the environment we're in. We think it's a tricky economic environment with lots of uncertainty, so we're purposely running at lower leverage ratios right now.

Robert Paun: 37:32 Okay. And then what are your expectations or plans for the $100 million of preferred equity that you mentioned maturing later this year?

Andrew Beckman: 37:43 So I believe 55% of that is a fixed rate preferred, and 45% of what's maturing is floating rate. Our goal with respect to the floating rate preferred is to refinance that in new floating rate preferred, and from a cost perspective, given the fact that it's already floating, it should be mostly sideways. The fixed rate preferred, we're evaluating options with respect to that. The fund currently has significant amount of liquidity. One option is to just pay that off. Another option is to roll that into more floating rate preferred. So we're evaluating all options.

Robert Paun: 38:43 Okay. The next question is a two-part question here. What's the cost of leverage, and how do you think about the use of leverage in this environment?

Andrew Beckman: 38:54

In terms of the cost of leverage, the weighted-average cost is around 6% as of March 31st, our preferred, which other than that floating rate tranche I mentioned, is primarily fixed, so fairly attractive at sub-5%. And our traditional debt, which floats with SOFR, has a cost of just north of 8% due to SOFR being in the 5s.

Robert Paun: 39:34

Great. And then last question that I can see: what is your fee structure today? What are your fees?

Andrew Beckman: 39:46

So the management fee on the fund is 1.35% on assets, and the incentive fee on the fund is a 10% incentive fee on income and there is no incentive fee on capital gains. And it might make sense to just provide a little perspective on fees. As we mentioned throughout the presentation, our material large focus for this fund is highly structured private investments. It's approximately 40% of the portfolio today, and we definitely see opportunity for it to grow. So when we look at our fee structure and we look at our fund, we view our fund as being in between a traditional closed-end fund, which invests primarily in public investments, and a BDC, which invests in all private investments. And actually, to go a step further, our private loans and our private investments tend to be even more highly structured than your traditional BDCs. So when I turn to fees and answer that question on what they are, we view our fees as being in between the traditional closed-end fund fees and the traditional BDC fees.

Robert Paun: 41:18

Great. So this concludes the first-quarter 2023 FSCO call. We hope that we answered all of your questions. If not, please feel free to reach out to myself, Robert Paun, on the Investor Relations Team for the fund. Thank you all for joining us today, and we look forward to speaking with you soon. Thanks.