Robert Paun: 00:05

Good morning and welcome to FS Credit Opportunities Corp.'s 3rd quarter 2023 earnings 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 October 24th, 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 September 30th, 2023. A link to today's webcast and the presentation is available on the company's webpage at www.fsinvestments.com. Please note that this call is the property of FSCO. Any unauthorized rebroadcast of this call in any form is strictly prohibited. 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.

01:28

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 materially 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 evaluative 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 speaking on today's call will be Andrew Beckman, head portfolio manager for FSCO and Nick Heilbut, director of research and portfolio manager for FSCO. Also, joining us on the phone is James Beach, Chief Operating Officer of the Fund. Before turning it over to Andrew, I'd like to note that we will not be taking live q and A during today's webinar, however, you can submit your questions using the q and a function on the left side of your screen and we will strive to answer as many questions as possible throughout the webinar and at the q and a session at the end.

02:52 In addition, I'd like to point out the resources that we have listed at the bottom of the screen, which you can access through the webinar. I will now turn the call over to Andrew.

Andrew Beckman: 03:00 Thank you Robert, and thank you all for joining us today. We are pleased to report solid results for the 3rd quarter as the fund returns 7.1% driven by strong earnings as net investment income. Fully covered distributions of 17 cents per share and NAV increased 30 cents per share quarter over quarter. We announced a 15% increase in the annualized distribution effective with the July monthly payment, bringing the annualized distribution rate to approximately 9.9% today. This marks the second increase since the fund's common shares were listed on the New York Stock Exchange in November of last year. The largest contributor to performance during the quarter was appreciation in the funds directly originated investment in New Giving Inc. The healthcare and pharmaceuticals company. The company's revenue and EBITDA have grown significantly driven by growing patient census and increased financial performance as operational measures implemented last year continue to positively impact the business.

04:22 In addition, the Fund's directly originated investment in a midstream energy company. Operating in the Permian Basin was a meaningful contributor to performance during the quarter as the company generated strong earnings growth. These investments are good examples of our ability to identify situations where return premiums exist due to complexity of a company's balance sheet, the illiquidity of an asset, unconventional ownership, where as a result of corporate events in both investments, the fund received equity ups as part of our debt investment providing for the potential for meaningful capital appreciation beyond the largest contributors. Positive performance was broad based across the portfolio during the quarter as contributors. Far outpaced detractors we're pleased with the fund's NAV return of 18.3% year to date as of September 30th, 2023, which outperformed high-yield bonds by 839 basis points and loans by 1,233 basis points. As many participants are aware, we implemented a phased approach to listing FSCO's common shares through which one third of

common shares were available for trading in November of last year.

05:54

An additional one third of shares were made available for trading 90 days after the listing on February 13th, and the final one third of shares were made available for trading on May 15th. The discount at which the stock has traded compared to the net asset value narrowed significantly during the quarter. We believe this is reflective of the fund's recent positive performance, broader market stability, and the reduced selling pressure on the stock. Now that all phases of the listing are complete while the price to NAV discount has narrowed, we believe the current discount at which the stock is trading compared to the net asset value is still too large and not indicative of the health of the portfolio or the forward return potential of our investments. We believe FSCO offers a differentiated value proposition in the market 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, mitigating risks, and achieving economies of scale.

07:13

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. As of September 30th, 2023, the split between public and private investments was 57% and 43% respectively. We tend to have a differentiated focus than traditional credit funds. We're not constrained by specific asset class mandate. We can invest across loans, bonds, structured credit or highly structured equity and across fixed and floating rate assets. As previously noted, 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, a lack of publicly available information and the niche nature of the potential asset or company. Our private investment portfolio includes highly bespoke investments originated through our firm-wide sourcing network. Our intensive due diligence process benefits from the sharing of collective insights on markets and individual credits.

08:38 We believe our origination capabilities within the private market and focus on providing specialized financing solutions differentiates us from our closed end fund peer group. The fund offers a highly attractive annualized distribution yield of approximately 9.9% based on NAV and approximately 12% based on stock price, which we believe is attractive on an absolute and relative basis compared to our peers. The distribution has been fully covered through net investment income since I joined FSS and the current investment team assumed management of the fund in January of 2018. Over that time, net investment income has represented an average of 117% of distributions paid to shareholders. The portfolio is weighted to senior secure debt with a focus on first lien debt, which has helped preserve capital over time. Senior secured debt represented 77% of the portfolio's fair value as of September 30th, 2023. Floating rate assets comprise approximately 54% of the portfolio as of September 30th.

09:56 We're seeing the benefit of higher base rates pass through to shareholders as evidenced by our ability to increase the annualized distribution by a total of 34% through two distribution increases since December of last year. Finally, the fund uses a modest 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. I'll now turn the call over to Nick to provide our perspective on the markets and discuss our investment activity during the quarter.

Nicholas Heilbut: 10:37 Thanks, Andrew. Rising real yield, negatively impacted core fixed income returns and other rate sensitive assets during the third quarter of 2023. Amid strong economic data and a clear Fed pivot toward a higher for longer rate environment, the U.S. Treasury curve steepened during the quarter with two year treasury yields rising 17 basis points while the 10-year yield spiked 75 basis points and ended the quarter at 4.59% its highest level since August, 2007.

11:12 Demand for high yield bonds and senior secured loans continued to handily outpace new supply. Year-to-date, senior secured loans returned 3.4% during the third quarter benefiting from significant institutional demand

from collateralized loan obligation managers while high yield bonds returned 0.5% amid elevated rate and equity volatility and rising net outflows in September. Lower rated securities outperformed driven by a combination of improved economic sentiment and their lower duration profiles. While the technical backdrop supported high-yield bond and leveraged loan prices amidst strong investor demand and limited supply fundamentals deteriorated modestly as evidenced by the uptick in defaults. The high-yield default rate, including distressed exchanges increased to 2.6% at the end of October while loan defaults and distressed exchanges increased to 3.08% as of the same period. This compares to default rates of 1.65% for each high-yield bonds and loans as of December 31st, 2022. We believe the current environment requires a deep bottoms up understanding of fundamental credit risks.

12:39

In our experience, inflection points in a market cycle or periods of volatility often present attractive investment opportunities. As Andrew will discuss further, we are focused on businesses with strong cash flows, moderate leverage profiles and management teams with deep operational experience managing through market cycles. Turning to investment activity during the third quarter purchases total 203 million compared to sales exits and repayments, approximately 172 million amid heightened market volatility. New investment activity focused on higher quality first being senior secured debt across private and public credit while sales and repayments were concentrated and select second lien and other junior debt and equity. Approximately 41% of new investment activity was in privately originated investments during the quarter and comprised entirely of first lien senior secured loans. Public credit investments, which represented approximately 43% of purchases during the quarter were comprised of first lien loans and high yield bonds. The increase in rates throughout the quarter provided opportunities selectively invest in high-yield bonds, trading at meaningful discounts to par value, providing the fund with attractive current yields and the potential for upside appreciation.

14:11

The remainder of the purchases during the quarter were comprised by opportunistic portfolio hedges. As of September 30th, 2023, approximately 77% of the

portfolio consisted of senior secured debt unchanged from the previous quarter. The Fund's allocation to subordinate debt was 7%, also unchanged from the previous quarter. Asset backed financed represented 4% of the portfolio compared to 6% as of June 30th, 2023. While equity and other investments accounted for 12% compared 10% as of the end of the second quarter, public credit represented approximately 57% of the portfolio while private credit comprised approximately 43% of the portfolio, the largest sector weightings at quarter end or healthcare equipment services followed by consumer services and commercial and professional services. We believe these investments offer the potential to drive strong risk adjusted returns and operate in areas of the economy that may be more insulated in the event of a broader economic slowdown. Turning to the liability side of our balance sheet, we believe our cost structure gives us a competitive edge with 46% of drawn leverage comprised of preferred debt financings, which provide favorable regulatory treatment versus traditional term or revolving debt facilities.

15:47 Approximately 46% of drawn leverage is multi-year fixed rate preferred debt, and provides flexibility in the types of assets we can borrow against On August 1st, the fund paid down 100 million of preferred debt maturing during the month. As a result, all of the funds preferred debt matures in 2024 or beyond. At quarter end, the fund's cash balance was approximately 76 million. Despite a modest cash balance, we have ample availability in our credit facilities should a liquidity need arise. I'll now turn it back to Andrew to discuss our forward outlook.

Andrew Beckman: 16:29 Thanks, Nick. Financial markets continue to wrestle with the forward path of the economy and geopolitical conflicts. A steady stream of strong growth data and the Fed's purposeful messaging away from rate cuts combined to fuel a bond market sell off in September that gained speed in October, but that has since reversed itself despite the recent run-in equity markets.

16:56 We remain cautious about the economic outlook and steep potential for future volatility and therefore have been more cautious about making new investments than we would be in a more benign environment. We think being a bit extra cautious is prudent, not only to

minimize potential drawdowns, but because such volatility often creates dislocations that can create attractive investment opportunities for the fund. We believe the strong index level returns this year mask strong underlying cross currents in the public and private credit markets. Performance differences across ratings and asset classes could become more pronounced as economic conditions change. We believe active management combined with sound fundamental credit underwriting will be critical to driving returns and avoiding excess risk. We continue to focus on senior debt investments with strong terms at attractive yields or expected total returns and are generally avoiding debt in private equity owned companies where we think there could be material risk on asset leakage or lender on lender violence.

18:09 We're also cautious on credits where there are significant EBITDA add-backs that may never materialize and instead are focusing on companies with true free cashflow. We are invested in credit instruments with appropriate loan to values to ensure ultimate repayment of the obligations even if the environment deteriorates or equity multiples compress. Our sector allocations are informed by bottoms up fundamental research and we tend to avoid highly cyclical areas of the economy and less the loan to value in those types of investments is particularly low. We've constructed the portfolio around these attributes and are confident in the position of the portfolio as well as the opportunity set. In our experience, the opportunities in private and public credit tend to ebb and flow and relative attractiveness can shift around meaningfully. Our goal is to dynamically allocate capital of the most attractive opportunities across the credit and business cycle, and we think this leads to enhanced stockholder returns relative to a more confined strategy.

19:23 We believe the flexibility of our strategy and the expertise of our team have helped drive strong outperformance versus the loan and high yield bond indices from January, 2018 through September 30th, 2023. FSCO outperformed high yield bonds by approximately 361 basis points per year and loans by 195 basis points per year. I should mention that those are gross returns for high yield bonds and loans and if one were to invest in those underlying instruments,

they'd have to do so through some vehicle that would have some fees and further reduce those returns. We're proud of our performance on an absolute and risk adjusted basis. 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, the sell side research analyst, mutual fund managers, private wealth managers, and other private credit and close end fund managers. Once again, thank you all for joining us today and with that we'll take a brief pause to review the queue before answering your questions.

Robert Paun: 21:01

Thanks, Andrew. Just as a reminder, you can submit your questions using the Q&A function on the right side of your screen. We'll just pause here. Okay. Our first question market related, can you talk about the current market environment today as far as pricing spreads on new opportunities, structure of deals, and how this has changed from the beginning of the year?

Andrew Beckman: 22:07

Sure, so if you were to focus on the public markets and just looked at kind of the loan market, you'll see spreads have come in a bit, so loan spreads are in about 65 basis points a year to date, and then on the flip side, rates have kind of moved out, so SOFR has moved out about 86 basis points, so net total yields are up a little bit. A lot of that's driven by risk-free rates, that's the public market, the average broadly syndicated loan. On the private side, we have not seen spreads move to the same extent. I think spreads are more or less unchanged on a year to date basis and yields are higher because of the base rates and I think what you're seeing on the private market is a pullback from finance and counterparties in the middle market space, predominantly banks, regional banks, so particularly for non-sponsored businesses, there's been a real pullback in regional banks providing capital and that's why the private market opportunity has stayed wide to the public opportunity.

Robert Paun: 23:29

Next question on opportunities for next year. What are your expectations for new deal flow and new opportunities Heading into 2024,

Andrew Beckman: 23:41

We're optimistic about 2024. We continue to see a very strong pipeline on the private side driven by what I mentioned before about regional banks really pulling out of the market and de-risking their balance sheets. And then on the public side we've seen a little bit of a pickup in opportunity as private equity firms can start to underwrite the economic outlook a bit more with the fed language indicating a potential pause. So we're seeing M&A activity pick up a little bit and that usually kind of feeds through to kind of public market volume. So overall we're excited about next year and have a very strong pipeline.

Robert Paun: 24:34

And then next question, what type of risks are you seeing the best and most attractive opportunities in terms of public versus private specific sectors or industries? Any color would be helpful there.

Andrew Beckman: 24:51

So right now the best opportunities that we're seeing on average are in privates. There are a few attributes that make privates more attractive. One, we think the market's a little bit more disciplined as spread. As I mentioned earlier, you haven't seen the same spread compression that you've seen in the public markets. Two leverage levels and loan to values we think are more conservative in the private stuff that we're looking at. Three deal documents and kind of structure is a lot better. The private deals that we do just tend to really lock down the capital structure. Syndicated loans and bonds really still have quite a bit of loopholes for borrowers to take advantage of lenders they've not been stamped out of that market yet, so for all those reasons, spread downside protection through loan to values and structural protections, we find privates to be more attractive than public right now. In terms of specific sectors or industries, we're focused on companies and sectors where you've seen a pullback of lending by commercial banks. We're also focused on defensive sectors where we can underwrite credits even if we were to see a slowing of the economy or potentially even a recession.

Robert Paun: 26:39

Great, and you've talked a lot about your private investments and the attractive there, the allocation has increased over the past few quarters. Do you have a specific target allocation for private versus public investments?

Andrew Beckman: 26:55

So as mentioned right now our private exposure is approximately 43% of the portfolio. We do not have a set target, but we do believe that there is room for both private and public in the portfolio, so you won't see either one of those buckets go away. We like to go where the opportunity set is Right now we view privates as more attractive. That was not the case in the back half of last year where we saw Publix more attractive, but right now we view the private pipeline and the average private investment as being more attractive than what we're seeing in the public market, so we could see that increase in the near term or medium term.

Robert Paun: 27:47

Next question's a macro question. What future economic conditions would be the most concerning regarding the future performance of the fund?

Andrew Beckman: 27:59

We run a balanced portfolio which is deliberately positioned for potential margin degradation, which could arise from either inflation or a demand slowdown. In addition, high rates are not a significant problem for the book. The portfolio has performed well this year despite the rising rate environment. We achieve this by keeping our investments low loan to value and maintaining a relatively short duration portfolio. So we see ourselves as being defensively positioned for the obvious economic risks that may come to pass in 2024.

Robert Paun: 28:45

Great. Next question on net asset value, can you provide some more color on the nav move in the quarter? Seemed like a strong move higher this quarter.

Andrew Beckman: 28:59

Sure. So if you look at the top five contributors to nav and those contributors represented roughly 40% of the move in nav, you have three private positions, two of which were mentioned in my comments, new giving as well as kind of the midstream energy business in the Permian. And then outside of that we had an investment in a consumer products company, a private investment in consumer products company that also had UPS that performed strongly in the quarter, and then there were two investments in publicly traded instruments, one in a company called Optum and another in a company called One Call that were the other two strong movers in the quarter. Outside of that, it was really kind of broad based uplift throughout the portfolio.

Robert Paun: 30:11

Next question, the stock has had a nice move higher in the past few months, but it continues to trade at a discount to its net asset value. Why do you think that is and what are the plans to close the gap here?

Andrew Beckman: 30:27

So the stock has performed well over the last few months and the discount has closed meaningfully. Particularly if you look at the lows this year on a price to kind of nav basis, we've moved quite a bit. What do we do from here? We're focused on the performance of the fund, investing in high quality instruments and continuing to perform well. And I believe showing the street that we have a high quality portfolio that performs well and performing well compared to our peers will help us continue to shrink the discount outside of performance. We're focused on our IR efforts and talking to analysts and investors to pitch the fund and make investors aware of the high quality nature of the portfolio and we're hopeful that our efforts all around will close the discount. We think our stock should trade much more in line with book value as well as the peer group.

Robert Paun: 31:45

Great. And then any plans for a share repurchase plan to help narrow the discount?

Andrew Beckman: 31:53

We continuously discuss everything with the board, all potential options including repurchase programs. At this time, we do not have one in place, but it's something that we will continue to talk about as we monitor the funds liquidity and investment options that exist.

Robert Paun: 32:21

Next question on the dividend, can you just remind us of the dividend policy and the plan going forward?

Andrew Beckman: 32:29

Sure. So as I mentioned, we've increased the dividend two times since going public. The second increase happened in July. It was a 15% increase. And so on one hand we want to continue to kind of push that dividend up when we can. On the other hand, we are focused on distributing income and not overreaching, so having a fund that's kind of balanced and works, so we continue to monitor the income of the portfolio and as it increases, we will push it through to investors. We're also watching rates though and the rate curve. Obviously that's been a big benefit for funds like ours,

but if you look to 2024, the rate curve starts to kind of move the other way. So we're evaluating everything.

Robert Paun: 33:28 Next questions on the right side of the balance sheet. Can you just talk about leverage and targets on the capital structure?

Andrew Beckman: 33:37 So in August of this year, we repaid a hundred million dollars of preferred that was coming due. We repaid it because we had excess liquidity. It is likely something that we will look to replace when market conditions are there and we think we could price something attractively. So I think, or I would point investors to our Q two capital structure before that repayment, and I would say that that is a good benchmark for target leverage levels.

Robert Paun: 34:24 Great. Next question. While rising rates aren't an issue for your portfolio today, will sustained higher rates have an issue 12 months out from now or do you believe companies will be able to sustain the higher rate environment?

Andrew Beckman: 34:43 So we stress every investment in our portfolio for a wide range of potential environments, including an environment with higher interest rates in the future. This portfolio has been deliberately hydrated throughout the year, and for the most part, good businesses can raise prices in inflationary environments, which can end up being a net benefit to the p and l if rates go up. So we think from a fundamental perspective, the book is very well positioned should interest rates rise over the next 12 months and don't see that as a material risk to the book.

Robert Paun: 35:24 Great. Looks like we've answered all the questions in the q and a chat function here, and if we didn't answer your calls questions, you can feel free to reach out to the investor relations team. With that, this concludes today's call. Hope everyone has a great Thanksgiving and a happy holiday season and we'll talk to you next quarter. Thanks.