FSCO Q2 2024 Earnings Call Transcript

Joseph Montelione: 00:00

Good morning and thank you all for joining us for FS Credit Opportunity Corp.'s second quarter 2024 earnings conference call. Please note that FS Credit Opportunities Corp. may be referred to as FSCO, the Fund or the Company throughout this call. These conference calls are 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 August 5th, 2024. 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 June 30th, 2024. 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 and the unauthorized rebroadcast of this call in any form is strictly prohibited.

01:09

Today's conference call includes forward looking statements with regard to future events, performance and 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 that differ materially from those projections 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 the law. Additionally, information related to past performance while a helpful, evaluative tool is not necessarily indicative of future results, the achievement of which cannot be assured. Investors should not view the performance of FSCO or information about the market as indicative of FSCO's future results.

02:12

Speaking on today's call will be Andrew Beckman, head of FS Global Credit and Portfolio Manager for FSCO and Nick Heilbut, Director of Research of FS Global Credit and Portfolio Manager for FSCO. Also joining us on the phone is James Beach, Chief Operating Officer of the Fund.

02:35 Following our prepared remarks, we will take questions from the audience. If you'd like to submit your questions, please use the Q&A chat function on the right side of your screen. We'll strive to answer as many questions as possible. In addition, I'd like to point out the resources that we have listed at the bottom of the screen, which you can access throughout the call, including a link to the Q2 2024 earnings presentation. I will now turn the call over to Andrew.

Andrew Beckman: 03:03 Thank you Joe, and good morning everyone. We are proud of the results we delivered for our shareholders during the second quarter of 2024 across several key fronts.

03:14 First, the Fund delivered a net return of 2.75% based on NAV. While portfolio performance was broad based during the first quarter, the top 10 contributors (based on issuer) accounted for over 40% of the total realized and unrealized appreciation during the quarter. Year to date, as of June 30th, 2024, the Fund generated a net return of 8.67% based on NAV. Outperforming high yield bonds by 609 basis points and loans by 432 basis points. This performance was strong on an absolute basis and a relative basis as FSCO outperformed many of the larger credit focused peers in the closed-end Fund space.

04:04 We believe our performance reflects the dynamic nature of our strategy and ability to source differentiated investments. Our strategy includes investing across public and private credit with the focus on generating return premiums driven by the complexity of a company's balance sheet, the illiquidity of an asset, unconventional ownership or corporate events. We have a very robust sourcing engine that's a combination of business led and firm-wide sourcing investments.

04:35 Next, the Fund paid distributions of 18 cents per share in the second quarter. As has been the case since our team assumed management of FSCO in January of 2018, net investment income fully covered distributions paid during the quarter. As of August 30th, 2024, the Fund's annualized distribution yield was 10% based on NAV and 11.5% based on the stock price.

05:05 On May 16th, 2024, the Fund issued a hundred million dollars of term preferred shares due in May of 2029. At 205 basis points over treasuries, the preferred financing provides the Fund with additional purchase power and favorable pricing. As of June 30th, 2024, the Fund's cash balance was approximately $104 million, and we have ample availability on our credit facilities.

05:35 Finally, the discount in which the Fund's common shares traded relative to its net asset value narrow significantly in 2023 and that trend has continued in 2024. We believe the improvement reflects the Fund's continued strong performance, the increase in the annualized distribution in March and the broader strength in credit markets. We're pleased that FSCO shareholders earned a total return of 10.6% in the second quarter of 2024, and we believe the current discount as of the stock is trading compared to nav, still does not reflect the health of the portfolio or the high quality of our investment program.

06:20 I'll now turn the call over to Nick to provide our perspective on the markets and discuss our investment activity during the first quarter.

Nicholas Heilbut: 06:29 Thanks Andrew. U.S. economic growth was solid during the second quarter of 2024, bolstered by the strength of the consumer. Despite some signs of cooling, a generally strong labor market provided a tailwind for consumer spending. Treasury yields rose modestly during the quarter as the 10-year yield increased 14 basis points to 4.34%, while the policy sensitive two-year yield increased 10 basis points to 4.72%.

06:57 Credit markets benefited from the supportive macro backdrop and carry driven returns. While investors reduced and delayed their expectations for fed rate cuts throughout the quarter. Senior secured loans returned 1.85% during the quarter while high yield bonds return 1.05% higher rated bonds LED returns as doubled. Bonds returned 1.29% compared to 0.13% for triple crated bonds. Loan performance was mixed as de-rated loans outperformed both higher and lower rated peers

07:35 Against the generally solid economic backdrop, defaults remain largely check. The second quarter produced the lowest volume of defaults since the

fourth quarter of 2022. While the default rates including distressed exchanges ended the quarter below the 25-year average for both high yield bonds and loans, we expect a false will likely increase through next year with the compositions skewed toward loans due to weaker credit Fundamentals and a higher pace of distress transactions across the market. The volume of distressed loan transactions through July is already the largest annual total on record. We also expect the divergence in recovery rates between high yield bonds and loans to continue recovery rates for high yield bonds over the last 12 months are 40%, which is directly in line with the longer term average while loan recoveries are 43% today and well below the historical average of approximately 64% we believe active management combined with some Fundamental credit underwriting will remain critical to driving returns and avoiding excess risk in a year ahead.

08:47 Turning to investment activity, the Fund remained fully invested throughout the first quarter. Purchases excluding portfolio hedges total approximately $233 million compared to sales exits and repayments of $234 million. Credit markets remain competitive during the, especially in these times, we continue to leverage the insight and deal flow across FS investments' $82 billion asset management platform and use our deep relationships with commercial and investment banks. Non-bank intermediaries sponsors, industry specialists and other like-minded investment firms to drive steady portfolio investments in public and private credit.

09:32 Approximately 67% of new equity investment activity was in privately originated investments and purchases were weight to first lien senior secured loans and to a lesser extent, subordinated debt. Public credit investments represented a third of the investment activity during the quarter with 91% of purchases in first lien loans.

09:54 As of June 30th, 2024, approximately 83% of the portfolio consisted of senior secured debt unchanged from the previous quarter. The Fund's allocation to subordinated debt was 4% compared to 5% as of March 31, 2024. Asset-based finance represented 4% of the portfolio while equity in other investments represented nine public credit comprise 48% of the portfolio as of the end of June while private credit comprised 52%.

10:26 Excluding asset-backed finance investments, the largest sector weightings at quarter end were Consumer Services followed by Commercial and Professional Services & Healthcare Equipment and 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.

10:48 Turning to the liability side of our balance sheet, we believe our cost structure gives us a competitive edge with 58% of drawn leverage as of June 30th, 2024, comprised of preferred debt financings, which provide favorable regulatory treatment vs. traditional term loans for revolving debt facilities and flexibility in the types of assets we can borrow against.

11:13 I'll now turn it back to Andrew to discuss our forward outlook.

Andrew Beckman: 11:18 Thanks, Nick.

Economic data and credit returns were both solid in the second quarter of 2024, yet markets were whipsawed with significant volatility following quarter, driven by a mix of lackluster economic data that called the economic soft landing narrative into question and shifted Fed rate expectations. While markets recovered is certainly possible that we see further bouts of volatility through the remain of the year as investors continue to monitor geopolitical conflicts and wrestle with the forward path of U.S. rates, the U.S. economy and the presidential election in November.

11:57 Recognizing the potential for volatility 2024, which constructed the portfolio based on several key attributes.

First, we are focused on businesses with strong cash flows, modest leverage profiles and management teams with deep operational experience managing re market cycles. We're investing in credits with appropriate loans and values to ensure ultimate repayment of the obligations even in a more pronounced economic slowdown. Our sector allocations are informed by our bottom-up, fundamental research and we tend to avoid highly

cyclical areas of the economy unless those investments are particularly low leverage credit spreads are tight and covenants and broadly syndicated loan markets are weaker than usual. This, coupled with uncertainty over inflation, rates and the durability of the economy are causing us to have a higher bar for evaluating new investments. We also believe maintaining some extra buying power is prudent, not only to minimize potential drawdown by not being too levered, but also to take advantage of attractive investment opportunities arising in periods of volatility.

13:19 Second, we continue to focus on senior debt investments with strong terms and attractive yields or expected total returns. We generally avoid debt in private equity owned companies where we think there could be material risk of asset leakage or disputes between lenders. We're also cautious on credits where there are significant EBITDA add-backs that may never materialize and instead focus on true free cash flow.

13:51 We seek to identify situations where return premiums exist is the complexity of a company's balance sheet, the illiquidity of an asset, unconventional ownership, or as a result of corporate events as opposed to for credit quality.

14:10 Third, we'll continue to leverage size and scale drive differentiate outcomes for our investors. FSCO is one of the largest credit focused closed-end funds in the market with 2.1 billion in assets as of June 30th, 2024. Size and scale matter in credit investing, especially when it comes to maximizing deal flow, mitigating risks, and achieving economies of scale. The portfolio management team also leverages the full resources, infrastructure and expertise of FS Investments. As Nick discussed, we believe our leverage structure provides FSCO with a unique advantage as a large percentage of our drawn leverage as multi-year fixed rate preferred debt and provides flexibility in the types of assets we can borrow against.

14:58 Finally, our ability to invest across public and private markets differentiates us from traditional credit funds and allows us to adjust allocations based on where we believe the best risk adjusted return opportunities lie. Our goal is to dynamically allocate capital to the most attractive opportunities across the credit and business

cycle, and we think that leads to enhanced stockholder returns relative to a more confined strategy. Importantly, we are not constrained by a specific asset class mandate. We can invest across loans, bonds, structured credit and highly structured equity investments and across fixed and floating rate assets.

15:46 Our private investment portfolio includes highly bespoke investments originated through our team and firm wide sourcing network. Our intensive due diligence process benefits from sharing of collective insights on industries and individual credits. We believe our origination capabilities within the private market and our focus on providing specialized financing solutions differentiates us from our closed-end fund peer group.

16:14 In summary, we believe FSCO is a compelling long-term investment opportunity based on our well positioned portfolio, low average duration, healthy distribution, diversified capital structure, and flexible strategy. We believe we have a Fund and platform built to drive strong risk adjusted returns through a diverse range of economic and financial market conditions by investing in less traditional areas of the credit market, including opportunistic and event driven credit, special situations, and private structured capital solutions. Since the current investment team assumed all portfolio management responsibilities in January of 2018, the Funds net returns have outperformed the gross returns of high yield bonds by 334 basis points and of loans by 217 basis points per year. 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.

Joseph Montelione: 18:38 Okay, our first question, what is the target LTV for portfolio companies we invest in?

Andrew Beckman: 18:45 Sure, so we take a bottoms up approach and look at where the value's coming from and the stability of that asset value or enterprise value. So it really depends, but I would say on average our typical investments are going to be somewhere between 50%-60% loan to value based on FS' view of value, not necessarily the owner of a business's view of value. Often LTD is lower based on where businesses may transact or what owners will believe that businesses work.

Joseph Montelione: 19:39

Great. Our next question, are there any considerations for buying back equity to take advantage of the discounts in NAV?

Andrew Beckman 19:25

So, we and the board are constantly evaluating the best use of capital for the Fund. We are weighing buying back shares with our distribution policy, with our investment opportunities in the market at any given time, and it's a constant discussion with the board on how to allocate capital to those three opportunities.

Joseph Montelione: 20:09

Our next question, does the expected decline in rates affect the Fund's ability to pay the 6 cents per share monthly dividends? Do you anticipate cutting your dividends when interest rates do fall?

Andrew Beckman: 20:22

So right now we believe our dividend is very well protected. We've modeled out the base case or I would say what the market is projecting from a rate perspective and the dividend looks nicely covered certainly for a period of time. Depending on what happens with rates and how low they go, the whole sector is likely to have some earnings pressure in the downward rate environment. I think the way to look at our Fund is really on a spread basis, so a spread basis over the SR rate and our goal is to generate an attractive spread to whatever the risk rate is. Our portfolio is 62% floating, so we can't totally insulate ourselves from the rate environment, but I would note a significant portion of our earnings is generated from fee-based income and that's not directly tied to the direction of rates. So I think in summary, we have to see where rates are. I think we are as insulated if not better insulated than most, but can't fully diverge from the macro.

Joseph Montelione: 21:54

Our next question, it's great to see that the stock performed very well so far this year, but FSCO still trade to the 10 to 12% discount in net. You provide the color as to how the stock is valued relative to peers?

Andrew Beckman: 22:07

So closing the discount is a big focus of ours. We continue to focus on strong investment management to deliver returns that are best in class. We think that will ultimately drive the stock price. If you look at our stock, we're mostly in line from a dividend perspective

today. Our policy with respect to our dividend is to be prudent and offer a dividend that is well covered. If you look at many of the peers in the closed end space, they are over distributing to achieve a higher yield. So we sort of trade in line from a dividend perspective, but that discount is there because our absolute dividend yield on a nav basis might be a tad lower than some of those peers that are over distributing.

Joseph Montelione: 23:10 Our next question, the Funds generated a significant portion of net earnings from dividends and fee-based income in the first half. Can you talk a bit about how these revenues are generated?

Andrew Beckman: 23:23 So one-time fee income is usually tied to originations, so private deal originations as well as exit fees. So, if you think about our typical deal, we usually get a fee upon the closing of the deal that goes to the Fund. It could be anywhere from one to three and a half points, and then some of our deals have backend fees and those could be either hardwired exit fees where there is a fee payable upon repayment of the loan. Other times they could be more contingent type fees that are tied to early repayment by call premiums and whatnot. Those fees should be generally pretty steady regardless of the interest rate environment. Obviously those fees are more tied to deal activity, new transactions originated as well as exits on the dividend side. Occasionally the Fund will invest in equity. Usually it's equity that we get for a mini cost upon investing in a private transaction. So think about warrants for the ability to buy some really cheap equity upon our primarily like debt based deal and then occasionally we will get dividends associated with those equity states. That was the case with the investment that led to the large dividend earlier this year.

Joseph Montelione: 25:16 Next question. You mentioned spread tightening in your paired remarks. Can you provide a bit more color on what you're seeing in the market today as far as pricing and spread levels and how that compares to six months ago?

Andrew Beckman: 25:30 So we've seen general spread tightening both in the private and public markets. The private markets, the statistics are not as good, but when we look at one stat that's out there, it shows average private credit spreads of 630 basis points as of the end of 2023 and spreads

today at around 530 basis points. So that one statistic shows about a hundred basis points of private credit spread tightening. We feel like that's around what we're seeing. So private credit markets are about a hundred basis points tighter than they were. If you look at on the run private credit, I would say the average sponsor loan, so the direct loan to sponsor that bypasses banks and goes through one of the big private direct lenders is probably coming at around 475 basis points over SOFR. Today we're generally not playing in that market. We're usually playing in the part of the market where they're either kind of smaller sponsors, more story credit or non-sponsored are usually a premium for that, but it gives you a direction and if you look at on the run public credit markets, the average new issue B three, which is sort of comparable to the average new sponsor private loan, our feel is that B three is probably coming around 350 basis points. So a hundred to 125 basis points, type two private credit.

Joseph Montelione: 27:27

Our next question, how have macro views changed over the last few months? What is your perspective on the current balance between being in a borrower versus lenders market? Specifically, are you seeing an increase in borrowers leveraging lenders into our pricings and are you seeing tighter or looser covenant structures overall?

Andrew Beckman: 27:50

It's a great question. So the market I think is definitely transitioning to a borrower's market. You can see it in the big uptick in repricing Q2 repricing for the highest on record. You've increased competition in private credit, lots of money being raised for private credit and that's putting more eyeballs on the space and more competition for deals, which obviously gives borrowers a little bit more leverage in their negotiations. All of that is leading to that spread tightening that we've seen as opposed to as well as more favorable non-economic terms for lenders. So borrow some fewer covenants, wider covenants, et cetera.

28:56

That said, it doesn't mean credit is unattractive, it's just tighter than it was. We still think credit screens relatively attractive compared to equities and other asset classes based on valuations and projected returns, returns. Additionally, we still see some really nice opportunities in more off the run areas of the credit market. A lot of the dynamics that I mentioned

are dynamics in on the run areas. Ever since the financial crisis, we've seen mandates that are more and more constrained and our whole strategy is to focus on areas of the market that those mandates don't focus on and we see some really nice opportunities there. I can point you to a couple statistics relative to some of the market statistics I gave you, but our private originations in the quarter came at an average yield of 12.6%. So if you think about a 475 basis points that's on the run, a couple hundred basis point premium to that and then in the public markets, we're picking our spots, but our average investment in Q2 had a spread to SOFR north of 600 basis points. Again, that compares to that 350 through 75 basis points be great. So we're seeing plenty of opportunity.

Joseph Montelione: 30:43 Our next question, the portfolio is approximately 52% private today compared to 46% one year ago, and as you mentioned, 67% of new investment this quarter was private. Can you talk about the opportunity, why this opportunity is attractive today and what spreads are you deploying after both public and private investments?

Nicholas Heilbut: 31:07 Sure. So we continue to see good opportunities to act as a creative solutions provider to borrowers in the private market. I think a lot of the reason for that is the design of our business and the relationships that we have and capabilities that we have in-house on our team. Andrew touched on some of the spreads in his prior answer a little bit, a little bit higher in the private market for 700, but we're also seeing attractive things in the public market. So we continue to put money to work at a 600 spread or greater. Some examples of opportunities in the private market in the last quarter include an investment that we led in core health and fitness investment in a company called ECI, a pharma business, a following investment, a support portfolio company called Nephron, restructured investment in another healthcare company, something in the gaming space, subject sports equipment space. So we have broad reach into the market, strong capabilities like let stat to create idiosyncratic opportunities in the private space.

Joseph Montelione: 32:43 Great. Our next question, do you believe the economy will slow down the coming quarters? If so, how do you shift your Fund's focus to best preserve NAV?

Nicholas Heilbut: 32:54 Yeah, so we see some signs of modest slowing in the economy. I think we still have the view that the chance of a recession in the U.S. is below 50% over the next 12 months, but we're always mindful of underwriting downside scenarios to make investments and I think first and foremost we want to pull to our standards when we underwrite deals through all points in the cycle and achieving appropriate predator protections as well as investing in good businesses is always the best way to limit downside.

33:31 So far, we've been able to continue identifying good opportunities with superior risk adjusted returns. So I think the case of investing and the style of investing that we've been doing is consistent and mindful protecting the downside should things deteriorate. And then I'd also mentioned that our Fund has the flexibility to take advantage of market dislocations as well as broad sector expertise, which allows us to focus on sectors that fall out of favor, just their slowdowns and how they consumer or other kinds of micro types of opportunities. So I think we're pretty well positioned.

Joseph Montelione: 34:25 Great. Our next question, where do the best risk adjusted return sit within your portfolio today? Are these predominantly first lien senior secured risk, or are you willing to go down in the capital structure?

Nicholas Heilbut: 34:41 So what we've seen over and over in credit is that there are just huge advantages to being secured. Like our career, the mark of our experience has continued to illustrate that being secured is normally the best place to be in the capital structure. And so generally speaking, that's where we like to focus very downside oriented. Obviously we understand that spreads compliant, the economy slow down. There can be Socratic challenges that businesses face, but if we do a good job structuring and underwriting our investments should get our money back plus our approved on and they piece this stuff along the way, eventually we do our job well.

35:34 And that kind of informs the core go-to market strategy, which is protect principle, don't lose money, there's a limit to what we can do around market to market, but if we're careful and when things go bad, we kind of, you get your money back and maybe a little return as opposed to you take a bath on something

approach, we think we'll be able to continue out performing over time.

Joseph Montelione: 36:06 Our next question, can you discuss your fee structure relative to peers In the closed and Fund space?

Nicholas Heilbut: 36:15 We view our peers as a mixture of closed end Funds and BDCs. Half of our portfolio is BEC life, so private investments represent 52% of the portfolio. I'd actually go a step further and say that half is actually more intensive than BECY credit given the special nature of many of our private deals and the non-sponsored nature. So they're heavily negotiated, heavily diligent, highly monitored transactions. Two thirds of our investments in this quarter were in direct originations, so the trend is up.

37:04 That said, the remainder of our portfolio are in public investments. Again, those public investments are not on the run type investments, but more intensive investments also underwrite and monitor. But if you just look at the public private nature of our business, it's sort of half-closed-end Fund life, half BDC life. And if you look at our fee structure, it fits in between the pros and Funds and BDC fee structures.

Joseph Montelione: 37:47 Next question, can you provide an update on non-pool investments in the portfolio?

Nicholas Heilbut: 37:55 Yeah, so non crus are about 2.7% of fair market value. Again, predominantly first lead. So just because something is not CRU doesn't necessarily mean we're going to lose money on that investment and we're were comfortable with the level of not tools in the portfolio. There were two new non accruals in the quarter, one investment of the $5.3 million fair market value and one with the fair market value of 23.

Joseph Montelione: 38:39 Our next question, can you talk about leverage and targets on the capital structure at quarter end, the revolver was fully paid down. Leverage on growth basis was 0.48 times, which is the lower end of the range for FSCO business reduction in leverage, intentional?

Nicholas Heilbut: 38:59 So our views on leverage haven't changed in terms of target level leverage levels. I had say two things. One with respect to this particular reduction, it was really a function of two different things. The biggest was nav

growing over the last few quarters and debt levels not changing that much, just ticking down a little bit, but that leads to a lower ratio. So that was the biggest driver.

Andrew Beckman: 39:26

The second thing just to think about is given our focus on private investments, you can't always perfectly time them. They ebb and flow in terms of when a repayment may be coming. We don't get a lot of notice from repayments come and originations have their own timelines that can move around. So any particular day, week, quarter end, it's possible you're hit with a repayment with the new origination coming not exactly at the same time and that probably speaks for the slight reduction in debt that we've had quarter over quarter.

Joseph Montelione: 40:17

Our last question, given that the revolver and Turin mature this December, do you intend on refinancing and or raising additional leverage and also what is your target liquidity level?

Nicholas Heilbut: 40:31

We have plans to address the 2024 maturities where we're inactive discussions right now about the most cost effective way and flexible way to do that. And from a target perspective, our view is nothing has changed. We're focused on maintaining our current leverage target and we're also focused on making sure we have the right base of leverage in terms of debt versus preferred.

Joseph Montelione: 41:15

Great. This concludes today's call. Thank you Andrew. Thank you Nick. If you any follow up questions or if we didn't address any of your questions, please feel free to reach out to myself, Joseph Montelione. Thank you. Goodbye.