FSCO Q3 2024 Earnings Call Transcript

Joseph Montelione: 00:00 Good morning and thank you all for joining us for FS Credit Opportunity Corp third quarter 2024 earnings call. Please note that FS credit Opportunities Corp may be referred to as FSCO, the Fund, or the Company throughout this call.

00:16 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 23rd, 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 second quarter ended September 30th, 2024. A link to today's webcast in the presentation is available on the company's webpage@fsinvestments.com onto the investor relations tab. Please note that this call is the property of FSCO. Any unauthorized broadcast of this call in any form is strictly prohibited. Today's conference call include a forward statement includes forward-looking statements with regard to future events, performance or operations of FSCO. These forward looking statements are subjects 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 materially from these statements. FSCO does not undertake the updated 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 past performance of FSCO or information about the market as indicative of FSCO's future results.

02:09 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 Credit and Portfolio Manager for FSCO. Also joining us on the phone is James Beach, Chief Operating Officer of the Fund.

02:30 Following our prepared remarks, we will take questions from the audience. If you'd like to submit your questions, please use the Q&A function on the right side of your screen and we'll strive to answer as many questions as possible. In addition, invite to point to the resources that we have listed in the bottom of the screen, which you can access throughout the call, including a link to the earnings presentation.

02:53 I will now turn the call over to Andrew.

Andrew Beckman: 02:57 Thank you Joe, and good morning everyone. We are proud of the results we delivered for our shareholders during the third quarter of 2024 across several key fronts.

03:08 First, the Fund delivered a net return of 3.35% based on NAV. While portfolio performance was broad base during the quarter, the top 10 contributors based on issuer accounted for 49% of the total realized and unrealized appreciation during the quarter. Year to date As of September 30th, 2024, the Fund generated a net return of 12.31% based on NAV outperforming high yield bonds by approximately 430 basis points and loans by 580 basis points. This performance was strong on an absolute and relative basis. As FSCO outperformed many of the larger credit focused peers in the close end fund space. We believe our performance reflects the dynamic nature of our strategy and the 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 for corporate events. We have a very robust sourcing engine that's a combination of business led and firm wide sourcing. Nest. The firm paid distributions of 18 cents per share in the third quarter, as has been the case since FS global credit team assumed management of FSCO in January of 2018.

04:40 Net investment income fully covered distributions paid during the quarter. As of November 22nd, 2024, the fund annualized distribution yield was 10.3% based on NAB and 11.1% based on the stock price. Finally, the discount at which the Funds common shares traded relative to its net asset value narrowed significantly in

2023, and that can trend continued in 2024. We believe the improvement reflects the Fund's continued strong performance, the increase in the annualized distribution and the broader strength in the credit markets. We're pleased that FEO shareholders earned a total return of 2.6% in the third quarter of 2024 and 27.4% year to date as of November 22nd, 2024.

05:31 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: 05:41 Thanks Andrew.

05:42 Over the past two years, higher intesreted rates have dampened transaction volumes and overall setiment in private markets. Private credit performance has remained strong, however, driven by the resilience of the U.S. economy and fundamentals of U.S. middle modern companies.

05:59 The U..S economy has grown 5.5% in real terms since the Fed began raising interest rates in the first quarter of 2022 or 2.4% on an annualized basis.

06:10 Middle market companies have been both drivers and beneficiaries. The economic stream, the average revenue growth from market companies was nearly 13% as of June 2024. Privately originated senior loans returned 12.5% over the past year, marking the highest on record outside of late 2020 and early 2021 amid the COVID recovery period. Following 75 basis points of Fed rate cuts thus far this year, it's clear that the Fed is set to reduce short-term rates further, but the pace of timing and future cuts is less clear. Lower rates in the absence of a recession would likely spur rebounded M&A activity and create greater opportunities for private lenders. In addition, lower rates may provide some relief to borrowers, especially those with constrained balance sheets.

07:00 Public credit markets who benefited from the support of macro backdrop coupled with the constructive if softening fundamental picture. Amid the defining rate environment, high yield bonds return 5.28% and now perform senior secured loans by 324 basis points. Lower rated credit drove high yield returns as triple C bonds returned 11.5% during the quarter outpacing double D bonds by 7 27 basis. Despite the decline in race loan prices have been supported by strong CLO demand. Loan performance was mixed as single B loans outperformed double B loans and CCC rated loans. While starting yields are compelling, the quality of the broader loan market is low as composition has shifted towards lower rating credits with comparatively higher leverage than lower interest coverage.

07:54 Credit risks continue to diverge as high yield bond default rates fell to a 26 month low while loan defaults have risen to a 44 month high as of the end of October. While default rates including distressed exchanges ended the quarter below their 25 year average for both bonds, we expect defautls will likely increase modestly throughout the next year with a composition skewed towards loans due to weaker credit fundamentals in a higher pace of distressed transactions across the market. Management combined with sound fundamental credit, underwriting remain critical to driving returns and avoiding excess risk in the year ahead.

08:35 Turning to investment activity, the Fund remains fully invested throughout the third quarter purchases, excluding portfolio hedges total of approximately $270 million compared to sales exits and payments of 233. Credit markets remain competitive during the war, especially in times we continue to leverage the insight and deal flow processes. Investments $82 billion asset management platform and use our chief relationships with commercial and investment banks. Non-bank intermediaries, sponsors, industry specialists and other like-minded investment firms drive a steady pipeline of investments in public and private credit.

09:18 Approximately 59% of new investment activity was in privately originated investments, a hundred percent of which were in first lien loans. Public credit investments represented 41% of new investment activity during the quarter, of which approximately 65% were at first.

09:37 As of September, public credit comprised 42% of the portfolio with private credit comprising 58%. By asset type, approximately 82% of the portfolio consisted of senior debt while subordinated debt is 6% of the portfolio. Asset based finance is 3% of the portfolio and equity and other investments represents 9% of the portfolio as of September 30, 2024.

10:04 Excluding asset based finance investments, the largest sector weightings at quarter end were Consumer Services, Healthcare Equipment and 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 than the broader economic slowdown.

10:26 Turning to the liability side of our balance sheet, we believe our cost structure gives us competitive edge with 53% of drawn leverage as of September comprised for debt financings which provide favorable regulatory treatment versus traditional term or revolving debt facility and flexibility in the types of assets we can work against.

10:45 I'll now turn it back to Andrew to discuss our forward outlook.

Andrew Beckman: 10:48 Thanks Nick.

10:50 Economic data and credit returns were both solid during the third quarter of 2024. While many strategists are forecasting a benign market environment for the remainder of the year and into 2025, it's possible to see periods of volatility driven by geopolitical conflicts, the path of U.S. rates and new policies following the leadership changes in the White House and Congress following the November election.

11:16 While we are not necessarily positioning for expected volatility, our portfolios constructed to be durable over the long term. Key attributes include:

11:27 First, we're focused on businesses with strong cash flows, modest leverage profiles and management teams with deep operational experience managing through cycles. We're invested in credits with appropriate relative values to ensure ultimate repayment of the obligations even in a more pronounced economic slowdown. Our sector allocations are informed by our bottoms up fundamental research and we tend to avoid highly cyclical areas of the economy and less loans values are particularly low. Credit spreads are tight and covenants in the broadly syndicated loan markets are weak. This coupled with uncertainty over inflation rates and the durability of the economy are causing us to be a bit more cautious about making new investments than we would be in other environments. Therefore, we believe maintaining extra bonding power is prudent, not only to minimize potential drawdowns but also take advantage of attractive investment opportunities for arising from periods of volatility.

12:29 Second, we continue to focus on senior debt investments with strong terms and attractive yields. We're expected total returns. We generally avoid debt and 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 free cash flow.

12:53 We seek to identify situations where return premiums exist due to the complexity of a company's balance sheet, the illiquidity of an asset, unconventional ownership, whereas a result of corporate events.

13:06 Third, we'll continue to leverage the size and scale to drive differentiated outcomes for our investors. FSCO is one of the largest credit focused closed-end funds in the market with $2.2 billion assets as of September 30th, 2024. Size and scale matter in credit investing, especially when it comes to maximizing deal flow, mitigating risks and achieving economies to 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 FEO with a unique advantage as a large percentage of our drawdown leverage is multi-year fixed rate preferred debt, and provides flexibility in the types of assets we can borrow against.

13:51 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 return opportunities lie. Our goal is to dynamically allocate capital, 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. Importantly, we are not constrained by a specific asset class mandate. We can invest across loans, bonds, and structured credit as well as highly structured equity and across fixed and floating rate assets.

14:30 Our private investment portfolio includes highly bespoke investments, originated through our team firm-wide sourcing network. Our intensive due diligence process benefits from the sharing of collective insights on the markets and individual credits. We believe our origination capabilities within private markets and focus on providing specialized ving solutions differentiates us from our closed end fund peer group.

14:56 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 the flexibility of our strategy.

15:11 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 non-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 fund net returns have outperformed the gross returns of high yield bonds by 294 basis points and by loans by 230 basis points per year.

15:46 Once again, thank you all for joining us today.

15:48 With that, we'll take a brief pause and review the queue before answering your questions.

Joseph Montelione: 17:28 All right, first question, in November, you declare the ninth street monthly dividend at the 6 cent per share rate. Any insights into what forward-looking dividend policy may look like, particularly in light of current rate expectations?

Andrew Beckman: 17:46 So we will continue to review our distribution on an ongoing basis. We will look at the Fund's natural earnings profile, the trajectory of forward looking base rates where credit spreads are and where our Fund is and where the peers are, so it's not a static policy. In addition to looking at those attributes, the Fund does generate a decent amount of fee-based income, so that's not directly tied to interest rates and bears monitoring. And lastly, we are fortunate to have significant spill back dollars, which should keep our distribution rate higher than where it might otherwise be if base rates fall.

Joseph Montelione: 18:36 Great. For our next question, private credit continues to tighten relative to public credit. Do you believe that the relative value still exists in private credit today after accounting for the liquidity premium?

Andrew Beckman: 18:49 So in the deals that we see, I would say both asset classes are tightening, so the like for like transaction and private credit versus public credit I believe has tightened in a commensurate way. Public credit is really tight. I would tell you the average B three that we see for a new issue buyout is probably coming at around three 50, maybe 3 25 over SOFR. The average new private credit transaction with a similar credit profile is probably coming right around S 500, so it's still coming at 150 to 175 basis point premium. We don't think that's changed. The other thing to think about is the structural premium in terms of what you're getting in private credit docs versus public credit docs, and we think the structural premium still exists with private credit docs generally being a lot tighter than public credit docs, which creates downside protection.

Joseph Montelione: 20:01 Great. Next question in your prepared remarks, you mentioned seeing a lot of weak covenants in the market. How's this affecting deal volumes?

Andrew Beckman: 20:11 The average new issue broadly syndicated loan has very weak covenants. Some of those weaker covenants are spilling into the top part of the private credit market, private credit for large blue chip sponsors and some of the smaller sponsors are trying to get some of the terms that the larger guys are getting, which is similar to the public market protections. We're keeping our bar up, so within private credit, we're passing on those transactions that generally mimic the public credit market. It's causing us to need to increase n look at more deals because with a higher bar you have a lower hit rate. But that said, we believe our deal flow is sufficient to implement that strategy and we've been very active in good transactions.

Joseph Montelione: 21:18 Next question. You mentioned that the portfolio was approximately 58% private in Q3 compared to 52% Q2. Do you expect allocation to increase over time and can you talk about the opportunity, why the opportunity is attractive today, what spreads you are deploying at in both public and private investments?

Andrew Beckman: 21:42 We believe the opportunity is attractive because there is a nice spread premium for private credit in general, which I mentioned as well as a structural premium where we think you get better downside protection in a default scenario and thus higher recoveries. The other thing I would mention is dispersion in private credit is much more significant than it is in public credit, so it creates the opportunity for a significantly more alpha. If you look at the new issue B three broadly syndicated term loan, there's very, very little dispersion, maybe 25 basis points of dispersion in terms of where something might come. So if the average deals coming at three 50, maybe a really strong deal comes at 3 25 and weak deal comes at 3 7, 5 25 basis dispersion.

22:49 The thing we like about private credit is we can see a significant amount of dispersion depending on the deal dynamics. It is possible to get 200 basis points plus of dispersion. So if you look at our originations, we had five new originations in the quarter, $162 million that originated in gap yield, 11.5% and a spread of 700. So if you look at the generic private credit deal that I mentioned, that 500 over, we were able to find 200 basis points or so worth the dispersion, which you can't find in the public markets. So right now we continue to be positive on private credit, but that said, we will continue to monitor the markets and go where the opportunity is. Best things change.

Joseph Montelione: 23:52 Next question, are there any sub-sectors in credit, which in your view currently present more of a relative value versus the broader market?

Nicholas Heilbut: 24:02 Yeah, so healthcare is an industry that always requires deep fundamental knowledge and expertise as well as network of relationships and experience to invest in, and that can create the opportunity for excess returns. So we found some nice opportunities there as we often do, and then maybe median entertainment stands out as an area where there's ongoing technological and distribution related changes in the landscape. And then over the last several years, there have been some specific labor challenges in Hollywood and Hollywood adjacent industries as well that have created some disruption and opportunity to find excess return and crafting deals to well positioned businesses.

Joseph Montelione: 25:00

Great. Next question, what is your latest view on the macro environment in light of recent rate moves in the presidential election? How do you expect recent developments to affect the portfolio?

Nicholas Heilbut: 25:15

Well, certainly the recent rate moves and the Trump presidency suggests that base rates will probably remain a little higher than people were thinking six months ago, and so we think we're nearer to a trough, a trough in rates and indeed may actually see an uptick in inflation in 2025. We're generally agnostic on rates when it comes to investing and allocating the portfolio. 63% of the portfolio is floating rate today, so that higher kind of bases FR or short end can be good for portfolio yield for us. Obviously we'll be mindful of the shape of the yield curve and there have been changes there. We'll continue to monitor that and look for opportunities, but I think we're set up in a way right now, which should be pretty strong. If base rates stay where they all tick up, obviously other than that, we will look to take advantage of dislocations in sectors that may out of favor. I mean, we don't know what will happen with tariffs. I think we have a reasonable base case regarding corporate taxes, but there could be other changes in the regulatory landscape that favor certain industries or negative for others, and that can create opportunity. So we'll have more to say about that as things progress next year.

Joseph Montelione: 27:17

Next question. Are there any updates on investments in the portfolio that are on?

Nicholas Heilbut: 27:24

Yeah, so right now non rules are just under 3% of fair market value in the portfolio, which is a level that we're comfortable with and broadly in line with historical levels in the portfolio. There was one new non-accrual this quarter, which was an investment we have in a company called LaserShip, which is a distribution business that's sort of run into macro driven, largely macro driven sort of revenue shortfalls and was over lever coming out of COVID, but we have a path forward there that's about $11 million of fair market value portfolio.

Joseph Montelione: 28:19 Next question, can you discuss your fee structure relative to your peers in the closed-end fund space?

Andrew Beckman: 28:27 Yes. This is a question we get a lot because we have an incentive fee and we also have a management fee that can optically be viewed as being a tad higher relative to closed-end fund peers. I think the thing that's important is we view our peers as not just closed-end funds, but a mixture of closed-end funds as well as BDCs. If you remember from my remarks, 58% of our Fund is invested in private credit, so not only is that BDC, if you look at our average private investment, it is a more tailored, more structured and more intensive private investment than the average investment the BDC makes. But if you wanted to simplify things and say 58% of our fund is like A BDC and 42% of our Fund is like a closed end fund and blended the fees, you would see something that really justifies our fees and maybe even makes our fees look a bit low.

Joseph Montelione: 29:41 Great. Next question. The revolver and term loan are due to mature in December. Has there been any progress in refinancing the capital structure?

Andrew Beckman: 29:52 Yes, so we successfully refinanced our leverage facility with Barclays in September. We're able to take advantage of historically tight levels in the market and refinance the term loan and revolver at SOR plus two 15, which was down from SOR plus 2 65. We're also able to reduce our fee on undrawn capital to 35 basis points from 55 basis points just to refresh. The facility still consists of a $285 million return loan and a $65 million revolver, so that sizing has been unchanged. The other thing worth mentioning is in addition to pricing improvements, we were able to improve some of the composition requirements which allow for increased borrowing capacity from our private credit book.

Joseph Montelione: 30:50 Great. This concludes today's call. Thank you, Andrew. Thank you, Nick. If you have any follow-up questions or if we didn't address any of your questions, please feel free to reach out to myself, Joe Montelione. Thank you.