## FSCO Q4 2024 Earnings Call Transcript

**Joseph Montelione**: 00:00 Good morning and thank you all for joining us for FS Credit Opportunity Corp fourth quarter and full year 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. 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 the press release that FSCO issued on February 6th, 2025. In addition, FSCO is posted on its website a presentation containing supplemental financial information with respect to its portfolio and financial performance for the quarter and year ended December 31st, 2024. A link to today's webcast and the presentation is available on the company's webpage at fsinvestments.com under the in 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.

01:06 Today's conference call includes forward-looking statements with regards to future events, performance or operations of FSCO. These forward-looking statements are subject to the uncertainties in predicting future results and conditions. Certain factors could cause actual 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.

02:06 Speaking of 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 FSCO.

02:26 Following our prepared remarks, we'll 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 and we'll strive to answer as many questions as possible. In addition, I'd like to point out the resources that we have listed on the bottom of the screen, which you can access throughout the call, including a link to the earnings presentation. I will now turn the call over to Andrew.

**Andrew Beckman:** 02:54 Thank you, Joe, and good morning everyone. We're pleased with the results we delivered for our shareholders during the fourth quarter and full year in 2024 across several key fronts.

03:05 First, FSCO delivered a net return of 14.25% in 2024 based on the fund's net asset value outperforming high yield bonds by approximately 603 basis points and loans by approximately 530 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.

03:33 We believe our performance reflects the dynamic nature of our strategy. Investing across public and private credit is a focus on generating return premiums driven by lower competition asset mispricings of less understood businesses or corporate events in complex situations.

03:51 Next, the fund paid distributions of $0.71 cents per share in 2024. 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 and full year, we increased the funds monthly distribution amount by approximately 5% in March, 2024, driven by rising market yields and the continued strong performance of our investment portfolio. This was the third distribution increase. Since the funds common shares were listed on the New York Stock Exchange in November 2022. Following year end, we increased the fund's monthly distribution amount by 7.5% in January 2025, representing an increase of approximately 52% over the fund's distribution rate at the time of listing. As of February 27th, 2025, the fund's annualized distribution yield is 10.7% based on NAV and 11.2% based on market price.

05:00 We deployed $884 million across private and public credit assets in 2024. In our view, private credit offered greater value relative to public credit. Approximately $618 million or 70% of our investment activity during the year was in private credit assets with an average yield of 12.1% While M&A activity was generally slow throughout the year. The fund benefited from our robust deal sourcing engine, which includes our team and firm-wide origination network as well as our private sourcing partnership with JP Morgan Finance directly originated investments.

05:40 Finally, we made substantial progress in reducing the discount at which the fund shares trade relative to its net asset value. The discount narrowed to approximately 5% as of December 31st, 2024 compared to 18% a year earlier. We are encouraged by the progress and believe the significant improvement reflects the fund's continued strong performance, multiple increases in monthly distribution rate since its listing and their broader strength in credit markets, FSCO shareholders earned a total return of 10.3% in the fourth quarter and 34.9% in 2024. 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:** 06:31 Thanks, Andrew.

06:32 The US economy remained on sound footing in 2024 and strong contributions from household spending, business investment and government spending. Inflationary pressures moderated considerably, yet remained above. The federal reserve's preferred 2% target. Falling, yet sticky, inflation enabled the Fed to cut interest rates by 100 basis points during the year against the backdrop of falling rates and solid economic growth. The 2-10 Treasury yield curve uninverted for the first time in more than two years as the policy sensitive 2-year Treasury yield was flat nearly year over year while the longer end of the curve rose with the 10-year Treasury yield rising 69 basis points.

07:16 Public credit markets delivered strong returns in 2024, supported by a favorable macro backdrop, elevated yields and a resilient but moderating fundamental environment. Senior secured loans and high yield bonds returned 9% and 8.2% respectively. High yield bond and loan spreads tightened throughout the year

and ended in the 92nd and 88th percentiles respectively compared to historical averages. In addition, lender protections in the public market materially weakened amid a highly competitive lending environment. Private credit was not fully immune from the risks presented in public credit markets yet offered materially higher spreads over short-term rates throughout 2024. Spreads for traditional sponsored direct lending strategies and non-sponsored transactions sat at 523 basis points and 684 basis points respectively as of December 31st, 2024. Private credit investors were also able to inject greater discipline into deal terms and structures. Covenant-lite issuance represented just 28% of core middle market private equity, private credit insurance issuances through December compared with 90% of the public loan market. Private credit yields remained attractive, resulting in an income-based total return of 12% for the 12 months ending December 31st. Private credit yield volume totaled $295 billion in the year double in 2023 volumes.

08:53 Sentiment among middle market companies finished the year on a notably strong note. According to a survey of US middle market business leaders, 78% reported they were optimistic about the state of the national economy while 85% were upbeat about their local economies. The data support such optimism with revenue growth of 12.9% and employment growth 10% among domestic middle market firms far outpacing those of their large cap peers.

09:23 According to our investment activity, the portfolio remained fully invested during the fourth quarter as it was throughout 2024, driven by a healthy pipeline of private and public investments that we believe offer attractive yields and strong covenants. During the fourth quarter, sales exits and repayments of $260 million exceeded purchases of $226 million when excluding portfolio hedges for the annual purchases excluding portfolio hedges total $884 million compared to sales, exits and repayments of$ 849 million.

09:58 As Andrew mentioned, we believe private credit offers greater relative value compared to public markets. In 2024, approximately 70% of new investment activity was in privately originated investments, 91% of which were in first lien senior secured loans we lend to lower

and core middle market companies with average earnings of $25 to $75 million, which we believe is a competitive sweet spot. These are generally robust businesses that are offering too small for large credit managers make interest in all their balance sheets, may not fit the standardized criteria for conditional lenders like banks. As a result, there is typically a greater ability to control deal firms and create highly structured investments to protect against downside risks.

10:45 We invest in both sponsored and non-sponsored back transactions within sponsored lending. We do not compete against the large direct lending funds and instead lend to small or emerging sponsors where there's typically less competition and greater potential to capture a yield premium. Non-sponsored lending opportunities comprise a wide range of borrowers that in many cases have never taken outside capital. This includes multi-generational family owned businesses, sole proprietors or other tightly held businesses. We like these types of investments because there's often a strong ability to control deal terms and create highly structured investments to protect our downside.

11:25 More broadly, we view private credit as the core foundation of FSCO's portfolio and will opportunistically invest in public markets over time. We focus on high quality performing companies and less traffic corners in public markets and may use periods of market dislocation to acquire quality assets at discounted prices. We also focus on event driven opportunities that arise from corporate actions such as mergers and acquisitions. Upcoming debt for misunderstood growth opportunities.

11:57 As of the end of the year, private and credit investments represented approximately 65% of the portfolio compared to 47% a year ago. Approximately 84% of the portfolio consisted of senior secured debt compared to 82% the previous quarter. Funds allocation to unsecured debt decline to just 5% as of the end of the year compared to 6% at the end of the previous quarter. Asset-based finance represented 3% of the portfolio, which was flat the previous quarter and equity and other investments represented 8% of the portfolio versus 9% at the end of the previous quarter.

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| | 12:36 | Turning to the liability side of our balance sheet, we believe our cost structure gives a competitive edge to 47% of drawn leverage as of the end of the year comprised of preferred shares which provide favorably regulatory treatment versus traditional termil revolving debt facilities and flexibility in the types of assets we can borrow. |
| | 12:55 | Again, I'll now turn it back to Andrew to discuss our forward outlook. |
| **Andrew Beckman:** | 13:01 | Thanks, Nick. |
| | 13:03 | While many strategists forecast the benign environment to for 2025, we are starting to see volatility driven by trade policy and political uncertainty. It is possible this continues where we see additional bouts this year as US policy evolves and we see the outcome of the various geopolitical conflicts and economic data. |
| | 13:27 | While short-term volatility can affect the mark to market of our portfolio, our portfolio is constructed to be durable over the long term. We believe active management combined with sound fundamental credit underwriting will remain critical to driving returns and avoiding excess risk. We believe FSCO offers a differentiated value proposition built to drive strong risk adjusted returns through a diverse range of economic and financial market conditions driven by several factors. |
| | 13:58 | First, we're focused on businesses with strong cash flows, modest leverage profiles and management teams with deep operational experience managing through market cycles. We're invested in credits with appropriate loan to 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. |
| | 14:26 | Second, we continue to focus on senior debt investments with strong terms and attractive yields for 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 with |

lenders. We're also cautious on credits where there are significant EBITDA add backs that may never materialize and instead focus on free cashflow.

14:52 Third, we will continue to leverage 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 $2.3 billion in assets as of December 31st, 2024. Size and scale matter in credit investing, especially when it comes to maximizing deal flow, mitigating risks, 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 the unique advantage as a large percentage of our drawn leverage is multi-year fixed rate preferred debt and provide flexibility in the types of assets we can borrow against.

15:38 Finally, our ability to invest across private and public markets differentiates us from traditional credit funds and allows us to just allocations based on where we believe the best risk adjusted 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 specific asset class mandate. We can invest across loans, bonds, structured credit and highly structured equity investments and across fixed and floating rate assets.

16:17 In summary, 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 as the fund's performance during 2024 again highlighted and we look forward to the opportunities of the coming year.

16:34 Once again, thank you all for joining us today.

16:38 With that, we'll take a brief pause to review the queue before answering your questions.

**Joseph Montelione:** 17:15 Alright, thank you Andrew. First question, with the election behind us, what are your expectations for M&A and deal flow relative to what we saw last year?

**Andrew Beckman:** [17:29]

Well, we're starting to see signals of the M&A market improving. I think there were a lot of people that were waiting just for the election to be behind them to just understand what administration they're dealing with and I think the new administration and the SECC are generally viewed as business friendly and we think that should spur activity. We did start to see a pickup at the end of last year, so there were strong deal volume in Q4, but particularly in December. More specifically for our fund, we closed nine direct originations in Q4, which was significantly higher than the pace earlier in the year.

**Joseph Montelione:** [18:24]

Great. Our next question, are there any political concerns or keeping an eye on with the new administration, most notably tariffs or other potential challenges?

**Andrew Beckman:** [18:38]

Yes, I mean absolutely. While we do invest primarily in US based companies, I mean tariffs are certainly a concern when you think about the supply chain. A lot of US businesses do source things, parts of their supply chain from overseas. Additionally, tariffs can create inflationary pressures and potentially choke consumer demand, so it's possible that the effects of tariffs manifest itself in a slowdown on the economic side also, immigration constraints are likely to put upward pressure on labor costs, which can hit that consumer as well, so I think we're very concerned about tars. We're doing our best to try to avoid investments that will be overly affected by them and stick with investments that are as insulated as possible, but obviously the broad economic effects are a little bit more difficult to manage, so that's where we just have to be kind of prudent from a loan to value perspective and invest in credits that have a margin of safety to potentially a slow down.

**Joseph Montelione:** [20:16]

Great. Our next question in January, you raised the monthly monthly dividend by about 7.5%. Any insights into what forward looking dividend policy may look like while in light of current rate expectations?

**Andrew Beckman:** [20:37]

Well, we continue to review our distribution policy on an ongoing basis by analyzing the fund's natural earnings profile, the trajectory of forward looking base rates, which had been moving around by quite a bit. If you kind of go back to last summer and fast forward to

today, there's been a lot of up and downs including Q1 this year, so we're constantly monitoring that and also the yields of our credit based peers. I think one of the things we're fortunate to have is a significant amount of spill back dollars, so those were earnings that weren't necessarily fully distributed in prior years, which we can use and intend to use in our distribution and it could provide some cushion. There's more if there's a decline in interest rates or kind of yields tighten. The other thing I'd mentioned is a portion of our earnings are typically generated from fee-based income, which is not directly tied to the direction of interest rates more tied to yield flow.

**Joseph Montelione:** 22:01 Great. Our next question says it looks like the portfolio is now 65% private. This compares to 47% a year earlier. Believe that this is the higher ends of the range and do expect allocation or do you continue, do you expect the allocation to continue to grow?

**Nicholas Heilbut:** 22:25 I think we are sort of approaching the higher end of the range, but we also believe private credit's a key differentiator between us and our peers drives a return profile. That's a little bit more BDC like and in addition, we've had the opportunity to continue investing back in our team, so our business has grown and with that the origination capabilities in private credit have expanded, so today we see a much higher level of high quality deal flow than we did two or three or four years ago in the private credit markets, which on average means the opportunity set that we see in private credit is more attractive than it has been historically. So I think that helps explain the shift in our business and portfolio mix and it's a trend that at the margin we expect to continue.

**Joseph Montelione:** 23:27 Great. Our next question, how do the deals that you've recently closed compared to spreads in the broader market when looking at the broader private credit markets?

**Nicholas Heilbut:** 23:41 So I think today if you looked at the private credit market, the average transaction is probably printing around S&P 500 for sponsor deals. There are certainly deals that are printing south of that for very large transactions. You see spreads as tight as four 50 from time to time looking at the fourth quarter, the nine new private originations for us had an average gap yield of

11.3%, which is pretty close to a spread of 700. So I think there's a fairly material difference between the portfolio that we're originating and managing in this fund and the broader private credit market.

**Joseph Montelione:** [24:37] Great. Next question, it looks like leverage ticked up in the end of the year at 0.6 debt to equity. Do you plan on maintaining that level going forward?

**Andrew Beckman:** [24:49] So our leverage level was a bit elevated close to year end largely as a function of timing given we were funding several investments at quarter end. I think leverage is generally expected to remain in line where it has trended historically and whether it's a little bit towards the higher end of the range where it might've ended Q4 or slightly lower end of the range where began early in the year last year. It's just really largely a function of market opportunities that are available at the time. The other thing I'd mentioned is NAV has grown significantly over the last few quarters, which effectively reduces the effect of leverage on nav. So meaning the dollars are a little bit less meaningful and you have to focus on the ratios.

**Joseph Montelione:** [25:54] Our next question, staying on the topic of leverage, it says, I noticed that you have a couple of preferred maturities maturing in November of this year. How do you plan on addressing those maturities and will that materially increase the cost of leverage?

**Andrew Beckman:** [26:12] We've had exploratory conversations with banks and plan to engage a bank at some point in the near future to start to address those maturities, so it's something we do plan to refinance. I will say the pricing for new preferreds appears to be quite attractive and the spread level will be inside of the spreads of our existing preferred. The total rate is likely to also be inside the weighted average cost of our leverage. That said, the preferreds that come due in 2025 were basically put on during a zero rate environment, so we're likely to see a total cost that's above those two tranches.

**Joseph Montelione:** [27:22] Great, and one final question. Are there any updates on investments in the portfolio that are on non-accrual?

**Andrew Beckman:** [27:32] Non-accrual is a percentage of fair market value, approximately 2.5% and we're very comfortable with

this level. There were no new non accruals for the quarter, so I think that level's a good level to think of.

**Joseph Montelione:** 27:55 Great. This concludes today's call. Thank you Andrew, and thank you Nick. If you have any follow-up questions or if we didn't address one of your questions, please feel free to reach out to myself, Joe Montelione. Thank you.