INVESTMENTS®

THE U.S. MIDDLE MARKET

A potential source of income, growth and diversification

ALTERNATIVE THINKING

CONTENTS

In today's low-growth and low-interest rate environment, many investors are turning to alternative investments for their potential to increase returns and enhance diversification as a way to meet long-term investment objectives. While investors have long relied on traditional investments, such as stocks and bonds, to meet their financial goals, economic trends appear to be shifting toward a "new normal"—one characterized by lower interest rates and slower economic growth.

Going forward, the growth and income generated by traditional investments may be considerably lower than in years past.

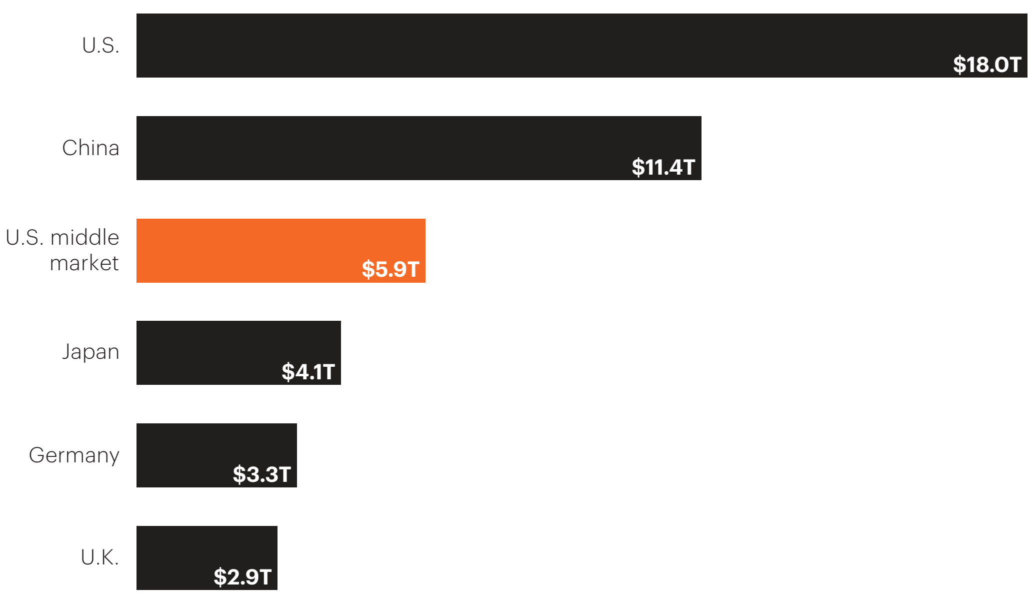
THE U.S. MIDDLE MARKET

The debt and equity of private U.S. middle market companies may be an attractive source of income, growth and diversification.

A driver of the U.S. economy

While most individuals' portfolios include an allocation to public equities, investing in private companies is often overlooked. Ranging in size from $10 million to $1 billion in annual sales, there are approximately 200,000 middle market companies in the United States.[1] Middle market companies employ nearly 50 million American workers and account for about one-third of U.S. private sector gross domestic product. For perspective, if the U.S. middle market were a country, its GDP would rank it as the third-largest economy in the world—ahead of Japan, Germany and the United Kingdom.[1]

U.S. MIDDLE MARKET RANKS AS THE THIRD-LARGEST ECONOMY[1]



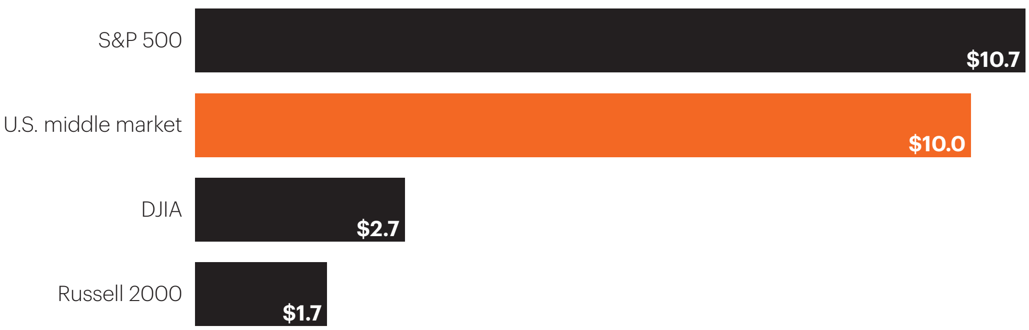
Source: 2Q 2016 Middle Market Indicator, National Center for the Middle Market.

1 National Center for the Middle Market, 2Q 2016 Middle Market Indicator. The Middle Market Indicator is a quarterly business performance update and economic outlook survey conducted among 1,000 C-Suite executives of middle market companies. For the purposes of the 2Q 2016 Middle Market Indicator, the National Center for the Middle Market defined the U.S. middle market as U.S. companies having annual revenues from $10 million to $1 billion.

A large untapped market

U.S. middle market companies generate $10 trillion in annual revenue.[1] By comparison, S&P 500 companies generated approximately $10.7 trillion in revenue in 2015, while the companies represented in the Dow Jones Industrial Average generated approximately $2.7 trillion in revenue.[2]

A COMPARISON OF TOTAL ANNUAL REVENUE ($ TRILLIONS)

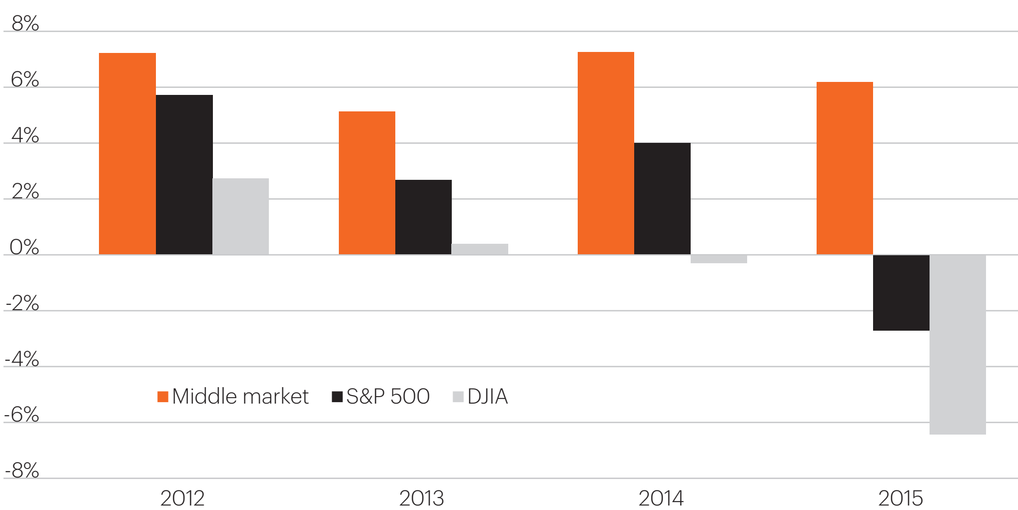


Sources: National Center for the Middle Market. Bloomberg.

A source of consistent growth

As of June 30, 2016, nearly 72% of middle market companies reported increases in year-over-year revenue.[1] Moreover, the rate of revenue growth for U.S. middle market companies remained a healthy 7.2% in the second quarter of 2016.[1] In fact, U.S. middle market company revenue growth has consistently outperformed the revenue growth of large cap companies over the past four years.[3]

MIDDLE MARKET REVENUE GROWTH OUTPERFORMS LARGE CAP



Sources: National Center for the Middle Market. Bloomberg. FS Investments.

2 Bloomberg.
3 National Center for the Middle Market. Bloomberg.

INVESTING IN THE MIDDLE MARKET FOR INCOME

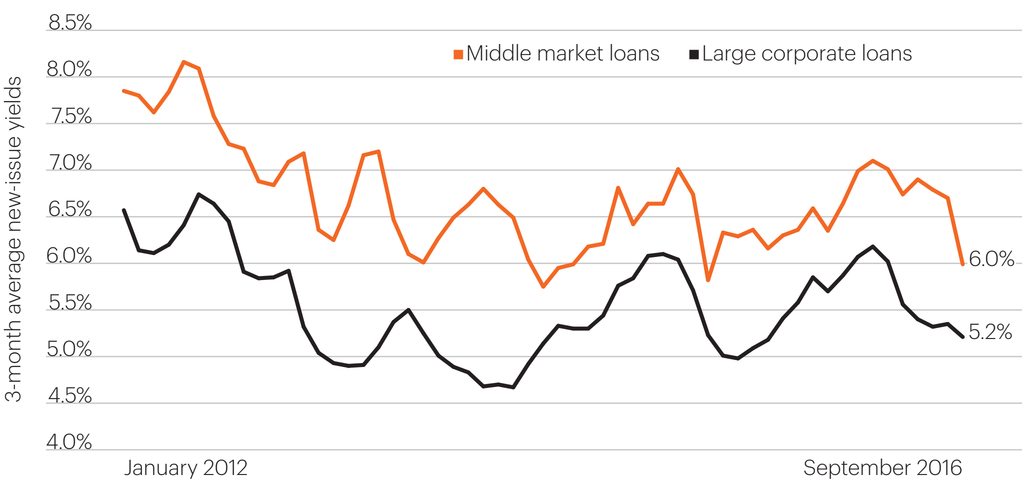
Generating a high level of income in today's low-interest rate environment is becoming increasingly difficult. Interest rates have been trending lower for more than three decades as central banks around the world remain highly accommodative.

Although the U.S. Federal Reserve raised interest rates in December 2015, global interest rates have continued to trend lower. In today's lower-for-longer interest rate environment, investing in the debt of private middle market companies may provide higher levels of current income than traditional fixed income investments.

The middle market premium

Middle market loans are often illiquid and issued by below-investment grade companies. Because they are smaller and generally have fewer places to turn for their capital needs, middle market companies often pay a higher rate of interest compared to larger peers that are able to access the traditional markets (syndicated bank financings or public bond offerings). This so-called "middle market premium" has averaged more than 100 basis points, or 1.0%, over the past five years.[4]

THE MIDDLE MARKET PREMIUM



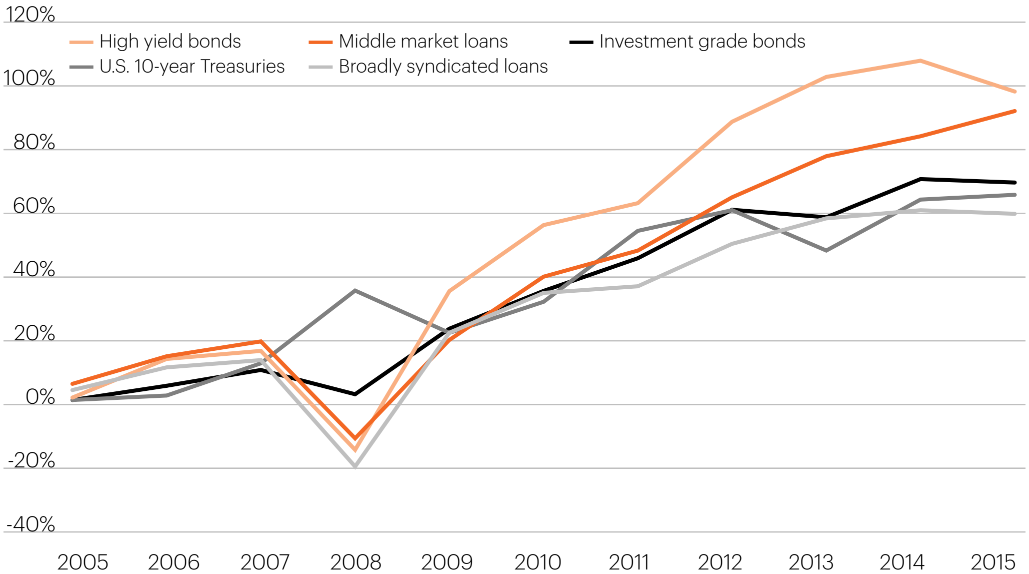
Sources: S&P Capital Market Intelligence. Large corporate loans represented by the S&P/LSTA Leveraged Loan 100 Index. Middle market loans represented by the S&P/LSTA Leveraged Loan Index (middle market component, which is based on companies with annual EBITDA of $50 million or less).

4 For period from January 2012 to September 2016. Middle market loans and large corporate loans are represented by the S&P/LSTA Leveraged Loan Index (based on companies with annual EBITDA of $50 million or less).

Middle market loan performance

This yield premium has contributed to generally high total returns for middle market loans compared to other types of fixed income investments. Between 2005 and 2015, middle market loans generated higher total returns than both broadly syndicated loans and investment grade corporate bonds. On an annualized basis, middle market loans returned 6.1%, compared to 4.4% for broadly syndicated senior secured loans, 4.8% for U.S. 10-year Treasury Notes, 4.9% for corporate bonds and 6.4% for high yield bonds.[5]

CUMULATIVE TOTAL RETURNS 2005–2015



Sources: S&P Capital Market Intelligence, Bank of America Merrill Lynch. Broadly syndicated loans represented by the S&P/LSTA Leveraged Loan Index. Middle market loans represented by the S&P/LSTA Leveraged Loan Index (middle market component, which is based on companies with annual EBITDA of $50 million or less). High yield bonds represented by the Bank of America Merrill Lynch High Yield Master II Index. U.S. 10-year Treasuries represented by the Bank of America Merrill Lynch U.S. 10-year Treasury Index. Investment grade bonds represented by the Bank of America Merrill Lynch Corporate Master Index.

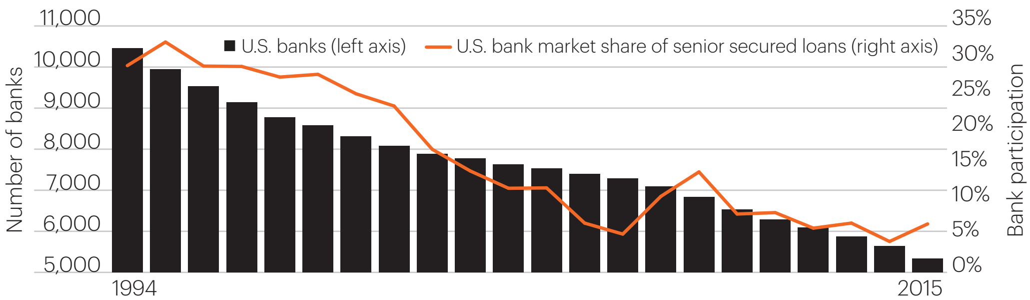
5 S&P/LSTA Leveraged Loan Index (middle market component, which is based on companies with annual EBITDA of $50 million or less). S&P/LSTA Leveraged Loan Index. Bank of America Merrill Lynch High Yield Master II Index. Bank of America Merrill Lynch 10-year U.S. Treasury Index. Bank of America Merrill Lynch Corporate Master Index.

Declining number of lenders

Most middle market companies have historically relied on commercial banks to meet their financing needs. However, industry consolidation and the impact of increased banking regulations, such as the Dodd-Frank Act and the Volcker Rule, have forced some commercial banks to reduce or eliminate businesses that lend to middle market companies. Between 1994 and 2014, the number of U.S. commercial banks declined by nearly 50%.[6] In the wake of this consolidation, some U.S. middle market companies have found themselves without a banking partner to finance their growth, make acquisitions or fund day-to-day operations.

BETWEEN 1994 AND 2014, THE NUMBER OF U.S. COMMERCIAL BANKS DECLINED BY NEARLY 50%.[6]

NUMBER OF U.S. BANKS AND MARKET SHARE

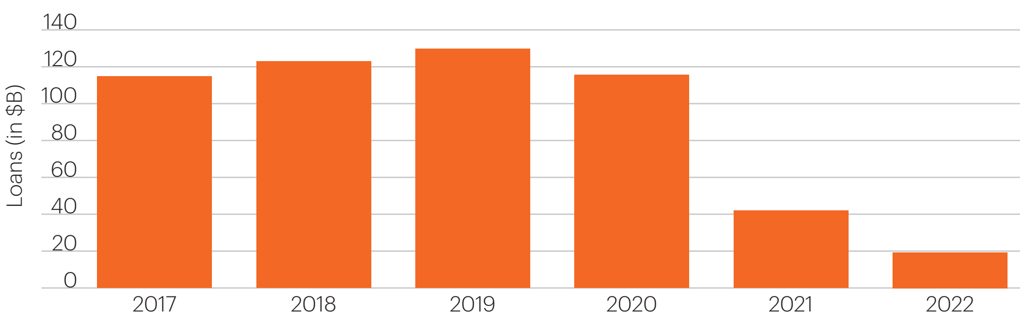


Sources: FDIC and S&P Leveraged Commentary and Data.

Growing need for capital

At the same time, middle market companies face significant refinancing needs. Approximately $544 billion in middle market loans mature between 2017 and 2022.[7]

MIDDLE MARKET LOAN MATURITIES



Source: Thomson Reuters LPC.

While some of these businesses will be able to rely on commercial banks for their financing needs, others will likely be forced to find alternative sources of capital. This structural shift has led to a growing opportunity for non-bank lenders with the capital and experience necessary to source, analyze and underwrite loans to middle market companies, as well as an opportunity for investors seeking income.

6 Federal Deposit Insurance Corporation.
7 Thomson Reuters LPC.

INVESTING IN THE MIDDLE MARKET FOR GROWTH

Growth is a cornerstone for nearly every portfolio. However, global growth rates have steadily and consistently declined over the last 50 years.[8] With few signs to suggest that this trend will reverse course in the near term, we believe investors will need to re-evaluate traditional asset allocation strategies and prepare their portfolios for a lower-for-longer growth environment. Investing in private middle market companies may help.

Investing in and owning private middle market companies

Public companies often have many, even thousands, of shareholders, while private companies are typically owned by a smaller shareholder base (family owned or tightly held by the management team). As a result, owners of private companies may have a greater say over the operations of a business than those who invest in large public companies.

Investing in the middle market relies less on publicly available information and more on an investment manager's ability to analyze and appropriately value the company and, in turn, help grow and improve the company's operations. Therefore, investment in private companies has typically been dominated by large institutional investors that invest through professionally managed private equity funds. Institutions have significantly grown their allocation to private equity funds over the past 10 years as a source of growth and diversification. Together, pension funds, sovereign wealth funds and insurance companies accounted for 72% of all capital invested in private equity funds as of January 2016.[9]

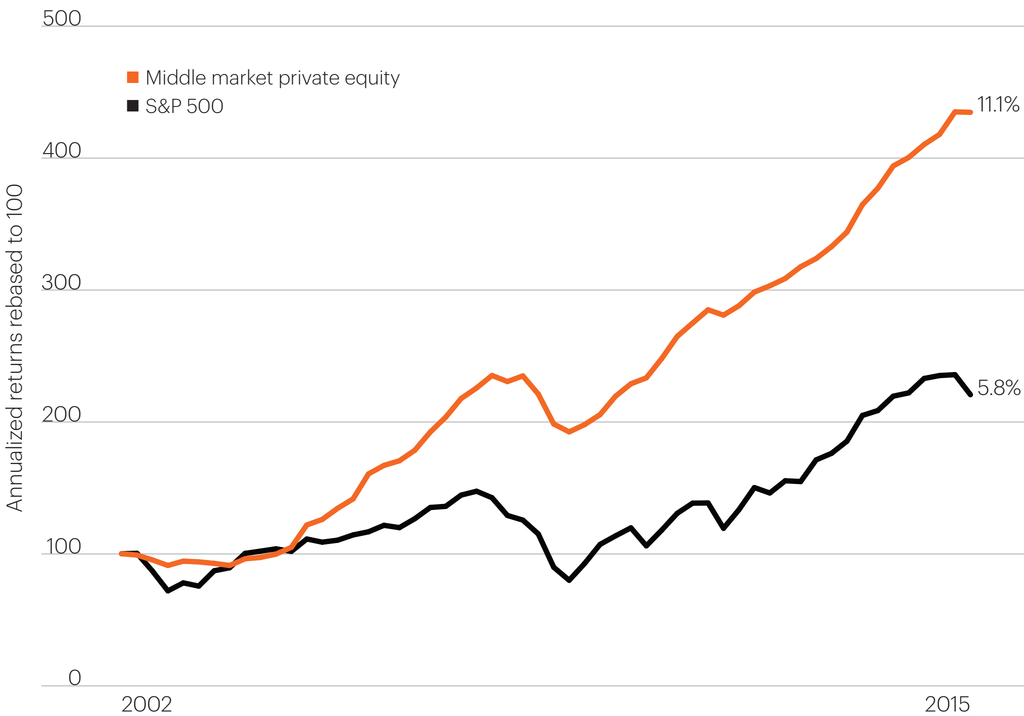
Today, there are more than 1,000 private equity funds in operation.[10] However, most have high investment minimums and rigid suitability requirements. These thresholds have largely restricted individual investors from investing in private equity funds and, in turn, the equity of private middle market companies.

8 Macrobond. Global GDP growth (% change), based on five-year rolling average.
9 Preqin: Private Equity Update, 6th Annual Global Fund Finance Symposium. March 2, 2016.
10 Cambridge Associates.

Middle market private equity outperformance

A review of private equity fund performance may help illustrate how investing in private equity has compared to public equity markets. Over the past 15 years, middle market private equity funds have meaningfully outperformed the S&P 500, nearly doubling the index's return between January 1, 2002, and December 31, 2015.[11]

PERFORMANCE OF MIDDLE MARKET PRIVATE EQUITY VS. S&P 500



Past performance does not guarantee future results.

Sources: Preqin, Private Equity Buyout Quarterly Index. Buyout by Fund Size as of June 30, 2015. Bloomberg: S&P 500 Index.

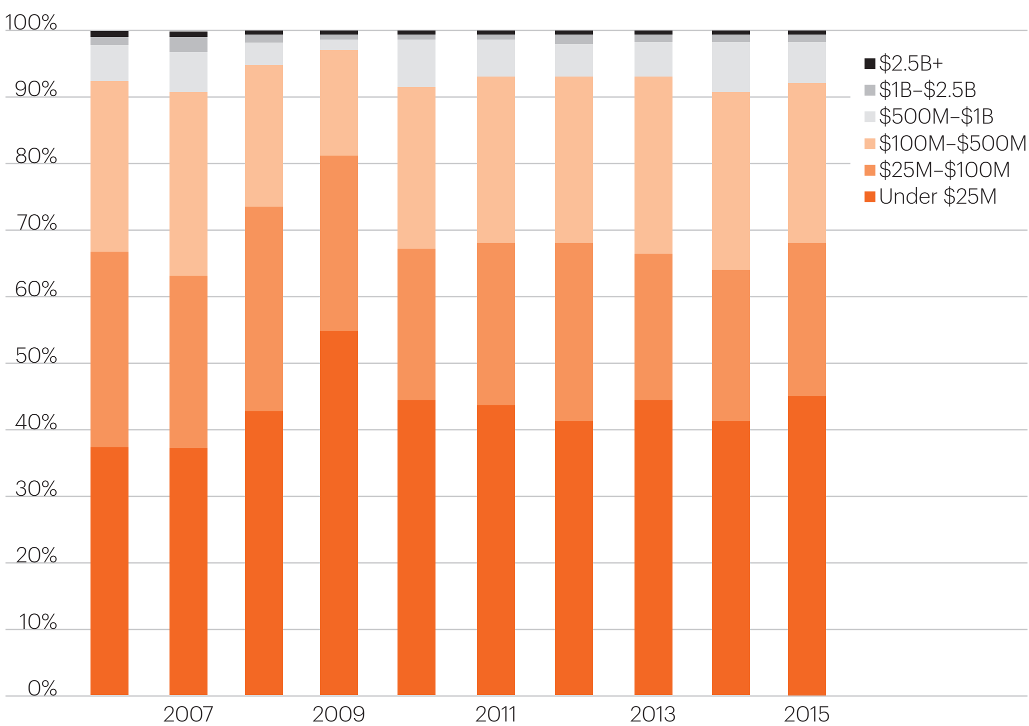
11 Preqin, Private Equity Buyout Quarterly Index.

A fragmented market creates opportunity for experienced managers

The middle market tends to be more fragmented (with many companies of varying sizes in a wide range of industries) compared to the market for larger private companies. As a result, private equity transactions targeting middle market companies also tend to be more fragmented. For example, in 2015 private equity deals targeting middle market companies (transactions valued at less than $500 million) represented approximately 92% of the total number of transactions but just 42% of total investment activity.[12] As discussed in further detail in the following section, fragmentation within the middle market often results in a wide dispersion of valuations for private middle market companies, creating an opportunity for managers with the expertise and experience to identify the best companies for investment.

Conversely, private equity deals targeting larger private companies (transactions valued at more than $500 million) represented 58% of all activity in 2015, but just 8% of the total number of transactions in 2015. One result is a more crowded and competitive market for large private equity transactions and, in turn, often higher purchase prices for the buyers of those companies.

U.S. PRIVATE EQUITY PERCENTAGE OF DEALS BY SIZE



Source: Bain & Company Global Private Equity Report 2016 based on PitchBook data, http://bit.ly/21hj9dz.

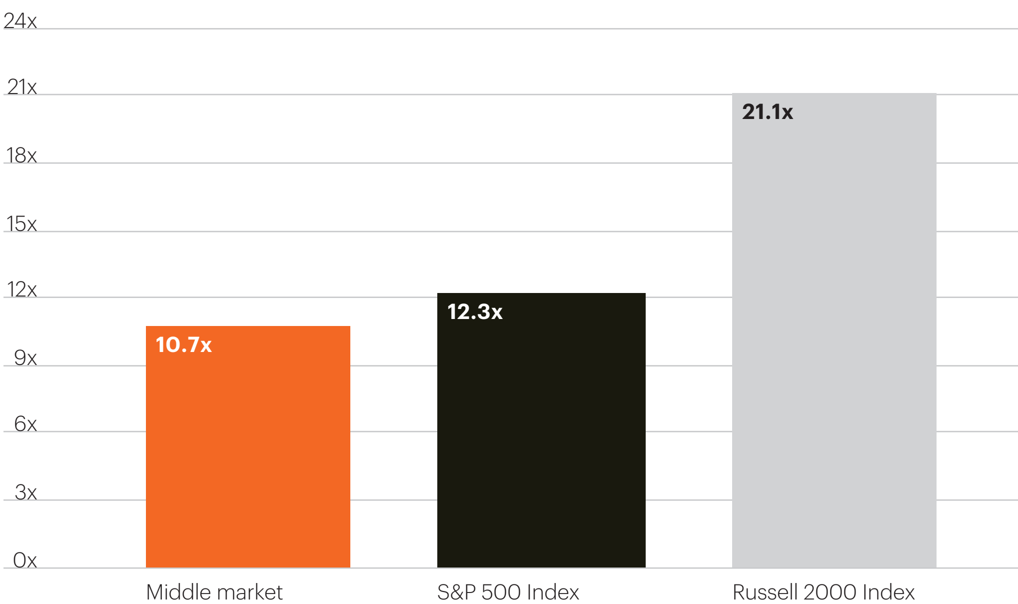
12 PitchBook, 1Q 2016 U.S. PE Breakdown, http://bit.ly/24HoF0e.

Relative bargains

One of the most commonly used metrics in business valuation is enterprise value (EV), which represents the entire economic value of a company (value of equity plus outstanding debt, among other items). The purchase and sale prices for private companies are often stated as a ratio of a company's enterprise value to its cash flow, or earnings before interest, taxes, depreciation and amortization (EBITDA). The higher the EV/EBITDA, or valuation multiple, the higher the purchase or sale price.

As of December 31, 2015, the average valuation for private equity fund purchases in the middle market was 10.7x compared to 12.3x for companies in the S&P 500 and 21.1x for the Russell 2000.[13] This data suggests that it is generally cheaper to buy a private company than to invest in a comparable public company.

ENTERPRISE VALUE / EBITDA MULTIPLES AS OF DECEMBER 31, 2015



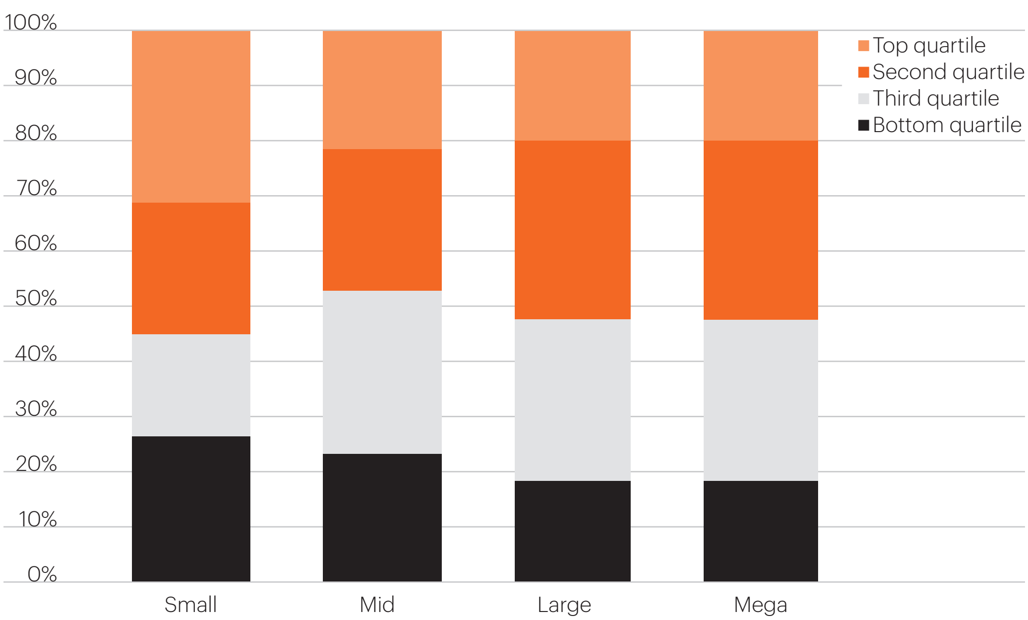
Sources: PitchBook as of December 31, 2015; Bloomberg.

13 PitchBook mid-market EV/EBITDA multiples as of December 31, 2015.

Manager matters

Investing in middle market companies relies less on publicly available data and more on an investment manager's ability to successfully underwrite, acquire and grow middle market companies. As a result, manager selection is critical when investing in the equity of private middle market companies, with performance differing meaningfully depending on the size of the private equity fund.[14] While past performance does not guarantee future results, history shows that small- and mid-sized private equity funds have the largest proportion of funds ranked as top quartile (a common way to rank and compare the performance of asset managers or investments). However, small- and mid-sized funds also have the greatest proportion of funds in the bottom quartile. This disparity may be due, in part, to the relative difficulty in identifying, valuing, operating and growing middle market companies and the experience, size and relationships often required to generate strong risk-adjusted returns.

BUYOUT FUND SIZE AND QUARTILE RANKING



Source: Preqin, Private Equity Spotlight, "Does Size Really Matter?," August 2015, http://bit.ly/1q9BbT8. Buyout fund size ranges as defined by Preqin: Vintage 1992–1996: Small buyout ≤$200M, Mid buyout $201M–$500M, Large buyout >$500M. Vintage 1997–2004: Small buyout ≤$300M, Mid buyout $301M–$750M, Large buyout $751M–$2B, Mega buyout >$2B. Vintage 2005–2015: Small buyout ≤$500M, Mid buyout $501M–$1,500M, Large buyout $1,501M–$4.5B, Mega buyout >$4.5B. Data is from 1992–2015; all performance is net of fees and expenses.

14 Preqin Private Equity Spotlight, "Does Size Really Matter?," August 2015, http://bit.ly/1q9BbT8.

A COMPLEMENT TO TRADITIONAL PORTFOLIOS

By focusing on a specific investment objective, investors can make a more informed decision on how investing in the debt and equity of private middle market companies can complement their traditional portfolios.

Investors seeking current income and diversification might consider middle market senior secured loans to complement a traditional bond portfolio. Growth-oriented investors looking to earn a higher return in exchange for a certain amount of illiquidity might consider investing in the equity of private middle market companies.

		INVESTMENT OBJECTIVE		
TRADITIONAL INVESTMENTS	**MIDDLE MARKET INVESTMENTS**	**CAPITAL PRESERVATION**	**INCOME**	**GROWTH**
Equities: Large, mid, small, growth, value, international, emerging markets	Middle market private equity			● (Primary)
Fixed income: Treasuries, investment grade, high yield, emerging market debt	Middle market private debt	● (Secondary)	● (Primary)	

● Primary objective ● Secondary objective

INCORPORATING MIDDLE MARKET STRATEGIES CAN HELP MEET SPECIFIC INVESTMENT OBJECTIVES

Investing in the private debt or equity of middle market companies is significantly different than owning a pool of traditional assets, such as stocks and bonds. Generally, middle market investments are illiquid and difficult to access compared to traditional investments. As a result, middle market investments may have higher expenses compared to traditional investments. When building a portfolio that includes middle market investments, investors and their financial advisors should consider an individual's financial objectives, investment time horizon, risk tolerance and liquidity needs. Before investing, individuals should be aware of the benefits and risks associated with investing in the middle market and seek the advice of a qualified investment advisor.

In the context of middle market investments, higher returns may be accompanied by increased risk and, like any investment, the possibility of an investment loss. Investments made in middle market companies may be less liquid and harder to value than investments made in large, publicly traded corporations. As a result, the current investing environment favors experienced managers with both the scale and depth of market relationships needed to identify, structure and fund middle market investments with attractive return profiles.

SUMMARY

While individual investors have typically focused on traditional allocations to large, public companies, the universe of private companies is significantly larger than those whose shares trade on national exchanges.

Private middle market companies collectively account for one-third of U.S. jobs and 33% of private U.S. GDP and generate $10 trillion in annual revenue.[1] Yet, this key driver of the U.S. economy is often overlooked by individuals due to the challenges they have historically faced in accessing private middle market companies. For those with access, investing in the private debt and equity of U.S. middle market companies may help to diversify traditional portfolios and may be a source of higher income and capital appreciation than traditional U.S. equity and bond investments.

THE MIDDLE MARKET:

15 American Express and Dun & Bradstreet, “The Middle Market Power Index: Catalyzing U.S. Economic Growth,” April 2015.

ABOUT ALTERNATIVE THINKING

FS Investments is dedicated to supporting financial advisors and investors in making informed investment decisions with ongoing education on alternative investments. As a leading manager of alternatives, we focus on creating access to asset classes, strategies and asset managers that can help investors achieve their long-term investment goals. Our Alternative Thinking educational platform can help deepen your understanding of alternative investments and the role they can play in your overall investment strategy.

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