FS INVESTMENTS®

BUSINESS DEVELOPMENT COMPANIES

Seeking income and diversification through direct investments in the U.S. middle market

ALTERNATIVE THINKING

A prolonged period of low interest rates has made it increasingly difficult for investors to find sustainable sources of meaningful current income. In this environment, business development companies (BDCs) may help provide an alternative source of income and diversification for investors and a timely source of capital for private U.S. middle market companies.

IN THE FOLLOWING PAGES, WE WILL:

- Further define and explain what a BDC is
- Outline the benefits that BDCs may offer investors
- Discuss the key differences between BDCs' investment strategies, objectives and managers
- Explain how a BDC may be incorporated into an investor's portfolio

WHAT IS A BDC?

BDCs facilitate the flow of capital from individual investors to the domestic private sector, including U.S. middle market companies. Generally, a BDC must invest at least 70% of its assets in private U.S. companies or public companies with a market capitalization of less than $250 million. By pooling investments from individual investors, BDCs help provide many middle market companies with the capital necessary to operate and grow their businesses. BDCs were created by Congress in 1980, but it was in the years following the 2008 financial crisis that they experienced their greatest period of growth.

BDCs HELP MATCH THE INVESTMENT NEEDS OF INDIVIDUALS WITH THE CAPITAL NEEDS OF PRIVATE U.S. COMPANIES

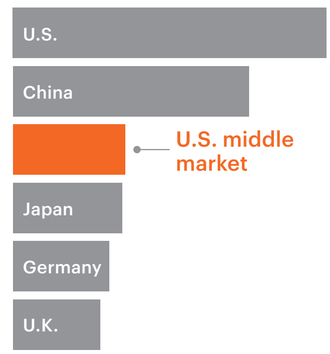
INDIVIDUAL INVESTORS | **BUSINESS DEVELOPMENT COMPANY** | **PRIVATE U.S. COMPANIES**

BDCs offer access to the U.S. middle market

Nearly 200,000 businesses comprise the U.S. middle market, which accounts for nearly one-third of America's private sector GDP and more than 47 million jobs.[1]

If ranked as a country, the U.S. middle market would represent the world's third-largest economy, larger than Japan's economy but smaller than China's.[1] Investing in private middle market companies has historically been limited primarily to large institutional investors, such as endowments or pension funds, due to high investment minimums and suitability requirements. BDCs help provide individual investors access to this large segment of the American economy.

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



Regulations limit traditional lenders

While these businesses play an indispensable role in our economy, sweeping regulatory changes have led to many banks reducing or closing businesses that historically provided capital to middle market companies. New financial regulations have even forced some non-bank lenders to sell or close their corporate lending businesses. For example, after the Financial Stability Oversight Council determined that General Electric Capital Corporation (GECC) should be subject to supervision by the Federal Reserve as a systemically important financial institution, GECC sold off, exited or significantly downsized its lending businesses, once a stalwart in the lending industry.[2]

REGULATIONS IMPACTING TRADITIONAL LENDERS

- Dodd-Frank — Act that intends to address the systemic challenge of "too big to fail" institutions, mitigate the need for future large-scale bank bailouts and promote financial stability
- Volcker Rule — Section of the Dodd-Frank Act that restricts banks from engaging in certain lending activities, among other things
- Basel III — Global framework that is intended to strengthen bank capital requirements by increasing bank liquidity and decreasing bank leverage
- OCC Leveraged Lending Guidance — Guidance provided by the Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC) and the Federal Reserve intended to "ensure that leveraged lending activities of federally regulated financial institutions are conducted in a safe-and-sound manner"[3]

1 International Monetary Fund World Economic Outlook, October 2015. 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 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.

2 U.S. Department of the Treasury, https://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx.

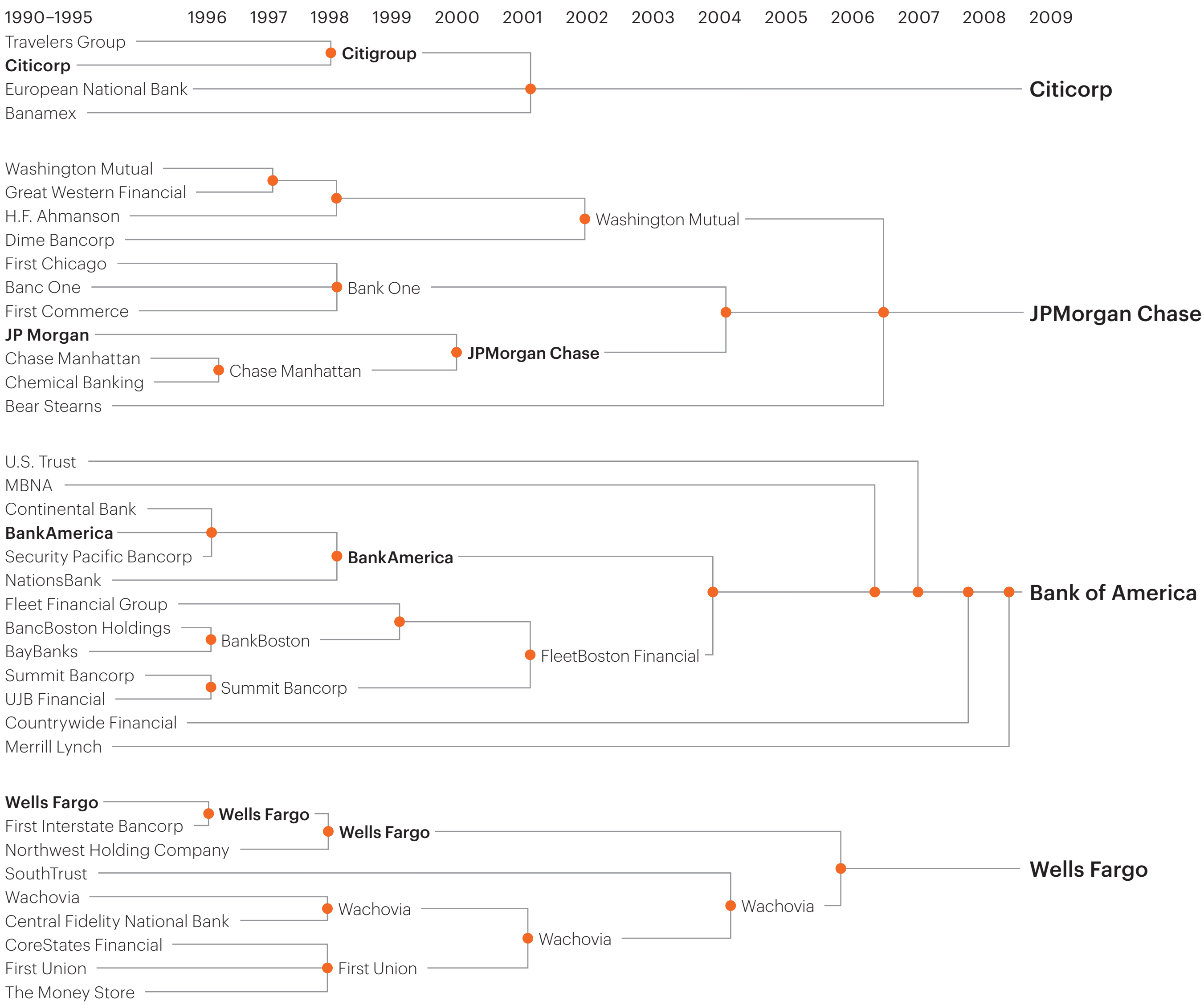
3 FDIC Interagency Guidance on Leveraged Lending: Frequently Asked Questions, https://www.fdic.gov/news/news/financial/2014/fil14053.html.

Bank consolidation leaves a lending void

At the same time, the number of banking institutions in the United States declined from a peak of more than 18,000 since federal regulators began keeping track in 1934 to just 5,300 in 2015.[4] In 2015, U.S. banks represented 7% of the total investor base for senior secured loans to U.S. middle market companies, down from 28% in 2003.[5]

As many commercial banks and non-bank lenders have scaled back their middle market lending operations, BDCs are increasingly helping to fill the void.

BANK CONSOLIDATION 1990–2009



Source: Federal Reserve, U.S. Government Accountability Office.

4 FDIC, https://www.fdic.gov/bank/statistical/stats/2015dec/industry.pdf.

5 S&P Capital IQ 4Q15 High-End Middle Market Lending Review.

BENEFITS OF BDCs

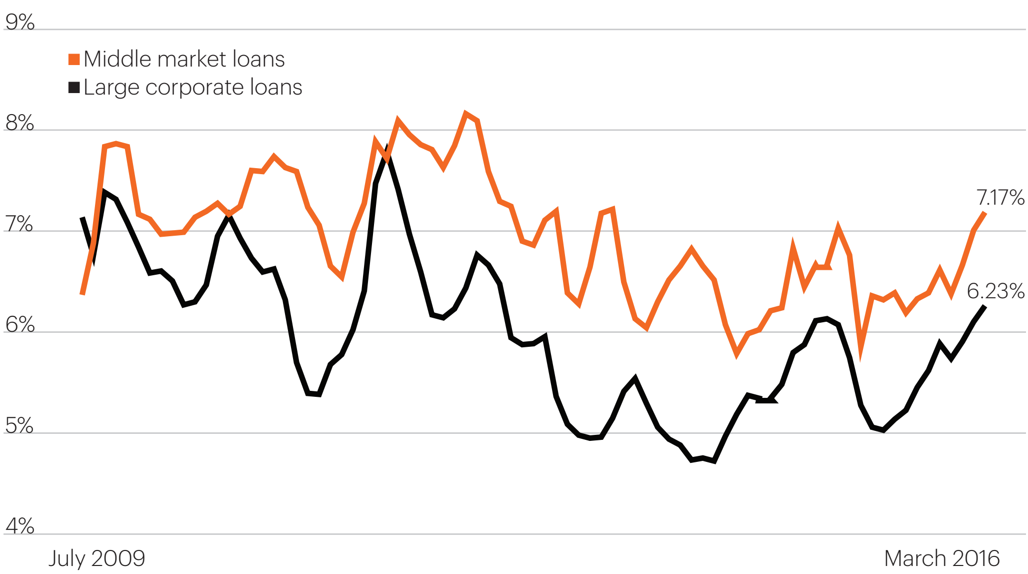
In addition to financing the growth of middle market businesses, BDCs may appeal to investors because they may offer an alternative source of income, growth and diversification.

1 Income in a low yield environment

By investing in the debt of middle market companies, BDCs may serve as a source of meaningful income for investors due to the following factors:

YIELD PREMIUM: Loans of middle market companies have historically provided higher levels of current income than those of larger private companies. Because middle market companies are smaller and generally have fewer places to turn for their capital needs, they often pay a higher rate of interest than their larger peers that may be able to access the public capital markets. Investors can tap into this "middle market premium" by investing with a manager that has a proven track record of identifying, analyzing and underwriting loans to middle market companies.

MIDDLE MARKET LIQUIDITY PREMIUM

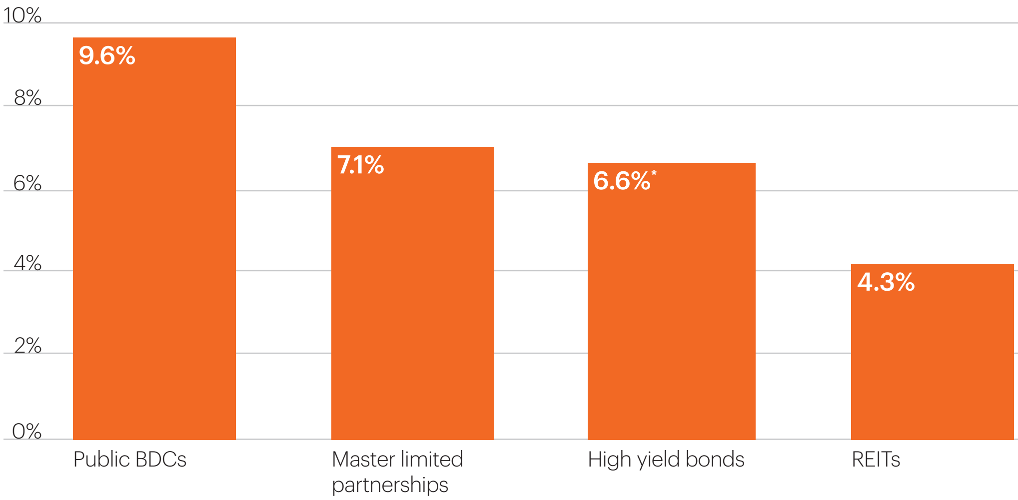


Source: S&P Global Market Intelligence. Large corporate loans represented by the S&P/LSTA Leveraged Loan 100 Index. Middle market loans represented by the S&P/LSTA Middle Market Index. There are varying levels of risk associated with each type of investment. Past performance is not indicative of future results.

It is important to note that investments with higher yields may be accompanied by a higher degree of risk. This risk, whether actual or perceived, may be based on considerations such as time horizon, liquidity and investment rating, among other factors.

PASS-THROUGH INCOME: A BDC must distribute at least 90% of its taxable income to investors to maintain its tax status as a regulated investment company (RIC). As a result, BDCs have generally generated high levels of current income as compared to many traditional income-producing investments.

DISTRIBUTION RATES AND YIELD ACROSS VARIOUS ASSET CLASSES



Source: Bloomberg, as of July 25, 2016. Public BDCs are represented by the Wells Fargo BDC Index, which is intended to measure the performance of all business development companies that are listed on the New York Stock Exchange or NASDAQ and satisfy specified market capitalization and other eligibility requirements; Master limited partnerships are represented by the Alerian MLP Index; High yield bonds are represented by the BofA Merrill Lynch High Yield Master II Index; REITs are represented by the FTSE NAREIT All REIT Index. There are varying levels of risk associated with each type of investment. Past performance is not indicative of future results.

It is important to note that investments with higher distribution rates or yield may be accompanied by a higher degree of risk. This risk, whether actual or perceived, may be based on considerations such as time horizon, liquidity and investment rating, among other factors.

The primary difference between a distribution rate and yield hinges on whether or not the income an investor receives is a contractual obligation of the issuer. For example, a BDC's distribution does not represent a contractual obligation of the fund. As a result, the amount and timing of a BDC's distribution may be subject to change over time and may constitute a return of capital that would reduce an investor's principal investment amount. However, a high yield bond's yield is simply a bond's coupon—which is a contractual obligation of the issuer—divided by its price.

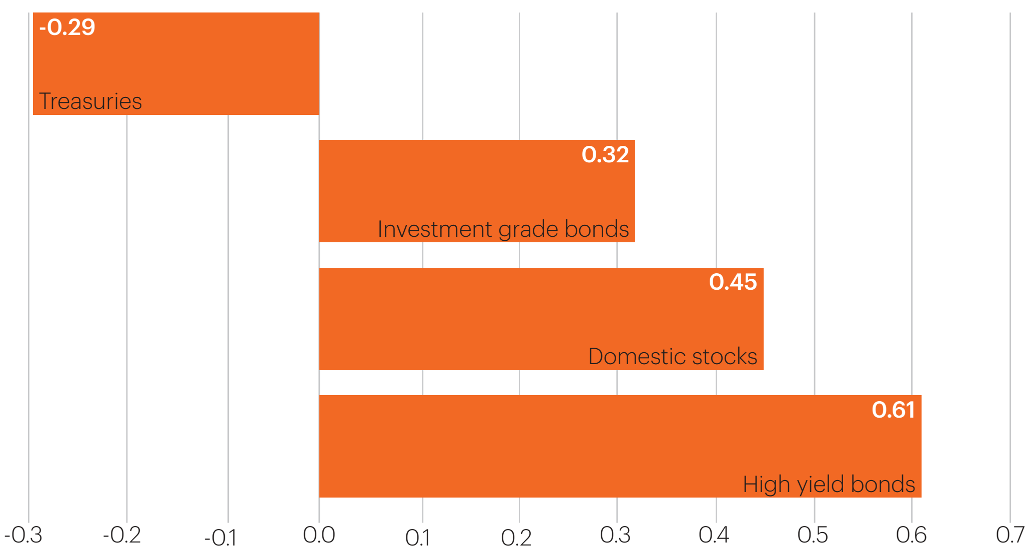
*Percentage shown is the yield of the investment.

2 Low correlation to many traditional investments

Middle market loans historically have had a low correlation to many traditional investments, such as stocks and investment grade bonds, and have been negatively correlated to U.S. Treasuries.

While middle market loans are more highly correlated to high yield bonds, they are typically the first obligations of a company to be repaid, before junior debt or equity investors. Unlike most high yield bonds, loans are typically secured by a borrower's assets, including cash, inventory, equipment and property, which may help protect an investor's principal if a company comes under financial stress.

CORRELATION OF MIDDLE MARKET LOANS WITH MANY TRADITIONAL INVESTMENTS



A CORRELATION OF +1 IMPLIES THAT TWO INVESTMENTS TEND TO MOVE UP AND DOWN TOGETHER. A CORRELATION OF -1 IMPLIES THEY TEND TO MOVE IN OPPOSITE DIRECTIONS.

Source: Middle market loans represented by the S&P/LSTA Middle Market Index. S&P Leveraged Commentary and Data. Correlation data from January 1997 through February 2016. Treasuries are represented by the BofA Merrill Lynch 10-year Treasury Index; Investment grade bonds are represented by the BofA Merrill Lynch U.S. Corporate Master Index; Domestic stocks are represented by the S&P 500 Index; High yield bonds are represented by the BofA Merrill Lynch High Yield Master II Index.

Investing in middle market loans is different than investing in traditional investments, such as stocks and bonds. Middle market loans are often illiquid and issued by below-investment grade companies. When building a portfolio that includes middle market loans, investors and their financial advisors should first consider the individual's financial objectives. Investment constraints such as risk tolerance, liquidity needs and investment time horizon should be taken into consideration. Past performance is no guarantee of future results.

3 Regulatory protections

BDCs are regulated under certain provisions of the Investment Company Act of 1940, which provides limited regulatory protections and requires them to:

- Maintain an independent board of directors and custodian, which holds and safeguards the BDC's assets similar to how an escrow account functions
- Disclose financial performance through regular filings with the SEC
- Disclose the value of its investments on a quarterly basis

4 Diversification and distribution requirements

BDCs may elect to register as regulated investment companies for tax purposes. As RICs, BDCs generally are exempt from corporate-level federal taxation on any income they distribute to shareholders if they:

- Meet asset diversification tests including, among others, investing no more than 5% of their total assets in any single investment or more than 10% of the voting stock of any single issuer
- Derive at least 90% of their gross income for each tax year from dividends, interest, capital gains or other investment income
- Distribute (or pass through) at least 90% of their investment company taxable income to shareholders
- Distribute at least 98% of the net ordinary income generated within a calendar year and 98.2% of their capital gain net income produced within a one-year period

A BDC'S ROLE IN A PORTFOLIO

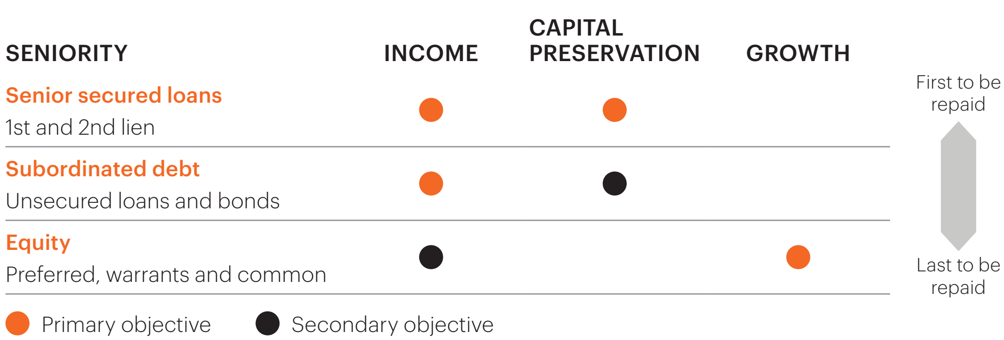
Just as open-end mutual funds allow investors access to a wide range of asset classes, geographies and industry sectors, the investment objectives and strategies of BDCs may also vary widely.

Investment strategy

BDCs may help investors achieve a range of investment objectives based on the types of assets in which they invest. BDCs that invest primarily in a company's debt (senior secured loans and high yield bonds) may serve as an alternative source of income. Senior secured loans are typically the first to be repaid in the event a company defaults on its obligations, ahead of subordinated debt and equity holders. As a result, high yield bonds have historically had lower recovery rates in the event of default than senior secured loans, due to their lower priority for repayment.

BDCs that invest predominantly in equity securities may assume a higher degree of risk as compared to BDCs that invest primarily in senior parts of the corporate capital structure. In exchange for assuming a higher level of risk, equity-focused BDCs may provide a higher level of return and growth.

Investors should work with their financial advisors to better understand how BDCs may provide an alternative source of income, growth and diversification to their portfolio.



The manager matters

Investing in alternative assets, such as private debt and private equity, relies less on publicly available data and more on a manager's ability to analyze and underwrite its investments. Therefore, a manager's ability can have a more significant impact on returns when compared to traditional investment strategies. For example, the average annual difference in returns between the top- and bottom-quartile alternative asset fund managers is nearly 23%.[6] For private equity fund managers, the average annual dispersion is more than 16%.[6] For traditional investment strategies, such as domestic stock and investment grade bond funds, the average annual difference in returns between top- and bottom-quartile managers is just 4.4% and 4.3%, respectively.[6] For this reason, investors must carefully consider a BDC manager's track record, expertise, size and scale before investing.

Public vs. private

While Congress created the BDC in 1980, it was in the years following the 2008 financial crisis—a period of rapid consolidation in the banking industry—that they experienced their greatest period of growth. As of early 2002, assets of publicly traded BDCs totaled $4.2 billion.[7] That figure grew to approximately $60 billion as of December 31, 2015.[7] Publicly traded BDCs are listed on a national securities exchange, offer daily liquidity to shareholders and are subject to the daily volatility of the public markets.

A private BDC does not trade on a national securities exchange and is designed as a long-term investment, generally providing investors with limited liquidity five to seven years following its launch. In addition, the share price of a private BDC is typically based on the value of the fund's investments while public BDC shares can trade at a premium or discount to net asset value. The industry's first private BDC launched in 2009. The private BDC industry has since grown to more than $18 billion in assets as of December 31, 2015.[8]

Both public and private BDCs are closed-end funds and therefore have little need to manage to liquidity or become forced sellers during periods of market stress.

6 Morningstar and FS Investments. Analysis based on the average dispersion in annual total returns of mutual funds in each quartile, as ranked by Morningstar. Based on total return data from 2001 through 2015.

7 Keefe, Bruyette & Woods. Data as of March 23, 2016.

8 Based on public filings.

UNDERSTANDING KEY INVESTMENT CONSIDERATIONS

Investors need a clear understanding of the risks and benefits of BDCs to make well-informed investment decisions. Working with a financial advisor, investors should take the primary considerations below into account before investing.

INVESTMENT OBJECTIVE

BDCs may help investors achieve a range of investment objectives based on the types of securities in which they invest. For example, BDCs that invest primarily in a company's senior secured debt (senior secured loans and bonds) may serve as an alternative source of income, while a BDC that invests primarily in equity securities may be better suited for investors seeking growth. Investors should carefully consider a BDC's investment objectives and asset allocation to ensure they are properly aligned.

RISK TOLERANCE

BDCs typically invest in below-investment grade companies, which means that they may, among other things, experience higher default rates and be less liquid and harder to value compared to investment grade companies. A BDC's yield and total return potential should be weighed against the level of risk assumed within the portfolio.

INVESTMENT TIME HORIZON

An investment in a BDC can involve significant costs. Investors should consider a BDC's fees as well as liquidity, or the frequency with which an investor may buy or sell their shares. As noted, public BDCs trade on a national securities exchange and typically provide investors with liquidity on a daily basis. Shares of publicly traded BDCs may be subject to the daily volatility of the public markets.

A private BDC is designed as a long-term investment, generally providing investors with limited liquidity during its offering period.

SUMMARY

BDCs provide individuals with access to private debt and equity investments, which have historically only been available to large institutions.

Following the financial crisis, BDCs have emerged as a timely source of capital for private U.S. middle market companies as regulatory changes and consolidation have limited traditional banks' lending operations. At the same time, investors have turned to BDCs for their meaningful level of income and lower correlation to many traditional investments.

BDCs represent a diverse asset class with a variety of investment strategies and objectives. With a clear understanding of the risks and benefits they may bring to a portfolio, investors can make well-informed decisions on how to best incorporate BDCs into a diversified portfolio.

RISK FACTORS

An investment in the securities of any of the BDCs sponsored by FS Investments (each, a "fund" and, collectively, the "funds") involves a high degree of risk and may be considered speculative. The following are some of the risks an investment in such securities involves; however, investors should carefully consider all of the information found in the section of the applicable fund's prospectus entitled "Risk Factors" or "Types of Investments and Related Risks," as applicable, before deciding to invest in such securities.

- Because there is no public trading market for shares of the non-traded funds and the non-traded funds are not obligated to effectuate a liquidity event by a specified date, if at all, it is unlikely that investors will be able to sell their shares. While the non-traded funds intend to conduct quarterly tender offers for their shares, only a limited number of shares will be eligible for repurchase and the non-traded funds may suspend or terminate their share repurchase programs at any time.
- Investors may not receive distributions or the funds' distributions may not grow over time. The funds may pay distributions from offering proceeds, borrowings or the sale of assets, and the funds have not established limits on the amount of funds that they may use from net offering proceeds or borrowings to make distributions. Distribution proceeds may exceed the funds' earnings and, therefore, portions of the distributions that they make may represent a return of capital for tax purposes.
- Investors in shares of certain of the funds may be subject to an annual distribution fee, and may also be subject to a contingent deferred sales charge if they tender their shares within certain time periods as described in the applicable prospectus.
- An investment strategy focused primarily on privately held companies presents certain challenges, including the lack of available information about these companies.
- Investments in securities and other obligations of companies that are experiencing distress involve a substantial degree of risk, require a high level of analytical sophistication for successful investment and require active monitoring.
- Investments in expectation of a specific event or catalyst can result in losses if the event fails to occur or it does not have the effect foreseen.
- Investing in middle market companies involves a number of significant risks, any one of which could have a material adverse effect on the funds' operating results.
- A lack of liquidity in certain of the funds' investments may adversely affect the funds' businesses.
- The funds are subject to financial market risks, including changes in interest rates, which may have a substantial negative impact on their investments.
- The funds have and may in the future borrow funds to make investments, which increases or would in the future increase the volatility of their investments and may increase the risks of investing in their securities.
- The funds have limited operating histories and are subject to the business risks and uncertainties associated with any new business.
- The offerings of the non-traded funds still in their offering stages are "best efforts" offerings and if such funds are unable to raise substantial funds, then they will be more limited in the number and type of investments they make.

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.

TO LEARN MORE ABOUT ALTERNATIVE THINKING

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