



FS INVESTMENT CORPORATION II

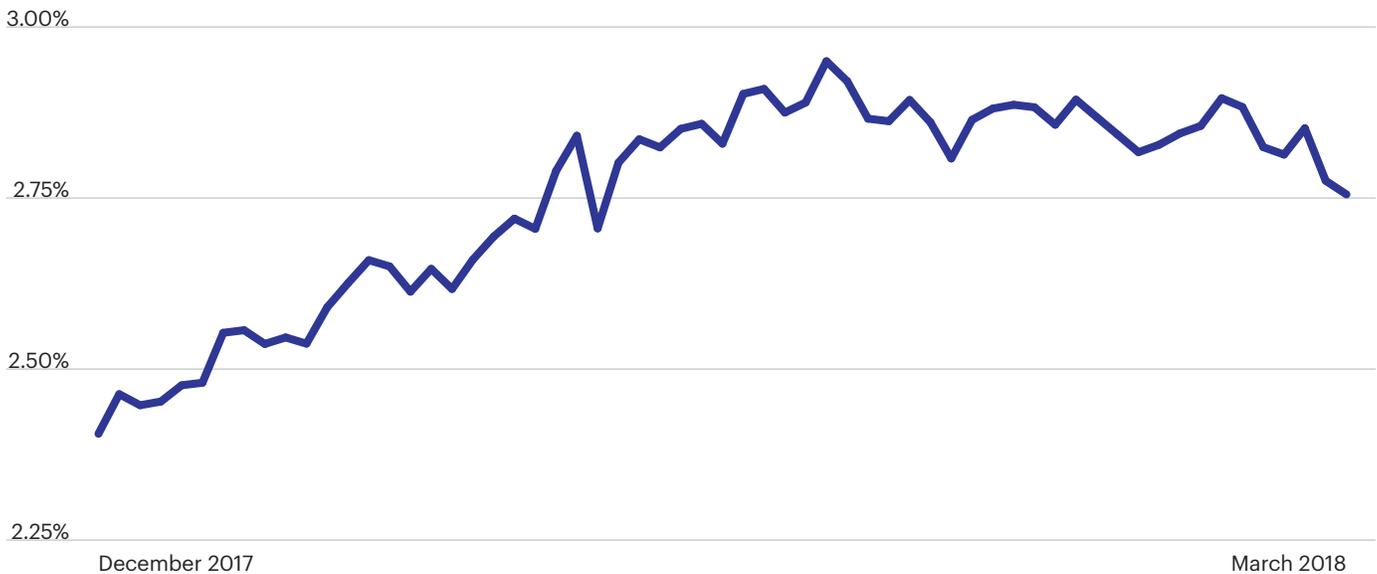
Summary

- The U.S. economy continued to expand during the first quarter of 2018 as the pace of job creation accelerated. Corporate credit and equity markets experienced heightened volatility as both interest rates and trade tensions rose during the quarter.
- High yield bonds and senior secured loans generated total returns of approximately -0.9% and 1.6%, respectively, during the first quarter of 2018.¹ It was the second consecutive quarter in which returns on senior secured loans outpaced those of high yield bonds.¹
- FS Investment Corporation II (FSIC II, or the Fund) generated a stockholder return (without sales charge) of -0.1% for the quarter ended March 31, 2018, compared to 1.6% for senior secured loans.^{1,2}

Market review

Corporate credit markets were mixed during the first quarter of 2018. Senior secured loans outperformed high yield and investment grade bonds as credit and equity markets experienced heightened volatility.¹ The U.S. economy continued to expand during the first quarter of 2018, driven by ongoing strength in the labor market. Strong global growth data and improved investor sentiment helped push the yield on the 10-year U.S. Treasury note higher, rising approximately 52 bps through the first half of the quarter.³ The rise in rates was buoyed by the prospect of nascent inflationary pressures and the potential for a more active U.S. Federal Reserve. Rates declined modestly toward quarter-end as markets digested the potential impact of trade policy, growing fiscal deficits and pressures within the technology sector that affected some of the largest names in the S&P 500, including Facebook and Amazon.³

U.S. 10-YEAR TREASURY YIELD



Source: Bloomberg.

[An investment in FSIC II involves substantial risks. For a summary of these important risk factors, please turn to page 4 or click here.](#)

An investment in FSIC II involves a high degree of risk and may be considered speculative. Investors are advised to consider the investment objectives, risks, and charges and expenses of FSIC II carefully. Investors should read and carefully consider all information found in FSIC II's reports filed with the U.S. Securities and Exchange Commission.

FSIC II is closed to new investors. This fund commentary is for informational purposes only and does not constitute an offer to sell nor a solicitation of an offer to buy the securities described herein.

This commentary is available for advisor use only in the state of Ohio.

Citing strong job gains and a low unemployment rate, the FOMC raised the target federal funds rate during the quarter to a range of 1.50%–1.75%.⁴ In the Fed’s Summary of Economic Projections, policymakers bumped up their forecasts for real GDP growth and the target federal funds rate in the coming years.⁵ However, the Fed surprised many investors by maintaining their median estimate of three rate hikes in 2018, rather than adjusting their projections to four as some market participants expected.⁵

Policymakers changed their tone from recent months as new Fed Chair Jerome Powell and Fed Governor Lael Brainard noted in separate appearances during the quarter that previous economic headwinds had shifted to tailwinds.

Against a backdrop of rising U.S. government bond yields and equity market volatility, senior secured loans drew significant investor interest due to their floating rate coupon and position as a potential hedge against rising interest rates. For the quarter, senior secured loans saw inflows of nearly \$3 billion and returned 1.6%.^{1,6} This compares to outflows of approximately \$15 billion and a return of -0.9% for high yield bonds.^{1,6} High yield bonds turned in their worst quarterly performance since the fourth quarter of 2015.¹

Performance review

Throughout the first quarter of 2018, FSIC II maintained its focus on senior secured, floating rate investments, which we expect will help drive long-term performance and provide downside protection in the event of further credit market volatility.⁷ The Fund generated a stockholder-based total return (without sales charge) of -0.1% compared to a return of approximately 1.6% for senior secured loans and -0.9% for high yield bonds during the quarter.^{1,2}

The Fund’s NAV decline was driven largely by unrealized depreciation in a select number of holdings within the Fund’s portfolio as two investments accounted for more than 55% of the Fund’s total quarterly NAV depreciation. Specifically, one directly originated investment in an aerospace manufacturer accounted for nearly 30% of the total quarterly depreciation as the company’s operations are increasingly dependent on lower-margin commercial business versus its historic high-margin defense accounts. FSIC II is currently negotiating a restructuring with the company. An upstream energy company was the second-largest contributor as the company’s high cost structure and depleting asset base weighed on its valuation. We are currently in discussions with the company’s management team to rationalize the company’s cost structure and maximize the Fund’s investment.

Since its inception on June 18, 2012, FSIC II’s annualized stockholder return is 7.7% (without sales charge) and 5.7% (with sales charge).² By comparison, senior secured loans returned 4.9% and high yield bonds returned 6.5% during the same period.¹

FSIC II paid distributions of approximately \$0.19 per share during the quarter ended March 31, 2018, representing an annualized distribution rate of 8.77% based on the Fund’s distribution reinvestment price of \$8.60 per share as of quarter-end.⁸

Conclusion

While we believe the scale and breadth of our platform is a significant advantage going forward, we expect increased competition in the middle market and consolidation within the business development company (BDC) sector. To position FSIC II for further success, we recognize we must continue to evolve the financing solutions we offer and further leverage our scale, access a broader set of investment opportunities, and better serve our portfolio companies and sponsors. To this end, FS Investments announced in December 2017 a partnership with KKR to manage all FSIC funds, including FSIC II, as well as the BDCs currently managed by KKR, Corporate Capital Trust and Corporate Capital Trust II.

Since its inception on June 18, 2012 through March 31, 2018, FSIC II’s annualized stockholder return is 7.7% (without sales charge) and 5.7% (with sales charge).² By comparison, senior secured loans returned 4.9% and high yield bonds returned 6.5% during the same period.¹

As part of the partnership, FSIC II can now co-invest across the full-breadth of KKR Credit's platform, which we believe will create access to expanded deal flow and new sources of income and return. We believe the certainty, stability and scale of the newly announced partnership, along with the expansion of our internal credit investment team, will create significant value for our investors. Since receiving the necessary shareholder approvals for FS and KKR to formalize our partnership, we are focused on optimizing the combined FS and KKR platforms. As part of that effort, we are considering potential mergers of our six BDCs that comprise the FSIC and CCT franchises, which represent the entirety of FS and KKR's middle market diversified direct-lending BDC platform.

We believe that merging these entities will provide business and operational synergies that will expand long-term shareholder value, specifically through reduction in administrative costs, expansion and diversification of the investment portfolio, and the optimization of our capital structure with lower borrowing costs. Any mergers will, among other things, be subject to market conditions and the review and approval from each fund's respective independent board of directors.

STOCKHOLDER RETURNS AS OF 3/31/18

(without sales charge), compounded monthly

YTD	1 year	3 year (annualized)	5 year (annualized)	Since inception (annualized)	Cumulative total return since inception	(with sales charge), compounded monthly Cumulative total return since inception	Inception date
-0.1%	2.8%	5.5%	6.8%	7.7%	53.4%	38.1%	June 18, 2012

Stockholder returns (without sales charge) are the total returns an investor received for the highlighted period taking into account all distributions paid during such period, compounded monthly. Except for the YTD, 1-year and 3-year periods, the calculation assumes that the investor purchased shares at FSIC II's public offering price, excluding selling commissions and dealer manager fees, at the beginning of the applicable period and reinvested all cash distributions pursuant to FSIC II's distribution reinvestment plan (DRP). Since FSIC II closed its public offering in March 2014 and has since issued new shares only pursuant to its DRP, the calculation of FSIC II's stockholder returns (without sales charge) for the YTD, 1-year and 3-year periods assumes that the investor purchased shares at the beginning of the applicable period at a price based upon FSIC II's DRP on such date. Valuation as of the end of each period is the redemption price pursuant to FSIC II's share repurchase program on such date. Stockholder returns (without sales charge) do not include selling commissions and dealer manager fees, which could total up to 10% of FSIC II's public offering price. Had such selling commissions and dealer manager fees been included, performance would be lower. Upon liquidation or redemption, market conditions may cause the actual values to be more or less than the values shown.

FSIC II is closed to new investors. FSIC II's total expenses as a percentage of average net assets attributable to common stock was 9.10% for the year ended December 31, 2017.

Stockholder return (with sales charge) is the total return an investor received since inception taking into account all distributions paid during such period, compounded monthly. The calculation assumes that the investor purchased shares at FSIC II's public offering price, including the maximum selling commissions and dealer manager fees, at inception and reinvested all distributions pursuant to FSIC II's DRP.

Valuation as of the end of each period shown above is the repurchase price pursuant to FSIC II's share repurchase program on such date. Upon liquidation or repurchase, market conditions may cause the actual values to be more or less than the values shown.

An investment in any fund sponsored by FS Investments involves significant costs, and investors should review the information in the applicable fund's prospectus regarding fees and expenses.

Note: All figures may be rounded. Returns shown are historical and are based on past performance. Past performance is not indicative of future results.

- Total returns are based on indices and represent income from regular interest and dividend payments and appreciation in market value with respect to the securities included in the indices. Indices used: high yield bonds – ICE BofAML U.S. High Yield Master II Index, which is comprised of U.S. dollar-denominated below investment grade corporate debt securities publicly issued in the U.S. domestic market; senior secured loans – Credit Suisse Leveraged Loan Index, which is an index designed to mirror the investable universe of the U.S. dollar-denominated leveraged loan market; 10-year U.S. Treasuries – ICE BofAML 10-year U.S. Treasury Index, which measures the total return of the 10-year U.S. Treasury note. This data is for illustrative purposes only and is not indicative of any investment. An investment cannot be made directly in an index.
- Please see the table above for a description of how FSIC II's stockholder returns (without sales charge) and stockholder returns (with sales charge) are calculated.
- Federal Reserve Bank of St. Louis, <https://bit.ly/29ecBfp>.
- U.S. Federal Reserve March press release, <https://bit.ly/2H700yp>.
- U.S. Federal Reserve Summary of Economic Projections, <https://bit.ly/2puYJ6Y>.
- J.P. Morgan High-Yield and Leveraged Loan Morning Intelligence, as of April 6, 2018. Based on data from Thomson Reuters Lipper.
- Although senior loans in which FSIC II invests may be secured by specific collateral, there can be no assurance that the collateral will not decrease in value or lose its entire value over time, which may have a financial impact on FSIC II.
- The annualized distribution rate shown is expressed as a percentage equal to the projected annualized distribution amount per share (which is calculated by annualizing the distribution amount per share of \$0.19 paid in the quarter ended March 31, 2018, without compounding), divided by FSIC II's distribution reinvestment price per share of \$8.60 as of March 31, 2018. The annualized distribution rate may be rounded. The payment of future distributions on FSIC II's shares of common stock is subject to the discretion of FSIC II's board of directors and applicable legal restrictions and, therefore, there can be no assurance as to the amount or timing of any such future distributions. For the quarter ended March 31, 2018, 100% of FSIC II's distributions were funded through net investment income on a tax basis. No portion of FSIC II's distributions during the quarter ended March 31, 2018 was funded through expense reimbursements from FSIC II's sponsor. The determination of the tax attributes of FSIC II's distributions is made annually at the end of FSIC II's fiscal year, and a determination made on an interim basis may not be representative of the actual tax attributes of FSIC II's distributions for a full year. The actual tax characteristics of distributions to stockholders are reported to stockholders annually on Form 1099-DIV.

RISK FACTORS

Investing in FSIC II may be considered speculative and involves a high level of risk, including the risk of a substantial loss of investment. The following are some of the risks an investment in FSIC II's common stock involves; however, you should carefully consider all of the information found in Item 1A of our annual report on Form 10-K entitled "Risk Factors."

- Because there is no public trading market for shares of FSIC II's common stock and FSIC II is not obligated to effectuate a liquidity event by a specified date, if at all, it is unlikely that you will be able to sell your shares. If you are able to sell your shares before FSIC II completes a liquidity event, it is likely that you will receive less than you paid for them. While FSIC II intends to conduct quarterly tender offers for its shares, only a limited number of shares will be eligible for repurchase and FSIC II may amend, suspend or terminate the share repurchase program at any time.
- FSIC II invests in securities that are rated below investment grade by rating agencies or that would be rated below investment grade if they were rated. Below investment grade securities, which are often referred to as "junk," have predominantly speculative characteristics with respect to the issuer's capacity to pay interest and repay principal. They may also be difficult to value and illiquid.
- FSIC II's distributions may be funded from unlimited amounts of offering proceeds or borrowings, which may constitute a return of capital and reduce the amount of capital available to FSIC II for investment. Any capital returned to stockholders through distributions will be distributed after payment of fees and expenses.
- An investment strategy focused primarily on privately held companies presents certain challenges, including the lack of available information about these companies.
- Investing in middle market companies involves a number of significant risks, any one of which could have a material adverse effect on FSIC II's operating results.
- A lack of liquidity in certain of FSIC II's investments may adversely affect its business.
- FSIC II is subject to financial market risks, including changes in interest rates, which may have a substantial negative impact on its investments.
- FSIC II has borrowed funds to make investments, which increases the volatility of its investments and may increase the risks of investing in its securities.
- FSIC II's previous distributions to stockholders were funded in significant part from the reimbursement of certain expenses, including through the waiver of certain investment advisory fees that are subject to repayment to its affiliate, FS Investments, and its future distributions may be funded from such waivers and reimbursements. Significant portions of these distributions were not based on FSIC II's investment performance, and such waivers and reimbursements by FS Investments may not continue in the future. If FS Investments had not agreed to reimburse certain of FSIC II's expenses, including through the waiver of certain of its advisory fees, significant portions of these distributions would have come from offering proceeds or borrowings. The repayment of any amounts owed to FS Investments will reduce the future distributions to which you would otherwise be entitled.