



## FS Investment Corporation II

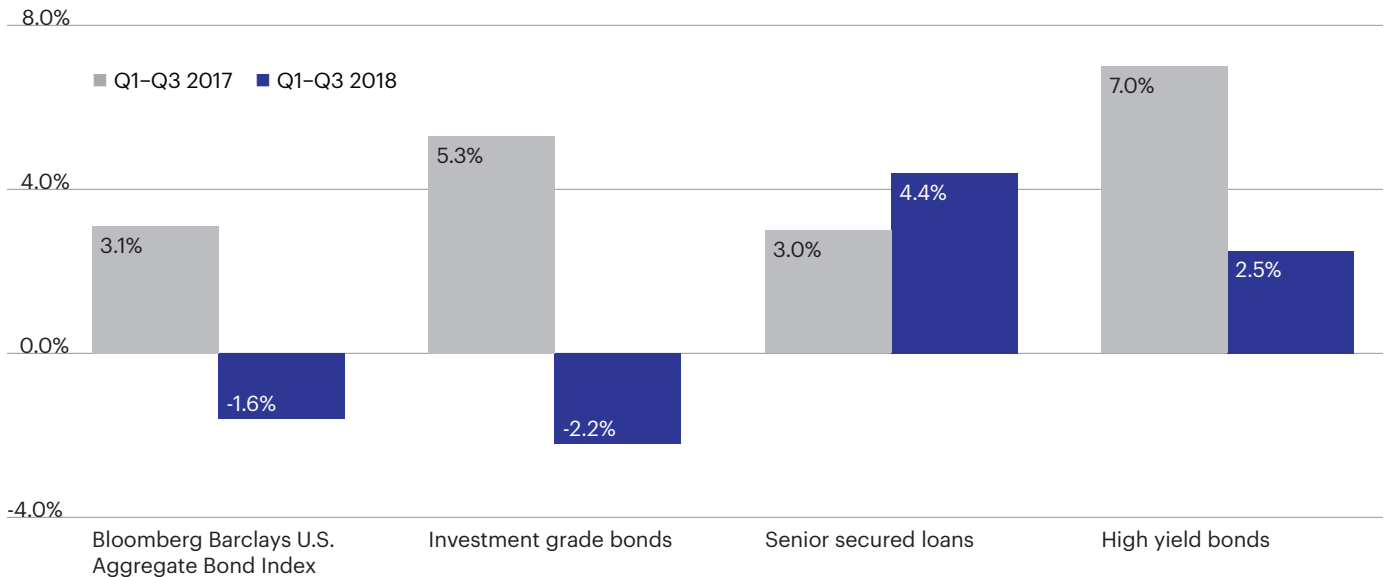
### Summary

- The U.S. economy gathered steam during the quarter, showing broad-based strength across a range of indicators including employment and consumer confidence figures. The strong macro backdrop supported corporate credit and equity market returns during the quarter.
- Generally tight market conditions prevailed during the quarter as credit spreads remained near cycle tights, as they have through much of 2018. High yield bonds and senior secured loans generated total returns of approximately 2.4% and 1.9%, respectively, during the third quarter of 2018.<sup>1</sup>
- FS Investment Corporation II (FSIC II, or the Fund) generated a stockholder return (without sales charge) of 1.0% for the quarter ended September 30, 2018.<sup>2</sup>

### Market review

The U.S. economy gathered steam during the quarter, showing broad-based strength across a range of indicators including employment and consumer confidence figures. The yield on the 10-year U.S. Treasury note rose approximately 20 basis points during the quarter, briefly reaching 3.1%.<sup>3</sup> Both the Consumer Price Index and Personal Consumption Expenditures Price Index remained above the Fed's preferred 2% inflation target. Against this backdrop, the Fed hiked interest rates for third time this year at its September meeting and raised its forecast for economic growth both this year and next.<sup>4</sup> The strong macro backdrop helped boost returns on corporate credit and equity markets during the quarter. Senior secured loans and high yield bonds, which are generally less sensitive to changes in interest rates, outpaced investment grade bonds during the quarter and year to date.<sup>1</sup>

### YTD PERFORMANCE ACROSS MAJOR FIXED INCOME ASSET CLASSES<sup>1</sup>



Source: Bloomberg.

**[An investment in FSIC II involves substantial risks. For a summary of these important risk factors, please turn to page 5 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.**

The generally tight conditions that have prevailed within the corporate credit markets in recent quarters remained in place during the third quarter. During the past quarter these conditions did not abate, and investor appetite for floating rate loans remains elevated. Bank loan mutual funds experienced nearly \$16 billion in inflows through the first three quarters of the year.<sup>5</sup> Against the backdrop of sustained demand for floating rate investments, leveraged loan spreads have remained near cycle tight through much of the year, and corporate issuers in the broadly syndicated markets have continued to take advantage of the current market dynamic to push out maturities, lower their financing costs and loosen covenants.<sup>1</sup>

Senior secured loan and high yield bond returns benefited from supportive economic conditions during the quarter. Senior secured loans generated quarterly returns of 1.9% while high yield bonds returned 2.4%.<sup>1</sup> It was the second quarter in which high yield bond returns outpaced senior secured loans.<sup>1</sup> Year to date, however, high yield bond performance is significantly below that of the same period in 2017 while senior secured loans have slightly outpaced their performance last year.<sup>1</sup> Higher-duration assets, such as U.S. Treasuries and investment grade corporate bonds, have underperformed year to date as interest rates have gradually moved higher in 2018.<sup>1</sup>

### **FS Investments and KKR partnership overview**

Since announcing the partnership between FS Investments and KKR, FSIC II has focused on deriving the full benefits of the partnership in three key areas:

- First, given the highly competitive lending environment, FSIC II selectively allocated capital during the quarter with a focus on senior secured debt. The Fund committed \$559 million to new direct originations, 100% of which were floating rate, senior secured loans.
- Second, FS/KKR Advisor, LLC (FS/KKR), the Fund's investment adviser, continues to aggressively manage the Fund's legacy underperforming credits. FS/KKR is working closely with the management teams and financial sponsors of these companies to address their operational and/or liquidity needs.
- Finally, FSIC II closed on a \$650 million revolver during the third quarter as part of a \$3.4 billion five-year omnibus revolving credit facility across the Fund, FS Investment Corporation, FS Investment Corporation III and Corporate Capital Trust, Inc. The new revolver provides FSIC II with a cheaper source of financing relative to some of the Fund's prior borrowing facilities, allows the Fund to borrow against a more diversified set of assets and will allow for more efficient deployment of cash.

These collective efforts are designed to increase the Fund's allocations to direct originations, grow portfolio yield, reduce volatility in the Fund's net asset value and otherwise help improve distribution coverage.

Since its inception on June 18, 2012 through September 30, 2018, FSIC II's annualized stockholder return is 7.4% (without sales charge) and 5.6% (with sales charge).<sup>2</sup> By comparison, senior secured loans returned 4.9% and high yield bonds returned 6.3% during the same period.<sup>1</sup>

## Performance review

FSIC II paid regular cash distributions of approximately \$0.19 per share during the quarter. Distributions were fully funded through net investment income on a tax basis. FSIC II's annualized distribution rate was 8.98% based on the distribution reinvestment price of \$8.40 per share as of September 30, 2018.<sup>6</sup>

The Fund's net asset value declined to \$8.23 per share as of September 30, 2018 from \$8.31 per share as of June 30, 2018. The decline in NAV was partially offset by distributions paid during the quarter as the Fund generated a stockholder-based total return (without sales charge) of 1.0% compared to 1.9% for senior secured loans and 2.4% for high yield bonds.<sup>1,2</sup> (Please see the performance disclosure on page 4 for a detailed description of the calculation of stockholder returns.)

Detractors to performance during the third quarter were concentrated in a select number of underperforming legacy portfolio companies. For example, four portfolio companies represented \$27.5 million, or 68%, of the \$40.7 million total unrealized depreciation during the quarter. More broadly, five legacy investments have weighed on performance over the last several quarters and have represented the majority of the Fund's total unrealized depreciation during the first nine months of the year. FS/KKR believes the performance issues over the last several quarters are company-specific as opposed to reflective of fundamental weakness across the entire portfolio. Non-accruals represented 1.7% of the portfolio's fair value and 5.3% based on amortized cost as of September 30, 2018. FS/KKR is aggressively working with the management teams and financial sponsors of these companies to address their operational and/or liquidity needs and maximize the outcome for FSIC II's investors.

## Investment activity

Following the formalization of the FS and KKR partnership in April 2018, FSIC II's pipeline of new investments has grown significantly. New direct origination activity was approximately \$559 million during the third quarter, including unfunded commitments, up from \$202 million during the prior quarter. The Fund's third-quarter originations were entirely in floating rate, senior secured loans. Despite the generally issuer-friendly conditions found in the liquid, broadly syndicated markets, all of the Fund's direct origination activity in the third quarter included at least one maintenance covenant.

More broadly, total purchases during the quarter were \$731 million. As of September 30, 2018, senior secured debt represented 87% of the fair value of the portfolio, unchanged from the prior quarter. Subordinated debt investments represented 6% of the portfolio's fair value as of September 30, 2018, compared to 5% the prior quarter. Equity investments represented 6% of the portfolio's fair value at quarter-end.

## Conclusion

The third quarter marked the first full quarter of operations for the FS/KKR partnership. The immediate focus of the partnership is to aggressively manage the underperforming credits to help stabilize FSIC II's net asset value. At the same time, FSIC II will seek to maximize the benefits of its exemptive relief order to co-invest with KKR's credit platform and access a growing investment pipeline focused on upper middle market companies. FS/KKR believes the upper middle market offers a differentiated source of deal flow for FSIC II and attractive investment opportunities due to lower competition.

FS/KKR expects these combined efforts will help grow portfolio yield, reduce portfolio volatility and meet the Fund's income and return objectives for investors over the long term.

Looking forward, FS/KKR continues to evaluate the potential for a liquidity event for investors. While the timing and nature of such an event is subject to the approval of the Fund's board of directors and market conditions, the Fund will keep investors and their financial advisors apprised of any developments as any potential liquidity event draws closer.

### STOCKHOLDER RETURNS AS OF 9/30/2018

(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
2.0%	1.3%	6.1%	6.2%	7.4%	56.6%	41.0%	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.**

1 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 composed of U.S. dollar-denominated below investment grade corporate debt securities publicly issued in the U.S. domestic market; investment grade bonds – ICE BofAML U.S. Corporate Master Index, which is composed of publicly issued, fixed-rate investment grade corporate debt; 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.

2 Please see the table above for a description of how FSIC II's stockholder returns (without sales charge) and stockholder return (with sales charge) are calculated.

3 Federal Reserve Bank of St. Louis, <https://bit.ly/29ecBfp>.

4 U.S. Federal Reserve, <https://bit.ly/29y0ljN>.

5 Thomson Reuters Lipper.

6 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 September 30, 2018, without compounding), divided by FSIC II's distribution reinvestment price per share of \$8.40 as of September 30, 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 September 30, 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 September 30, 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.