FS KKR Capital Corp. II

Q2 Fund commentary

As of 6/30/2020

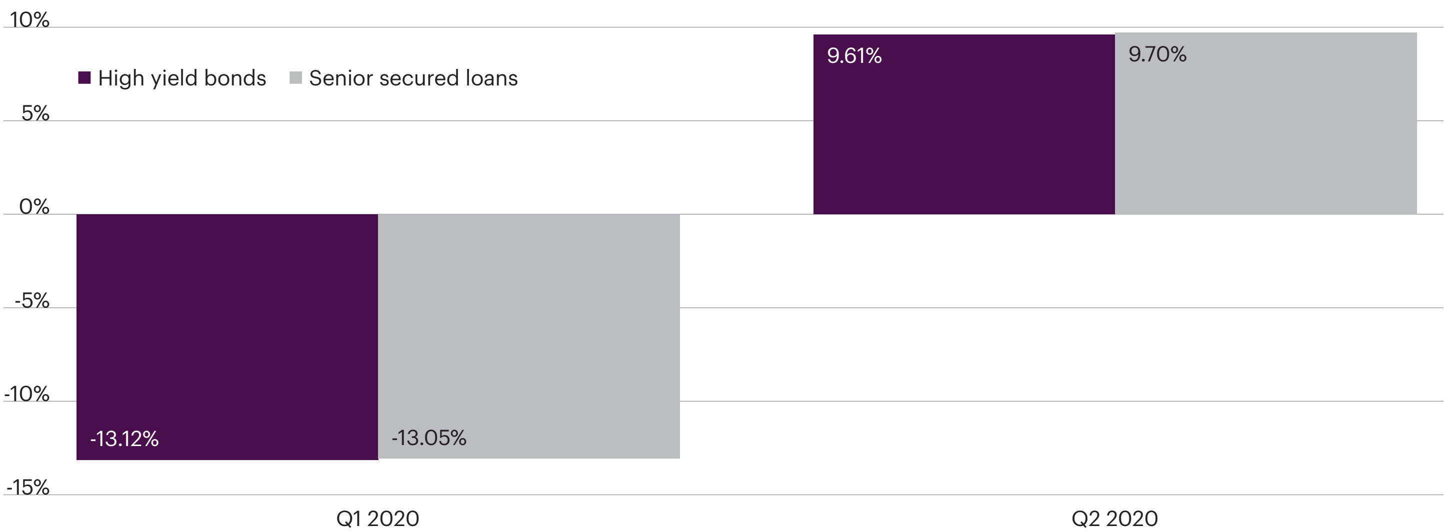
Summary

- The U.S. economy continued to face significant pandemic-induced challenges during the second quarter, though major economic indicators began pointing toward recovery.
- During the quarter, high yield bond and senior secured loan markets rallied almost all the way back to where they were before the crisis, returning 9.6% and 9.7%, respectively.[1] On a year-to-date basis, high yield bonds and senior secured loans returned -4.8% and -4.6%, respectively, through June 30.[1]
- The Fund's net asset value (NAV) declined -1.9% to $24.22 per share as of June 30, 2020, down from $24.68 per share as of March 31, 2020.[2] Broad portfolio appreciation was offset by depreciation in certain older vintage, legacy investments and previously challenged investments, as well as businesses impacted by the continuing effects of COVID-19.
- The board of directors declared a distribution of $0.55 per share for the third quarter of 2020, which equates to a 9.1% annualized yield based on the Fund's NAV as of June 30, 2020.

Market review

The U.S. economy continued to face significant pandemic-induced challenges during the second quarter, though major economic indicators began pointing toward recovery. New economic releases remained well below their year-over-year readings but showed significant bounce backs from their lows of late Q1 or early Q2. Employment figures remained at the center of the economic downturn in Q2 as more than 32 million Americans filed initial unemployment claims during the quarter, adding to the nearly 12 million who filed in Q1.[3] However, nonfarm payrolls bounced in May and June and the national unemployment rate declined to 11.1%, well below forecasts that reached as high as 19%.[4] Similarly, retail sales recorded their largest-ever monthly decline in April but returned to pre-pandemic levels by June. Equity and fixed income markets saw significant rebounds during the quarter as investors generally focused on the month-over-month improvements in economic data combined with massive fiscal and monetary stimulus measures. The Federal Reserve announced its intention to maintain rates at the zero lower bound for the foreseeable future, while it also began purchasing bonds of investment grade and certain high yield issuers in its ongoing effort to ensure that credit markets remain open for borrowers. The 10-year U.S. Treasury yield generally traded within a tight range between approximately 0.55%–0.75% through most of the quarter.[5]

HIGH YIELD BOND AND SENIOR SECURED LOAN RETURNS[1]



Source: ICE BofAML U.S. High Yield Index, S&P/LSTA Leveraged Loan Index, as of June 30, 2020.

An investment in FS KKR Capital Corp. II involves substantial risks. For a summary of these important risk factors, please turn to page 4 or click here.

During the second quarter, high yield bonds and senior secured loans returned 9.6% and 9.7%, respectively.[1] On a year-to-date basis, high yield bonds and senior secured loans returned -4.8% and -4.6%, respectively, through June 30.[1] Beyond the headline numbers, nearly one-third of high yield bonds issued year to date were secured, representing the highest level of secured bond issuance since 2009. Only 11% of high yield bond issuance year to date has been used to fund merger and acquisition (M&A) activity, which marks the lowest level since the 2008 financial crisis. Finally, operating companies have been building cash reserves at an unprecedented pace, as cash on hand as a percentage of total debt increased to 15%, another record level, eclipsing even Q4 2009's level of 14%. Taken together, we believe these data points indicate that many management teams and company owners are intensely focused on maintaining liquidity, cutting costs and evaluating new growth opportunities in a marketplace that is demanding goods and services be delivered in new and inventive ways.

In somewhat unexpected fashion, high yield issuance reached a quarterly record of $140 billion. Year to date through June 30, high yield bonds also saw record issuance of $224 billion. In contrast, the leveraged loan market, which was quite hot in January and early February, saw zero new issuance in March and was slow to recover in Q2. Fund flows for bank loan mutual funds since March have been steadily negative, in a range of $10 billion–$20 billion in outflows per month. Additionally, collateralized loan obligation (CLO) issuance is down approximately -50% year to date as compared to 2019. Since CLOs are one of the largest buyers of loans, the lack of issuance has dampened loan demand.

Performance review

FS KKR Capital Corp. II's (NYSE: FSKR) NAV declined -1.9% quarter over quarter to $24.22 per share as of June 30, 2020, from $24.68 per share as of March 31, 2020, following the 4-to-1 Reverse Stock Split.[2]

There were three primary drivers of performance during the second quarter:

- **Broad portfolio appreciation:** The appreciation of $198 million we experienced across the portfolio was primarily driven by a combination of positive operating results and improved market conditions during the second quarter for certain investments that were initially impacted by COVID-19 during Q1. As the economy continues to stabilize, we believe this portion of our investment portfolio may continue to increase in value as these names move back toward their cost basis.
- **Underperformance of select older vintage assets:** Broad portfolio appreciation was offset by $206 million in depreciation among a select number of older vintage assets originated prior to the FS/KKR partnership, including energy investments. Approximately 75% of the decline was driven by our energy exposure and three specific older vintage, legacy investments which were in weaker positions prior to the onset of COVID-19 and therefore have been disproportionately impacted by the pandemic.

  This portion of our investment portfolio has a combined cost basis of $887 million and an aggregate fair value of $408 million, representing a blended valuation of 46% of par. We believe we have the resources, including a fully staffed workout team and the ability to leverage the full KKR platform, to maximize the recovery for the Fund's weaker older vintage investments. While it has been difficult working through these investments, we are beginning to believe that the worst is behind us from a depreciation standpoint.
- **COVID-related depreciation:** Approximately $45 million of portfolio depreciation during the quarter was driven by the continuing effects of COVID-19 on the operations of a portion of our portfolio companies. We are comfortable with the operational performance for the majority of these companies and do not believe they are in jeopardy of violating covenants. Furthermore, a number of companies within this portion of the portfolio have received financial support from their private equity sponsors.

During the quarter we placed four investments on non-accrual with a combined cost and fair value of $168 million and $124 million, respectively. Our largest non-accruals during the quarter were two legacy investments. Non-accruals represented 11.0% of the portfolio on a cost basis and 5.4% of the portfolio on a fair value basis. As previously noted, we believe we have the resources to maximize the recovery of these investments for our investors.

Our board of directors declared a distribution of $0.55 per share for the third quarter of 2020, which equates to an annualized yield of 9.1% based on the Fund's NAV per share of $24.22 as of June 30, 2020. We believe there is a path to increasing the Fund's net investment income by reducing non-performing assets and opportunistically deploying our available liquidity of approximately $1.6 billion, or roughly 22% of the value of our investment portfolio. Over the long term, we currently expect our dividends per share will equate to a minimum of 9.0% yield based on NAV per share. We acknowledge there will be certain quarters where our annualized yield may be greater or less than this figure due to quarter-to-quarter fluctuations in the business from an operational standpoint.

Investment activity

We are focused on principal protection with our new investments, which involves financing good companies, understanding the macro picture and structuring investments to help manage downside risks. Our $182 million of total investments, combined with $367 million of net sales and repayments, equated to net portfolio reduction of $185 million during the second quarter. We remain extremely selective in our origination and underwriting process, especially given the added complexities associated with making new commitments during this unique period.

As of June 30, 2020, the Fund had a fair value of approximately $7.3 billion, consisting of 164 portfolio companies. This compares to a fair value of $7.5 billion and 179 portfolio companies as of March 31, 2020. We maintained the Fund's focus on senior secured debt during the quarter and, since FS/KKR Advisor was formed, we have worked to turn the investment portfolio toward what we believe to be more conservative investment structures in companies with more defensible operating positions. Senior secured debt represented 79% of the portfolio's fair value as of June 30, 2020, including investments underlying the Fund's borrowing facility. Approximately 50% of our investment portfolio is composed of assets originated by FS/KKR Advisor, and approximately 59% of total assets in the portfolio have been originated by the KKR Credit platform.

Portfolio by asset type (based on fair value)	**12/31/2018**	**6/30/2020**
1st lien loans	67%	67%
2nd lien loans	9%	9%
Other senior secured debt	1%	3%
Subordinated debt	2%	5%
Asset-based finance	9%	6%
Strategic Credit Opportunities Partners, LLC	8%	6%
Equity/other	4%	4%

Listing summary

On June 17, 2020, FS KKR Capital Corp. II commenced trading on the New York Stock Exchange (NYSE: FSKR). FSKR, together with its affiliate, FS KKR Capital Corp. (NYSE: FSK), represents the second-largest publicly traded BDC platform in the market based on assets under management.

During the quarter, we began executing on the Fund's previously announced $100 million share repurchase program. As of July 31, 2020, we have repurchased approximately $11 million of shares under this program.

One of the key strategic considerations of the listing was that it provided a path to unlock significant borrowing capacity, which can be deployed to support our portfolio companies as well as make opportunistic investments given current market conditions. Our available liquidity of approximately $1.6 billion equates to approximately 22% of the value of our investment portfolio, which we believe is a competitive advantage in the current environment.

Outlook

While we continue to navigate in an uncertain macroeconomic environment, the prospect for substantial economic recovery remains a real possibility over the coming quarters. Actions by the federal government and the Federal Reserve, which are providing significant fiscal stimulus and liquidity support to the marketplace, provide pillars of support for an economy which increasingly feels as though it is moving toward its own method of reopening regardless of governmental and public mandates.

Against this backdrop, our primary objective remains protecting and maximizing the value of our investments in existing portfolio companies. We expect to leverage the strength of our origination footprint to add selectively to the portfolio. In our view, the coming quarters will present a great opportunity to deploy capital on attractive terms. We will be cautious and highly selective in doing so, but we believe current conditions will provide a real opportunity to add highly accretive investments to the portfolio.

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 indexes and represent income from regular interest and dividend payments and appreciation in market value with respect to the securities included in the indexes. Indexes used: high yield bonds – ICE BofAML U.S. High Yield Master II Index, which is designed to track the performance of U.S. dollar-denominated below investment grade corporate debt publicly issued in the U.S. domestic market; investment grade bonds – ICE BofAML U.S. Corporate Master Index, which tracks the performance of U.S. dollar-denominated investment grade corporate debt publicly issued in the U.S. domestic market; senior secured loans – S&P/LSTA Leveraged Loan Index, which is a market value-weighted index designed to measure the performance of the U.S. 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 Assumes the value in common shares is the NAV per share. Effective June 10, 2020, FSKR completed a 4-to-1 reverse stock split of its shares of common stock (the Reverse Stock Split). Share and per share amounts have been adjusted to reflect the Reverse Stock Split on a retroactive basis.

3 U.S. Department of Labor, though April 30, 2020. https://bit.ly/2WjHTrQ.

4 U.S. Bureau of Labor Statistics, http://bit.ly/2LlatqP.

5 Federal Reserve Bank of St. Louis, http://bit.ly/2J3ufoX.

RISK FACTORS

Investing in FS KKR Capital Corp. 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 the Fund'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" filed with the U.S. Securities and Exchange Commission (the SEC).

- The Fund 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.
- The Fund'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 the Fund for investment. Any capital returned to shareholders 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 the Fund's operating results.
- A lack of liquidity in certain of the Fund's investments may adversely affect its business.
- The Fund is subject to financial market risks, including changes in interest rates, which may have a substantial negative impact on its investments.
- The Fund has borrowed funds to make investments, which increases the volatility of its investments and may increase the risks of investing in its securities.
- The Fund's previous distributions to shareholders were funded in significant part from the reimbursement of certain expenses, including through the waiver of certain investment advisory fees.

FORWARD-LOOKING STATEMENTS

Statements included herein may constitute "forward-looking" statements as that term is defined in Section 27A of the Securities Act of 1933, as amended (the "Securities Act"), and Section 21E of the Securities Exchange Act of 1934, as amended by the Private Securities Litigation Reform Act of 1995, including statements with regard to future events or the future performance or operations of FS KKR Capital Corp. II. Words such as "believes," "expects," "projects," and "future" or similar expressions are intended to identify forward-looking statements. These forward-looking statements are subject to the inherent uncertainties in predicting future results and conditions. Certain factors could cause actual results to differ materially from those projected in these forward-looking statements. Factors that could cause actual results to differ materially include changes in the economy, risks associated with possible disruption to the Fund's operations or the economy generally due to terrorism, natural disasters or pandemics such as COVID-19, future changes in laws or regulations and conditions in the Fund's operating area, unexpected costs, charges or expenses resulting from the business combination transaction involving the Fund, failure to realize the anticipated benefits of the business combination transaction involving the Fund, and the price at which shares of the Fund's common stock may trade on the NYSE. Some of these factors are enumerated in the filings the Fund makes with the SEC. The inclusion of forward-looking statements should not be regarded as a representation that any plans, estimates or expectations will be achieved. Any forward-looking statements speak only as of the date of this communication. Except as required by federal securities laws, the Fund undertakes no obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. Readers are cautioned not to place undue reliance on any of these forward-looking statements.