FS Energy & Power Fund

Summary

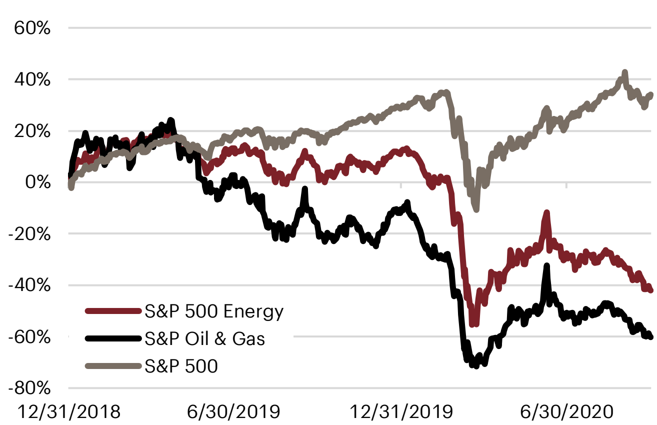
- Following two quarters in which the energy sector experienced extreme swings, crude prices remained within a tight trading band near $40 per barrel throughout the third quarter.[1]
- Global crude consumption rose during the third quarter amid a solid economic bounce in the U.S. and abroad. On the supply side, global production was generally flat from a quarter earlier but approximately 10% below its peak level from Q4 2019.
- Energy senior secured loans and high yield energy bonds returned 5.7% and 2.7%, respectively, during the quarter. Upstream equities fared considerably worse, returning -18.7%.[2,3,4]
- FS Energy & Power Fund (FSEP or the Fund) generated a shareholder-based total return of -0.31% in the third quarter as we maintained our focus on retaining capital and enhancing the Fund's liquidity.[5]

Market review

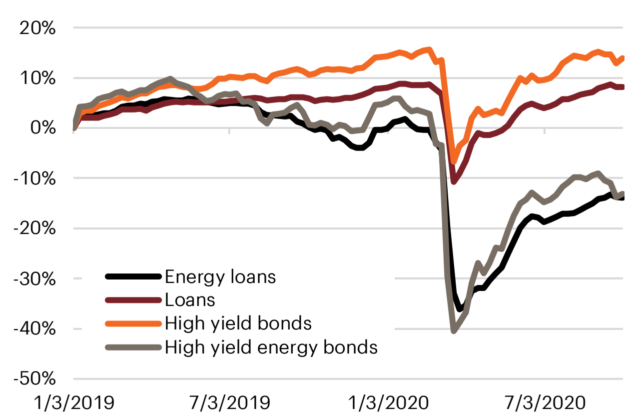
Following two quarters in which the energy sector experienced extreme swings, crude prices remained within a tight trading band near $40 per barrel throughout the third quarter.[1] Global crude consumption rose approximately 10% in Q3 amid a solid economic bounce in the U.S. and abroad. On the supply side, global production was generally flat quarter over quarter and approximately 10% below the peak level of crude production in Q4 2019.[6] Saudi Arabia affirmed its commitment during the quarter to hold OPEC+ member nations accountable for their previously agreed-upon production cuts of 7.7 million barrels per day through December, including additional supply reductions, if necessary.

Following a 2.9% rise in Q2, natural gas prices fell approximately -5.6% during the third quarter, the result of a late-quarter sell-off.[6] Despite the decline, supply/demand dynamics look more attractive now than at the beginning of the year. At 97.5 billion cubic feet per day, U.S. shale production increased slightly in Q3 from a quarter earlier but remained far below its pre-COVID peak of approximately 104 billion cubic feet per day in Q4 2019.[6] Meanwhile, total natural gas consumption rose again in Q3, from approximately 71 billion to 77 billion cubic feet per day.[6] The EIA projects that consumption will continue to grow through the next two quarters.[6] This more balanced supply/demand picture is expected to help boost prices through Q1 2021.[6]

Energy stocks total return
Indexed to 1/1/2019



Energy bonds & loans total return
Indexed to 1/1/2019



Source: Bloomberg Finance, L.P., as of September 30, 2020. Energy loans are represented by the S&P/LSTA Leveraged Loan Index (energy component). Loans are represented by the S&P/LSTA Leveraged Loan Index. High yield bonds are represented by the ICE BofAML High Yield Master II Index. High yield energy bonds are represented by the ICE BofAML High Yield Energy Index.

While $40 oil is an improvement over prices seen during much of the first half of 2020, it is still well below the year-end 2019 price of approximately $61 a barrel. Against this backdrop, energy assets were mixed in the third quarter. Senior secured energy loans and high yield energy bonds returned 5.7% and 2.7%, respectively, compared to -19.7% for the S&P 500 Energy Index and -11.2% for mid-cap energy stocks.[2,3,4] Yields on high yield energy bonds, which peaked at approximately 23.1% in late-March 2020, continued their steady decline, ending the quarter at 9.1%.[3] Yields on the broader high yield market reached as high as 11.1% in March before ending the quarter at 5.8%.[7]

Total returns
(without sales charge)

	Q3 2020	YTD
FSEP	**-0.31%**	**-38.8%**
Energy HY bonds	2.7%	-17.6%
Energy senior secured loans	5.7%	-13.0%
Upstream equities	-18.7%	-54.4%

Performance review

Given the challenging conditions in the energy markets throughout much of 2020, we have taken several steps this year to retain capital and enhance the Fund's liquidity. These include suspending the Fund's quarterly tenders and the regular monthly distributions following the March distribution as well as reducing leverage by paying down borrowings. While the Fund's net asset value declined modestly from $3.32 per share as of June 30, 2020, to $3.28 per share as of September 30, 2020, we believe these efforts have helped stabilize the portfolio over the last two quarters.

Net realized and unrealized losses were -$0.04 per share. There were three primary drivers of performance during the quarter:

- **Appreciation in certain FS/EIG broadly syndicated investments:** As energy loan and high yield bond prices moved higher during the quarter, FSEP's broadly syndicated assets sourced through FS/EIG Advisor generally contributed to NAV performance during the quarter. Unrealized gains within the power sector were the largest contributor to the performance based on subsector.
- **Stable performance in FS/EIG-originated assets**: Directly originated investments sourced through FS/EIG Advisor were largely stable during the quarter. We expect to continue to grow the Fund's allocation to FS/EIG-originated assets with a focus on first-lien debt and opportunistic investments.
- **Underperformance of select older vintage assets**: Much of the realized and unrealized losses during the quarter, and over the last several quarters, have been driven by older vintage investments in upstream companies that are located in challenged basins and/or have experienced fundamental deterioration in their operations. Therefore, while energy prices remained well above their April lows, the fundamental performance of certain of our older vintage portfolio companies is less correlated to rising energy prices than their peers due to the fundamental stress on their business. Against this backdrop, two of the Fund's largest legacy upstream investments were restructured during the quarter. We view these restructurings as a significant step forward in our efforts over the last several quarters to address the performance of larger, stressed businesses in the portfolio, which have dragged on performance. Following the restructurings, FSEP received equity in the reorganized companies.

Restructurings over the past two quarters have reduced the Fund's non-accruals as we continue to reposition older assets that have dragged on performance. Altogether, five investments were on non-accrual as of September 30, 2020, representing 3.9% of the Fund's portfolio based on fair value and 16.8% based on amortized cost. This compares to 11.0% based on fair value and 25.1% based on amortized cost as of June 30, 2020. During the third quarter, however, just one new investment was placed on non-accrual, representing 0.18% of the Fund's portfolio based on fair value and 0.82% based on amortized cost. The vast majority of non-accruals have been driven by older vintage upstream investments. We are actively working with the management teams and owners of these companies to address their liquidity and operational needs in order to maximize shareholder value.

The portfolio continues to generate a moderate degree of income. Against this backdrop, the Fund's regular cash distributions to shareholders remain suspended. However, beginning in Q2 2020, the Fund's board of trustees and FS/EIG Advisor have evaluated the Fund's ability to pay distributions on a quarterly basis based on market conditions and the Fund's financial operations. FSEP's board declared a distribution of $0.03 per share each on June 29, 2020, paid to shareholders on July 10, 2020, and September 29, 2020, paid to shareholders on October 12, 2020. FSEP's board and FS/EIG Advisor will continue to evaluate the Fund's ability to pay any distributions on a quarterly basis through the rest of 2020.[8]

Investment activity

Total purchases during the third quarter were $215 million, of which $149 million was committed to new direct originations. The majority of investment activity in the portfolio for the three months ended September 30, 2020 resulted from restructuring activity. In total, FSEP has committed over $1.7 billion to EIG-sourced investments. As of September 30, 2020, direct originations represented 88% of the portfolio based on fair value, compared to 55% as of December 31, 2017, prior to the formation of the FS/EIG partnership. Exited investments totaled approximately $228 million during the third quarter, driven by the quarterly restructuring activity.

Since forming the FS/EIG partnership in 2018, we have grown the Fund's allocation to infrastructure assets, including midstream and power companies, which historically tend to have more predictable earnings than upstream companies. At the same time, we have significantly reduced the allocation to older vintage upstream companies, which have dragged on performance for several quarters.

Portfolio by subsector (based on fair value)	**12/31/2018**	**9/30/2020**
Upstream	64%	48%
Midstream	11%	36%
Downstream	1%	—
Power	6%	6%
Service & equipment	18%	6%
Industrials	—	1%
Sustainable Infrastructure Investments, LLC	—	3%

We have focused on growing our allocation to senior secured debt and preferred equity investments in order to achieve our income and growth objectives. As of September 30, 2020, senior secured debt investments represented approximately 53% of the portfolio's total fair value.

As of September 30, 2020, preferred equity investments represented approximately 24% of the portfolio based on fair value, compared to 25% the previous quarter. EIG-originated preferred equity investments differ from typical preferred equity in that they are usually income generating and normally include structural protections and significant asset coverage. For FSEP's preferred equity investments, we typically seek a high current coupon, structural downside protections and some form of equity upside.

Portfolio by asset type (based on fair value)	**12/31/2018**	**9/30/2020**
1st lien loans	23%	29%
2nd lien loans	20%	12%
Senior secured bonds	17%	12%
Unsecured debt	30%	8%
Preferred equity	2%	24%
Sustainable Infrastructure Investments, LLC	—	3%
Equity/other	8%	12%

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

1 Federal Reserve Bank of St. Louis, https://bit.ly/2Jg7WgX.

2 S&P/LSTA Leveraged Loan Index (energy component).

3 ICE BofAML U.S. High Yield Energy Index.

4 SPDR S&P Oil & Gas Exploration & Production ETF.

5 For more information on shareholder returns, see the table above. For the 12 months ended September 30, 2020, FSEP's cash distributions on a tax basis were sourced 100% from net investment income. The payment of future distributions on FSEP's common shares is subject to the discretion of FSEP's board of trustees and applicable legal restrictions and, therefore, there can be no assurance as to the amount or timing of any such future distributions.

6 U.S. Energy Information Administration, https://bit.ly/2G9S3re.

7 ICE BofAML U.S. High Yield Master II Index.

8 There can be no assurance that the Fund will be able to pay distributions in the future. The timing and amount of any future distributions to shareholders are subject to applicable legal restrictions and the sole discretion of the Fund's board.

Additional resources

Please visit FSEP's webpage at www.fsinvestments.com/investments/all-investments/fsep or www.fsinvestments.com/resources/fs-energy-power-fund-update for additional resources.

Shareholder returns as of 9/30/2020

(without sales charge), compounded monthly					(with sales charge)	
1 year	3 year (annualized)	5 year (annualized)	Since inception (annualized)	Cumulative total return since inception	Cumulative total return since inception	Inception date
-40.3%	-16.8%	-8.7%	-3.0%	-24.3%	-31.8%	July 18, 2011

Shareholder 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 shareholder returns (without sales charge) for the 1-year period, the calculation assumes that the investor purchased shares at FSEP's public offering price, excluding any selling commissions or dealer manager fees, at the beginning of the applicable period and reinvested all distributions pursuant to FSEP's distribution reinvestment plan (DRP). Since FSEP closed its public offering in November 2016 and has since issued new shares only pursuant to its DRP, the calculation for the 1-year period assumes the investor purchased shares at the beginning of the applicable period at a price based on FSEP's DRP on such date. Shareholder returns (without sales charge) do not include selling commissions and dealer manager fees, which could total up to 10% of the public offering price. Had such selling commissions and dealer manager fees been included, the performance shown would be lower.

Shareholder 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 FSEP's public offering price (which includes the maximum selling commissions and dealer manager fees) at inception and reinvested all distributions pursuant to FSEP's DRP.

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

FSEP's public offering price was subject to a sales charge of up to 10% and offering expenses of up to 1.5% of the gross proceeds received in the Fund's offering.

FSEP's annualized total expenses as a percentage of average net assets attributable to common shares was 8.28% for the nine months ended September 30, 2020.

Risk factors

An investment in the common shares of FSEP involves a high degree of risk and may be considered speculative. The following are some of the risks an investment in our common shares involves; however, you should carefully consider all of the information found in Item 1A of our annual report on Form 10-K and subsequent quarterly reports on Form 10-Q entitled "Risk Factors" and the Form 8-K filed on March 31, 2020.

- Because there is no public trading market for our common shares and we are not obligated to effectuate a liquidity event by a specified date, it will be difficult for you to sell your common shares. If you are able to sell your common shares before we complete a liquidity event, it is likely that you will receive less than what you paid for them. While we intend to conduct quarterly tender offers for our common shares, only a limited number of our common shares will be eligible for repurchase and we may suspend or terminate the share repurchase program at any time.
- Our 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 us for investment. Any capital returned to shareholders through distributions will be distributed after payment of fees and expenses.
- Our investment policy is to invest, under normal circumstances, at least 80% of our total assets in securities of energy and power companies. The revenues, income (or losses) and valuations of energy and power companies can fluctuate suddenly and dramatically due to a number of environmental, regulatory, political and general market risks, which have historically impacted our financial performance, including our offering price, and may continue to in the future. For information about the Fund's offering price, visit www.fsinvestments.com.
- 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 our operating results.
- A lack of liquidity in certain of our investments may adversely affect our business.
- We are subject to financial market risks, including changes in interest rates, which may have a substantial negative impact on our investments.
- We have borrowed funds to make investments, which increases the volatility of our investments and may increase the risks of investing in our securities.
- FSEP is a long-term investment for persons of adequate financial means who have no need for liquidity in their investment. To invest in FSEP, an investor must have either (i) a net worth of at least $70,000 and an annual gross income of at least $70,000, or (ii) a net worth of at least $250,000. Some states, such as Kansas, impose higher suitability standards.
- Our previous distributions to shareholders 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 our affiliate, FS Investments, and our future distributions may be funded from waivers from our current adviser and affiliate, FS/EIG Advisor. Significant portions of these distributions may not be based on our investment performance, and such waivers by FS/EIG Advisor may not continue in the future. If FS/EIG Advisor does not agree to reimburse certain of our expenses, including through the waiver of advisory fees, significant portions of future distributions may come from offering proceeds or borrowings. The repayment of amounts owed to FS/EIG Advisor will reduce the future distributions to which you would otherwise be entitled.
- The global outbreak of COVID-19 (commonly known as the coronavirus) has caused volatility, severe market dislocations and liquidity constraints in many markets, including securities FSEP holds, and may adversely affect the FSEP's investments and operations.