FS KKR Capital Corp. II

Q4 Fund commentary

As of 12/31/2019

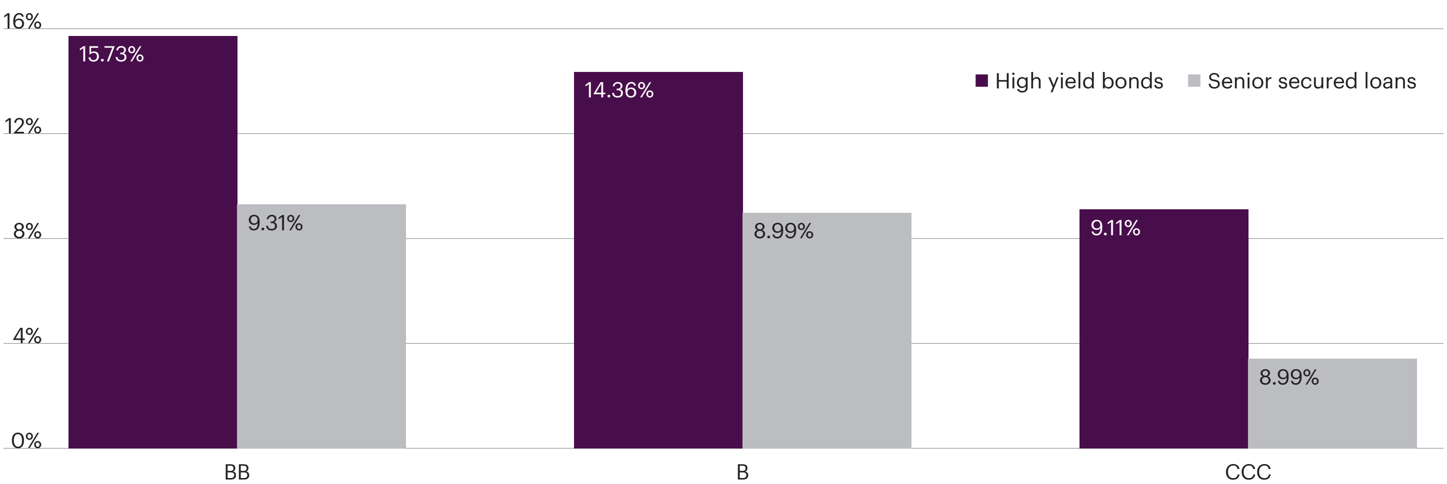
Summary

- Equity and fixed income markets rose during the fourth quarter of 2019 fueled by the Fed's 0.25% rate cut and generally positive economic data.
- High yield bonds and senior secured loans returned 2.6% and 1.7%, respectively, during the fourth quarter. Despite the strong headline returns, investors were increasingly selective as BB and B rated loans and bonds significantly outperformed CCC rated assets during the quarter.[1]
- The mergers of FS Investment Corporation II (FSIC II), FS Investment Corporation III (FSIC III), FS Investment Corporation IV (FSIC IV) and Corporate Capital Trust II (CCT II) closed on December 18, 2019. The combined company was renamed FS KKR Capital Corp. II (the Fund).
- Our previous guidance was to list the Fund in the first half of 2020. While our guidance has not changed, we continue to monitor market conditions given the significant rise in volatility as the global financial markets assess the potential impact of the COVID-19 virus. A listing will, of course, be subject to market conditions and board approval. We will provide further updates once available.

Market review

Both equity and fixed income markets rose during the fourth quarter, propelled by an accommodative Federal Reserve and moderate yet still positive U.S. growth. Strong jobs figures continued to support the consumer as the U.S. unemployment rate declined slightly during the quarter, touching on 50-year lows. Both manufacturing and non-manufacturing industries showed signs of strength. The ISM Non-Manufacturing Index, which includes mining, agriculture, finance and healthcare, among other industries, rebounded during the fourth quarter, moving further into expansion territory.[2] The ISM Manufacturing Index, which served as a drag on economic growth throughout 2019, moderated further.[3] The Fed lowered rates by 25 bps for the third meeting in a row in October before holding the target federal funds rate steady in December, serving as a tailwind to risk assets—such as equities and below investment grade credit investments.[4] After hitting a 3-year low in early September, the 10-year U.S. Treasury yield moved moderately higher during the quarter in response to an improving economic outlook and a reduction in trade tensions between the U.S. and China.[5]

HIGHER-RATED BONDS AND LOANS OUTPERFORMED IN 2019[1]



Source: ICE BofAML U.S. High Yield Index and S&P/LSTA Leveraged Loan Index, as of December 31, 2019.

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.

An investment in FS KKR Capital Corp. II (the Fund) 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 the Fund carefully. Investors should read and carefully consider all information found in the Fund's reports filed with the U.S. Securities and Exchange Commission.

The Fund 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.

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High yield bonds returned 2.6% during the fourth quarter and 14.4% in 2019 while senior secured loans returned 1.7% and 8.6% over the same periods.[1] Fueled by a supportive Federal Reserve, a stable macro backdrop and low corporate default rates, 2019 returns across both asset classes were roughly double their 10-year averages. Underneath the strong headline return figures, however, there was a wide dispersion between higher- and lower-rated credits. Specifically, higher-rated bonds and loans (BB and B) significantly outperformed their lower-rated (CCC) peers during the quarter and throughout the year. The performance differential in 2019 was a notable change from the previous several years, when lower-rated credits led returns.

Senior secured loans generated positive returns despite facing significant technical headwinds throughout the quarter and year. Unlike high yield bonds, senior secured loans saw massive outflows in 2019, totaling nearly $38 billion, in the face of a protracted low-interest rate environment.[6] Outflows gradually eased during the fourth quarter, however, as economic data improved, and the 10-year Treasury yield moved approximately 25 bps higher.

After a generally strong start to 2020, global financial markets experienced a sharp reversal driven by the uncertain impact of the COVID-19 virus. The Federal Reserve implemented an inter-meeting cut of 50 bps and expressed a willingness to do more to support the U.S. economy.[4] The last time the Fed cut rates between meetings was in 2008 at the height of the financial crisis.[4] As of the time of publishing, loans (-7.6%) and high yield bonds (-9.1%) have generally held up well compared to equities (S&P 500: -15.7%; MSCI World: -20.2%) year to date.[1]

Merger summary

The mergers of FSIC III, FSIC IV and CCT II into FSIC II closed on December 18, 2019, creating the second-largest BDC with approximately $9 billion in assets as of December 31, 2019. FSIC II was the surviving entity in the mergers and the combined company was renamed FS KKR Capital Corp. II.

A key consideration of the merger plan was to ensure all shareholders received equal value in shares of FS KKR Capital Corp. II through net asset value (NAV)-for-NAV mergers. FSIC III, FSIC IV and CCT II shareholders received equal value in shares of FSIC II based on each fund's NAV as of December 16, 2019. FSIC II was the surviving entity since it was the largest fund based on total assets and had the longest track record. We believe the track record length will be important as we seek to create demand from prospective institutional investors in preparation for a listing.

Prior to the closing of the mergers, each fund paid its regular December distribution in cash to investors. In addition, FSIC IV and CCT II paid a special cash distribution of $0.24 per share and $0.19 per share, respectively, representing previously undistributed net investment income and capital gains.

Performance review

Following the closing of the mergers, FS KKR Capital Corp. II will pay distributions on a quarterly basis. The Fund's board declared a distribution of $0.15 per share for the first quarter, payable on April 2, 2020. The annualized distribution yield is 8.15% based on the Fund's NAV as of December 31, 2019.[8]

Prior to the mergers, the annualized distribution amounts differed among the non-traded funds. Therefore, FS KKR Capital Corp. II's distribution for the first quarter of 2020, on an annualized basis, may be higher or lower depending on the fund(s) a shareholder owned prior to the mergers.

To the extent the Fund generates net investment income in excess of the regular quarterly distributions, we expect to pay out a portion of excess income to shareholders through a special distribution, subject to board approval.

Turning to performance, the Fund's NAV declined to $7.36 per share as of December 31, 2019 from $7.59 per share as of September 30, 2019. The quarterly NAV decline was driven predominantly by unrealized losses with the vast proportion of those losses driven by older vintage assets originated prior to the FS/KKR partnership. For context, 9 out of the top 10 detractors to performance during the fourth quarter were older vintage assets. Since many of these investments were top holdings in the Fund in 2019, they had an outsized impact on performance.

We believe these performance issues are company-specific as opposed to reflective of fundamental weakness across the entire portfolio. In fact, non-accruals represented 2.1% of the portfolio based on fair value as of December 31, 2019. We continue to work with the management teams and equity owners of these companies to maximize shareholder value for our investors. This can be achieved in a few ways, including working with the company's equity owners to provide additional capital, extending the maturity of our debt, providing additional financing or restructuring our investment.

Looking forward, we will continue to seek ways to reduce the Fund's exposure to underperforming investments and grow our allocation to KKR-originated investments. Enhancing portfolio diversification was a key driver of our strategic rationale for the mergers. As of year-end, FS KKR Capital Corp. II's portfolio was composed of over 200 companies compared to a pre-merger low of 94 companies in FSIC IV and high of 174 companies in FSIC II. The mergers also helped to reduce the pro forma concentration of the Fund's top 10 issuers from 28% as of December 31, 2018 to 24% as of December 31, 2019 based on fair value.

In addition, we maintained our focus on investing primarily in senior secured debt, which represented 79% of the portfolio's fair value as of December 31, 2019. Approximately 67% of the portfolio was invested in first-lien senior secured loans and 9% was in second-lien senior secured loans as of December 31, 2019 based on fair value. Other senior secured debt represented 3%, and equity/other investments represented 4% of the portfolio's fair value as of December 31, 2019. Finally, asset-based finance investments represented 6% of the portfolio as of December 31, 2019 based on fair value. We view this portion of the portfolio as an opportunity to make investments with strong collateral protection, low correlation to the broader markets and equity-like upside potential by providing customized financing solutions to underserved areas of the market, including aircraft, consumer finance, auto and equipment finance businesses.

We will continue to seek ways to maximize the benefits of the breadth of KKR Credit's platform with a focus on accessing a growing investment pipeline of upper middle market companies. We believe the upper middle market offers a differentiated source of deal flow and attractive investment opportunities due to lower competition. We expect these combined efforts will help reduce portfolio volatility and meet the Fund's income and return objectives for investors over the long term.

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 – Credit Suisse Leveraged Loan Index, which tracks the investable market 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 Institute for Supply Management, Non-Manufacturing ISM, http://bit.ly/32TLgrV.

3 Institute for Supply Management, Manufacturing ISM, http://bit.ly/31UcDlm.

4 U.S. Federal Reserve, http://bit.ly/34d93mT.

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

6 Refinitiv Lipper.

7 Assumes the value in common shares is the NAV per share and the value of the preferred shares is the liquidation preference.

8 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 $0.15 paid in the quarter ended December 31, 2019, without compounding), divided by the Fund's distribution reinvestment price per share of $7.36 as of December 31, 2019. The annualized distribution rate may be rounded. The payment of future distributions on the Fund's shares of common stock is subject to the discretion of the Fund'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 December 31, 2019, 100% of the Fund's distributions were funded through net investment income on a tax basis. No portion of the Fund's distributions during the quarter ended December 31, 2019 was funded through expense reimbursements from the Fund's sponsor. The determination of the tax attributes of the Fund's distributions is made annually at the end of the Fund's fiscal year, and a determination made on an interim basis may not be representative of the actual tax attributes of the Fund's distributions for a full year. The actual tax characteristics of distributions to shareholders are reported to shareholders annually on Form 1099-DIV.

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).

- Because there is no public trading market for shares of the Fund's common stock and the Fund 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 the Fund completes a liquidity event, it is likely that you will receive less than you paid for them.
- 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.
- The listing of shares of the combined company on the New York Stock Exchange may not be completed on the anticipated timeline or at all.

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 or natural disasters, 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 failure to list the common stock of the combined entity on a national securities exchange. Some of these factors are enumerated in the filings the Fund makes with the SEC and are also contained in the Proxy Statement. 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.

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