



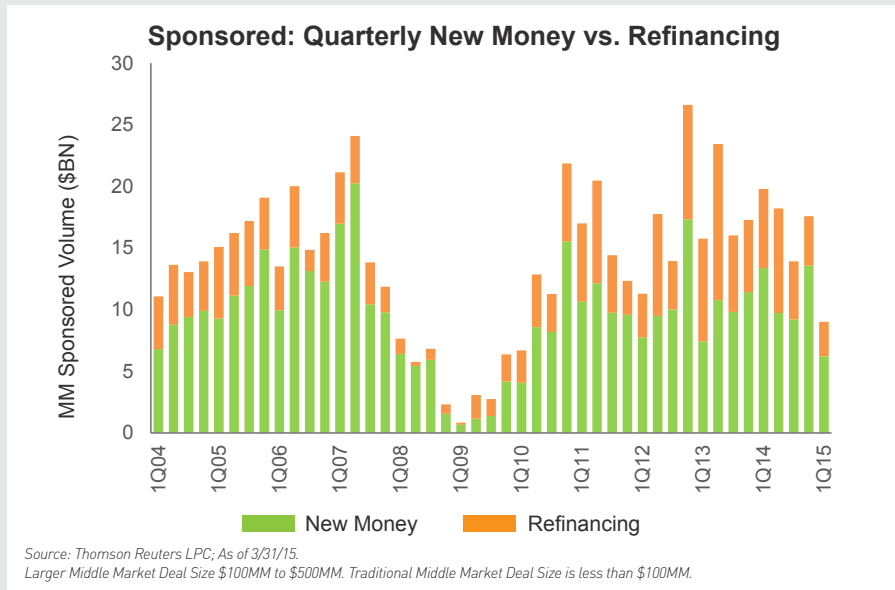
First Quarter 2015 Capital Markets Outlook

April 1, 2015

Taking a Pause

Middle market issuance has been off to a slower start this year, partially due to softer M&A activity (See Figure 1). Prior to the broader market sell-off at year end, new money deals were on the rise and leverage was ticking up—helping sponsors justify purchase premiums. Now, a reversal of fortunes has taken hold. Last year’s reset ushered in a pullback in leverage as well as greater deal selectivity, widening the bid-ask spread and dampening the appetite for M&A. Although sponsored loan volume stands at just \$9 billion year-to-date, we expect the middle market lending environment to improve over the year. However, for the near term, we are likely to see opportunistic refinancing and dividend recapitalizations dominating new money transactions.

Figure 1

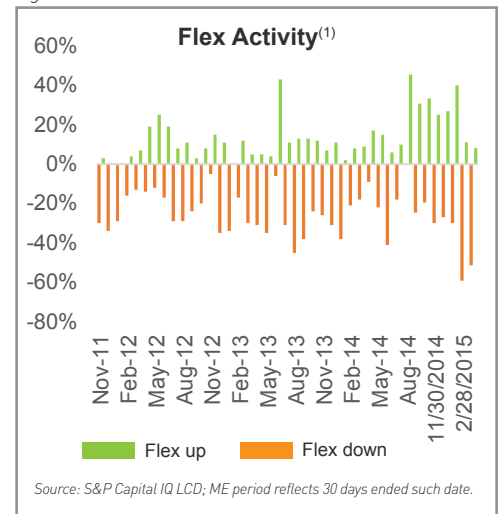


The “Haves” and “Have Nots”

While market bifurcation has persisted for some time—with high quality credits attracting a disproportionate share of interest from lenders—many have noted an intensification as of late. Credits that are perceived as having a “clean story” have typically been oversubscribed, leading spreads to flex down. On the other hand, so-called marginal credits have tended to flex wider or, in some cases, have been pulled from the market altogether. According to S&P Capital IQ LCD, as the March quarter unfolded, the percent of loans flexing down has been hovering in the 50-60% range, compared to 25-30% at year-end. Conversely, only about 10% of loans have been flexing up versus 25-40% just one quarter ago (See Figure 2).

Last year’s reset ushered in a pullback in leverage as well as greater deal selectivity, widening the bid-ask spread and dampening the appetite for M&A.

Figure 2



⁽¹⁾“Flex” refers to increase / decrease in the spread or margin on a syndicated loan when demand is more / less than expected.

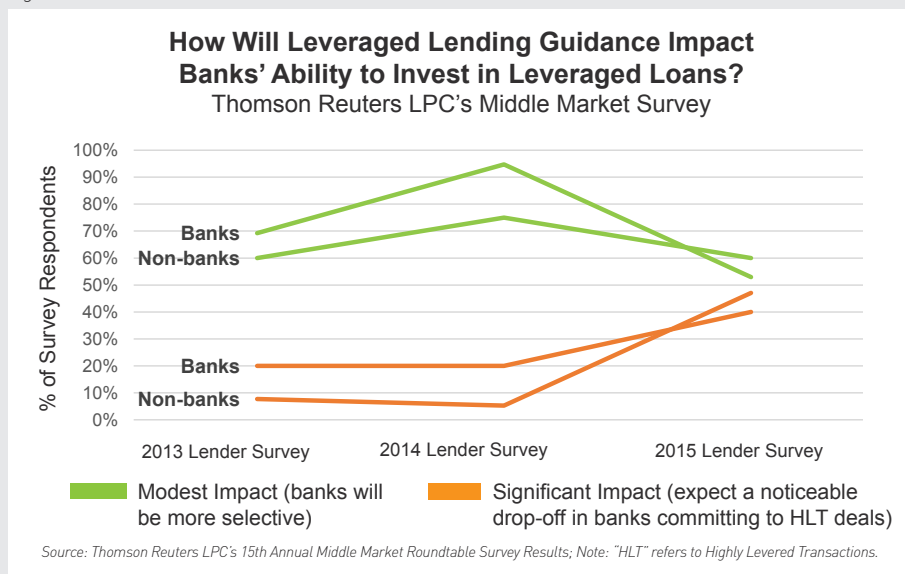
A Wake Up Call for Banks

Banks have been aggressively pursuing straight, down-the-middle credits that can be structured as Term Loan A transactions. These plain vanilla credits are highly desirable for traditional lenders, who have been hampered by U.S. regulators' leveraged lending guidelines relative to the level of funds they have to lend.

Issued in March 2013, the leveraged lending guidance is not new. However, as regulators underscore their seriousness—and banks digest their full impact—the guidelines are weighing more heavily in the decision-making process. The guidelines stipulate two hurdles: each transaction must fall below a six times leverage threshold as well as a 50% amortization rate, deleveraging over a five- to seven-year period. The latter has emerged as a prominent tripwire, although a transaction that fails either test typically prompts a decline. Such declines are transcending pre-existing relationships; they are not uncommon even for borrowers or sponsors seeking incremental funds from a current lender or agent. In those cases, borrowers and sponsors usually circumvent the banks to approach non-bank lenders directly.

Not surprisingly, Thomson Reuter's most recent Middle Market Survey indicated a significant increase in the number of lenders who anticipate a material drop off in banks' abilities to commit to highly leveraged transactions. Typifying this trend was GE Capital, which garnered headlines with its recent announcement to scale back or sell off its commercial lending arm. (See Figure 3).

Figure 3



Developments in Pricing and Structure

As the guidelines continue to have a cooling effect on banks' lending, unitranche structures have gained widespread momentum. Having expanded their market share in 2014, many expect them to make further inroads in 2015 as sponsors favor this structure over other solutions (see Figure 4, right).

From a pricing perspective, price discovery for both first lien and second lien at the beginning of the year has given way to clearer delineation for first lien (and even slight tightening for superior credits). However, second lien remains more opaque with price discovery still apparent.

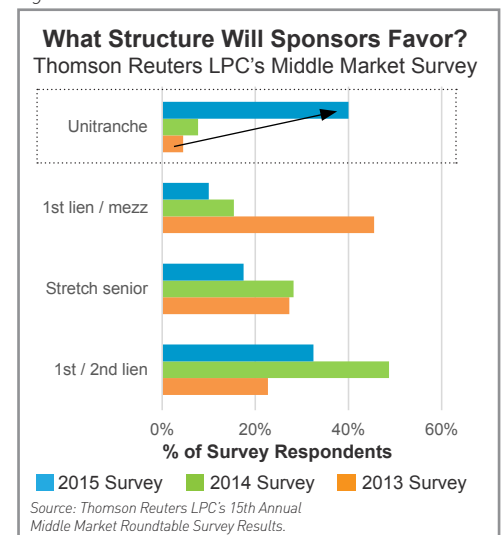
Finding Diamonds in the Rough

Against this supply-demand imbalance, Fifth Street has refrained from reaching for yield. Instead, we prefer to maintain careful underwriting standards while using our established origination platform to uncover pockets of opportunity.

Adhering to our investment criteria has proven successful in the past. Consider a medical products company we supported for a long-standing sponsor. While others worried that the company occupied a narrow niche and was overly dependent on a single customer, deep credit research gave us enough comfort to provide a one-stop financing facility. In the end, a constructive stance paid off in the form of a healthy return.

In our view, extending credit is straightforward. However, preserving capital demands a high level of selectivity aided by superior sourcing. With ~45 investment professionals including eight originators, we source the majority of our investments, focusing predominantly on sponsor-backed deals. In 2014, we reviewed over 1,000 middle market direct lending deals, yet closed only 4%; repeat sponsors accounted for over 60% of total transaction volume. Such a discerning stance enables us to find less competitive niches, where we believe we can ultimately earn attractive risk-adjusted returns.

Figure 4



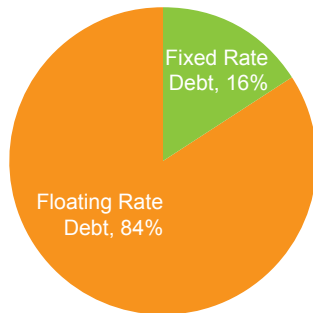
Eyes on the Fed

Cautious optimism with respect to the economy has brought the interest rate hike question to the forefront. How will a potential rise in interest rates impact the middle market? Some investors assume that portfolio companies may come under greater financial stress as interest payments on floating-rate debt increases. Prudent credit managers, however, have often factored in those risks when originating deals. In fact, portfolio companies' cash flows could potentially improve if rising interest rates signal some sort of fundamental improvement in the economy.

In addition, credit managers invested in floating rate investments stand to reap the benefits of additional income when interest rates eventually rise. With 84% of FSAM's credit-focused AUM in floating rate investments, we believe that the Fifth Street platform is well-positioned.

Figure 5

Fixed & Floating Rate Debt Investments as a % of FSAM's Credit-Focused AUM



As of 12/31/14.

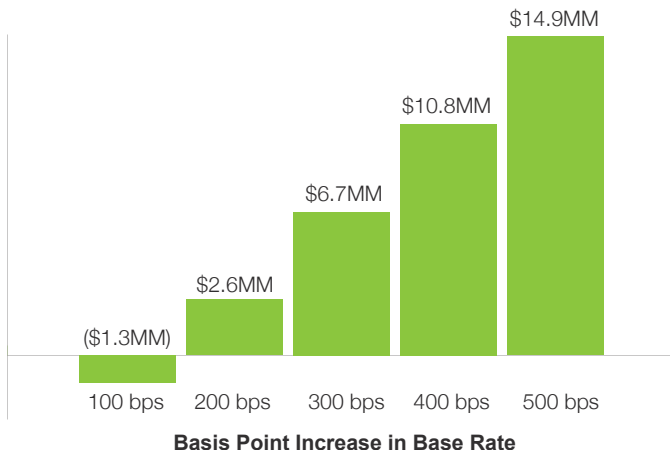
Generally speaking, interest rates will need to rise at least 75-100 bps for lenders to reap the benefits of additional income, factoring in interest rate floors. The market average Libor floor is approximately 100 bps; however, we believe the market will anticipate the benefit ahead of time.

To quantify the impact more broadly, consider

Fifth Street Senior Floating Rate Corp. (FSFR), a pure play with a portfolio of ~100% senior, floating rate loans. Figure 6 below reflects the benefit to FSFR's net spread income at various rate levels. Yet, with a current yield of over 11%⁽²⁾, FSFR represents more than just an interest rate play—it offers compelling income independent of the direction of interest rates.

Figure 6

FSFR's Estimated Annual Change in Net Spread Income from Interest Rate Changes



As of 12/31/14. Net spread income calculated as the difference between the change in interest income and interest expense.

% of Fifth Street Debt Portfolios in Floating Rate Investments:

- FSFR: ~100%
- SLF I and II: 100%
- Hedge Fund: ~100%
- FSC: 75%

As of 12/31/14.

Pure play FSFR has a portfolio of ~100% senior, floating rate loans... Yet, with a current yield of over 11%, FSFR offers compelling income independent of the direction of interest rates.

Fifth Street Activity

As a management team, we are confident about our business and the range of growth opportunities we are seeing. While our business development companies, Fifth Street Finance Corp. (FSC) and Fifth Street Senior Floating Rate Corp. (FSFR), have historically driven our strong growth, we remain committed to diversifying the asset management platform through other growth initiatives. Two initiatives that we are actively pursuing are the expansion of our CLO business and our hedge fund.

Debut CLO

During the quarter, FSAM announced the closing of its first collateralized loan obligation (CLO), Fifth Street Senior Loan Fund I, LLC ("CLO I"). At \$309.5 million, the CLO invests primarily in middle market senior secured loans sourced and originated through the Fifth Street platform. As a first-time issuer, FSAM was pleased with the institutional interest displayed—a validation of the strength of our direct origination platform. CLO I represents an important milestone in the continued growth of this product line. We are also continuing to evaluate the securitization of Fifth Street Senior Loan Fund II, LLC (SLF II) and are in active conversations with prospective investors as we look to raise our third senior loan fund, Senior Loan Fund III.

Strong Hedge Fund Results

Elsewhere, we are pleased to announce that our hedge fund

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marked its second anniversary in February⁽³⁾. Primarily focused on yield-oriented, uncorrelated, and liquid corporate credit assets and equities, the hedge fund has generated consistent results, with 25 out of 26 months of positive net returns⁽³⁾. The hedge fund has approximately \$80 million of AUM⁽⁴⁾ and continues to grow as a result of its unique alpha strategy.

Direct Lending Momentum

Beyond our existing products, we continue to explore other strategies in the direct lending space, which appear to be gathering momentum as a distinct asset class. According to Preqin, direct lending fundraising has already climbed fourfold since 2012 (\$7.1 billion versus \$29.1 billion of inflows in 2014), with room for further expansion. Over 60% of investors cited it as the most attractive investment opportunity in the current market⁽⁵⁾. Such robust interest comes as no surprise given that many global investors seek incremental returns without undue risk. Direct lending can also provide protection from rising interest rates and premium yields relative to traditional fixed income along with stronger asset protection. With an award-winning direct origination platform and a core focus on middle market credit strategies, we believe Fifth Street is well-equipped to capitalize on future momentum in the direct lending space. Our highly selective, sponsor-focused platform emphasizes scale, discipline and a focus on capital preservation.

Fifth Street Asset Management Inc. (NASDAQ:FSAM) is a growing credit-focused asset manager. The firm has over \$6 billion of assets under management across two publicly-traded business development companies, FSC and FSFR, as well as multiple private investment vehicles. The Fifth Street platform provides innovative and customized financing solutions to small and mid-sized businesses across the capital structure through complementary investment vehicles and co-investment capabilities. With a 17-year track record focused on disciplined credit investing across multiple economic cycles, Fifth Street is led by a seasoned management team that has issued billions of dollars in public equity, private capital and public debt securities. Fifth Street's national origination strategy, proven track record and established platform are supported by approximately 100 professionals across locations in Greenwich, Chicago, Palo Alto and Dallas.

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