Commentary and Perspectives from Fifth Street Asset Management

FIFTHSTREET

Second Quarter 2015

Capital Markets Outlook

July 29, 2015

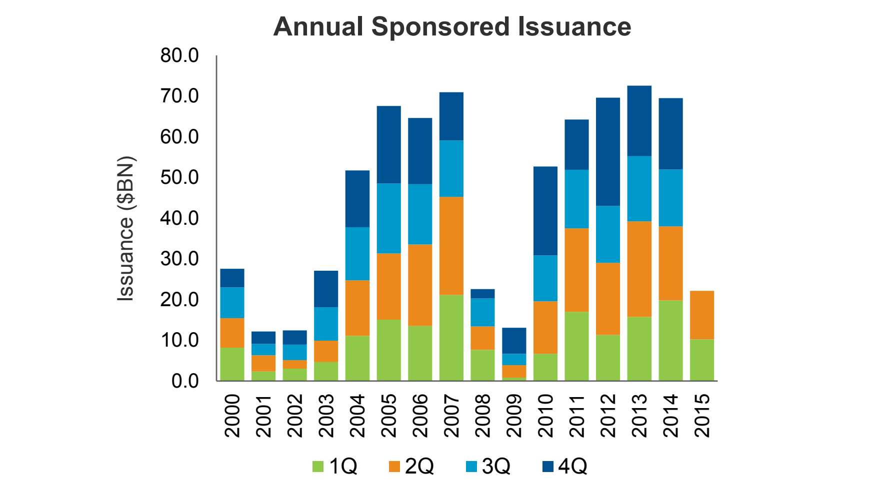
Modest Improvement, But Still Trailing

While U.S. middle market loan volume registered a slight uptick this quarter, the market has yet to approach levels seen one year ago. Although sponsored issuance gathered momentum in 2Q, increasing modestly to $11.9 billion, issuance for the first six months only reached $22 billion—the weakest first half in five years *(See Figure 1)*.

At $1 trillion, M&A volume in the U.S. has reached historic levels in 2015[1]; however, purchases by investment grade companies have overshadowed private equity purchases. On the other hand, the middle market represents a haven for private equity sponsors who are currently being outbid by cash-rich corporate buyers in the Broadly Syndicated Loan ("BSL") space. Many sponsors believe middle market conditions are more favorable than the BSL space, partially due to the prevalence of alternative lenders who continue to fill the void left by traditional banks hampered by strict capital requirements and leveraged lending guidelines.

Despite sluggish conditions, the middle market represents somewhat of a haven for private equity sponsors.

Figure 1

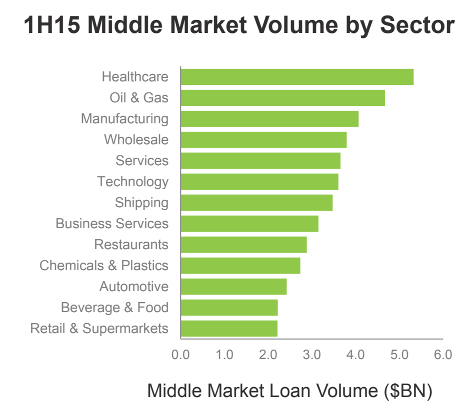


Source: Thomson Reuters LPC; As of 6/30/15.

Healthcare Leads the Pack

Despite sluggish conditions in the first half of 2015, we remain cautiously optimistic for the second half, given the seasonality of the M&A market. Although middle market valuations remain frothy and liquidity excessive, we have noticed an increase in deal flow in select industry verticals such as healthcare. At $5.3 billion, healthcare represented the top sector by volume in the first half of the year *(See Figure 2, right)*. This sector tends to exhibit lower leverage and improved economics when compared to other traditional sectors. We believe this dynamic exists because many lenders shy away from the complex reimbursement models which characterizes these credits and necessitates specialized origination and underwriting expertise.

Figure 2



Source: Thompson Reuters LPC; As of 6/30/15.

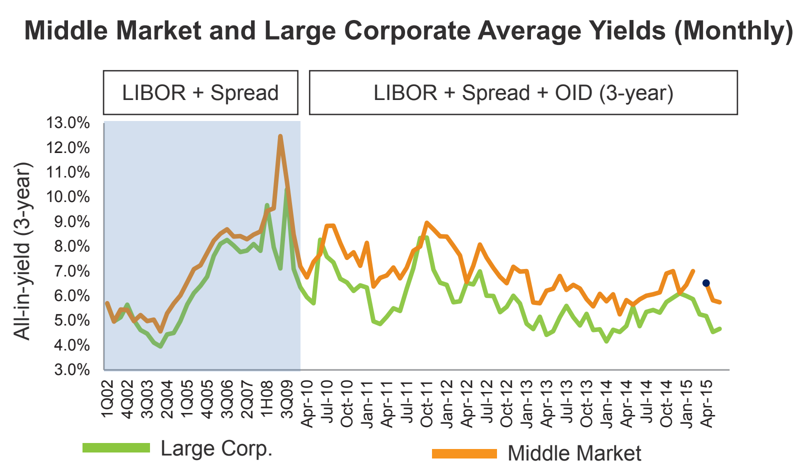
Pricing Squeeze Persists, While Middle Market Maintains Yield Premium

Driven by too much liquidity chasing too few deals and a slowly improving economy, pricing continues to show signs of downward pressure. During the second quarter of 2015, middle market term loan yields declined to 5.74%, with tightening occurring throughout the capital stack *(See Figure 3)*. While first lien pricing responded more quickly and by the largest magnitude, second lien followed suit, albeit to a lesser extent.

Despite the decline, middle market spreads still maintained their premium over large corporate spreads, where term loan pricing fell to 4.66%. Through the first half of the year, the 100+ basis points yield differential has held fast. The premium was re-established after disappearing during the broader market sell-off at the end of 2014. In our view, this yield differential represents an attractive liquidity premium for middle market investors. Investors seem to agree, as evidenced by the brisk pace of middle market fundraising so far this year. At over $8 billion, 2015's visible middle market capital raising appears on track to surpass levels reached last year[2].

As the economy continues to improve, our investment vehicles remain positioned for potential interest rate increases. We continue to see select deals decreasing LIBOR floors from 100 basis points to 75 basis points or 50 basis points, though the trend is still modest. Generally speaking, completing new deals with LIBOR floors below 100 basis points should slightly offset the negative impact of rising interest rates up to 100 basis points. After LIBOR rises more than 100 basis points, lenders (with a mix of floating and fixed rate liabilities) should generate additional income and benefit from a rising interest rate environment.

Figure 3



Source: Thomson Reuters LPC; As of 6/30/2015.
There was not enough data to show an average for March 2015.
Middle market borrowers have revenues & deal size equal to or less than $500MM. Large corporate borrowers have sales over $500MM.

Sizing Up the GE Exit

The landscape surrounding middle market leveraged lending continues to change, as evidenced by the sale of GE Capital's sponsor finance business to the Canada Pension Plan Investment Board. There is considerable uncertainty surrounding the sale's impact and, from our perspective, it seems premature to make a definitive assessment. With competition and liquidity both pervasive, the effects are unlikely to be immediate in our view.

We believe that the sale may be a harbinger of things to come, with more financial institutions exiting this space due to leveraged lending guidelines.

Non-Bank Lenders Gain Market Share

Due to regulatory headwinds, we see a continued disintermediation of leveraged lending from the traditional banking sector, characterized by declining bank participation in middle market leveraged lending, while participation from non-bank lenders has increased year-over-year.

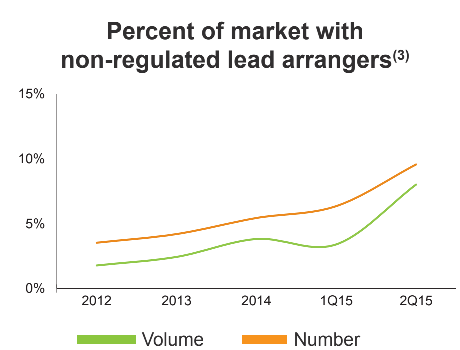
We believe that borrowers and sponsors favor a collaborative partnership approach, which non-bank lenders are typically able to provide through more flexible financing solutions, large hold sizes and diversified product offerings.

The non-bank lending space has become more institutionalized and continues to gain market share and influence. For example, during the second quarter through mid-June, non-bank lenders captured 8% of lead left mandates that LCD has tracked, by volume, and 9.6% by number of loans. These figures are up from 3.4% and 6.4%, respectively, in the first quarter *(See Figure 4, below)*.

As banks retreat, they are further fueling the institutionalization by partnering with non-bank lenders to offer investors access via separately managed accounts (SMAs).

Banks' pullback can also be seen in the lower tolerance for leverage. Leverage levels on institutional middle market deals peaked at 5.5x in 2007. In contrast, during the first half of this year, the average for middle market transactions hovered at 5.25x[2].

Figure 4



Source: S&P Capital IQ LCD

Middle Market CLOs Make Strides, But Still Have a Ways to Go

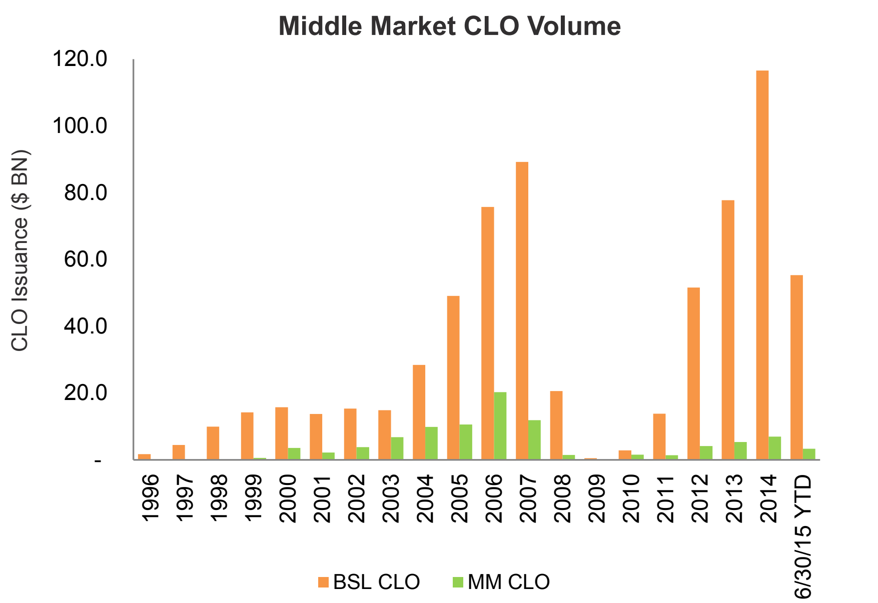
A flurry of last minute activity buoyed 6/30/15 YTD U.S. collateralized loan obligation ("CLO") volume to $58.68 billion. BSL CLOs accounted for $55.32 billion, or 94% of total issuance, while middle market CLOs totaled $3.36 billion (or 6%) during the period. As Figure 5 below demonstrates, the CLO market has rebounded considerably from its post-financial crisis trough. However, much of that recovery has been driven by BSL CLOs, whose 2014 volume of over $116 billion actually exceeded pre-crisis peak levels. Demand for middle market CLOs has strengthened as well, but not nearly to the same extent. From our perspective, we believe demand will continue to increase as a result of attractive yields, more conservative structures and favorable correlation statistics to broader liquid market alternatives.

However, several factors are still holding back the recovery of middle market CLOs. Generally speaking, investors remain somewhat wary of the relatively smaller size of the underlying borrowers and less liquid nature of middle market loans. In addition, middle market CLOs have a much thinner investor base for rated notes—especially for Aaa/AAA-rated notes. To spur growth, middle market CLOs need a deeper and more expansive investor base, as evidenced by the current difficulty placing Aaa/AAA notes (which account for 50+% of these structures).

In addition, the broader macroeconomic environment and cyclical summer slowdown haven't helped. Recent capital markets volatility has given investors pause as macroeconomic concerns ranging from a potential Greek exit to a slowdown in China have diminished investors' appetite for risk. These uncertainties have caused liabilities to trend wider, particularly in the middle market, with recent quality issues pricing Aaa/AAAs north of L+195 basis points.

These pressures have pushed out the timeline for a variety of deals. However, as the typical summer slowdown concludes and some of the recent macro events subside, we expect the market to 'find its footing,' suggesting that the pace of fourth quarter activity should be brisk.

Figure 5



Source: Thomson Reuters LPC, Wells Fargo; As of 6/30/2015.

Accelerated demand can be attributed to increased acceptance of the middle market as a sub-sector of leveraged finance—a trend we're seeing across vehicles.

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Fifth Street Activity

We are delighted to announce that Fifth Street was named "Lender Firm of the Year" at the 5th Annual ACG New York Champion's Awards—the second consecutive year that the platform has received a firm of the year distinction. The honor confirms our status as a premier lender to private equity sponsors in the middle market—one of the key drivers of the increased interest we are seeing in our platform.

We are currently in active discussions with various institutions that lack access to middle market direct lending. These prospective partners are looking to tap into our leading sponsor-focused origination platform, which has a multifaceted and nationwide sourcing strategy – soon to include a San Francisco office for which we recently signed a lease. In particular, we are noticing considerable interest in our first lien and one-stop financing transactions, which we believe have the strongest risk/reward trade-offs in today's environment.

Key Hire

The ability to attract experienced institutional investors as partners is a vote of confidence in Fifth Street's sourcing, underwriting and portfolio management expertise. As a result, we made a strategic hire during the second quarter to help us capitalize on this potentially significant opportunity and to execute on our vision of continuing to build a leading, diversified credit-focused asset manager. The addition of David Heilbrunn (Managing Director and management committee member) supports this goal of driving growth across Fifth Street's business lines, specifically focusing on expanding our growing structured credit products platform, developing institutional client relationships and optimizing various financing arrangements.

CLO Risk Retention Rules Create Opportunities

While CLO managers do not have to comply with U.S. and European risk retention rules until next year, firms are already gauging the impact of these rules. Established firms with access to permanent capital like Fifth Street have already developed viable solutions. However, new firms that lack the scale to retain the risk outright are approaching larger players to discuss a range of options including joint ventures. As a result, we believe this may drive industry consolidation among newer market participants.

Focused on Capital Preservation

Given the current market environment, some investors appear ambivalent towards investing in credit at this juncture in the cycle. They appear conflicted around timing their entry, particularly if the cycle has reached an inflection point. However, we believe our defensive positioning and differentiated credit portfolio may help alleviate investors' concerns. Fifth Street's award-winning origination platform allows us to uncover pockets of opportunity, while maintaining strict underwriting standards and a focus on capital preservation. We have continued to focus on senior secured instruments and have limited our exposure to cyclical industries, including energy, consumer-driven businesses and companies with direct retail exposure. While our size, scale and deep sponsor relationships allow us to source ~1,000 middle market loan opportunities per year, our single most important job is making smart investments in relatively secure credits with appropriate risk-adjusted returns, which is evidenced by a selectivity ratio of ~4%[4].

(1) Source: DealLogic. I (2) Thomson Reuters LPC; As of 6/30/2015. I (3) Copyright © 2015, S&P Capital IQ (and its affiliates, as applicable). Reproduction of this chart in any form is prohibited except with the prior written permission of S&P Capital IQ ("S&P"). None of S&P, its affiliates or their suppliers guarantee the accuracy, adequacy, completeness or availability of any information and is not responsible for any errors or omissions, regardless of the cause or for the results obtained from the use of such information. In no event shall S&P, its affiliates or any of their suppliers be liable for any damages, costs, expenses, legal fees, or losses (including lost income or lost profit and opportunity costs) in connection with any use of S&P information. I (4) Excludes capital markets deals.

Fifth Street Asset Management Inc. (NASDAQ:FSAM) is a nationally recognized credit-focused asset manager. The firm has over $6 billion of assets under management (as of 3/31/15) across two publicly-traded business development companies, Fifth Street Finance Corp. (NASDAQ:FSC) and Fifth Street Senior Floating Rate Corp. (NASDAQ: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 over 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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