Fund Research

KKR Credit Income Fund (ASX: KKC)

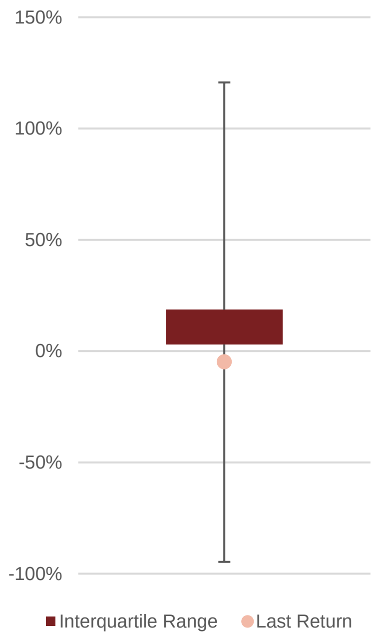
Overview

The KKR Credit Income Fund ('the Fund', ASX: KKC) is a listed income trust (LIT, 'the Trust') that seeks to provide investors with a regular income stream plus capital appreciation over a full market cycle via exposure to a diversified underlying portfolio of global traded and private credit investments through KKR's credit platform. KKC allows retail investors to easily invest in credit investment strategies not readily available to them. Through the Fund, investors get access to KKR's US$187 billion credit platform and a strategy that is highly diversified across geography and industry. The KKR Credit team comprises 160+ experienced investment professionals around the world that also leverages the expertise across KKR's broader global network of another 470+ investment professionals.

The Trust invests in KKR's Global Credit Opportunities (GCO) and European Direct Lending (EDL) strategies. The GCO strategy is focused on traded credits such as syndicated loans and bonds. The EDL strategy concentrates on private credit investments, which are typically bilateral loans between a lender and a borrower, with no or limited syndication and no secondary market.

The investment objective of the Trust is to provide stable income with a target distribution yield of 4-6% p.a. net of fees and expenses, payable monthly in arrears and a medium-term average total return of 6-8% p.a. net of fees and expenses. Given units in the Fund are in AUD and the underlying investments are offshore, the Manager utilises hedging to help manage currency risk. The Trust, GCO, and EDL strategies all intend to use leverage exclusively for liquidity and cash management purposes, in contrast to investment purposes.

Figure 2. Monthly Returns* Box Plot



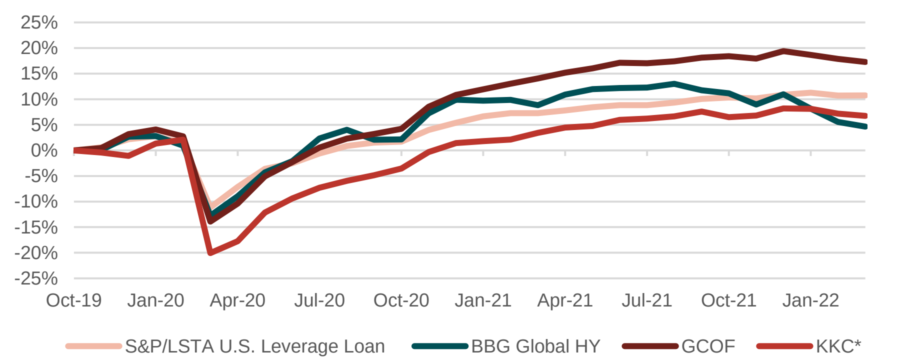
Source: BondAdviser, KKR. Annualised net monthly returns based on NTA. Since inception.

Figure 1. Monthly Net Returns* (%)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2022	-0.08	-0.85	-0.41										**-1.34**
2021	0.37	0.29	1.29	1.02	0.28	1.14	0.25	0.39	0.89	-1.01	0.30	1.29	**6.50**
2020	2.43	0.75	-21.7	2.90	6.82	3.13	2.31	1.43	1.19	1.38	3.32	1.76	**5.72**
2019											-0.42	-0.65	**-1.07**

Source: BondAdviser, KKR. As at 31 March 2022.
** Return is monthly net total return based on NTA plus dividends.*

Figure 3. Relative Cumulative Performance



** Calculated from cumulative net monthly returns of the Fund, based on NTA.*
Source: BondAdviser, KKR, Bloomberg. As at 31 March 2022.

Product Assessment

Approved | Improving

The Fund is set to continue increasing exposure to private assets via EDL which will both support Fund income and reduce NTA volatility.

KKR have implemented appropriate changes to address previous shortcomings. This support is set to continue, and our Outlook is upgraded to Improving.

KKR's Credit Income Trust provides investors with exposure to a **global portfolio** of largely **sub-investment grade credit investments**. Consequently, it has **higher expected return and risk than traditional investment grade credit products**. The Fund best suits investors looking for an attractive total return over the medium-term from a diversified portfolio of public and private credit. We expect the product to have low long-term correlation to traditional assets, so it should provide diversification benefits to retail investor income portfolios, which are biased towards domestic equity and/or hybrid income streams.

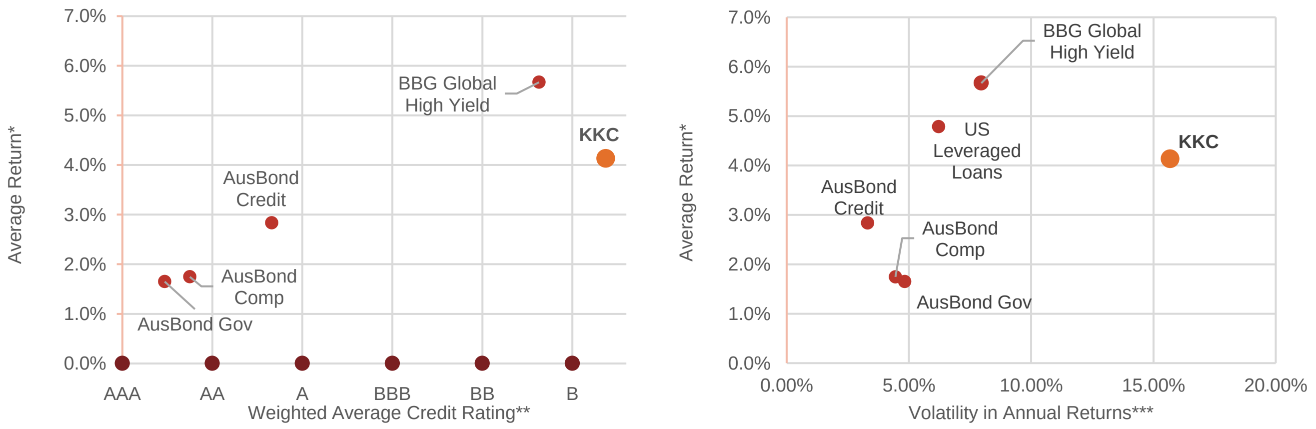
NTA performance since inception has been mixed. This is a largely a function of the market based COVID impact and currency hedging problems. Whilst COVID was exogenous to KKR's control, the (partially) endogenous currency hedging issues have in our opinion, been adequately addressed and performance rebounded well in 2021. 2022 performance has been impacted by rising bond yields and uncertainty from the Ukraine war noting that the CCC-rated investments were underweight oil and energy.

KKC's unit price has traded at a discount to NTA since the pandemic. In response, KKR initiated some unit price-friendly measures in 2021: **shifting to monthly distributions** from August 2021; and commencing an **on-market buy-back** in September 2021 (which remains in place) to help narrow the unit price discount. Additionally, KKR is **considering establishing an unlisted credit fund that would be able to buy units in KKC** – **this is our preferred price support mechanism** and manifestation of such would likely see us expect for the NTA discount to be eliminated. The discount has narrowed from the extremes of 2020 to around 10% currently.

Exposure to the EDL strategy has risen as anticipated and is expected to increase further. While credit risk remains significant, an increased contribution from the EDL strategy will support Fund income and **reduce NTA volatility** given private assets are less subject to mark-to-market movements.

KKR have implemented appropriate changes to address previous shortcomings. This support is set to continue, and our Outlook is upgraded to **Improving**, which **denotes our expectations that the Product Assessment will be upgraded within the next 12-24 months**. Performance to the targeted returns, on a rolling 24-month basis, has been sufficient for an upgrade, however, despite being confident that the structural and operational changes are satisfactory, further time is required by our methodology to empirically confirm this.

Figure 4. Estimated Risk-Adjusted Comparison (Underlying Portfolio for Weighted Average Credit Rating)

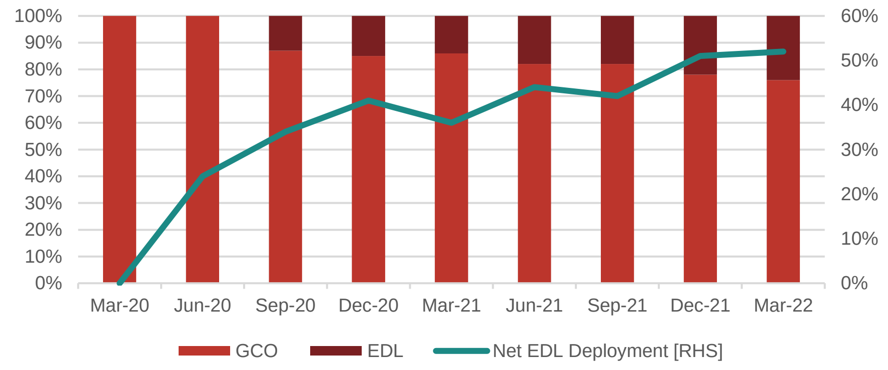


** All returns for indices calculated using annualised monthly returns since KKC's inception in November 2019. Average return for KKC based on NTA. ** Credit Ratings based on public ratings, KKR internal ratings and BondAdviser estimates. *** Calculated based on annualised monthly returns data since inception for KKC in November 2019. Source: BondAdviser, KKR, Bloomberg. As at 31 March 2022.*

Construction and Investment Process

Funds deployed into KKR's EDL strategy have increased in line with expectations to 24% of KKC's portfolio at 31 March 2022. Deployment of the EDL allocation stands at 52%. The EDL strategy is a key element of the Fund, and we expect exposure here to increase further over time.

Figure 5. Portfolio Strategy Mix



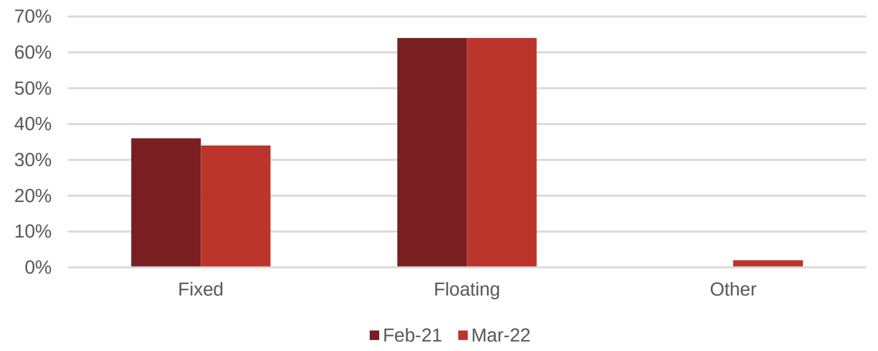
Source: BondAdviser, KKR.

Portfolio Risk Management

Our understanding is that the Fund was over-hedged in 2020 as a function of COVID-induced market declines. This resulted in material foreign currency derivative losses being realised in March 2020. In our opinion, this operational failure has been appropriately addressed with an increase in the number of hedging counterparties and moving to an SMA structure in GCO. Foreign currency forwards are used to manage currency risk, with tenors staggered based on maturity profile of investments. The Manager aims to have 95-100% of the portfolio currency hedged in terms of market value.

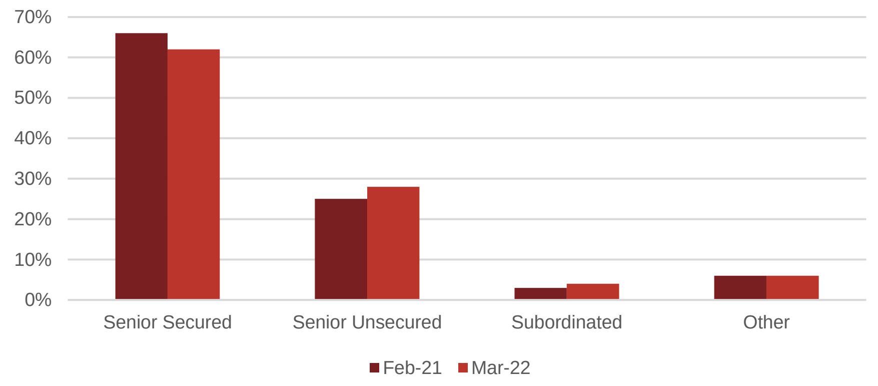
The majority of the portfolio (~64%) is comprised with floating rate investments. This leaves the Fund less at risk from rising interest rates than the broader bond market. With a portfolio duration of 1.5 years the Fund still exposed to interest rate risk, noting there have been significant moves in rates across the yield curve, one of the drivers behind the weaker start to 2022 in the Fund's returns.

Figure 6. Underlying Portfolio Interest Rate Exposure



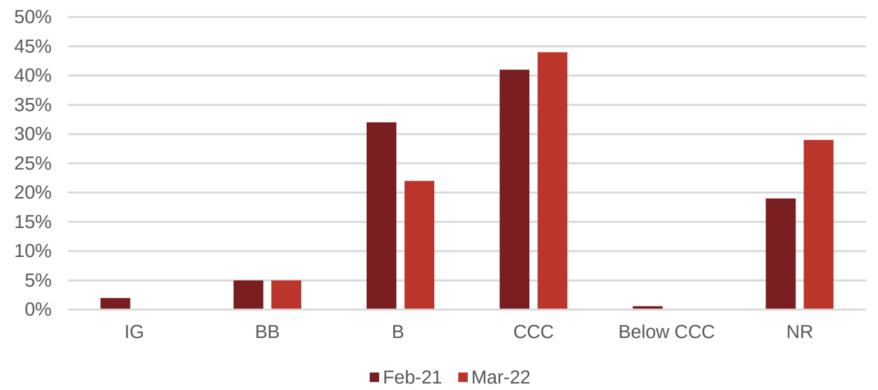
Source: BondAdviser, KKR.

Figure 7. Underlying Portfolio Asset Seniority Mix



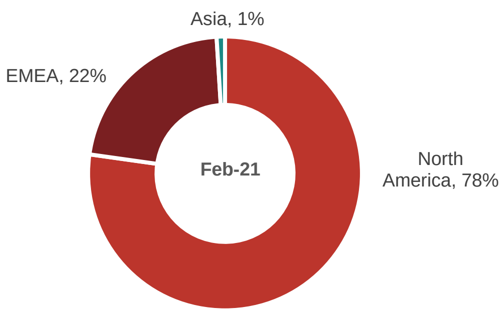
Source: BondAdviser, KKR.

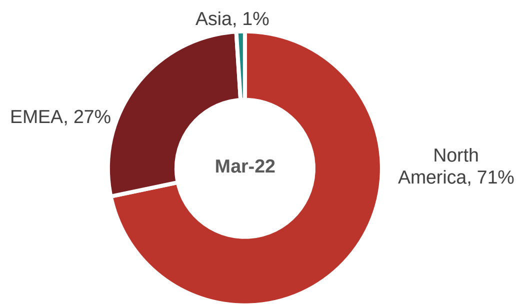
Figure 8. Underlying Portfolio Credit Rating Mix



Source: BondAdviser, KKR.

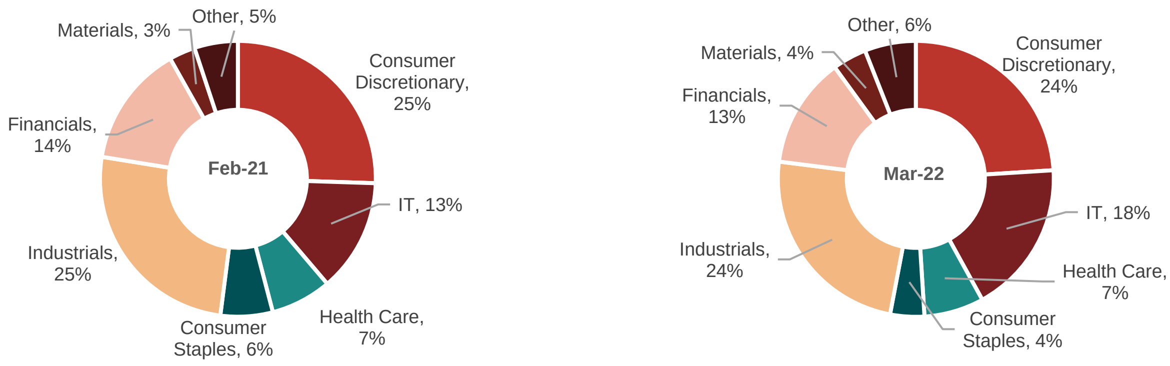
Figure 9. Underlying Portfolio Geography Mix - Feb-21 vs Mar-22





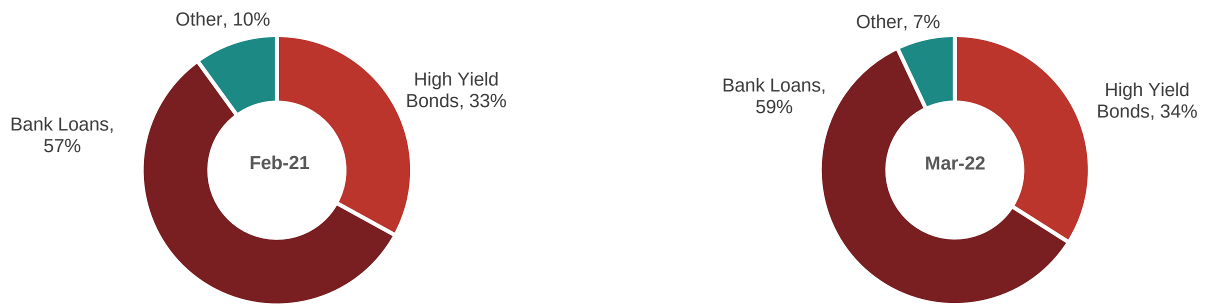
Source: BondAdviser, KKR.

Figure 10. Underlying Portfolio Sector Mix - Feb-21 vs Mar-22



Source: BondAdviser, KKR.

Figure 11. Underlying Portfolio Asset Type Mix - Feb-21 vs Mar-22

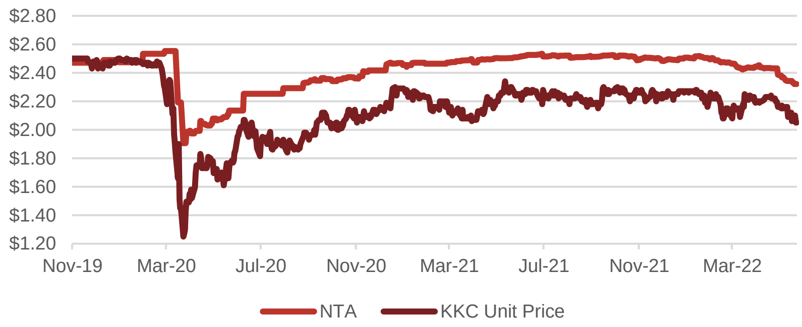


Source: BondAdviser, KKR.

Fund Governance

There have been **no material changes** to fund governance.

Figure 12. Net Tangible Asset Against Unit Price



Source: BondAdviser, Bloomberg. As at 25 May 2022.

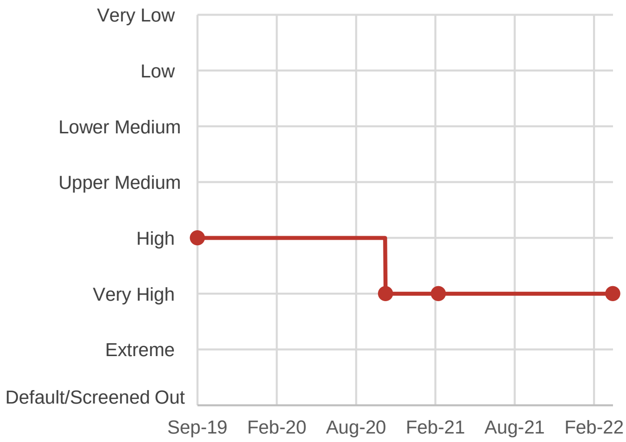
KKR provides NTA updates at least once a week, along with monthly reporting which includes insights into Fund performance and key metrics.

An on-market buy-back remains in place until 28 September 2022. To 12 April 2022, ~17.3 million units (~4.8%) on issue had been bought.

The legal structure of the Fund was reorganised in 2020, moving its holding from GCO into a separately managed account structure that is wholly owned by KKC as outlined in our April 2021 Update Report (see page 4). We believe this change was positive to unitholders from a cost, hedging and income perspective.

Quantitative Analysis

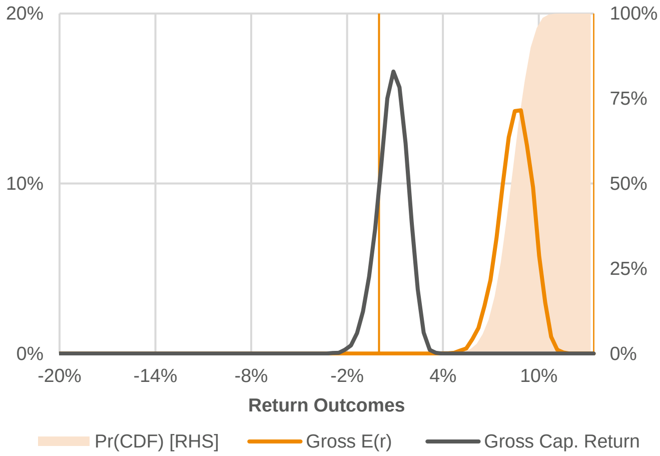
Figure 13. Risk Assessment

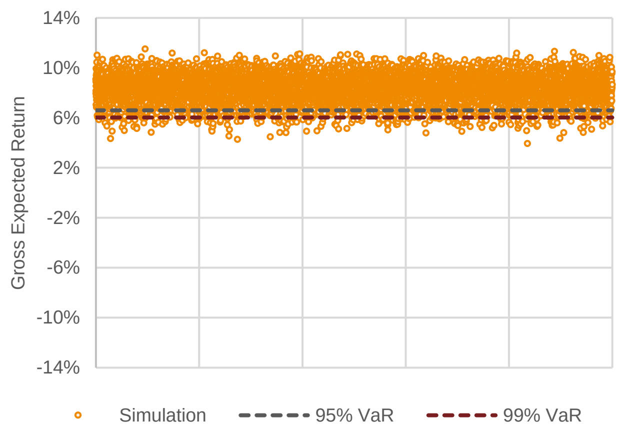


Despite the marginal increases in weightings to lower rated credits; higher yields, robust diversification and seniority drove modelling outcomes that were better than was previously tested. There was a notable reduction in tail risk due to a higher weighting to senior secured positions previously. Our estimated 99% VaR has reduced considerably from a -11.4% gross expected return to -8.5%, reflecting the improved loss given default for senior secured ranking debt.

21.8% of the portfolio is made up by its top 10 holdings, with a maximum 3.3% exposure. Continued reduction in individual issuer exposure along with increased diversification would be required to result in an upward notching of our Risk Assessment.

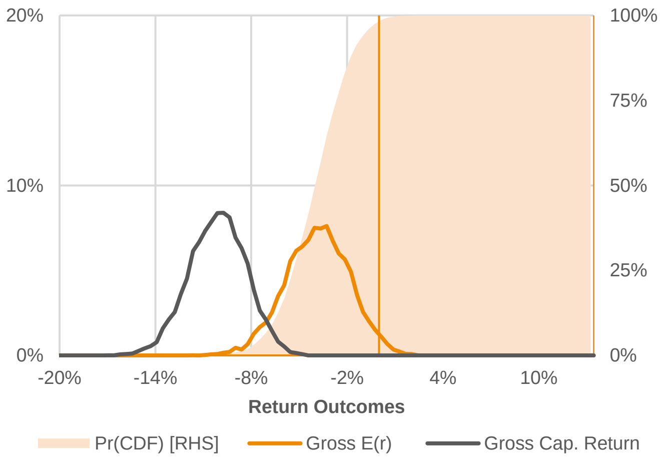
Scenario 1. Baseline Asset Assessment

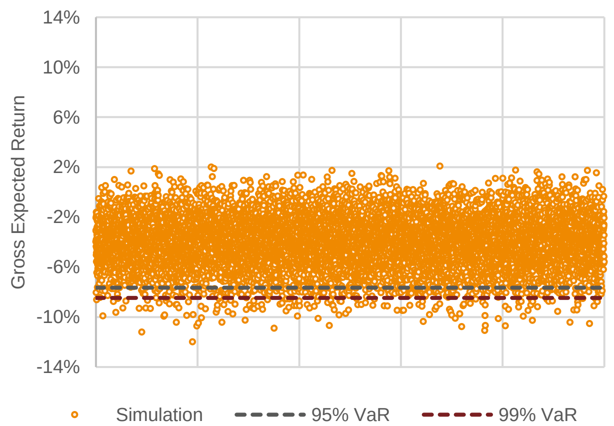




Source: BondAdviser Estimates. Excludes impact of fees. Gross capital returns excludes the value of coupons/income.

Scenario 2. Stressed Asset Assessment





Source: BondAdviser Estimates. Excludes impact of fees. Gross capital returns excludes the value of coupons/income.

Reporting History

KKC Update Report – 1 April 2021

KKC Update Report – 20 November 2020

KKC Initial Report – 18 September 2019

European Direct Lending Primer – 18 September 2019

Important Information

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Report created on 26 May 2022.