Fund Research

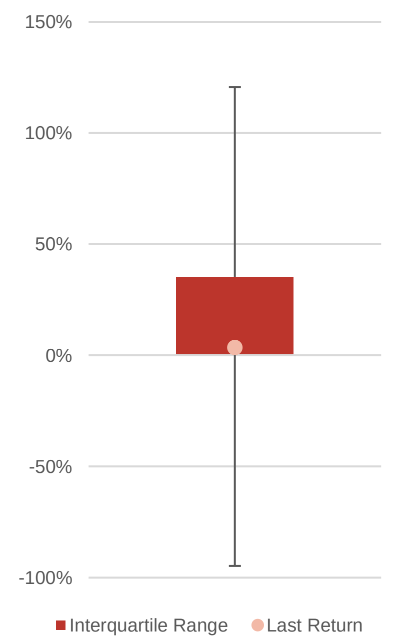
KKR Credit Income Fund (ASX: KKC)

Overview

The KKR Credit Income Fund ('the Fund', **ASX: KKC**) is a listed income trust (LIT, 'the Trust') designed to provide investors with access to high income generating, predominantly senior credit investment ideas globally through KKR Credit's product suite. The Trust will incorporate a blend of KKR's existing traded credit and private credit capabilities through the firm's Global Credit Opportunities (GCO) and European Direct Lending (EDL) strategies. Through the Trust, investors gain exposure to KKR's $72 billion credit platform and a strategy highly diversified across geography, sector and credit ratings. The KKR Credit team consists of 130 dedicated investment professionals around the world who are supported by KKR's global network of 480 investment professionals, utilising a "One Firm Approach" that allows KKR to leverage the best insights from across the firm to benefit its clients.

The investment objective of the Trust is to provide stable income with a target distribution of 4-6% p.a. net of fees and expenses, payable quarterly and an average total return of 6-8% p.a. net of fees and expenses. The Trust aims to provide investors with attractive, risk-adjusted returns and access to a diversified portfolio of income generating alternative credit investments through existing KKR strategies. As investments are made outside of Australia, the manager intends to hedge currency risk back to AUD. We also note that although neither the GCO nor EDL strategies employ leverage for investment, it is used for cash management purposes.

Figure 1. Monthly Net Returns Box Plot



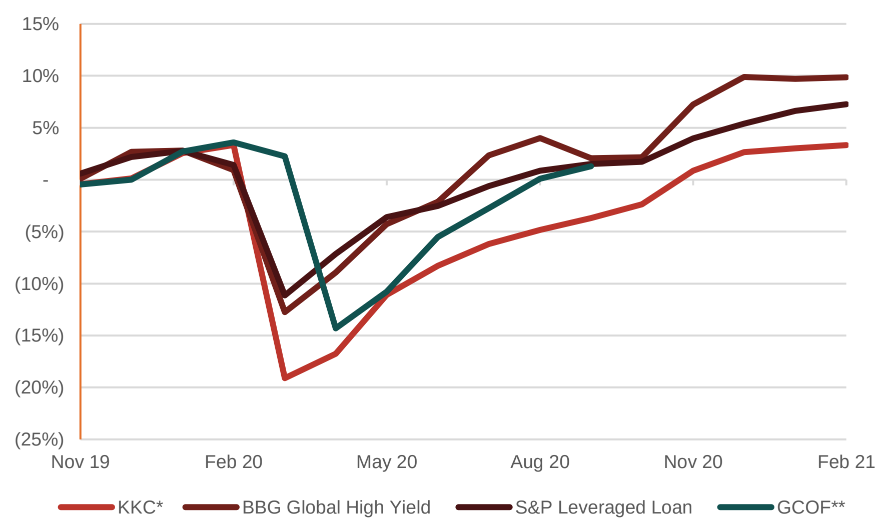
Source: BondAdviser, KKR. Annualised monthly, after fee, returns. Since inception.

Figure 2. Monthly Net Returns* (%)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2021	0.37	0.29											**0.66**
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	**5.70**
2019											-0.42	0.56	**0.14**

Source: BondAdviser, KKR. As at 28 February 2021.
** Return is monthly net total return based on NTA plus dividends.*

Figure 3. Relative Cumulative Performance



** Calculated from cumulative net monthly returns of the Underlying Fund.*
Source: BondAdviser, KKR, Bloomberg. As at 28 February 2021.

Product Assessment

Approved

KKC is supported by one of the most highly respected private-markets asset managers in the world.

KKR's Credit Income Trust (KKC) provides investors with largely sub-investment grade exposure to global credit opportunities. Accordingly, there is a higher amount of return and risk than traditional investment grade products.

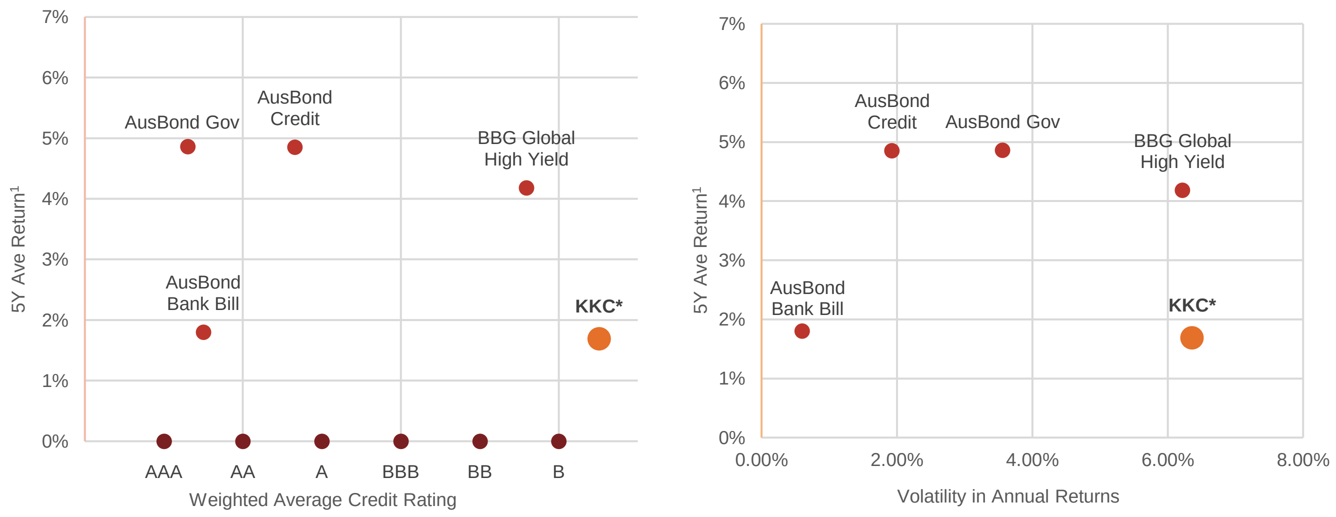
This product is best suited for investors looking to generate an **attractive total return** from a **diversified portfolio of public debt and private loans**. We expect the product will exhibit a low long-term correlation to traditional asset classes, making it a suitable diversifier to retail investor income portfolios, which are typically biased towards domestically sourced, equity-based and/or hybrid income streams. Our basis for recommendation on KKC is a blend of both subjective and objective analysis of the underlying portfolio and the manager's background, experience, analytical capability and proven track record in managing various credit strategies.

KKR possesses a highly experienced and talented team with deep industry relationships to execute upon the strategy and generate robust returns.

Although KKC's performance through its early phase was disappointing, both in terms of capital and income performance, it has since stablised. Given the sub-investment grade exposure, the strategy was not ideally positioned as the first impacts of COVID hit the financial world. Although performance was poor during this period, **NTA fell in-line with US high yield and loan indices**. Post the March 2020 result, however, the Fund has recovered well and has stablised returns at a more comfortable level.

As the global economy transitions to a post-COVID environment, KKC is well positioned to capture market improvements and will be better protected against future market NTA volatility as the **EDL strategy ramps up**. Although EDL exposure to KKC has always been expected and a key element of the offering, the underlying exposure has actually been minimal as the expected time to deploy is ~2-3 years. As KKC's committed capital is called to fund EDL deals over time, a more substantive proportion of the Trust will be comprised of direct lending assets. Despite **credit risk remaining significant**, an increased contribution from the EDL strategy will not only support income of the Fund, but given private assets are less subject to mark-to-market loss, **NTA should exhibit less volatility**.

Figure 4. Estimated Risk-Adjusted Comparison



[1] *Calculated using annualized monthly returns since February 2016. * Calculated using monthly returns since inception in November 2019.*
Source: BondAdviser Estimates, KKR, Bloomberg. As at 28 February 2021.

Construction and Investment Process

We expect to see the portion of KKR's European Direct Lending (EDL) strategy increasing in line with capital committed by KKC.

Portfolio Risk Management

There have been **no material changes** to KKC's portfolio risk management.

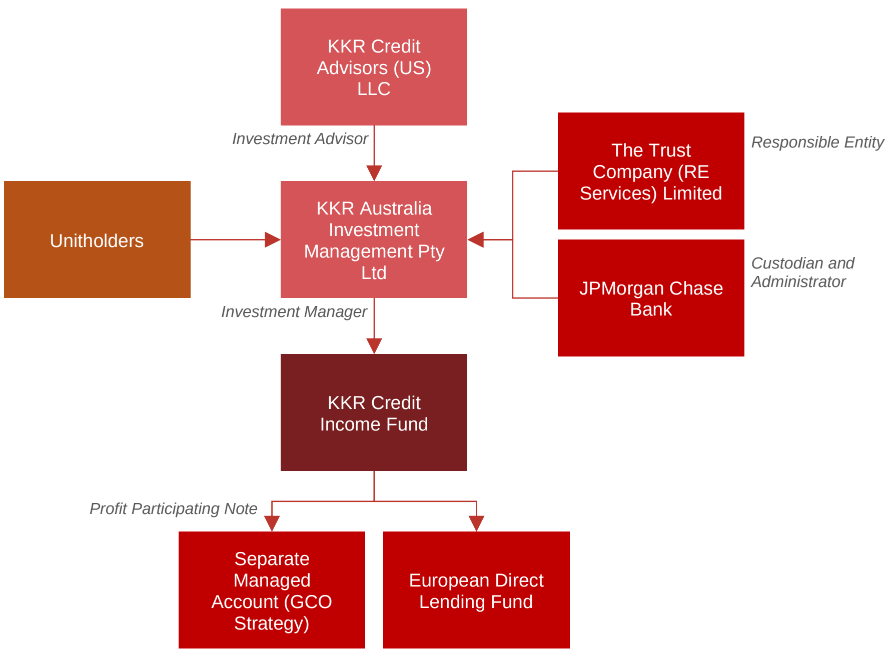
Fund Governance

In January 2020 KKR announced that it would reorganise its legal structure, **moving its holding from GCO into a separately managed account wholly owned by KKC** through an in-specie transfer. KKC will retain exposure to the GCO strategy, with the same investment team managing the KKC SMA alongside GCO, however KKC will no longer invest directly into GCO. The new legal structure is illustrated below, which can be compared the structure shown in our most recent Report.

On 15 January 80% of the assets held in GCO were moved into the SMA, with the remaining 20% expected to be transferred in April, after which time there will be no exposure to the GCO entity, however underlying exposure will remain unchanged due to the newly created SMA housing the assets.

This will allow for lower liquidity facility costs and increased cash flexibility. This provides KKR with a better ability to implement and increase its buyback capacity. Additionally, it provides scope for KKC to move to monthly distributions, given the greater control of underlying cashflows.

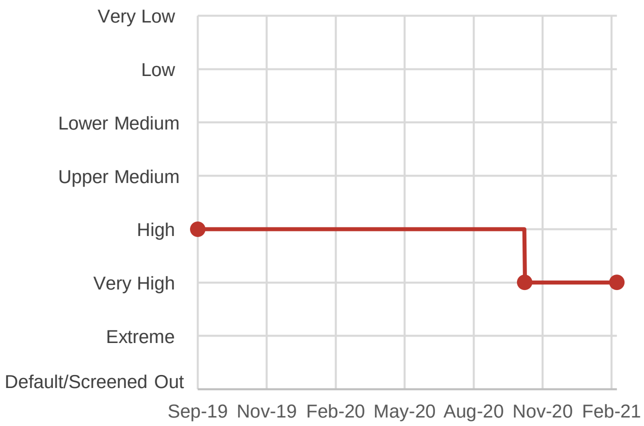
Figure 5. Legal Structure



Source: BondAdviser, KKR.

Quantitative Analysis

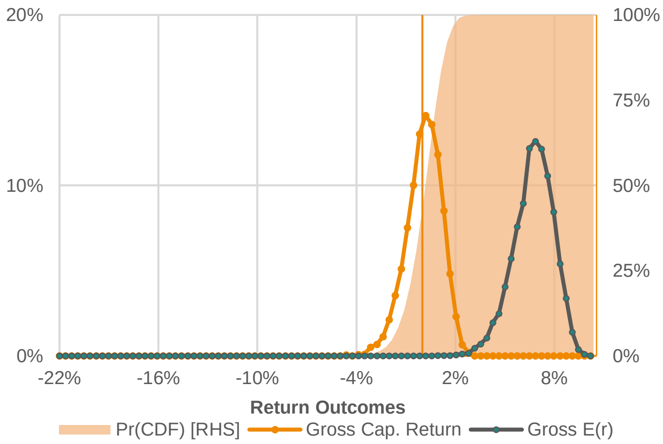
Figure 6. Risk Assessment

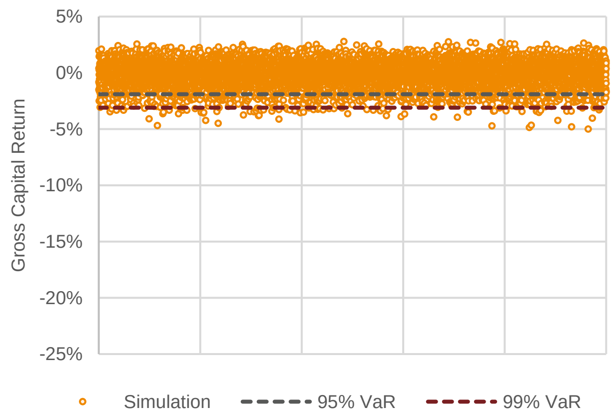


The **portfolio performs well due to diversification** and seniority improving loss given default outcomes. Our modelling output is similar to the output from the portfolio that was tested in 2019, although the marginal increase in <CCC assets has proportionally increased tail risk.

As the portfolio ramps into European Direct Lending, we expect both our modelling and the risk score to improve.

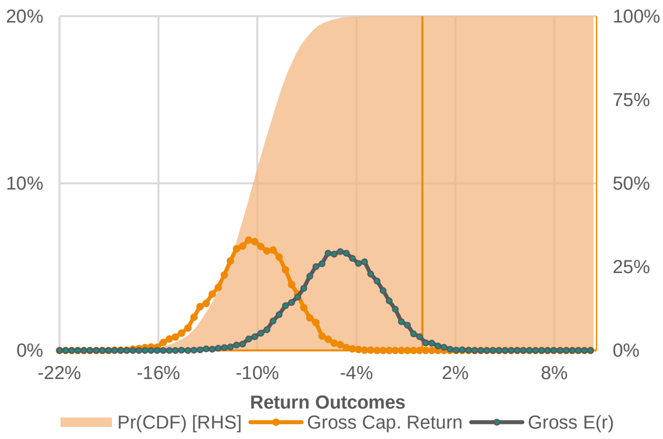
Scenario 1. Baseline Asset Assessment

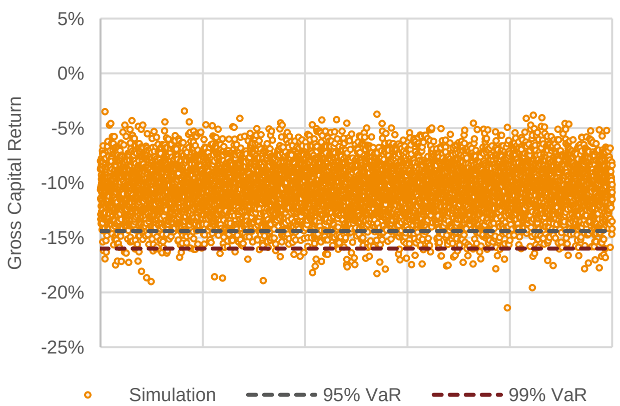




Source: BondAdviser Estimates. Excludes impact of fees. Gross capital returns excludes the value of coupons/income.

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 – 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 1 April 2021.