KKR

CREDIT INCOME FUND

KKC Investment Update

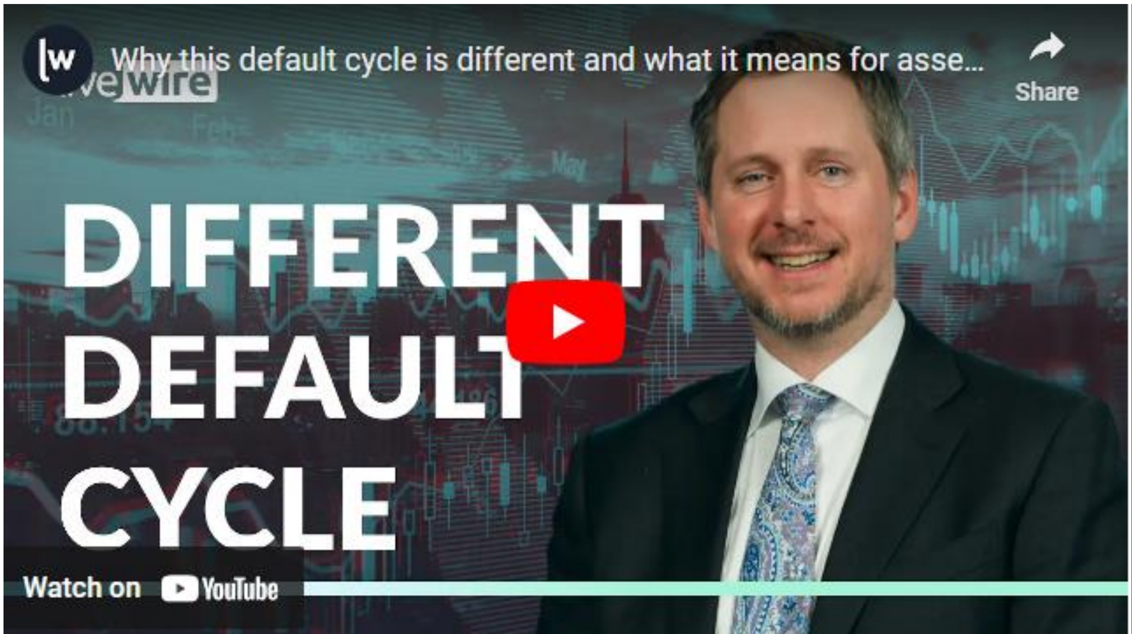
25 March 2024

Dear KKC Investor,

In recent Livewire interviews, KKR Partner Jeremiah Lane discusses why 2024 could deliver a positive continuation of 2023 trends in the credit markets; why leveraged loans are increasingly a place where solid returns can be found; and KKR's approach to investing in 2024.

Watch his three interviews or read our summaries below:

- '**Why this default cycle is different and what it means for asset allocation**,'
- '**How leveraged loans can outperform when rates are volatile**,' and
- '**3 ways to keep it simple (and earn solid returns)**'.



Why this default cycle is different and what it means for asset allocation

What are you seeing in terms of defaults and why does it matter for non-credit investors?

Jeremiah reflects on the past year, noting investors' anticipation of a traditional surge in defaults and spreads across various sectors. However, he observes that while many sectors experienced cycles, they did so asynchronously, not simultaneously. For instance, consumer businesses faced challenges due to declining post-COVID demand and rising import costs from China, but have since recovered. Healthcare businesses in the US struggled with nurse labour availability and costs, impacting margins, although signs of improvement are emerging. Currently, Jeremiah says weaknesses are evident in the chemicals and packaging sectors, with potential future challenges in home building. Despite sector-specific difficulties, Jeremiah emphasises that the economy has shown resilience, surpassing expectations, noting this strength as one of the reasons why last year ended up being such a strong year in the credit markets.

No economic recession is now the base case for the US, but what are the chances of a corporate or balance sheet recession occurring this year?

While Jeremiah acknowledges challenges within the banking system and in certain segments of the real estate market, particularly concerning loans held on bank balance sheets he argues the likelihood is minimal. Jeremiah says one of the things he's taken away from his time in the credit markets is the next problem is never the same as the last problem. He notes the apprehension last year following the failures of First Republic, Silicon Valley Bank, and Signature Bank. However, Jeremiah argues that the government now appreciates the risk to the system and those embedded in banks. They are taking appropriate steps to make sure any problems that happen in an individual bank don't spiral out of control and cause systemic problems.

How does a "higher for longer" rate environment impact where you find opportunities?

Jeremiah highlights that the prolonged period of higher interest rates has led to significantly increased yields in loans and bonds, offering investors greater returns. Consequently, investment strategies can be adjusted to achieve desired returns with less risk, a principle KKR terms "keeping it simple." Jeremiah says finding and to putting together a portfolio that will deliver what KKR has promised investors is now much easier than it was for much of the 2010s.

How leveraged loans can outperform when rates are volatile

What is a "leveraged loan" and why is it an investment opportunity worth talking about right now?

Jeremiah explains that a leveraged loan is a type of loan originated by a bank and then distributed to a group of investors (including KKR). These loans carry sub-investment grade ratings, typically BB, B, or CCC and often have a floating interest rate tied to the Secured Overnight Funding Rate (SOFR). Currently, higher quality loans may offer around 250 to 300 basis points over SOFR, while Single B loans might provide approximately 400 basis points over SOFR. The interest rate for triple C loans varies based on the borrower's credit quality. These loans are usually secured by a company's assets, offering a layer of protection in case of financial distress, such as bankruptcy, by ensuring investors are prioritised for recovery through the bankruptcy process.

Compared to other parts of the credit market, where do leveraged loans rank in terms of risk and reward?

Jeremiah discusses the significant changes in Federal Reserve policy over the past two years, highlighting how parts of the fixed income market traditionally deemed safe have posed substantial challenges for investors. For instance, government bonds issued at historically low interest rates in 2021 have become highly sensitive to shifts in the rate environment. Conversely, leveraged loans offer a unique advantage as they are floating-rate instruments and thus less susceptible to interest rate changes. Even with the Federal Reserve raising rates from 0% to 5.5%, the spread over the SOFR increases accordingly, providing investors with a stable income stream. Unlike fixed-rate bonds, the price of leveraged loans remains unaffected by broader economic interest rate fluctuations, resulting in reduced volatility and improved outcomes for investors. Additionally, there are differences in ranking, with high yield bonds tending to be unsecured. That means, compared to a loan, they're often second in line for recovery after a bankruptcy and there are a number of other more esoteric differences between the products.

The average coupon in leveraged loan markets is higher than in high yield for the first time. Why does that matter from a returns perspective?

Jeremiah argues that investing in an index of leveraged loans currently offers a yield of around 10%, whereas a broad portfolio of high yield bonds yields approximately 7.75% to 8%. When comparing these two options, high yield bonds would need to appreciate by about 2% to outperform leveraged loans. However, Jeremiah considers this outcome relatively unlikely, as it would either require significant interest rate decreases (which Jeremiah is skeptical about, as KKR subscribes to the "higher for longer" viewpoint) or substantial compression in spreads, which Jeremiah believes appears fair over the long term. Consequently, when weighing the tradeoffs between the two markets, KKR tends to favour the higher running yield that is available in loans versus the somewhat lower yield, but with more interest rate sensitivity that's available in high yield bonds.

How can you access this opportunity given it’s not widely available in Australia?

KKR provides access to its credit investment opportunities to Australian investors through two avenues. Firstly, through its listed investment trust, the KKR Credit Income Fund (KKC) (ASX: KKC), which is traded on the ASX. This fund allocates a portion of its assets to KKR's credit opportunities fund, focusing on investments in leveraged loans and high yield bonds. Additionally, it invests in KKR's private credit capabilities in Europe. Secondly, KKR has established an unlisted unit trust, GCOF, specifically dedicated to its credit opportunities fund. This trust allows investors to participate in a concentrated and high conviction approach to investing in loans and bonds managed by KKR.

3 ways to keep it simple (and earn solid returns)

How do you create and maintain a simple credit allocation?

What KKR means by "keeping it simple" is that investors don't have to work as hard in today's credit environment to generate a great total return, compared to the era of zero interest rate policy. He highlights the attractiveness of being able to achieve around a 9% total return in USD by investing in a diversified portfolio of high-quality loans and bonds, compared to the long-term averages, where indices of loans and bonds typically delivered slightly over 4% returns for most of the last decade. Jeremiah says there is significantly more return available through straightforward investing in these asset classes without the need to engage in complex strategies such as originating loans, distress for control, or navigating through bankruptcy. In essence, there are accessible methods to generate favorable returns in today's market without sacrificing liquidity or taking on unnecessary risks.

Talk me through the three main areas where you are finding simple value in today's market?

Jeremiah outlines three key strategies employed within the portfolio. Firstly, KKR includes a diversified set of high-quality loans and bonds, which serve as ballast. This diversified approach cushions against potential economic difficulties, ensuring a steady stream of interest payments from resilient companies even if the overall economy falters slightly.

Secondly, KKR invests in CLO tranches, particularly focusing on the BBB segment. These tranches can withstand significant default rates in the underlying portfolio, ensuring minimal principal loss. Jeremiah sees this as a relatively risk-remote asset, offering potential for substantial returns through active management.

Thirdly, KKR adopts a short duration strategy, favoring maturities in 2024, 2025, and early 2026. By engaging with fully leveraged companies nearing maturity, KKR negotiates extensions with favorable terms, such as better documentation or increased spreads. Overall, these strategies aim to generate outperformance while managing risk effectively in the credit market.

We've spoken about a "higher for longer" rate environment which is your base case for the US. How does that affect asset allocation or asset picking?

Contrary to market sentiment, Jeremiah believes the Federal Reserve is unlikely to quickly pivot to numerous rate cuts. While the market currently anticipates four rate cuts, Jeremiah's perspective aligns more closely with a forecast of three cuts. This skepticism extends to the potential for significant bond rallies, as it hinges on substantial spread compression, which Jeremiah does not foresee. Consequently, his assessment of the relative value between loans and bonds leans towards loans, influencing their investment approach towards favoring loans in the current environment.

What market conditions would it take for KKR to become more complex again?

Jeremiah highlights the longevity of KKR's strategy, spanning over 15 years. Reflecting on past challenges, he notes moments during the zero interest rate policy era when delivering decent total returns required extra effort. This involved seeking off-the-run deals for additional spread or participating in club deals with reduced liquidity. However, given Jeremiah's stance on the Federal Reserve's strategy, he considers it improbable for these characteristics to appear in the market again, solidifying his confidence in KKR's ability to adapt and deliver returns to investors without relying on alternative levers as seen in previous periods.

KEY BENEFITS AND RISKS

BENEFITS:

The key benefits of inventing in the Fund include:

- Attractive Target Distribution
- Attractive Target Return
- Diversified exposure
- Alignment of interests with Unitholders
- KKR product access
- Highly experienced KKR Credit team

RISKS

Key risks include:

- Allocation risk in relation to the Investment Strategy
- Illiquid and long term investments in relation to the Investment Strategy
- Potential conflicts of interests of the Responsible Entity and the Manager and its affiliates

- Entities within the “Perpetual Group” may also act in various capacities for other funds or accounts, which may conflict with the role the Responsible Entity plays with respect to the Trust.
- Market and economic risks in relation to an investment in the Trust
- Currency risk in relation to an investment in the Trust
- Pricing risk in relation to an investment in the Trust
- Liquidity risk relating to Units in the Trust in relation to an investment in the Trust
- Operational risk in relation to an investment in the Trust
- High yield investments risk in relation to debt investments
- Credit risk in relation to debt investments
- Interest rate risk in relation to debt investments
- Bankruptcy risk in relation to debt investments

If you are uncertain as to whether an investment in the Trust is suitable for you, please contact your stockbroker, financial adviser, accountant, lawyer or other professional adviser.

About KKR

48	US$553	US$219	700+	US$25
years of experience	billion total assets under management[1]	billion credit assets under management	KKR Investment Professionals	billion invested alongside our clients[2]

(1) Figures as of 31 December, 2023. Represents assets managed by KKR or its strategic partners (on a proportionate basis) as to which KKR is entitled to receive a fee or carried interest (either currently or upon deployment of capital) and proprietary general partner capital.
(2) Includes investments/commitments made by KKR’s balance sheet, KKR employees and other affiliates. Investments made by current and former KKR employees are retained by those individuals personally. Includes unfunded commitments made by individuals.

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General

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Information in this update

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