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KKR CREDIT & MARKETS

Building Upon Our Roots: Asia Pacific's Credit Transformation



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Executive Summary

Asia's public and private credit markets present a rare opportunity for investors: a chance to invest in a region where growth remains resilient, demand for credit outstrips supply, and structural market inefficiencies play to the strengths of fundamental credit investors with local knowledge and relationships across the region.

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The longer-term thesis for investing in Asia Pacific credit has a great deal to do with the macroeconomic evolution and complexity of the region. Despite China's slowdown, Asia Pacific continues to grow at twice the pace of the U.S. and Europe. Moreover, we believe lower real yields should be a positive for valuations and a risk recalibration has helped to reshape the Asia Pacific landscape. For many years, real estate issuers played an outsized role in Asia Pacific's liquid credit markets and were the primary driver of the market's exponential growth. However, a wave of defaults amongst Chinese real estate developers catalyzed a wide reset in asset valuations that extended beyond the property sector, dramatically shifted the composition of the market, and eroded investor confidence. In our view, the sell-off created attractive entry points for investors and compelling relative value compared to the United States and Europe.

As we reflect upon the last 18 months of changes across the market, there is tremendous need for capital at a time when compelling relative value exists across the region. Though market volatility persists and higher interest rates continue to be digested, there remain sound issuers in need of near-term capital solutions. From a global relative value perspective, we believe valuations in the Asia Pacific market provide an attractive opportunity for diversification and total return in a portfolio with generally lower leverage levels (ex-China).

While regional nuances can contribute to complexity in investing across Asia Pacific, we believe that active management and a local presence are prerequisites to success. Each country has macro, political, and fiscal idiosyncrasies, so in our view, there is no "One-Asia". In our 20-plus year track record investing in Asia Pacific, we have found that having deep connections in the region, an on-the-ground presence, and an active and selective investment approach that prioritizes principal protection and durable cash flows is invaluable for producing and executing on differentiated investment insights. The trust we have built further facilitates our

investment processes enabling us to have a deep understanding of the local economies. Pairing our integrated resources with a diversified investment tool kit enables our team to be agile, proactive and establish conviction for our investors.

Asia Pacific continues to march to a different economic beat compared to both Europe and North America. Broadly, the economic outlook continues to gain momentum following the countries' re-opening post COVID. We are energized by the opportunity this pickup in activity presents, including an uptick in business travel and tourism that has spurred positive economic activity across the region. Importantly, when the Fed begins its easing campaign, both lower interest rates and a weaker U.S. dollar could become additional tailwinds to growth.

For example, the economic backdrop and growth cycle within Japan is very different than what China is

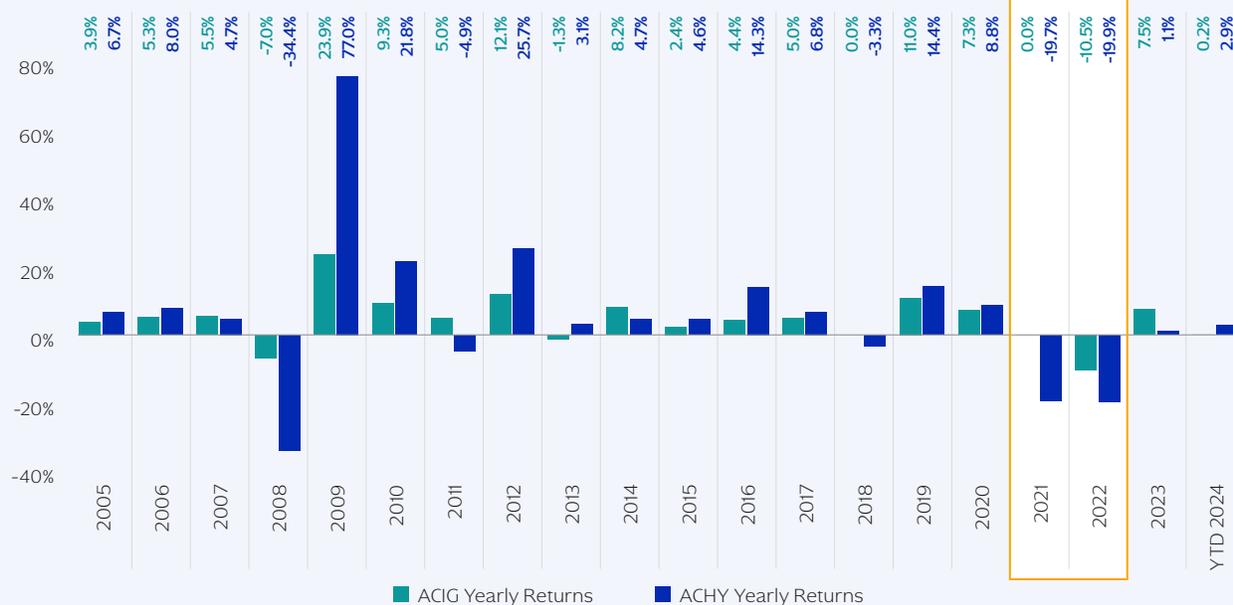
experiencing. Additionally, we view Southeast Asia as a diverse set of economies and underlying macro forces contributing to a broad investment opportunity set.

As we look deeper at the Asia Pacific markets, valuations and sentiment have not yet expressed the same optimism and thus we believe there is further upside to be priced in. The drawdowns in the Asia high yield ("HY") and investment grade ("IG") markets persist and these markets are still well below their peak point from early 2020.¹

The divergence between the broader macro picture and the credit market's performance has left some investors asking, "Is now the right time to lean in?"

EXHIBIT 1 | Asia High Yield & Investment Grade Yearly Returns

In the past 20 years, there has never been two back-to-back negative market years.



Source: Bloomberg, Bank of America. Asia High Yield Market represented by ICE BofA Asian Dollar High Yield Corporate Index and Asia Investment Grade Market represented by ICE BofA Asian Dollar Investment Grade Corporate Index. Information as of January 31, 2024

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We recently sat down with Brian Dillard, Dengzhao Pan and Kristopher Novell to discuss how the structural market inefficiencies in the traded credit market contributed to the vast sell-off and why it is an attractive time to invest in both private and public credit in the region.

What does the Asia traded credit market look like, particularly compared to its U.S. and European counterparts?

Including local currency, Asia Pacific is the second largest credit market in the world.² It is also less mature and less liquid than its U.S. and European counterparts and can often be more volatile due to persistent structural inefficiencies, fragmentation and the historical concentration of both the issuer and passive investor base. However, it is precisely these inefficiencies coupled with growing tailwinds and dispersion that present compelling relative value opportunities for investors.

While the USD-denominated Asia Pacific corporate bond market is sizeable at \$1.6 trillion,³ it is equivalent to a sliver of the U.S. and European comps, at \$10.3 trillion⁴ and \$3.5 trillion,⁵ respectively. Although smaller in notional size today, the Asia Pacific dollar bond market is growing with evolving financing needs. For example, a new regional U.S. dollar corporate bond index that includes Japan, Australia and New Zealand launched last year, expanding the investible market even further.

We believe the expansion of the dollar-denominated corporate bond market will provide additional opportunities for investors.

What are the main structural considerations in this market?

The Asia Pacific traded credit market has an outsized share of passive investors. This contributes to technical volatility that can often distort the fundamental value of many credits and cause mark-to-market swings. However, this technical volatility creates an abundance of opportunities for disciplined fundamental credit investors.

For example, approximately 52%⁶ of the Asia Pacific liquid (traded) credit market is comprised of asset managers, the majority of which run passive strategies and are typically buyers of index or daily liquidity vehicles. Daily liquidity vehicles are usually rules-based and contribute to the high degree of market asymmetry. Flows into these funds and ETFs can often be sizable and drive either surges in demand or outflows that result in forced selling.

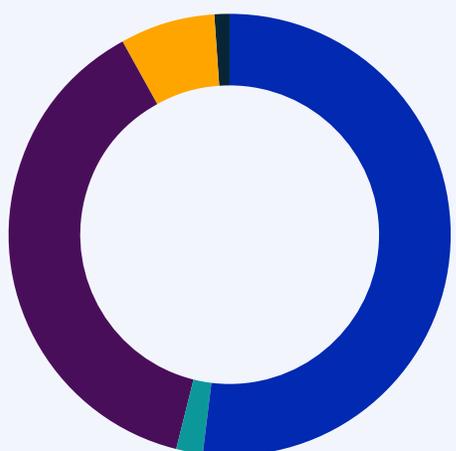
Less active buyers, such as traditional banks and insurance companies, comprise ~40% of the market and tend to employ a “buy-and-hold” strategy. In addition, the private banking buyer base, approximately ~7% of the market, is also “buy-and-hold” but frequently employs leverage.⁶ Adding leverage may increase the risk of margin calls and consequently downward pricing pressure when liquidity is needed.

The remaining ~1% subsegment of “other” investors are the absolute return buyer. These are the true active managers; however, most of these are hedge funds focused on distressed opportunities or China property restructuring opportunities.

The composition of the market creates what we refer to as *No Man's Land*: a gap in the market where credits may have been technically impacted rather than fundamentally. As an example, our team identified an opportunity with perceived “busted” convertibles that seemingly had no natural buyers but offered attractive economics and downside protection. Similar to the converts, many credits do not possess enough upside convexity to generate high teens returns, and thus are overlooked by the hedge fund community and factored out from many passive indices. Our approach is to identify value through fundamental credit analysis on individual names or event driven theses that strive to identify the upside potential across these misunderstood assets. We believe this can deliver a portfolio of double digit returns with highly attractive risk adjusted returns.

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EXHIBIT 2 | Asia High Yield Investor Base



■ 52% Asset Managers ■ 2% Pension/Insurance
 ■ 38% Banks ■ 7% Private Bank ■ 1% Other

Source: J.P. Morgan, Bond Radar, Bloomberg Finance L.P. Data as of 2022

How does the issuer composition of this market play into the opportunity for investors?

The Asia Pacific liquid credit market has had a longstanding skew toward real estate, and the evolution of that sector weighting is an important driver behind large technical swings in the market.

China's rapid expansion, specifically in property development and related industries, drove a large share of the liquid credit market growth over the last decade. Developers issued large amounts of debt, leading to a vast increase in the size of the leveraged credit market in Asia. To quantify, a typical real estate development project historically had equity contributions of less than 5%, with 95% being funded by debt.

As the Chinese property market softened, a wave of defaults occurred in 2021 and 2022 and many of these issuers exited the market. Ahead of the real estate induced stress in July 2020, real estate related issuers in China represented 54.3%⁷ compared to 6.6%⁸ of the market in January 2024. During this period, a large amount of the market's performance was highly correlated to the Chinese property market.

So, what does this shift mean for the market? The fact that Asia Pacific's market is concentrated in passive vehicles means that volatility can trigger dramatic price swings, or "gaps". During the large wave of property-related defaults, the market sold off as funds experienced negative pressure, leading to large and sometimes damaging outflows. This catalyzed a knock-on movement across the market. Investors fled and liquidity dried up, which impacted the valuations of a broad array of issuers unrelated to the real estate sector; a stark illustration of how strong technical catalysts can be in this market.

Importantly, the fundamental risk associated with China property bonds was an offshore-onshore mismatch. Most property bonds are held by offshore investors;

however, the actual projects are predominantly onshore which means there is no recourse for bondholders, exacerbating the volatility when things go wrong.

What is the longer-term impact of the real estate shock on Asia Pacific credit markets?

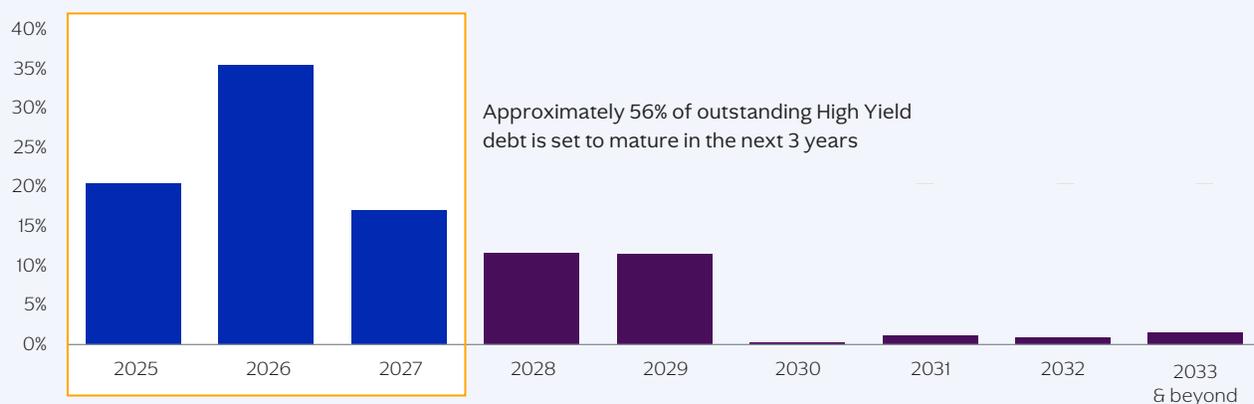
The market upheaval driven by the real estate shock resulted in a substantial risk recalibration. Ultimately, we believe this has been a net positive for the investment landscape, creating a more diverse base of issuers from both a sector and geographic perspective.

The property sector's stress also resulted in a lack of trust and consensus as investors assessed how to proceed, ultimately leading to outflows. From peak to trough, the Asian Dollar High Yield Corporate Index fell -51.0% on a total return basis⁹ from April 2021 to November 2022. This technical-driven selling created a cascade effect and catalyzed a reset in valuations.

After the large sell-off, we believe the Asia Pacific credit market offers compelling investment opportunities, particularly for investors who can lean in opportunistically with nimble, flexible capital. Valuations across industries have recalibrated, dispersion exists and the expansion of the market to include countries such as Japan and Australia should create a deeper assortment of mature businesses.

Not only is the market more diversified than ever before, but it is also growing, with an increasing number of issuers in need of financing ahead of the upcoming maturity wall. Although pending maturities impact many issuers globally, they are especially pronounced in Asia. For example, roughly 56% of the outstanding high yield debt is set to mature in the next three years and roughly 21%¹⁰ by the end of 2025. We believe issuers will fill the gap using both private and broadly syndicated credit markets. Lenders who can provide solutions across both are likely to be at an advantage.

EXHIBIT 3 | Asia High Yield Market Maturity Breakout



Source: Bloomberg, "Market" represented by ICE BofA Asian Dollar High Yield Index. Information as of 1/31/2024.

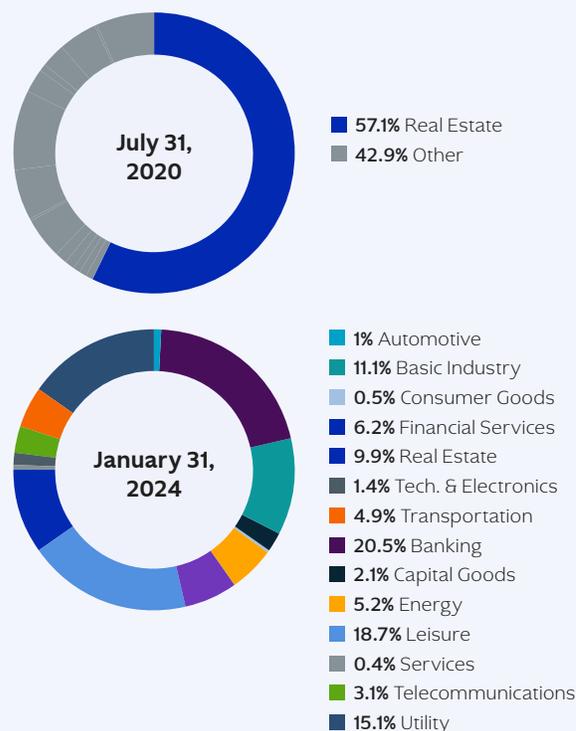
Simply put, why invest in Asia Credit now?

We are at an inflection point for Asia Pacific credit markets following the wave of defaults among Chinese property developers. The recent volatility has catalyzed structural changes that have removed many of the "risky" players from the index.

Today's market also presents a vastly different return potential opportunity than it did previously. The market is now composed of higher quality issuers and investors can likely achieve favorable economics with more balanced sector exposure.

Yet, despite the positive structural evolution in the market, we still have not seen valuations revert to normalized levels. At \$87.63 the weighted average price provides attractive upside price convexity alongside a compelling 10.0% effective yield,¹¹ as of January 31, 2024. We believe this is an attractive entry point relative to the opportunity set in Europe (\$92.84 and 6.1%)¹² and in the U.S. (\$92.54 and 7.6%).¹³

EXHIBIT 4 | Asia High Yield Market - Issuer Composition: Then and Now



Source: Bloomberg, ICE BofA, Asia High Yield Market presented by ICE BofA Asian Dollar High Yield Index. Information as of July 31, 2020 and January 31, 2024

The fact that demand for credit outstrips supply makes it a great time to be a lender generally, but this is especially apparent in Asia Pacific where the recent market sell off has increased the difficulty for issuers to obtain financing. Banks have been more stringent on lending, market volatility has made it more difficult for public syndication execution, and investor support has been muted. It is likely that this dynamic will persist for the foreseeable future or may even intensify.

While China's reopening has not been as robust as many anticipated, China and the Asia Pacific region nonetheless grew faster than its Western peers in 2023. We still expect this to continue in 2024 and beyond.

Putting all this together, we believe the opportunity set in Asia Pacific credit is currently very compelling. The dislocation in the real estate market prominently highlighted the inefficiency and nascency of the market, particularly in the way tight liquidity and a high market concentration of passive investment strategies can exacerbate mark-to-market volatility and trigger widespread valuation declines that may be divorced from fundamentals. This type of structural inefficiency and disruption creates opportunity for active managers with a regional and local approach to identifying value who can step in, underwrite, and provide liquidity selectively to the right issuers, helping to drive differentiated results.

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How can investors think about capitalizing on this opportunity?

In Asia, we emphasize the importance of shying away from passively managed credit vehicles, even more than in the U.S. and European credit markets. Technical factors not only contribute to pricing volatility but can also obfuscate credit fundamentals. There are also pockets of the market that lack natural buyers (i.e. busted convertible bonds), which is where fundamental credit underwriting creates investment opportunity for actively managed, flexible pools of capital. Active management, bolstered by bottoms-up research, with a laser focus on downside protection and durable cash flows, are key to being successful in Asia.

Our team is looking at the knock-on impacts from the broader valuation reset within the markets. Some key areas we see as an opportunity:

- **Proactivity around the need for capital:**

Over half of outstanding high yield debt in the region comes due in the next three years.¹⁴ As we look towards ways to address this maturity wall, the solution will likely fall as a balance between publicly syndicated debt and privately originated credit financing. We believe the private and public credit markets need one another to optimize outcomes and maintain healthy markets. As Christopher Sheldon, Co-Head of Credit & Markets, emphasizes in the Financial Times Op-Ed [Why Private Credit Still Needs Public Markets](#), we believe these financing channels are complimentary, and their symbiotic relationship is key to fully addressing issuers' needs. Customized and hybrid capital solutions capabilities offer additional flexibility in addressing financing needs. The benefit to hybrid capital solutions is the ability to structure contractual

economics and downside protection. This trend is global but amplified within Asia Pacific as each issuer faces its own unique financing needs pursuant to jurisdiction, underscoring the need to for on the ground expertise.

- **Investment Grade “IG” credits (BBB Rated):**

We continue to see a high degree of valuation skew from a ratings perspective. IG assets are trading at a relatively cheap price level due to the sell-off. Given liquidity was scarce, asset managers sold the perceived “safer” risk and positions with strong fundamentals to access immediate liquidity, ultimately contributing to declining prices of lower rated investment grade paper. For example, an investor can achieve a yield of 6.3% as of January 31, 2024, for IG risk.¹⁵ Select IG names offer high single to low double-digit yield with upside price convexity, creating a strong total return potential. As such, we are leaning into BBB-assets as they appear attractive from both a yield and price standpoint.

- **Convertible bonds:**

The Asia traded credit market is less mature than that of the U.S. or Europe, and both managing risk and identifying opportunities requires more specialization. We believe in keeping it simple and moving up in the capital structure or up in quality for better risk adjusted reward given persisting macro uncertainties. High quality convertibles (BB-rated) with puts that provide protection for the bondholder offer one way to express this view and while getting both strong upside potential and downside protection. These structures tend to be more borrower friendly, with protection for the investor in a downside scenario, typically have lower volatility, and could offer potential upside in the event of a conversion. Additionally, these assets have no natural market buyer and when they sell-off, can widen 150 - 200 bps relative to the bullet bonds from the same issuer.

- **Select exposure in Hong Kong:**

We believe issuers in Hong Kong with offshore assets and more limited exposure to China could have attractive upside potential given the residual overhang from China's real estate reset. We see value in select BB & BBB- rated insurance or financial names that have strong fundamentals, durable cash flows, and offer an attractive entry point.

- **Highly disciplined approach to China exposure:**

Even with the real estate turbulence, it is hard not to ignore the opportunity set in China, the region's largest economy and we take a highly regimented approach to investing there. Large technology companies with positive net cash flows and no refinancing issues, as well as IG insurance companies with durable cash flows, look attractive on a risk adjusted basis and stand to benefit from a risk recalibration within the market.

Our Firm's 20 plus year history in Asia Pacific is an invaluable resource for our team that continues to provide proprietary diligence insights and origination opportunities across the credit landscape. This longstanding local presence in the region, built on trusted relationships and a differentiated underwriting and risk management approach, is a strong competitive advantage, in our view, and has been integral to KKR's investment success within the region.

We believe the forward opportunity is immense for fundamental credit investors and our teams are energized about the opportunity set ahead of us in 2024 and beyond.

Endnotes

1. Market defined as ICE BofA Asian Dollar High Yield Corporate Index and ICE BofA Asian Dollar Investment Grade Corporate Index. Information as of January 31, 2024.
2. Source: Bank of America, October 2022. Asian Credit Market Primer.
3. Market defined as ICE BofA All Maturity Asia Pacific Dollar Index and ICE BofA Asia Convertible ex. Mandatory Indexes as of January 31, 2024.
4. Market defined as ICE BAML U.S. High Yield Index, ICE BAML U.S. Corporate Index, and ICE BofA US Convertible Excluding Mandatory Index as of January 31, 2024.
5. Market defined as ICE BofA Euro High Yield Index, ICE BofA Euro Corporate Index, ICE BofA European Convertible Excluding Mandatory Index as of January 31, 2024.
6. Source: J.P. Morgan, Bond Radar, Bloomberg Finance L.P. Data as of 2022.
7. Source: Bloomberg, BAML. Information as of July 31, 2020. "Market" represented by ACHY Index, BICS Industry Group.
8. Source: Bloomberg, BAML. Information as of January 31, 2024. "Market" represented by ACHY Index, Level 3 Group.
9. Source: Bloomberg, Peak-to-trough defined as the period 5/26/2021 - 11/3/2022. Index: ACHY Index.
10. Source: Bloomberg, "Market" represented by ACHY Index. Information as of 1/31/2024.
11. Source: Bloomberg, as of January 31, 2024. Index: ACHY Index. Stats are Par weighted price and effective yield.
12. Source: Bloomberg, as of January 31, 2024. Index: HE00 Index. Stats are Par weighted price and effective yield.
13. Source: Bloomberg, as of January 31, 2024. Index: HOA0 Index. Stats are Par weighted price and effective yield.
14. Source: Bloomberg, "Market" represented by ACHY Index. Information as of 1/31/2024.
15. Source: Bloomberg, Represents ACIG - BBB- portion of the market and its related effective yield. As of 1/31/2024.

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