KKR

Q4 2022 Market Review

KKR Credit & Markets

Credit's Odyssey: Steering Toward Ithaca

5 The Hunt for Capital

7 Credit Over Equities

8 Hunting Season Has Already Begun

10 Six Trends Driving Credit Markets

Written by:

Christopher A. Sheldon
Partner and Co-Head
Credit & Markets

Rory O'Farrell
Director,
Client & Partner Group

Executive Summary

At any other time, the events that took place in Credit markets during the fourth quarter of 2022 would have seemed extraordinary. Given the year gone by though, the Federal Reserve's back-to-back rate hikes and a pension crisis in the UK simply perpetuated a deep freeze in the Credit markets that stretched back to the onset of high inflation and rising rates. As 2023 got underway, a risk rally and signs of green shoots in parts of the Credit markets soon gave way to another volatility shock, this time in the form of an increasingly apparent asset-liability mismatch in the banking sector. It has never been clearer that the **Hunt for Yield** is now a **Hunt for Capital**.

Amid tighter financial conditions, it is a very good time to be a lender with ready capital. We believe Credit offers a better risk/return proposition than Equities in the near term due to the combination of higher yields, debt's position in the capital structure, the contractual nature of returns in Credit, and the pressure equity valuations are under as long as rates remain elevated.

Ultimately, we believe that capital markets will reopen, and we will explore some of the potential catalysts for that. In this letter, we consider what the Hunt for Capital means for investors in more detail, the case for Credit over Equities, and why a jogging pace strikes the right balance between the risk of moving too slowly in a market on the brink of change and the risk of diving too aggressively into risk in a volatile environment.

Presented for informational purposes only. Please see "Disclaimer" at the end of this presentation for additional information regarding market views and commentary.

The roller coaster market events of the past year have put us in mind of Odysseus contending with obstacle after obstacle in order to return home after his 10-year voyage in the epic poem, "The Odyssey." 2021 was a year of abundant lending and strong risk appetite. However, a shift occurred in 2022—the transition from the *hunt for yield* to the *hunt for capital*.

But markets follow cycles, just as classical poems follow a formula. The suspense of the poem is not about seeing whether Odysseus will reclaim his home, family, and property, but about when and how. Likewise, we expect the supply-and-demand dynamics to shift in Credit markets as new capital formation eventually drives demand. But it is a question of when–and how.

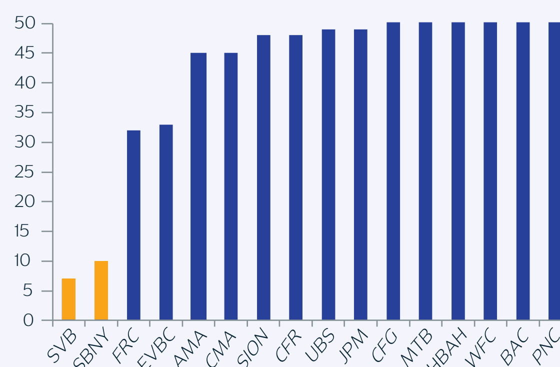
Banks are likely to pull back even further on lending. Financing was already challenging for borrowers, and that will continue or even become more extreme in the near term. The other way to look at the situation, however, is that it continues to be a good time to be a lender. Capital is extremely scarce, and private lenders can demand better terms: higher discounts, call protection, and other conditions. With more flexibility and certainty of execution, we think Private Credit will continue to take market share from syndicated markets as it becomes more of a mainstay option for borrowers. The ongoing opening and closing of the CLO market should also result in high yield bonds continuing to take share from leveraged loans. That being said, whether you are navigating treacherous seas and tricky deities or trying to find the best ways to deploy capital, being nimble enough to lean in to opportunities and avoid disasters amid fast-changing market conditions and high levels of uncertainty can offer compelling rewards. Volatile public markets are likely to keep producing pockets of dispersion, for example, while some private borrowers require bespoke capital solutions.

One of the reasons we can be so optimistic about the prospects for lenders is that we don't think the issues roiling the banking sector point to trouble in Credit fundamentals, but rather a combination of wavering confidence and an asset-liability mismatch. Some banks had extended duration by investing in longer-dated bonds. So long as they held them to maturity, there was no issue. But when they had to sell securities, to meet redemptions, they actually realized their losses. Silicon Valley Bank and Signature Bank were also outliers in that they grew their deposit bases very quickly, and a relatively high proportion of those deposits were uninsured (*Exhibit 1*). Banks were essentially in a position of hunting for capital that didn't materialize quickly enough. Looking at the overall banking system in the United States and Europe, however, it is clear to us that this is a liquidity crisis, and not yet a credit crisis.

EXHIBIT 1

Silicon Valley Bank and Signature Bank Look Like Outliers

Select Estimated FDIC Insured Deposit Balances as a % of Total Domestic Deposits



Source: Morgan Stanley as at March 9, 2023.

We see advantages in Credit over Equities, a view supported by our Global Macro & Asset Allocation team's forecast for a higher resting heart rate for inflation, higher long-term interest rates, and slower economic growth. These dim the prospects for corporate earnings growth and make the contractual return profile of Credit more attractive. We also echo the team's overall message to keep it simple. At a time when credit tied to large corporations with defensive cash flows and proven business models can yield double-digit returns on an unlevered basis, we feel there is no need to reach for stressed or distressed credit.

Key Themes

As we look across the market, we will cover the following themes:

01
The Hunt for Capital

02
Credit Over Equities

03
Hunting Season Has Already Begun

Presented for informational purposes only. Please see "Disclaimer" at the end of this presentation for additional information regarding market views and commentary.

The Hunt for Capital

It wasn't long ago that Credit investors were preoccupied by a hunt for yield. Now, at a time of high prevailing interest rates, the hunt for capital is the more relevant driver of Credit performance. Loan issuance is muted, and leveraged buyout activity has essentially ceased. Yet, some businesses still need financing or refinancing. Even in the current conditions, we have begun to see more demand for amend-and-extend deals, as well as opportunistic add-ons. After the transformational effect rising rates had on the markets in 2022, the capital for these transactions is in very short supply, and lenders can benefit from both higher base rates and higher premiums.

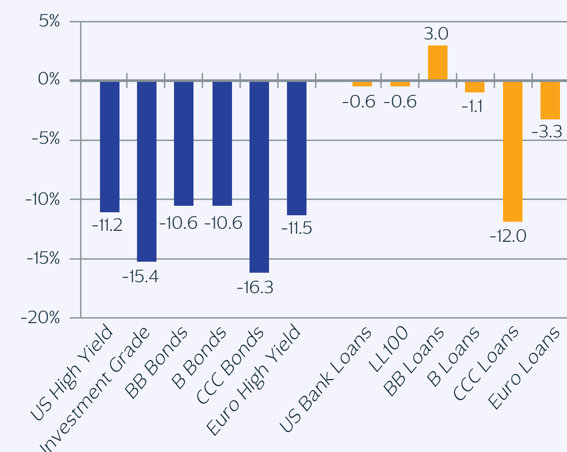
A slowdown in the formation of capital combined with the continuing, albeit low, demand for certain kinds of transactions lies behind the current hunt for capital. We saw forced selling in 2022, both when the strengthening U.S. dollar triggered margin calls for hedged investors and in the U.K.'s LDI crisis. As CLO creation slowed, banks shied away from taking new underwriting risk, and loan issuance retracted. Likewise, the IPO market all but shut as companies dealt with rebased valuations. Meanwhile, the intense pressure on both public Credit (*Exhibit 2*) and public Equity markets due to rising rates made many institutional investors overweight alternatives. As a result, borrowers are not the only ones hunting for capital. Alternatives funds are also challenged to find new capital at a time when many investors are already overweight and the return of capital to reinvest is happening more slowly.

The last three months of the year, which included the LDI crisis and two consecutive rate hikes from the U.S. Federal Reserve (including the fourth 75-basis-point hike of the year) would have been extraordinary at any time, but in the context of the entire year, it simply perpetuated the deep freeze in the system. Cash balances were insufficient, the strengthening dollar was hitting non-dollar investors hard, and wealth investors rushed out of bond funds. Banks were hamstrung by a combination of hung debt and a need for larger capital cushions to balance out the new valuations of their risk-weighted assets, a dynamic that has also contributed to the hunt for capital. Capital formation paused because for many market participants there was

EXHIBIT 2

Traded Credit Took a Severe Hit in 2022

2022 Performance



Source: Bloomberg as of February 10, 2023.

very little room to play offense, and the result was more dispersion on very little activity.

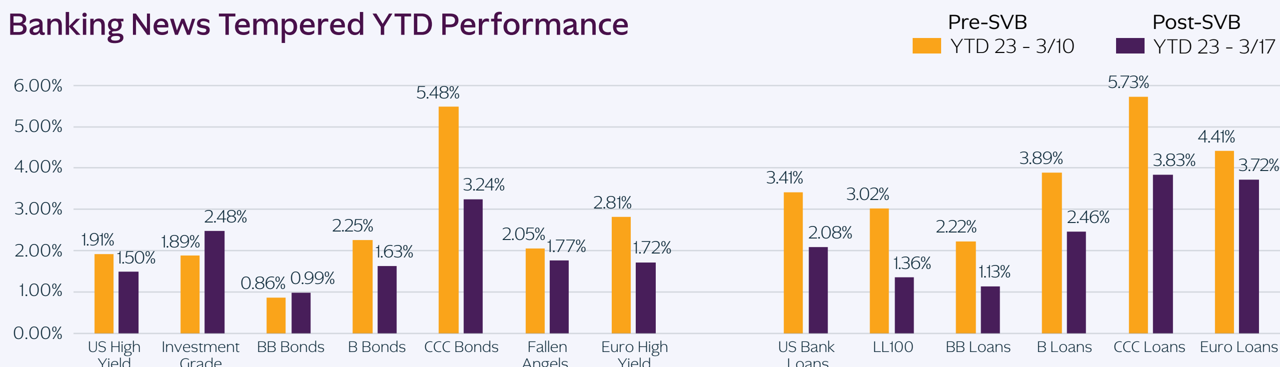
Before the banking sector upheaval in March, 2023, we saw a rally in risk assets, fueled by some stabilization in the upward trajectory of the dollar and signs of slowing inflation in January with the biggest rally coming in the lowest-rated (CCC) assets (*Exhibit 3*). With these developments, capital formation cautiously began again: for example, we saw some green shoots in the CLO market, an important development in our minds. We ourselves have priced CLOs in both Europe and the United States in 2023. CLOs are by definition hungry; they need leveraged loans to eat. Banks haven't been eager to originate loans in the face of higher underwriting risk, and a crisis focused on the banking sector is unlikely to change that. Concerns about the financial system are also likely to make it more difficult to raise capital.

On the other hand, private equity firms have more than $1 trillion in dry powder waiting to do deals. We know that at some point those potential deals will be attractive enough to entice syndicating banks back into the market, and when that happens, the match will light up a tinderbox. Risk will be on again, quickly–perhaps too quickly for investors who have been reactionary, rather than proactive in their

Presented for informational purposes only. Please see "Disclaimer" at the end of this presentation for additional information regarding market views and commentary.

EXHIBIT 3

Banking News Tempered YTD Performance



Source: Bloomberg as at March 17, 2023.

Note: YTD data through March 10 reflects returns before Silicon Valley Bank went into receivership, and March 17 data reflects the returns after that event.

allocations. When Odysseus finally did return to Ithaca after 10 years at sea, his triumph was swift and definitive. We think market participants may be surprised to see how fast the market equilibrium can shift from frozen to flowing once things get going given the extended lack of supply.

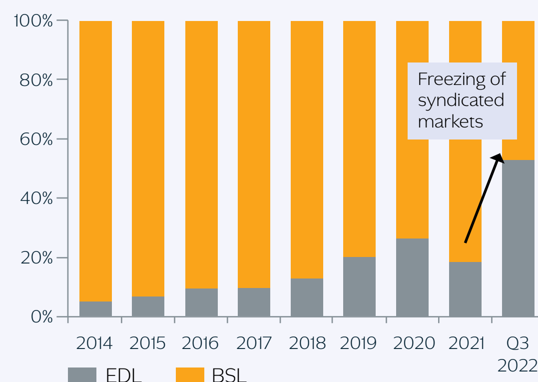
With the loan market shut, Private Credit has increasingly filled the financing gap for borrowers. We saw Private Credit take market share from leveraged loans for opportunistic add-ons, for example, in a situation similar to some of the COVID-related Private Credit add-ons we saw in May and June 2020. *Exhibit 4* specifically addresses the European direct lending market, but we think it is a good proxy for the global trend. In this case, we estimate that European direct lending pools of capital accounted for more than 50% of new loan issuance in Europe.

What has happened, in effect, is that the yield-hunters are becoming the hunted, chased by borrowers who are happy to pay a premium for scarce financing. Flexibility will serve capital providers well, as there are many attractive opportunities to deploy capital in the current environment. In addition to the Private Credit trend we mentioned above, we also expect high yield to take more share from leveraged loans so long as the CLO market remains unpredictable. Extraordinary events may have precipitated the shift to private credit, but we think there are other, more evergreen advantages attracting borrowers, including greater certainty of execution and the potential to provide more bespoke solutions that meet borrowers' specific financing needs. For example, we have seen high-quality companies with consistently high EBITDA turn to hybrid capital in order to preserve their IPO options and keep leverage to a minimum. Likewise, large companies that had traditionally only required senior debt are likely to also include junior debt in new capital structures when the market for dealmaking thaws.

EXHIBIT 4

Private Direct Lending Took Share from Syndication in Europe

Broadly Syndicated Loans vs. European Direct Lending Issuance (Based on Value)



Source: Ion Analytics, PitchBook LCD as at September 30, 2022.

Presented for informational purposes only. Please see "Disclaimer" at the end of this presentation for additional information regarding market views and commentary.

Credit Over Equities

As we discussed last quarter, our Global Macro & Asset Allocation (GMAA) team believes that after decades of low inflation, we are entering a new era of higher inflation, supported by shortages in labor and housing, the inflationary effects of the energy transition, and the rethinking of the global supply chain. Exposure to floating-rate credit is clearly attractive in a higher-rate environment, as is credit that has some embedded inflation protection, such as some parts of asset-based finance.

We continue to champion the compelling risk/return Credit markets offer compared to Equities (*Exhibits 5* and *6*). Our GMAA colleagues forecast the S&P 500 to return 5.2% annually over the next five years. In Private Equity, the team forecasts 12% returns on an annual basis over the next five years. In comparison, we are seeing returns above 10% in senior debt, and mid-teens for junior debt. For quite some time, GMAA has been advocating for some form of a more diversified portfolio, including 10% of the typical 40% bond allocation in traditional 60/40 portfolios with Private Credit. This asset class is benefiting from traditional lenders being sidelined, improved lending terms, higher absolute yields, and more attractive opportunities. But while the risk rally may have eliminated some of the lowest-hanging fruit in the traded markets, leveraged credit still offers compelling total returns due to elevated yields and idiosyncratic situations. The traded markets are likely to remain volatile for some time yet, which should in turn translate into more pockets of dispersion that can be opportunities for agile investors.

EXHIBIT 5

Credit Looks Cheap Relative to Stocks

Credit Suisse HY Index II YTW vs. SPX Earnings Yield, %

Source: Bloomberg as at March 10, 2023.

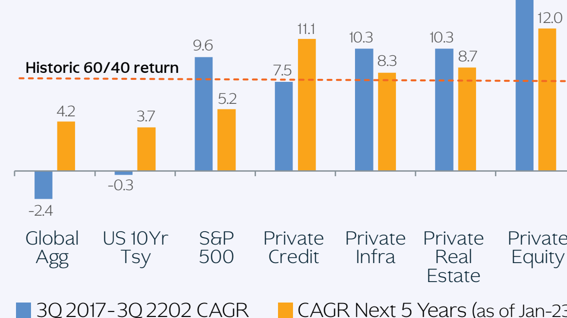
It's worth remembering that the relatively attractive yields on offer come at lower risk than equities due to debt's position in the capital structure. In Private Credit, lenders also have the benefit of better economics than they did at the same time a year or two ago. Original issue discounts are higher, and lenders can often extend current yields through call protection. We think this call protection could be of significant value when central banks begin lowering rates. As bank underwriting standards become tighter, the use of covenants, particularly maintenance covenants, will only increase, as they offer significant downside protection.

In comparing Credit to Equities, investors should also think about what drives value in both asset classes. For shareholders to see the value of their equity holdings increase, EBITDA has to grow or multiple expansion has to occur. Credit returns, on the other hand, are for the most part contractual. That means investors should achieve their target returns once a borrower pays interest and returns the principal of the loan. In a challenging environment in which rising costs and slower economic growth put pressure on margins, contractual returns seem preferable to a reliance on expansion.

EXHIBIT 6

Forecast: Lower Equity Returns and Higher Fixed Income Returns Relative to the Last Five Years

Past and Expected Returns, %



Our estimates for real estate returns are now designed to capture fund-level returns to LPs, rather than our previous approach of modeling unlevered asset-level returns. Key to our thinking is that this approach offers a better point of comparison between Real Estate, Private Credit, and Private Equity, as well as the fact that it more closely approximates how most investors think about accessing this asset class. Trader HY approximated using U.S. HY. Forward return data as at September 30, 2022. Source: Bloomberg, Cambridge Associates, Greenstreet BoFA, JP Morgan, KKR Global Macro & Asset Alllocation analysis.

Presented for informational purposes only. Please see "Disclaimer" at the end of this presentation for additional information regarding market views and commentary.

Hunting Season Has Already Begun

We mentioned before that we see the market as a tinderbox. What will be the catalyst for syndicating banks to return to the market? Before the run on Silicon Valley Bank, we saw several key indicators that pointed to a shifting stance in risk markets: the CCC-led risk rally (which we called as a historically attractive opportunity in the fourth quarter), positive fund and wealth assets flows, and new capital formation across CLOs and institutions. The market has clearly reset since then. If the events of the past few months have taught us anything, it is that investors who are waiting for a calm moment to get involved in the market again could be making a risky bet, as we think volatility will continue. Although capital formation will likely be slower, the need for capital is going to persist and could become more acute as market activity picks up. The season may not be in full swing yet, but make no mistake: It has started.

As we have noted in previous letters, the 2022 pullback was not driven by deteriorating fundamentals, but rather by technical factors. That's not to say fundamentals aren't under stress; we are focused on testing new deals to see how they will hold up in a period of declining EBITDA. We would caution investors to beware of listening too closely to the siren song of cheap prices without fully understanding the underlying business and how it might function in a market downturn. Still, we think the market will reopen all the more readily because the original shutdown was a function of interest rates rather than a more fundamental crisis. In the background, there is still more than $1 trillion in Private Equity dry powder ready to go to work. We expect to see scaled acquisition restart the syndicated markets.

Leadership is never more valuable than when a market is stuck on the cusp of changing for the better. Having the discipline, scale, and reach to fund businesses that have limited options is the only way to take full advantage of the hunt for capital. Still, we are well aware that many investors are still waiting for a better entry point before re-engaging and we hear over and over the same fears about the current environment. Our general view is that there are idiosyncratic risks in the markets, and more defaults will happen, but we don't expect them to drive the broader market down materially. Meanwhile, high-quality borrowers will still face an acute need for scarce capital. Waiting for a better entry point introduces the risk of missing the one we're in right now: Private capital takes time to deploy, and public markets trade gains away quickly. We think there are reasonable ways that investors can address all of the fears we hear and start getting involved before it is too late.

Risk 1: Economic recession

Mitigation: Keep it simple. Focus on large, high-quality borrowers with high margins of safety and deep equity cushions. These types of borrowers should be in a better position to withstand an economic downturn than their peers.

Risk 2: Inflation

Mitigation: Higher nominal returns are a positive side effect of inflation for investors, but high inflation also makes it more difficult for floating-rate borrowers and new issuers to service their liabilities. On the plus side, lenders have now had two solid years to evaluate how different businesses hold up in inflationary times, which makes for more confident underwriting. Once again, we think it is important to focus on larger, market-leading businesses in defensive sectors, which should be better equipped to pass through price increases to customers and defend their margins. Lending to pools of certain hard assets can also provide downside protection against inflation. As prices rise, so do replacement values for hard assets that serve as collateral.

Risk 3: Rising interest rates

Mitigation: Think of Credit holdings as a cushion. While rising rates may slow economic activity and put pressure on equity valuations, Credit returns are contractual in nature and can still generate attractive returns in a low-growth, rising-rate environment. We recommend a focus on assets with shorter duration, floating interest rates, or both.

Risk 4: Dislocated capital markets

It is unsettling when liquidity in the capital markets evaporates and large lenders step aside. However, we think these moments are opportunities to show leadership and provide capital to high-quality businesses that are temporarily caught out. The breadth and depth of our origination platform and access to pools of capital at exit are key differentiators in our view.

Presented for informational purposes only. Please see "Disclaimer" at the end of this presentation for additional information regarding market views and commentary.

In other words, there is a reason we (and our GMAA colleagues) recommend jogging, rather than walking. However, as long-term investors looking out further than a few weeks or months, we also recommend jogging instead of running. As the economy slows, some businesses will come under stress and we do expect an uptick in defaults. We do not see the current moment as a time to invest in stressed or distressed Credit. Those sorts of investments are for times of recovery, not the precipice of a downturn. Big companies, strong cash flows, high EBITDA, and defensive sectors and industries: We are in favor of keeping it simple.

With the Hunt for Yield Subdued, Bob and Carl are Off to Hunt for Capital

Illustration by: Jerry Capria, KKR Credit.

Presented for informational purposes only. Please see "Disclaimer" at the end of this presentation for additional information regarding market views and commentary.

Conclusion

Looking forward, we see six trends driving Credit markets and a way to play them all depending on investors' time horizon and risk preferences.

1. We believe it is a **great time to be a lender**, perhaps even an extraordinary one in the context of what many Credit investors have seen over the course of their careers. Total returns are extremely attractive, especially compared to equities on a risk-adjusted basis due to both the position of debt in the capital structure and enhanced economics due to call protection, protective covenants, and original issue discounts. New issue Private Credit is a good way to take advantage of this trend, and getting call protection when possible in subordinated Private Credit or new issue high yield bonds is very valuable in this rising-rate environment.
2. We expect **higher inflation and higher long-term rates** going forward, which should continue to make floating-rate assets and strategies with a degree of inflation protection such as asset-based finance attractive, especially relative to equities.
3. That said, particularly given the additional stress in the system precipitated by the recent banking crisis, it is a time to **keep it simple** rather than stretching for leverage or risk. Perhaps tying oneself to the nearest wooden beam as Odysseus did to avoid acting on the siren song would be an overreaction, but we do think it is imperative that investors learn to tune out the lure of cheap valuations until they understand whether there is value in the price or if the price reflects the value. The world is still uncertain in many ways. It seems likely that borrowers are going to come under increasing stress as central bank tightening slows economic growth, and we expect defaults to rise. High quality, larger businesses that can defend their margins are as simple as it gets, and that is where we recommend that investors focus.
4. The other consequence of ongoing market volatility is that pockets of **increased dispersion** are appearing in liquid markets, and this is a cycle that is likely to repeat several times more as limited supply contributes to volatility. Just as Odysseus had to contend with changing winds, investors will have to be flexible enough to take advantage of these moments *quickly*. As we discussed in our previous note, "The Law of the Jungle," history is ripe with examples of advantages that are quickly traded away. Multi-asset public Credit strategies give investors flexibility to stay nimble and act on opportunities as they come up in the market.
5. In this environment, we expect **Private Credit to continue taking market share** from Leveraged Credit as investors hunt for pools of capital with more certain execution and bespoke solutions. We think there are solutions across corporate credit, asset-based finance, and bespoke capital solutions that will benefit from this trend.
6. Finally, **flexibility is key**: Being a problem-solver with flexible capital is a way to show leadership in this market and lean into idiosyncratic situations in which high-quality borrowers are caught out for capital. Opportunistic pools of capital allow for bespoke solutions that solve problems for borrowers and create new opportunities with attractive downside protection for investors.

Getting stuck in a period of watchful waiting is a real risk, we feel. Even since our last letter, spreads have tightened in liquid markets, and Private Credit portfolios can take a long time to build. Those who show leadership early, and who have a plan, are the ones we think will reap the rewards.

Christopher A. Sheldon

Presented for informational purposes only. Please see "Disclaimer" at the end of this presentation for additional information regarding market views and commentary.

Disclaimer

The views expressed in this material are the personal views of Christopher A. Sheldon, Rory O'Farrell, and the Credit & Markets Team of Kohlberg Kravis Roberts & Co. L.P. (together with its affiliates, "KKR") and do not necessarily reflect the views of KKR itself. The views expressed reflect the current views of Mr. Sheldon, Mr. O'Farrell and the Credit & Markets Team as of the date hereof and neither Mr. Sheldon, Mr. O'Farrell and Credit & Markets Team nor KKR undertakes to advise you of any changes in the views expressed herein. In addition, the views expressed do not necessarily reflect the opinions of any investment professional at KKR, and may not be reflected in the strategies and products that KKR offers. KKR and its affiliates may have positions or engage in securities transactions that are not consistent with the information and views expressed in this material. This material has been prepared solely for informational purposes. The information contained herein is only as current as of the date indicated, and may be superseded by subsequent market events or for other reasons. Charts and graphs provided herein are for illustrative purposes only. The information in this material has been developed internally and/or obtained from sources believed to be reliable; however, neither KKR nor Mr. Sheldon, Mr. O'Farrell and the Credit & Markets Team guarantees the accuracy, adequacy or completeness of such information. Nothing contained herein constitutes investment, legal, tax or other advice nor is it to be relied on in making an investment or other decision. There can be no assurance that an investment strategy will be successful. Historic market trends are not reliable indicators of actual future market behavior or future performance of any particular investment which may differ materially, and should not be relied upon as such. This material should not be viewed as a current or past recommendation or a solicitation of an offer to buy or sell any securities or to adopt any investment strategy. The information in this material may contain projections or other forward-looking statements regarding future events, targets, forecasts or expectations regarding the strategies described herein, and is only current as of the date indicated. There is no assurance that such events or targets will be achieved, and may be significantly different from that shown here. The information in this material, including statements concerning financial market trends, is based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons. Performance of all cited indices is calculated on a total return basis with dividends reinvested. The indices do not include any expenses, fees or charges and are unmanaged and should not be considered investments. The investment strategy and themes discussed herein may be unsuitable for investors depending on their specific investment objectives and financial situation. Please note that changes in the rate of exchange of a currency may affect the value, price or income of an investment adversely. Participation of, and discussions with, KKR private markets personnel, KKR Capital Markets and KKR Capstone personnel, Senior Advisors, Industry Advisors and, if applicable, RPM and other Technical Consultants, in KKR Credit's investment activities is subject to applicable law and inside information barrier policies and procedures, which can limit or restrict the involvement of, and discussions with, such personnel in certain circumstances and the ability of KKR Credit to leverage such integration with KKR.

KKR

Kohlberg Kravis Roberts & Co. L.P.
30 Hudson Yards
New York, New York 10001
212-750-8300
www.kkr.com

Twitter: @KKR_Co

Linkedin: /company/kkr

Visit us on YouTube