CREDIT VIEWPOINTS

How the ESG 2.0 Framework Enhances Our Private Credit Investment Process

Introduction

As outlined in our April Credit Viewpoints paper, the management of environmental, social and governance (ESG) issues is a rapidly evolving, increasingly important component of investing. ESG integration has moved well beyond simply screening for high risk ESG activities and controversial gating issues, towards identifying areas where investment managers can see both positive societal impacts and attractive returns.

Credit markets pose particular challenges for ESG integration, with limited issuer disclosure across Private Credit, Leveraged Loan, and High Yield markets. **In 2021, the KKR Credit Team explored ways to enhance our approach to ESG integration for KKR's Private Credit investing activities, seeking to develop a systematic process to surface and monitor significant ESG information.** Working in collaboration with our investment teams, dedicated KKR ESG specialists, external consultants, investors, and a global NGO (non-governmental organization) with expertise in sustainable business, we developed what we believe to be a robust, repeatable and measurable process that we are calling "ESG Credit 2.0".

We believe this new ESG Credit 2.0 framework creates a strong foundation for (a) unearthing meaningful ESG-related data from, and incorporating ESG-focused operating procedures into, our Private Credit investment processes, and (b) identifying opportunities to invest into sustainable solutions and ESG-committed companies, both now and in the future.

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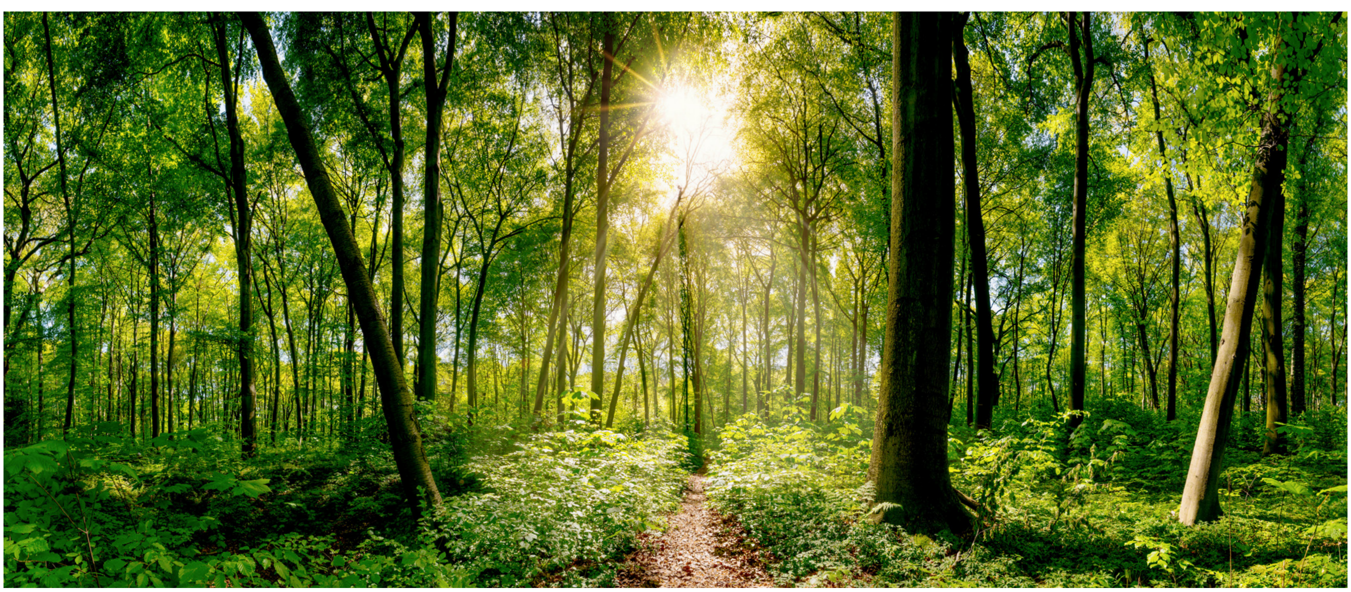
As credit investors, we understand that there are limits to our ability to mandate change. However, as custodians of $73 billion in Private Credit, we feel a sense of responsibility to try and facilitate positive change through our approach to our everyday investing activities. We aim to do this by engaging with our borrowers and their shareholders, asking difficult questions, maintaining an ongoing dialogue with our stakeholders, and, where appropriate and possible, providing our portfolio companies with incentives to improve their ESG profiles. This approach is designed to enable us to create positive difference while also seeking to deliver attractive risk-adjusted returns for our investors.



KKR's Leadership in ESG

As a firm, KKR has made a commitment to the idea that the integration of ESG issues into investment processes can create shared value. In 2008, the firm began to formalize efforts to protect and grow value by considering broader stakeholder issues as an integral component of the investment process. In 2009, KKR became a signatory to the United Nations-backed Principles for Responsible Investment (PRI) and helped to develop the guidelines for responsible investing as a member of the American Investment Council. In 2013, the firm codified its global Private Equity ESG Policy, and in 2020, replaced this policy with KKR's Responsible Investment Policy, which articulates KKR's approach to the consideration of ESG risks and value creation opportunities into our investment processes. The firm's commitment to ESG, and how it has been operationalized, is described in greater detail at https://kkresg.com/.

The ESG Credit 2.0 Framework

Following a year of development and testing, our ESG Credit 2.0 framework has now been incorporated into our underwriting process across our Private Credit business.

Through the ESG Credit 2.0 framework, we will collect valuable ESG-related information about our investments that we believe will enable us to unearth trends, identify aggregate areas of ESG risk, disclose relevant metrics to investors, and potentially identify investments as relevant to future sustainability-focused investment strategies.

> "Our investment teams are expected to implement the framework and incorporate ESG criteria on applicable transactions, proactively engaging with prospective portfolio companies and their owners"
>
> **Ken Mehlman,** Partner, Global Head of Public Affairs & Co-Head of Global Impact at KKR.

THE ESG CREDIT 2.0 PROCESS, KEY FEATURES:

1. **Scoring an investment opportunity** against our proprietary materiality-based[1] ESG Scorecard;
2. **Analyzing** whether companies provide sustainable solutions, e.g., advancing the UN Sustainable Development Goals (SDGs)[2];
3. **Seeking out** ESG due diligence and embedding ESG-related information rights in finance documents; and
4. **Looking for opportunities** to include meaningful ESG metrics, ambitious ESG targets / key performance indicators (KPIs) and incentives into finance documents.

ESG Considerations Integrated Into the Investment Process:

1. ESG Scorecard

- Score companies against pre-defined ESG criteria
- Use data to identify / monitor any areas that have scored poorly and revisit regularly

2. Sustainability Assessment

- Analyze whether a borrower's business model provides a solution to a sustainability challenge (e.g., SDGs)
- Collaborate with NGO or third party sustainability business experts to make this assessment

Gating List

ESG, regulatory, compliance and reputational issues considered before due diligence begins

Due Diligence

- Reputational Risk Screening ✓
- ESG Scorecard[3] ✓
- IC Checklist[3] ✓
- ESG Due Diligence ✓
- ESG Information Rights ✓
- ESG Questionnaire[3] ✓

Engagement

Sustainable Solutions Companies?
Does the company advance the SDGs, have an impact thesis and / or constitute transformation financing?

ESG-Committed Companies?
Can we agree measurable and meaningful ESG improvement targets (e.g. Sustainability Linked Loans)?

Monitoring

- Ongoing monitoring & updates of ESG Scorecards[3]
- Portfolio level reporting to LPs
- Annual monitoring of performance against ESG improvement targets[4]

3. ESG Due Diligence & Information Rights

- Request ESG due diligence on deals
- Request covenant for disclosure of ESG and anti-bribery and corruption policies

4. ESG Targets

- Designed a framework to structure meaningful "stretch" ESG targets / KPIs
- Incentivize through margin ratchet or document terms' flexibility

Note: For illustrative purposes only, may be subject to change. Please refer to "Important Information" for further details on KKR's internal information barrier policies and procedures, which may limit the involvement of personnel in certain investment processes and discussions. Above information as of December 31, 2021.

Process Informed by KKR's ESG Leadership Credentials and Supported by External Specialized Resources

External Resources

- Professional Services Firm (ESG KPI Framework)
- 3rd Party NGO (UN SDG Analysis)
- Other Third Party Vendors

KKR Firm-wide Resources

15-person ESG team:

- Sustainable Investing (9)
- Capstone (1)
- CPG (1)
- Compliance (1)
- Data Manager (1)
- Impact (1)
- Technology Officer (1)

Leadership

- PRI Signatory since 2009
- KKR Sustainability Expert Advisory Council
- PDI (2021) Responsible Investor of the Year Award
- Board / Committee Representation
    - LSTA
    - ELFA
    - SASB
    - PRI

Pre-Screening

Before we undertake initial commercial analysis of an investment, we expect all potential opportunities to undergo a three-part, pre-screening process:

01 Gating Issues

While not an exclusionary list, each investment is expected to be checked against a list of critical ESG, regulatory, compliance, and reputational issues. The list includes key considerations that will influence KKR's decision on whether to invest, and other considerations where additional scrutiny is needed before beginning significant commercial diligence.

02 RepRisk Analysis

RepRisk is a global company focused on ESG data science and machine learning with a significant database covering many privately held companies. Its online platform scans publicly-available information regarding ESG controversies for both public and private companies. An "incident report" is produced and, where there are issues of concern, we expect these issues to first be satisfactorily diligenced in order for the investment opportunity to progress.

03 Input from Internal KKR ESG Specialists

When there is a sensitive topic in an otherwise compelling commercial opportunity, our ESG specialists and the investment team will partner to work through any challenges.

Data-Collection and Engagement

From a sustainability perspective, we would like as many of our investments as possible to advance the SDGs, include impact theses, and be 'transformative investments', where relevant. Through the ESG Credit 2.0 process, we intend to collect data on investments that may contain these features. Whether a company does or does not include these features will not influence the investment decision for traditional Private Credit products. Separately, however, we will seek to incorporate ESG-considerations in the investment process through, among other steps, use of our innovative ESG Scorecard and, as appropriate, the incorporation of ESG features into loan agreements.

01 SDG Analysis

Prospective companies that pass the pre-screening process are then analyzed against the SDGs. The objective is to understand whether companies are making a positive contribution to society / the environment, as indicated by the SDGs. We look to ascertain whether a company's business model advances one or more of the SDGs, which broadly relate to driving solutions to mitigate climate change, benefiting communities and consumers, and/or driving a more sustainable future.

In order to make the assessment, we collaborate with a global NGO of sustainable business experts in an effort to bring both objectivity and credible third-party subject matter expertise. We have developed an iterative framework with the NGO designed to allow: first, the investment analyst to make an initial assessment; second, KKR's ESG team to test that assessment; and third, if the investment analyst and KKR's ESG team determine that an investment aligns with one or more SDGs, the NGO, as an outside consultant, to provide input on whether any of the SDGs are advanced. KKR's ESG team ultimately makes the final determination as to whether any of the SDGs are advanced. This process and analysis may continue throughout the Underwriting process.

02 Sustainability Analysis

We also look to identify and take note of companies that, while not necessarily advancing the SDGs, are part of another "impact" thesis. We are looking to identify companies backed by impact investors who are signatories to the Operating Principles for Impact Management, such that we believe there is a thoughtful and defensible sustainability thesis. Such investments may also be suitable for future ESG-focused strategies.

03 Transformative Investments

Here, we seek to identify opportunities to finance sustainability-related transformation, including transition from "brown" to "green" (e.g. transitioning coal assets to renewable assets).

04 Underwriting Engagement Process

In our credit underwriting process, we are striving to heighten our focus on ESG-related considerations and risk. We face a challenge in how to balance retaining our nimble underwriting approach, which we believe counterparties value, while aiming to devote greater attention to ESG topics. This challenge is probably best summarized as "taking complexity and creating simplicity". We believe that the new ESG Scorecard, in addition to other tools assisting due diligence considerations, which include Investment Committee checklists and ESG-focused due diligence, strikes this balance.

A) ESG Scorecard

Our proprietary ESG Scorecard, in part informed by the Sustainability Accounting Standards Board (SASB), is a key component of our analysis and data-collection efforts. **We developed the scorecard as a way to evaluate companies in which we are investing against materiality-based[1] ESG criteria.** Our analysts are expected to use the ESG Scorecard to provide an overall score for each applicable investment, allowing us to identify and monitor areas that have scored high or low and to revisit our scoring as facts and circumstances change. We also believe that analysis of data derived from the ESG Scorecards can provide investment insights.

Please access the Credit Viewpoints paper, [Meeting the Call for Innovation in Leveraged Credit and Private Credit ESG] for further details on the scorecard.

For illustrative purposes only.

B) Investment Committee (IC) Checklist

To help ensure that we systematically address due diligence and credit quality, we encourage the use of an IC checklist. The checklist prompts investment teams to ask targeted questions – Have background checks been conducted on management? Have we used independent channel checks on key relationships? Is there a reputable auditor? And many more. We believe the questions on the IC checklist are important to commercial underwriting more broadly and that addressing such questions helps us to understand and assess if a company may have ESG issues.

C) ESG Due Diligence

Our intention is to ask our potential borrowers for ESG-related due diligence items. It is not always the case that ESG due diligence materials are provided by the borrower, nor do we believe the lack of such materials will necessarily impact our decision to invest. Often there will be ESG issues covered in legal or commercial due diligence reports, which is helpful. However, we believe asking for specific ESG due diligence items helps with providing additional insight into potential and existing ESG issues.

D) ESG Targets

We believe there is an opportunity to bring Sustainability Linked Loans to private markets, as we have seen occur in public markets.

We have worked to build an **ESG-KPI framework** for incorporating such features into loans that include incentives (e.g. margin, covenant flexibility, maturity extension, etc.) for achieving **material** KPIs and setting ambitious sustainable performance targets (SPTs) that are capable of being measured and reported. We have aligned our approach to industry-best practice standards (e.g., LMA's Sustainability Linked Loan Principles) to help ensure that we are able to structure both "material" ESG KPIs and "ambitious" SPTs.

We have worked with a third-party expert to develop an ESG-KPI framework aligned to the Sustainability Linked Loan Principles that sets out:

1. How to **select a material** KPI
2. How to set and calibrate **an ambitious** SPT
3. The type of incentives that can be given to encourage attaining the KPI
4. The verification and reporting approach and standards

Given increasing global focus on reducing carbon footprint and increasing public focus on improving corporate diversity, equity, and inclusion, we think that the majority of these KPIs will relate to these topics. We believe our framework allows us to develop KPIs that target those issues most material to the portfolio companies and their sectors / industries. Our framework has received a second party opinion from Sustainalytics on its alignment with the Sustainability Linked Loan Principles developed by the Loan Market Association (LMA), Loan Syndications and Trading Association (LSTA), and Asia Pacific Loan Market Association (APLMA).

We are not taking the position that every investment we make must include ESG targets. However, whether or not we include KPIs in our loan documents, we think that engaging with our counterparts in these conversations may increase their focus on ESG issues and keep them alert to possible risks moving forward.

Documentation

Having made the decision to provide financing to a company, we also focus on trying to reflect our ESG priorities in the finance documentation.

01
ESG Information Rights

We typically look to include a contractual right that borrowers will provide us with copies of their ESG-related policies (e.g., employee health & safety policies) along with their anti-bribery and corruption policies. Failure to obtain these ESG policies does not prevent us from moving forward with a deal; but we would need to understand the company's reasoning for not providing them.

02
Document ESG Targets

Where we successfully establish KPIs and incentives to improve ESG in financings, we plan to document these as covenants so that we can hold companies accountable to the agreed upon targets.

03
KKR ESG Questionnaire

Finally, we may ask the Sponsor to complete a tailored version of the standard LSTA questionnaire for Asset Managers, which has been customized to align with KKR's Responsible Investment Policy.

Monitoring and Reporting

01
Ongoing Monitoring

Once an investment has been made, we aim to monitor ESG-related issues on an on-going basis and, where achieved, any on-going advancement of the SDGs or attainment of ESG Targets:

A) Credit QB

Our digital "quarterback" tool, which internally tracks the data from our credit investments, allows us to surface information from the ESG Scorecards and observe trends. It also provides an early warning system that may indicate where issues are likely to arise. Similarly, it can be used to track which companies are advancing the SDGs and the status of any ESG Targets that have been agreed to by borrowers.

B) Portfolio Monitoring Committee (PMC)

We plan to review company ESG Scorecards at least annually and expect our PMC to meet quarterly to review every credit in the portfolio – thus providing a formal opportunity to regularly assess any ESG risks or wins.

02
Reporting

We believe that the ESG Credit 2.0 process not only improves our Private Credit investing process, but also provides valuable data that we may share with our investors, depending on the relevant strategy, for example:

A) Scorecard Data

We will be able to report the data obtained from our ESG Scorecard analysis, including overall portfolio scores, breakdown by sector and split by Environmental, Social and Governance scores.

B) SDGs

We will be able to report what % of a portfolio has been determined to advance the SDGs, which particular SDG target, and an estimation of the company's impact based on the identified SDG contribution.

C) ESG Targets

We will be able to share which of our investments contain Sustainability Linked Loans. Below is an example of the types of ESG KPIs and targets that may be part of a Sustainability Linked Loan.

D) ESG Information Rights

We will be able to track and report deals where we did / did not obtain contractual disclosure of ESG policies.

Summary of ESG KPIs and Targets for a Target Company (Example Case)

KPI Category	ESG Metric	Year 1 ESG Target	Year 2 ESG Target	Year 3 ESG Target	Year 4 ESG Target	Year 5 ESG Target
Climate	Scope 1, 2 and 3 emissions (where material) aligned to industry benchmark (e.g. % of baseline emissions reduction)	Establish baseline and set targets	Scope 1+2: 97% Scope 3: 99%	Scope 1+2: 93% Scope 3: 98%	Scope 1+2: 89% Scope 3: 97%	Scope 1+2: 85% Scope 3: 96%
Human Capital (DEI)	Gender representation on the board (e.g. % of females on board)	10%	15%	20%	25%	30%
Human Capital (other than DEI)	Customer and / or employee satisfaction (e.g. improvement in Net Promoter Score)	60	65	70	75	>80
Material ESG topic based on sector	Waste management and recycling (e.g. % of recycled waste)	Establish baseline	75%	80%	85%	90%

Conclusion

KKR's ESG Credit 2.0 framework represents a commitment to include ESG pre-screening, data-collection, engagement, measurement and (where possible) incentives throughout our Private Credit investment process.

In addition, the implementation of ESG Credit 2.0 means we can expect many new products we offer to be classified under Article 8 of the Sustainable Finance Disclosure Regulation, which applies to funds that promote environmental and/or social characteristics.[5]

> "We believe that our ESG Credit 2.0 process positions us well to continue identifying ESG-related risks and leaning-in to opportunities where we can be agents for change and partners in shared value through our Private Credit investing business."

Chris Sheldon, Partner, Co-Head Credit & Markets

Indeed, over the course of 2022, we hope to launch products supporting our European Direct Lending, Global Junior Debt and ESG Accelerator strategies – the latter being a new global cross-capital structure strategy focused exclusively on sustainable and ESG-focused Private Credit investments.

Finally, we recognize that this is a continually evolving area. We are committed to making progress, regularly critiquing and evolving our approach, and welcome as always questions, ideas and feedback from our investors. ■

Please contact your Relationship Manager for further information on our credit strategies or ESG Credit 2.0 framework.

1. In this article, we are not using such terms "material" or "materiality" as they are used under the securities or other laws of the U.S. or any other jurisdiction, or as they are used in the context of financial statements and financial reporting. Materiality, for the purposes of this document should not, therefore, be read as equating to any use of the word in other KKR reporting or filings.
2. The SDGs are a collection of 17 global goals designed to be a 'blueprint to achieve a better and more sustainable future for all'. Set in 2015 by the UN General Assembly, they are intended to be achieved by the year 2030. The SDGs are aspirational in nature. The analysis involved in determining whether and how certain initiatives may contribute to the SDGs is inherently subjective and dependent on a number of factors. There can be no assurance that other parties will agree on a decision as to whether certain projects or investments contribute to a particular SDG. Accordingly, investors should not place undue reliance on the firm's application of the SDGs, as such application is subject to change at any time and in the firm's sole discretion.
3. Specific to KKR Credit Investment Process.
4. As applicable to strategy.
5. Sustainable investing as used and defined by KKR herein, which may differ from the technical definition of "sustainable investments" in Art. 2 No. 17 of how it is defined by the European Union's Sustainable Finance Disclosure Regulation.

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