KKR

CREDIT VIEWPOINTS

Meeting the Call for Innovation in Leveraged Credit and Private Credit ESG Analysis

Through an expansive data set, we have a rich and nuanced information framework with which to evaluate companies. Our ESG underwriting process is twofold: it reduces the downside risk to our investment decisions and highlights companies whose ESG efforts may have not yet been rewarded by the market.

Credit markets have posed unique challenges for the integration of environmental, social and governance (ESG) criteria, with limited issuer disclosure across Private Credit, Leveraged Loan, and High Yield markets. Third-party ESG ratings are often backward looking, are non-standardized across agencies, and historically have covered only a small subset of the issuers in our KKR portfolios. Some also fail to emphasize a company or industry's most material ESG issues. Meanwhile, there have been growing calls in the industry for enhanced transparency, data, and integrity in evaluating ESG performance in Credit investments.

Building on KKR's decade-plus track record considering ESG criteria in investment decision-making, the Credit team at KKR spent extensive time in 2021 analyzing how best to enhance our existing approach to ESG integration in our Credit investing strategies. In particular, we sought to ensure that our approach would continue our emphasis on materiality as core to our ESG analysis. In partnership with our investment teams, dedicated ESG specialists, sustainability advisors, external consultants, investors, and professional associations, we developed what we believe is a robust, repeatable and measurable process that we are calling 'ESG Credit 2.0.'

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We intend for ESG Credit 2.0 to enhance our existing process by further incorporating meaningful ESG-focused operating procedures into our credit investment processes — supporting our Limited Partners and current and future clients with their ESG management goals, while also identifying promising investment opportunities, anticipating and avoiding risk in our investments and engaging with the companies in which we invest, to accelerate sustainability and equity. At the core of this process is our 'ESG Scorecard,' which we believe provides a powerful analytic tool for meeting those goals. On the following pages, we describe our ESG Credit 2.0 framework and Scorecard and touch on intriguing insights that our analyses have surfaced.

As a firm, KKR believes that thoughtful management of ESG issues is smart business and an essential part of long-term success in a rapidly changing world.

The ESG Credit 2.0 Framework

At KKR, evaluation and discussion of ESG concerns have long been embedded in our investment process. Recently, there has been an increased focus on transparency, data, and integrity in ESG investments and ESG reporting. To evolve to the dynamic changes in this industry, we enhanced our existing processes and have developed our ESG Credit 2.0 Framework. ESG Credit 2.0 seeks to manage environmental, social, and governance issues in our investments in what we believe is a more thoughtful way. This is in addition to addressing data challenges faced by the industry as mentioned above. ESG Credit 2.0 has been integrated into the underwriting process for every transaction presented to our investment committees across our Credit business. Our investment teams think pro-actively about ESG topics, engaging systematically on ESG-related issues with prospective portfolio companies and their sponsors.

ESG CREDIT 2.0 IS CENTERED ON:

1. Scoring every credit investment against our proprietary criteria-based ESG Scorecard
2. Analyzing whether prospective portfolio companies advance the United Nations Sustainable Development Goals (SDGs)[1] for private credit investments
3. Conducting ESG due diligence, which may include embedding ESG-related information rights in financial documents, as well as proactively engaging with the issuers on ESG-related issues

The ESG Credit 2.0 Scorecard

Our ESG Scorecard is composed of the following elements:

1) Positive Tilting | By incorporating a positive tilt towards companies focusing on operating in sustainable and equitable ways, we are able to hone in on investments that are 'best in class' *relative to their peers* across our ESG criteria. Importantly, best in class does not mean an energy company is worse relative to other sectors. Best in class considers credits *within a sector* rather than comparing *across* sectors.

2) Broader Categories | While the core focus remains on widely known metrics such as carbon emissions, inclusion and diversity, and financial controls, we augment our definitions to include, for example, environmental management, a metric often not measured or disclosed alongside carbon intensity to provide what we consider to be a more robust evaluation of the environmental factor.

3) A Focus on Business Models Driving Sustainability | A focus on companies whose core business model promotes sustainability or equity can help us to identify best in class ESG credits. This includes companies that drive solutions to mitigate climate change, that benefit communities and consumers, and/or that drive a more sustainable future. These credits can encompass a broad landscape of innovations in industries not limited to, but including, transportation and logistics, healthcare and education, and sustainable products and services. This criterion uses the UN SDGs and KKR's Global Impact Fund[2] as guidance on how to define positive contribution.

4) Forward Outlook | We believe it is critical to understand how a business is moving forward and mitigating existing and potential risks around relevant ESG considerations. As noted earlier, third party ESG ratings tend to be backward looking. Outlook evaluation on the other hand is a momentum indicator: it answers 'is this business going in the right direction?' Is it going in the right direction for our environment? Is it going in the right direction for communities, employees, and stakeholders? Is the Leadership committed and executing?

5) Availability of Disclosed Information | We track and monitor the amount of disclosed information that is available related to ESG considerations by issuer and by sectors. We believe that this is a metric for better transparency into the thousands of issuers in the credit markets.

Investing for Progress

Expertise

KKR published its first ESG policy for the Private Equity business in 2013, and its Responsible Investment Policy covering various asset classes globally in 2020. In 2017, we committed to leveraging the Sustainability Accounting Standards Board (SASB) standards as an input for assessing potential investments and became an SASB Alliance member in 2018. We have access to an unparalleled network of internal and external ESG subject matter experts to support investment teams; we also conduct regular analyst trainings to ensure ESG evaluation consistency.

Collaboration

The ESG Scorecard was developed with input from our Limited Partners, ESG consultants, Investment Committee members, sector analysts, and KKR's dedicated Sustainable Investment team, a diverse team of ESG experts across specialties — including ESG integration across asset classes, ESG compliance, impact, and reporting — and geographies, with representation across North America, APAC and EMEA.

Technology

As a result of the Scorecard, we have obtained thousands of data points to analyze. We built an innovative technology platform to visualize and aggregate data and a database to track and evaluate ESG metrics. We are thus able to continuously and efficiently analyze portfolios and investment objectives and further increase our disclosure on ESG performance to our investors.

KKR global analysts completed 12 ESG training sessions that covered over 24 different sectors in 2021. These sessions, which were led by ERM,[3] taught critical components of assessing adequate ESG management and the material ESG issues specific to individual sectors.

15
PERSON DEDICATED ESG TEAM

160
INVESTMENT PROFESSIONALS

1,085+
SCORED CREDITS IN THE BANK LOAN, HIGH YIELD AND PRIVATE CREDIT MARKETS

Creating the Scorecard: Collecting And Distilling the Data

Integration of ESG Credit 2.0 was completed over one year, as circa 160 investment professionals individually scored over 1,085+ credits on our credit platform. This gave us a fully digital record of ESG due diligence and a database of quantitative metrics and qualitative analysis with which to more fully assess the ESG characteristics of our portfolios. Importantly, this process provided us with two critical insights on the leveraged loan and high yield markets:

INSIGHT #01 **Highly rated ESG companies in the bank loan and high yield markets are not being rewarded with lower credit spreads.** That said, the leveraged credit market is penalizing credits with material ESG concerns, with many of these credits trading 350bps wide of the high yield market.[4]

INSIGHT #02 As a result of our data collection, **we have identified a large amount of dispersion in ESG scoring vs. credit spreads. We believe this is where the opportunity resides in ESG credit investing.**

In the following pages, we offer more detail on our thinking, some of the specific challenges of the 'ESG Credit 2.0' environment that we are addressing, and how we anticipate that this all comes together to deliver for both a sustainable future and our investors. (If you are interested in learning more about our ESG Credit 2.0 Framework, please contact CreditStrategiesTeam@kkr.com.)

Expansion on our ESG Framework

As a firm, KKR believes that the thoughtful management of ESG issues is smart business and an essential part of long-term success in a rapidly changing world. KKR's work in this arena began as far back as 2008 when we began to formalize our efforts to protect and grow value by considering broader stakeholder issues as an integral part of the investment process. As part of this commitment, the company created a cross-functional, global team, now led by our colleague Ken Mehlman, dedicated to the management of **the firm's responsible investment strategy,**[5] implementing it across relevant asset classes, industries, and geographies. This team, along with our investment committees, has been actively involved in the development of the enhanced ESG Credit 2.0 framework and Scorecard.

As a firm we value interacting with and learning from external stakeholders who share our commitment, and collaborate regularly with our peers in these stakeholder communities for help in developing tools and resources and to strengthen our expertise. We also actively consulted with such subject matter experts in the development of our enhanced framework.

Both the proprietary framework and scorecard were developed explicitly to capture company information in a consistent format across credits. With this enhanced framework, we are now able to evaluate every credit across all of our Leveraged and Private Credit portfolios, giving us a fully digital record of ESG due diligence and a rich database of both quantitative metrics and qualitative analyses with which to more fully assess the ESG characteristics of each of our portfolios.

01

Positive Tilting

The core of many ESG investment strategies includes screening criteria. Negative or exclusionary screening — removing companies that score poorly on ESG criteria such as those having revenue from weapons or thermal coal — is widely understood within the industry and is a core to index methodology. We incorporate gating measures to identify significant ESG risks as a first step in our process, which maintains consistency with industry evaluation practices. However, we have also implemented a number of positive screening categories to help us better identify companies committed to sustainable business practices.

By incorporating positive screening, we focus on investments that are 'best in class' relative to peers. For our analysis, this requires identifying the highest scoring ESG credits within sectors. This is the direction we anticipate the industry will move towards in time.

02

Broader Categories

Our approach expands the landscape of what is evaluated within ESG criteria. **While our core focus is on widely used metrics such as carbon emissions, inclusion and diversity, and financial controls, we expand these definitions to include such categories as environmental management, social management, and sponsor reputation. The ESG Scorecard also takes a materiality-based approach, partly informed by the Sustainability Accounting Standards Board (SASB)[6] material ESG issues by industry. We also ask that investment analysts run an ESG headline risk search using the RepRisk platform to identify any major media controversies on the company, which should then be noted in the ESG Scorecard and escalated to the KKR Public Affairs team.**

Environmental management includes companies reducing negative environmental impacts outside of carbon targeting land, water, and resources. For example, a company may have minimal carbon emissions but may be a repeat offender in areas such as water pollution or habitat destruction.

Social management is also critical. A company and its affiliates may be in a business line that is known to have possibly significant social concerns that can directly affect company employees, customers, or relationships. These may include product safety concerns or worker safety, the latter an increasingly important factor in the credit universe as many companies are reliant on labor.

As a Firm, and as a private equity sponsor to many companies, KKR recognizes the importance of leadership and the ability to influence positive change. **We believe company sponsorship is an important driver of both sustainable business and also disclosure of material ESG-related information. Thus, we also evaluate sponsor reputation as part of our social criteria.**

03

A Focus on Business Models Driving Sustainability

As part of our framework, we also assess to what extent a company's business model is delivering an outcome that advances sustainability. We take into consideration the extent to which the issuer's activities are aligned with the SDGs. Through our partnership with KKR's Sustainable Investing team, we have been able to build on learnings from the KKR Global Impact Fund to incorporate consideration of the UN SDGs into our credit investment analysis. We note that the KKR's Global Impact Fund 1,[7] which has invested over $1 billion in 15 companies, pursues investment opportunities to grow and scale companies whose core business models address critical global challenges identified by the UN SDGs. 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. Many of these same themes such as the energy transition, sustainable living, workforce development, and inclusive growth have significant market tailwinds driven by consumer sentiment, corporate commitments and policy imperatives. Thus, these are areas where there is an opportunity to invest in companies that do well by doing good.

We are seeking to identify companies that we believe align with one or more of the following broad based goals: drive solutions to mitigate climate change, benefit communities and consumers, and/or drive a more sustainable future. These goals encompass a broad landscape of innovations in industries not limited to, but including, transportation and logistics, innovative and accessible healthcare and education, or sustainable products and services.

This approach is two-fold, firstly recognizing those companies that *currently* have a business model driving one of the above sustainable goals and secondly, identifying companies that may be pivoting their business model to adjust to an evolving business environment.

As an example, a company focused on packaging may not directly align with a

We assess a company's outlook using a three-pronged approach, considering E, S and G outlook each individually.

sustainable business model; however, a packaging company dedicated to minimizing the use of forest products by designing smaller packages or utilizing sustainable materials that could help consumers reduce their environmental footprint, could be important to identify. Capturing positive ESG intentions as well as tangible results is critical in our assessment.

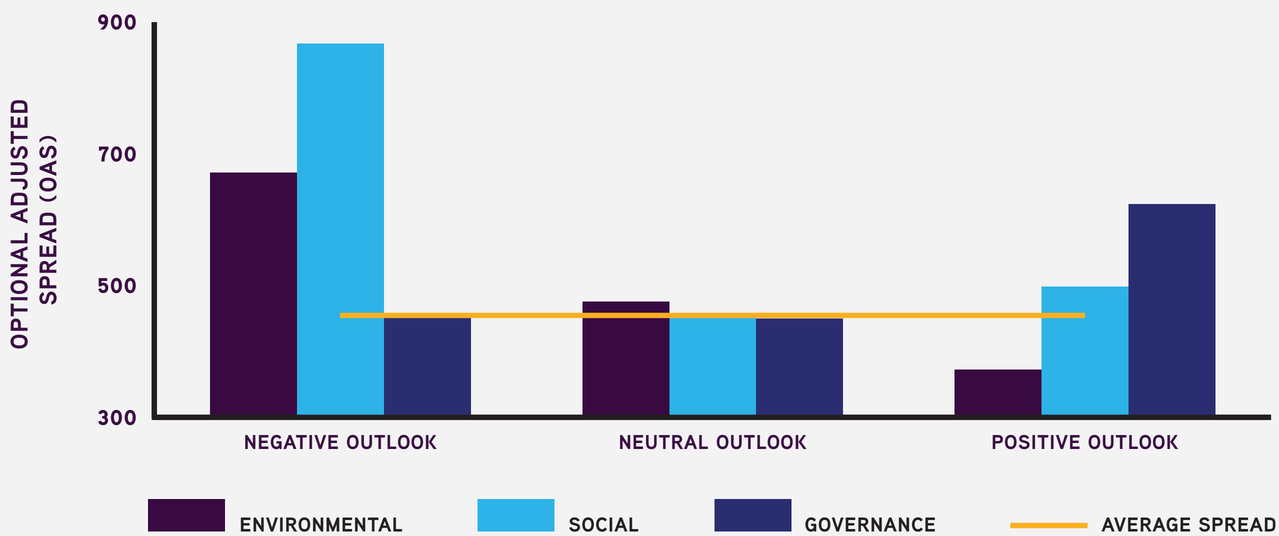
04
Forward Outlook

ESG ratings analyses tend to be backward looking, which means that they rely on carbon emission or diversity scores from prior earnings quarters. At KKR, we believe that it is also critical to understand how a business is moving forward and mitigating existing and potential risks around relevant ESG considerations. The backward looking data is used as a reference point for our analysts to develop a view on a company's forward trajectory.

We assess a company's outlook using a three-pronged approach, considering each of the environmental, social, and governance issues most material to the company based on the industry in which it lives. The recent increase in public attention on climate change has made environmental outlooks a more prevalent topic. That said, we cannot overlook the importance of positive social and governance outlooks as management teams demonstrate a commitment to sustainability that is broader than say carbon emissions alone.

Analysing our forward outlook data, we observe credits with negative ESG outlooks trade wider vs. neutral to positive outlooks. If we consider the below chart, we would expect positive ESG outlooks to have tighter spreads than those with neutral outlooks.

KKR Credit Portfolio: Average Spread by Outlook



Source: KKR Credit Analysis as of March 17, 2022.

05

Availability of Disclosed Information and Engagement

Assessing ESG risks in credit markets poses particular challenges. Only a minority of issuers in our Leveraged Credit portfolios — 15% to 40% — are covered by third party ESG vendor ratings. While ESG data can be readily available for public companies, the availability of disclosed information in private companies is more limited. This is especially impactful for the leveraged loan market, where 60.4%[8] of companies are privately owned and represent a meaningful part of our invested credits.

ESG-related disclosure across our portfolio is not at a level that we would like, with 40.4%[9] of our total universe of credits scoring 'low' on disclosure availability. We have identified asset class differences, with disclosure for HY issuers significantly better than bank loan issuers, as well as regional variation, with disclosure greater across European credits. We have prioritized disclosure as a key area where we can engage with our portfolio companies and drive change through constructive dialogue.

To overcome these data limitations, our analysts have engaged with management teams on ESG matters, manually researched company websites, and sent requests to issuers and underwriters. We track and assess the level and quality of ESG data available for each individual borrower through our proprietary digital ESG database. We also track subsequent engagement with our issuers, a key part of which is pressing for more and better quality ESG data. **Our ESG engagement is rapidly increasing and since we have started formally tracking this metric, engagement has increased from less than 10 companies in 2020 to 240 issuers currently or ~22%[10] of the issuers on our credit platform.**

Why do we think this is so important? Monitoring of and reporting on ESG metrics, such as carbon emissions, gives companies and investors the tools to set clear benchmarks and measure progress against these benchmarks. **Further, ESG insights act as a quality metric. Companies that are proactively monitoring and reporting ESG risks are companies that tend to be well-managed. Disclosure availability reduces the likelihood of investments in companies that may run into difficulties from poor governance, environmental negligence, diversity challenges, and other operational difficulties.** While a lack of action on diversity or social issues may not signal an immediate risk to credit-worthiness, it can be a valuable indicator of a weaker corporate culture or lack of commitment.

Collecting and Distilling the Data

When we aggregated the data from our qualitative and quantitative framework we saw numerous possibilities for utilizing this data both for analysing current portfolios as well as for generating returns.

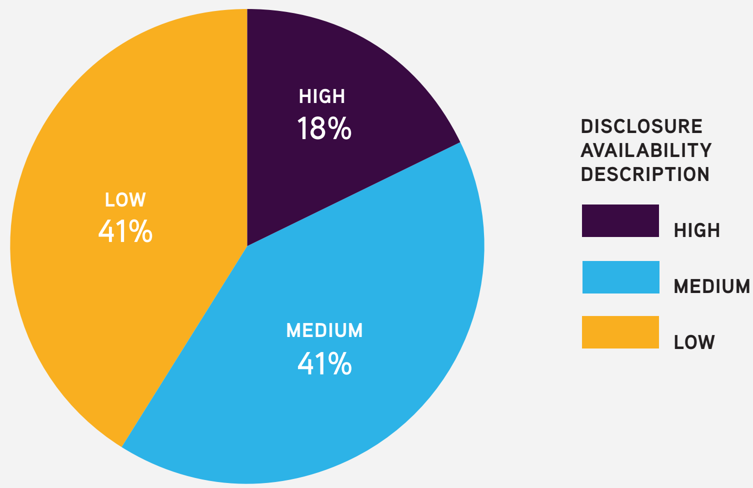
First, there is a considerable amount of dispersion across companies: those that score positively across our framework do not necessarily have the tightest credit spreads. While companies have credit risks outside of an ESG framework, e.g., declining revenue relative to competitors, we believe that there are elements captured in the ESG spectrum that can add additional insight as to *why* a company may be struggling or succeeding relative to its peers. For example, a sustainable flooring provider has a niche market providing carpet and luxury vinyl tile that is carbon neutral, and in some cases, carbon negative. This can be a key differentiator, as 90%[11] of their customers are trying to reduce carbon emissions — in theory this could drive greater revenue opportunities.

> As a result of thousands of data points, we have a unique perspective on how much dispersion exists across the credit markets. The ESG premium has not been priced in, creating a unique opportunity to identify companies that we believe are the best in class in a sector and have yet to be rewarded in market dynamics.

Does Credit Have an ESG Premium?

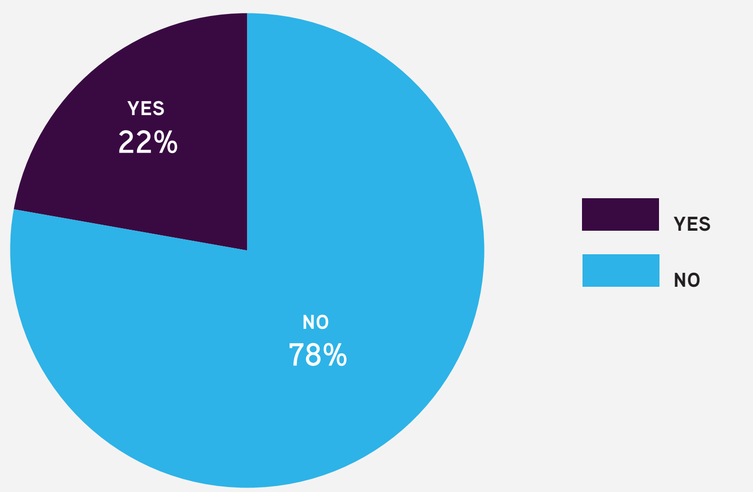
There have been numerous studies showing how investment-grade sustainable and or green bonds trade at a slight premium or slightly tighter in spread terms. However, the data we have analyzed from the leveraged credit market shows a wide range of dispersion between ESG ratings and spreads.

KKR Credit Portfolio: Disclosure Availability



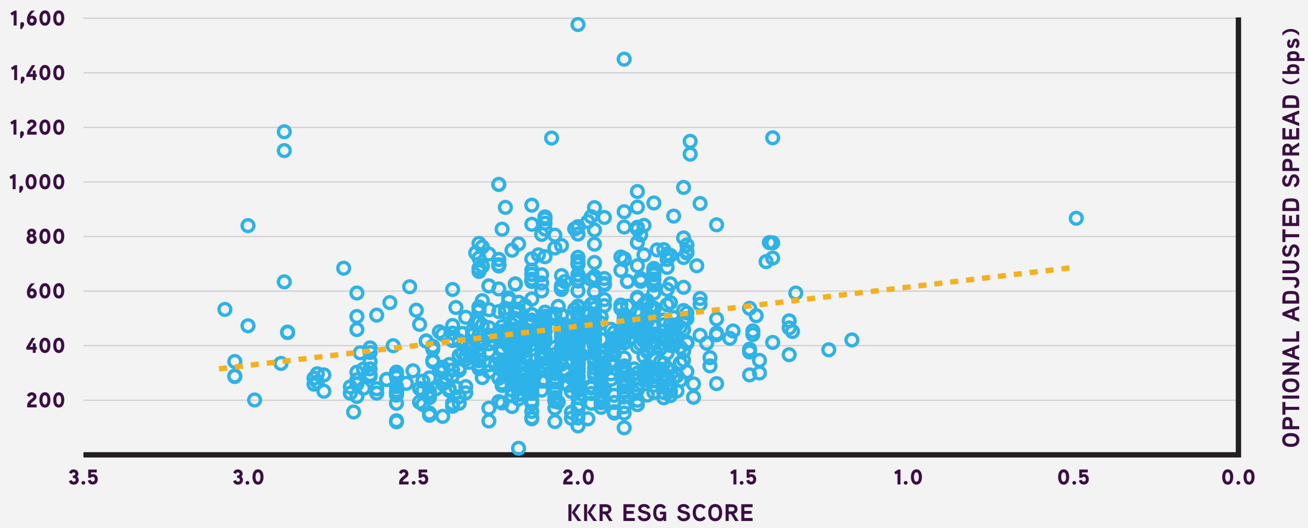
Source: KKR Credit Analysis as of March 17, 2022.

KKR Credit Portfolio: Company Engagement



Source: KKR Credit Analysis as of March 17, 2022.

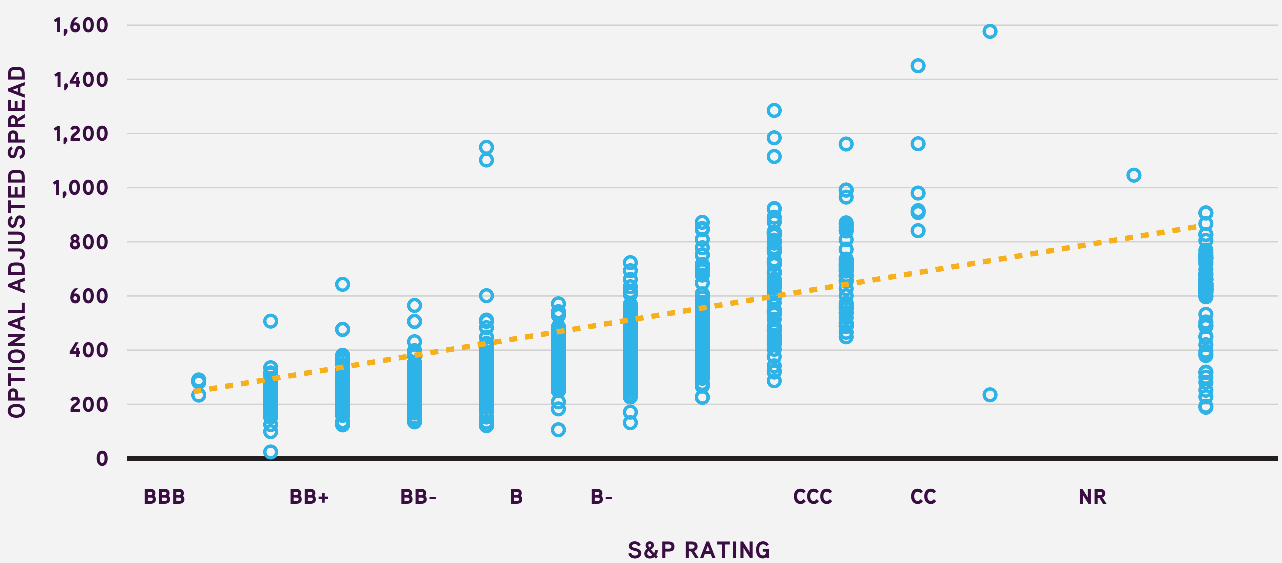
KKR Credit Portfolio: ESG Dispersion



Source: KKR Credit Analysis as of March 17, 2022. Dispersion of KKR Leveraged and Private Credit scores across universe of investments. ESG score range of 0.5–3.5 with 3.5 being the highest achievable score.

We believe as more ESG capital is raised in the Bank Loan, Private Credit and High Yield markets, the dispersion we are currently seeing in ESG scores vs. spread will begin to show a similar pattern akin to what we see with spread in credit rating agency ratings. In this scenario, the higher ESG scored credits will trade tighter and the lower rated ESG credits will trade wider. See chart below.

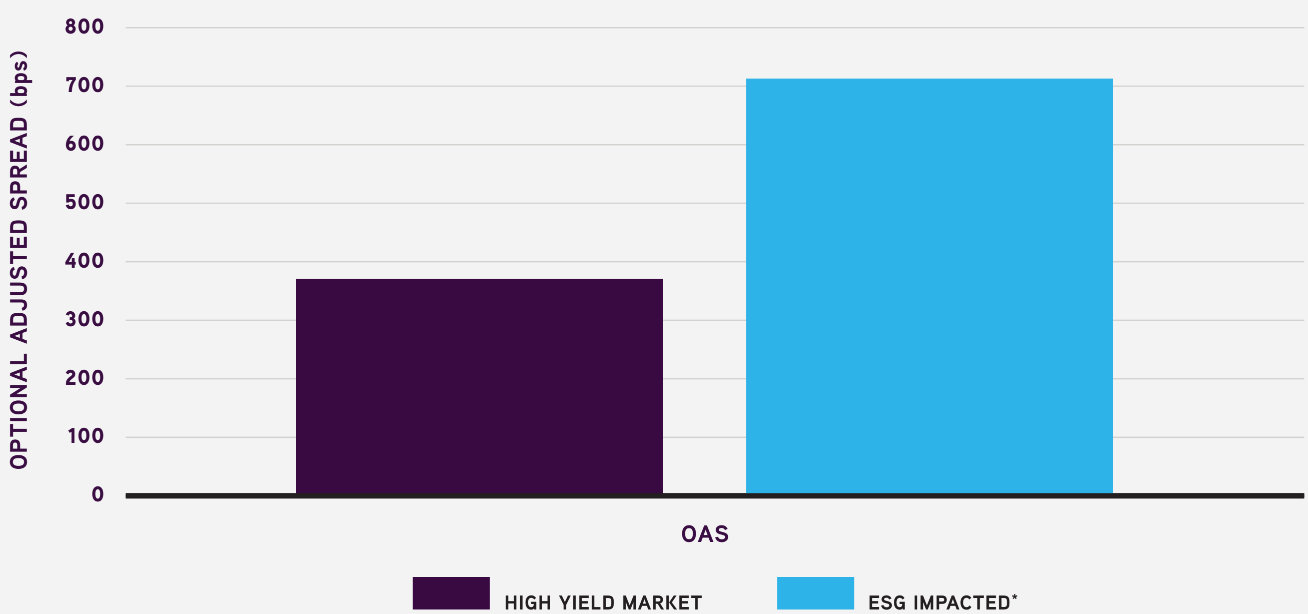
KKR Credit Portfolio: Spread to Rating



Source: S&P, BAML, KKR Credit Analysis as of March 17, 2022.

We are starting to see companies with material ESG concerns, such as those exposed to coal, oil sands, private prisons, or opioids, trade at much wider levels in the high yield market. On average these credits with material ESG concerns trade ~350bps wider than the market.

Overall HY Market vs. ESG Impacted Portion of HY Market



*Those with material ESG concerns. Source: KKR Credit Analysis as of March 17, 2022. ESG Impacted names based on KKR Credit Analysis.

We believe that investors are clearly beginning to avoid issuers with material ESG credit concerns. This has created a demand dynamic of return versus headline risk, resulting in higher spreads for more ESG controversial issuers. As the industry evolves to include a greater focus on positive factors, and as ESG disclosure and fund flows increase into this space, it is likely that an ESG premium will start to appear more clearly in the high yield market. **Indeed, we expect to see a technical shift, whereby highly rated ESG credits are rewarded with tighter spreads in the leveraged credit space. This creates opportunity for those that can be ahead of this trend.**

Conclusion

As noted earlier, we have already seen a considerable amount of dispersion across companies where those that score positively across our framework do not necessarily have the tightest credit spreads. We believe that dispersion will show a pattern to align with credit rating agencies as more sustainable and ESG capital grows in the leveraged credit and private credit markets. That said, we recognize that this will not be a change that happens overnight.

In an environment where technology has provided us a framework of constant feedback and information, we expect changes in market dynamics to happen instantaneously. Credit investing — both in public and private markets — requires significant patience as an investment. Investors commit capital to companies for five, ten, twenty plus years and, simply put, it takes time to see your principle investment returned. Similar to the broader credit environment, the transition and integration of ESG and sustainable investing will require time and patience. As investors, we commit to patience for different events not limited to integration from an acquisition, an additional quarter earnings, or how a new management team may execute. We can be patient with a company's commitment to a transformation focused on sustainability. Just as we seek to identify which companies may be accelerating in growth and revenue from a credit standpoint, our framework has expanded to more pointedly identify the companies that are accelerating to achieve more sustainable outcomes.

The ESG Credit 2.0 process is a commitment to include ESG screening, engagement, measurement, and (where possible) incentives to improve all of our investment decisions across the platform. We recognize that this is a continually evolving area with ever changing ESG performance demands and regulations. We are prepared for the journey ahead and committed to making progress, regularly critiquing, monitoring, and evolving our own approach. There will continue to be enhancements in the process as we move forward, and we are confident that our ESG management process positions us well to continue identifying ESG-related risks and to lean into opportunities where we can be an agent for change in the leveraged credit markets. How and when markets reward sustainability will take time, but we are patient and excited for the outcome. ■

1. The United Nations Sustainable Development Goals (SDGs) are the UN's blueprint to achieve a better and more sustainable future for all by 2030. https://sdgs.un.org/goals
2. KKR Global Impact Fund I pursues investment opportunities to grow and scale companies whose core business models address critical global challenges identified by the UN SDGs. KKR Global Impact Fund I had $1.3bn in total committed capital at the final close in February 2020. https://www.kkr.com/businesses/global-impact
3. Environmental Resources Management is the largest global pure play sustainability consultancy. ERM is currently a KKR PE portfolio company.
4. Source: KKR Credit Analysis as of March 17 2022. ESG Impacted names based on KKR Credit Analysis.
5. In May 2020, KKR published an enhanced Responsible Investment Policy — 'kkresg.com/assets/uploads/pdfs/KKR-Overall-RI-Policy-2020-vF.pdf,' that addresses the integration of ESG considerations across a wide range of asset classes.
6. The Sustainability Accounting Standards Board (SASB) Standards enable businesses around the world to identify, manage and communicate financially-material sustainability information to their investors. KKR has been a SASB Alliance member since 2018.
7. Consideration of the UN SDGs into our credit investment analysis involves significant judgment and may differ from another party's review of the criteria used.
8. Source: S&P LSTA as of December 31, 2021.
9. KKR Credit Analysis as of March 17, 2022. See Fig 2, 'KKR Credit Portfolio: Disclosure Availability.'
10. KKR Credit Analysis as of March 17, 2022. See Fig 3, 'KKR Credit Portfolio: Company Engagement.'
11. Per company management, as of November, 2020.

Important Information

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