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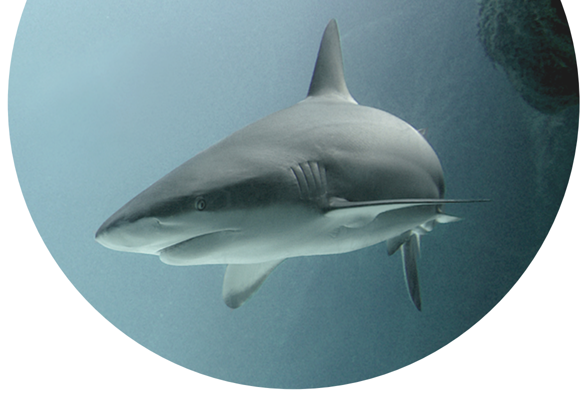


Credit Viewpoints Q1 2022

You're gonna need a bigger boat!

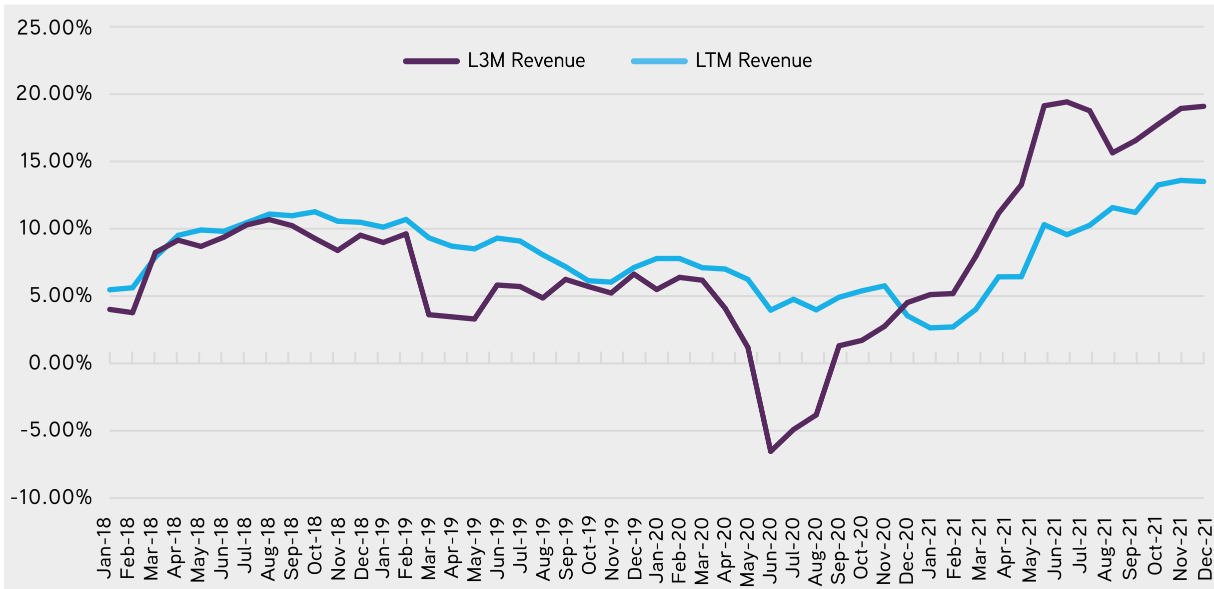
Through our recent conversations with management teams globally, we were reminded of the 1975 thriller "Jaws." In it Mayor Vaughn exclaims "We need those Summer dollars!" as he grapples with the decision to close beaches during the summer high season. After having to deal with COVID restrictions, forced business closures, Delta variant scares and now Omicron, there was a strong desire among CEOs to return to business as usual.

We examined top line growth in the nearly 300 borrowers in our global Private Credit portfolio and observed a significant increase overall. The chart below looks at trailing 12-month revenue growth over the prior period (blue line) and trailing 3-month revenue growth over prior quarter (purple line).

As we can see, there has been a welcome and sharp return of spending by businesses and consumers. Furthermore, pent up demand has started to come through in order pipelines and inventory levels are returning to more normal levels.

However, this growth is occurring at a time of unprecedented levels of coordinated global monetary stimulus. This begs the questions: "Is it really safe to jump back into the water again?" We sense the presence of an inflationary threat swimming just below the calm surface that should compel credit investors to reconsider their allocations.

Portfolio: Revenue Growth Rate %



As of December 31, 2021. Source: KKR Analysis.

In this investor letter we plan to cover three brief topics:

1. KKR's inflation view;

2. The impact of current price increases on borrowers; and

3. Why, to quote Chief Brody in Jaws, "You're gonna need a bigger boat"!

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1. KKR's Inflation View

For those seeking a more in-depth view on inflation and on implications for broader asset allocation, please see "**Same As It Ever Was?**" and "**A Different Kind of Recovery**" from our colleague Henry McVey. We use some of his charts here to support our portfolio observations but highly recommend his broader analysis.

Similar to Mayor Vaughn's belief in the film, there seems to be an acceptance among many investors that the presence of the "inflation shark" is transitory and it will soon swim quietly back into the sea. We have disagreed with this view for some time. We believe this recovery is unlike any other for several structural reasons we present below.[1] In short, we believe we are in a reflationary environment because:

1. There is a more accommodative approach to monetary policy in the U.S.;

2. Austerity is out and sustained global stimulus is in, with more of it going directly to consumers;

3. We see more input cost pressure in already-fragile supply chains; and

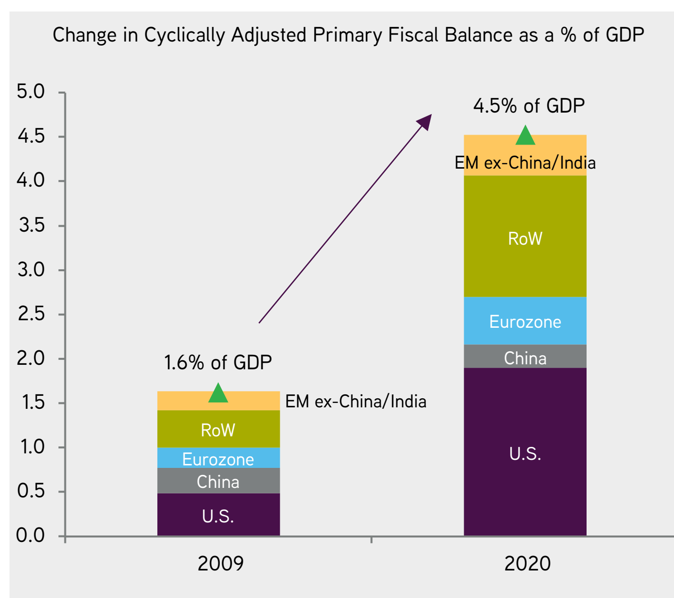
4. Lower rates mean easier financial conditions for longer.

Let's look at a couple of charts to support this view before pivoting to the impact on borrowers.

The first illustrates that fiscal spending today is about three-times as large as it was during the Global Financial Crisis which makes sense given the unique root cause of the COVID crises. We also note that more stimulus came from Western, rather than Eastern, governments. Our private credit portfolio is primarily focused on the US and Europe today (although it is growing in Asia).

More importantly this support has been directed at the consumer rather than at public investment.

The Global Response to COVID Has Ballooned Deficits by 3x Compared to the Support Provided During the GFC



Note that these are UBS estimates measuring the change in cyclically adjusted primary fiscal balance, which includes only net new measures and adjusts for the influence of the economic cycle on public finances. Data as at April 30, 2021. Source: UBS Research.

1. There are six overall but we focus on four here.

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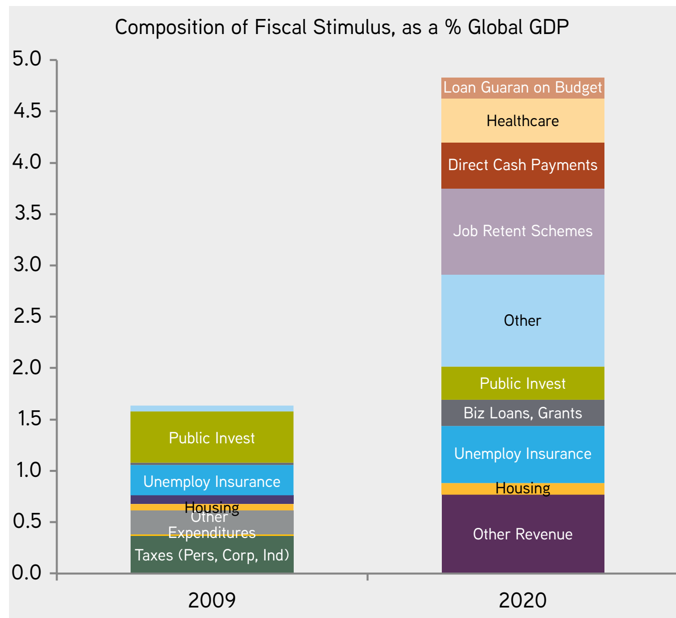
Against this backdrop it is no surprise that we have seen a rapid snapback in revenue growth for companies in our portfolio and we expect this trend to continue until stimulus spending is ended.

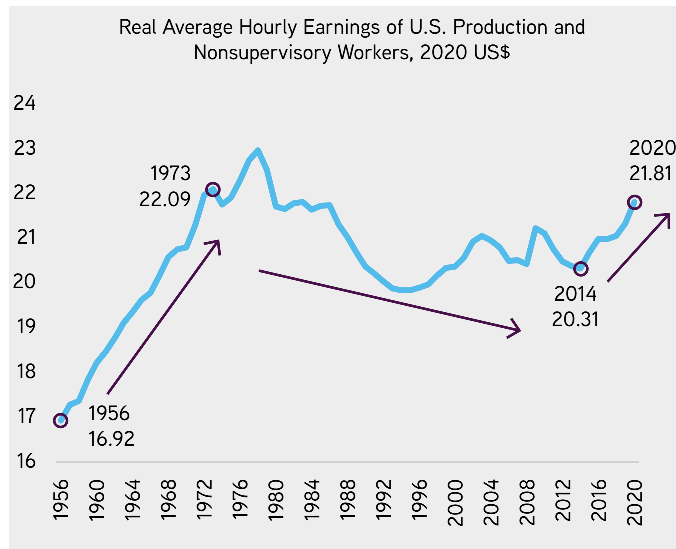
Direct Consumer Support Has Become the Focus This Crisis



Note that these are UBS estimates measuring the change in cyclically adjusted primary fiscal balance, which includes only net new measures and adjusts for the influence of the economic cycle on public finances. Data as at April 30, 2021. Source: UBS Research.

However, we are also seeing higher input prices. This is not just in commodities but also in real wages as shown in the chart at right. As we piece together this macro backdrop, let us now examine trends we observe at a micro level.

U.S. Real Wages Are Now Finally Headed Higher



Data as at May 31, 2021. Source: Census Bureau, Haver Analytics.

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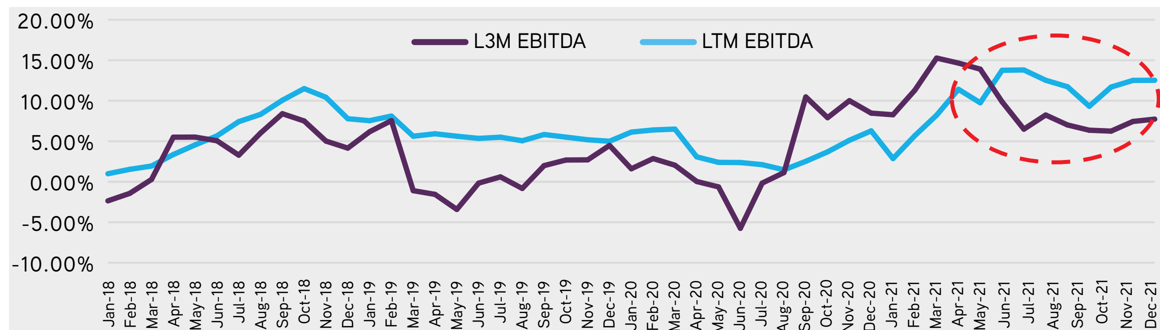
2. The impact of current price increases on borrowers

While we have already presented a chart illustrating the rapid revenue growth in our portfolio companies, in this section we focus on the impact the current macroeconomic environment is having on EBITDA margins and then, in the next section, on credit risk.

If we look at a similar trend in LTM (blue) and L3M (purple) EBITDA growth, we see what appears to be the beginnings of a slowing trend from Q3 2021 onwards in spite of the positive revenue growth profile.

Portfolio: EBITDA Growth Rate %



As of December 31, 2021. Source: KKR Analysis.

Digging into these trends by sector can give better insight into the implications for corporate borrowers.

In the table below we show the difference in EBITDA growth momentum on both a last 12-months and last 3-months basis versus prior year. We have divided the universe into sectors with a higher operating leverage and lower EBITDA margins and those with a greater ability to absorb higher input costs.

	6 Months Ago		Current		Change	
	LTM	L3M	LTM	L3M	LTM	L3M
High Cost %						
Materials	-12%	-9%	-82%	-45%	-70%	-36%
Consumer Staples	16%	19%	15%	5%	-2%	-14%
Industrials	8%	11%	20%	11%	12%	0%
Higher Cost Sector Average	**4%**	**7%**	**-16%**	**-10%**	**-20%**	**-17%**
Lower Cost %						
Consumer Discretionary	8%	21%	8%	8%	-1%	-13%
Communication Services	-29%	-4%	-38%	11%	-9%	15%
Financials	12%	12%	28%	25%	-16%	13%
Information Technology	3%	4%	7%	3%	4%	-1%
Healthcare	10%	20%	8%	4%	-2%	-16%
Lower Cost Sector Average	**1%**	**11%**	**3%**	**10%**	**2%**	**0%**
Energy	*-5%*	*-8%*	*12%*	*40%*	*17%*	*48%*

As of September 30, 2021. Source: KKR Analysis.

As we can see from the table there is a significant impact on earnings growth for all sectors but it is disproportionally impacting some. The shark is beginning to bite. Against this backdrop, we now discuss how we believe investors should respond.

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3. "You're Gonna Need A Bigger Boat!"

Let's summarise what we conclude from our analysis so far:

1. We are likely in a reflation scenario and interest rates are likely to increase;
2. There are sectoral differences in how companies are reacting to this environment; and
3. There are clearly winners and losers within sectors.

In terms of how best to respond, we recommend investors consider:

A. Floating rate debt and with a high credit premium relative to interest rate premium;
B. Preferred sectors with a demonstrable stability of cashflow generation; and
C. Businesses that have pricing power.

A. Relative Value

In terms of which boat we want to help us navigate the inflation shark infested waters, let's consider asset class first. The table below looks at current spreads on different fixed interest rate assets today. We then assume a 200bps increase in interest rates over the next five years to look at the impact on returns relative to current expectation.

We understand this is a high-level analysis, but we did want to highlight that there is little credit risk attainable in public highly rated fixed income today. The COVID crisis prompted a flight to perceived quality (i.e., investment grade and BBB debt) and we believe that these asset classes are highly susceptible to re-pricing risk if interest rates were to rise faster than expected.

Therefore, to avoid the perils of this, allocating to asset classes less reliant on price risk and more on credit could be beneficial. We believe floating rate-originated debt offers the best potential to do that today. However, within these asset classes it is imperative to find the strategies that best mitigate credit risk also to ensure optimal risk-adjusted return.

Strategy	Estimated % Fixed Rate Debt	Average Interest Rate Duration	Expected Annualized Return – Baseline	Expected Annualized Return – 200bps Rates Increase over 5 yrs
BBB Bond	100%	8.2	3.6%	0.3%
BB Bond	100%	4.7	4.7%	2.9%
B Bond	100%	3.4	5.9%	4.6%
BB Loans	0%	0.3	3.1%	3.0%
B Loans	0%	0.3	4.2%	4.1%
Originated First Lien Loan	0%	0.3	6.3%	6.2%
Originated Second Lien Loan	0%	0.3	8.6%	8.5%
Mezzanine Debt	30%	1.3	11.8%	11.3%
Asset-Based Finance	20%	1.2	14.0%	13.5%

As of December 31, 2021. Sources: S&P LCD, Bloomberg, KKR Analysis. "Expected Annualized Return — Baseline" calculated as: Current yield for traded bonds/loans (average coupon/average price or [average nominal spread + Libor]/average price for loans). Unlevered expected IRR for private assets (Originated 1L/2L, Mezzanine Debt, Asset Based Finance). "Expected Annualized Return — 200bps Rates Increase over 5yrs" calculated as "Expected Annualized return — Baseline" — 200bps/5*Duration.

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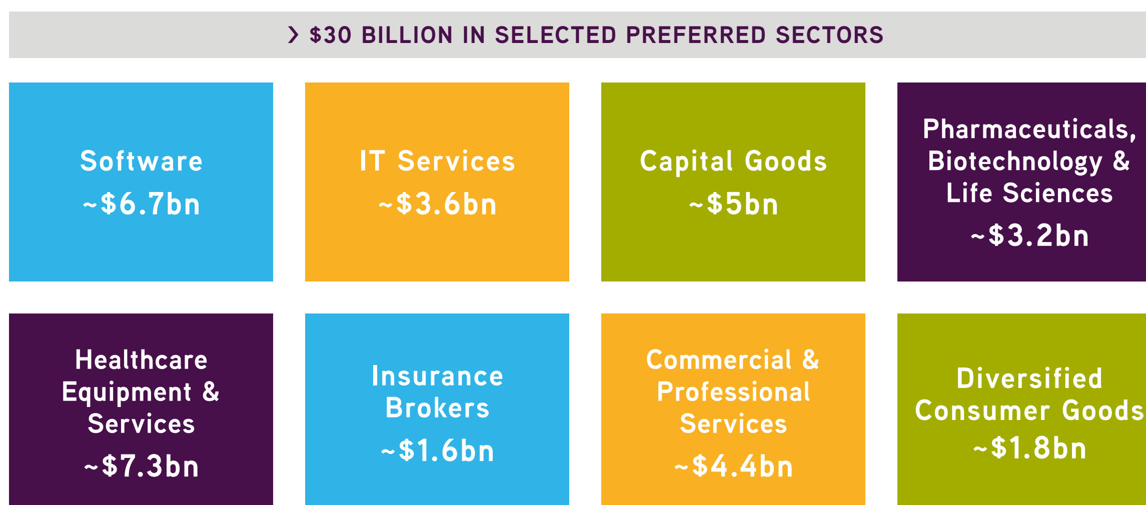
B. Focus on Stability

This brings us to where we are allocating credit today. The boxes below show our "preferred sectors" where we have allocated over $30bn of credit capital across the KKR Credit platform.



Notes: Selected Preferred Sectors. Not exhaustive. Numbers represent approximate exposure across all KKR Credit strategies as of September 30, 2021. Sectors based on GICS Industry Groups, Industries, and Sub Industries.

While there is variation in the types of businesses within these different boxes, there is a common theme.

We are cashflow volatility assessors. In order to ensure stability in our portfolio, we seek to avoid volatility in cashflow generation that may impair a company's ability to service its debt. We are strongly biased towards sectors that have high EBITDA margins and where commodity prices are not a large proportion of overall input costs.

This is part of the attraction of asset-based finance ("ABF") which is privately originated credit backed by the cash flow and security of large and diversified pools of financial and hard assets. In an inflationary environment, ABF loans typically benefit from floating rate cash flows, relatively short maturities and most important, diverse collateral — such as real estate or equipment — that can appreciate with inflation. Our positions were resilient during COVID due to downside controls we retain over lending volumes, credit profiles and temporary forbearances. Because ABF credit permeates all aspects of consumer and business economic activity, the market is enormous (we estimate $4.5 trillion, growing to $6.9 trillion over five years) and extremely diverse. Today, we are leaning into lending segments where we observe strong credit performance and robust origination volumes. On the consumer side, examples include residential housing and used auto lending while on the business side, examples include equipment and other hard asset leasing.

If we return to corporate debt and look at historical default rates by sector from Standard & Poor's, we see that sectors like consumer retail, energy and transportation with low EBITDA margins and a high operating leverage (i.e., inability to reduce costs or pass through price increases) all have higher than average default rates. Insurance, healthcare, telecommunications and IT companies all fare much better.

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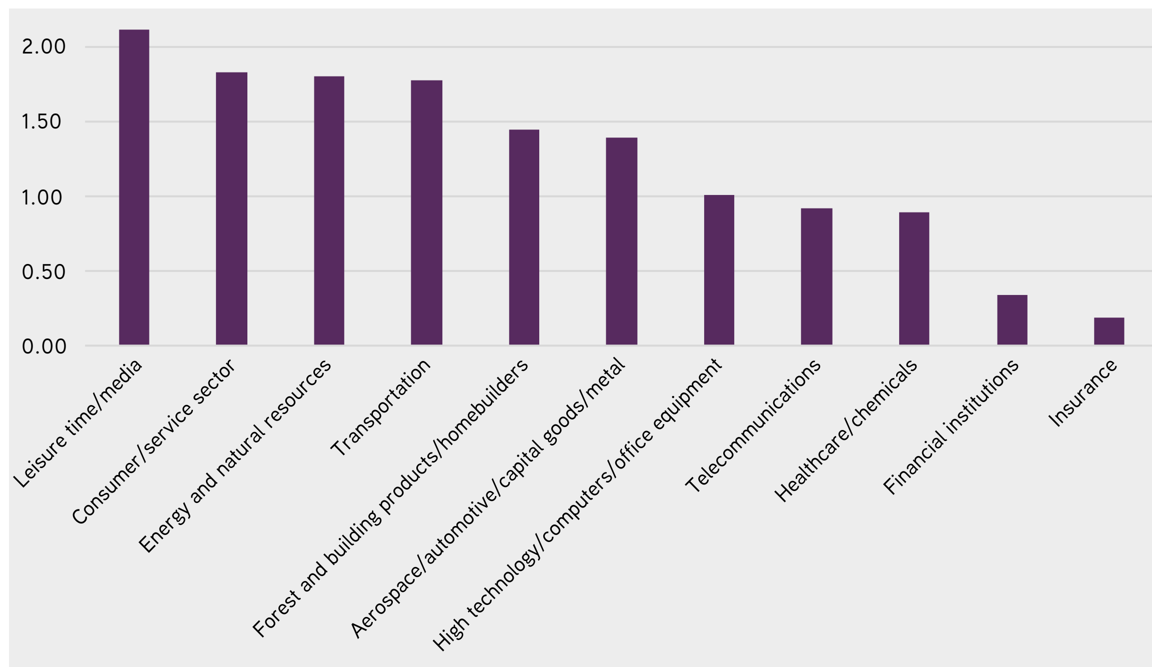
Median Default Rate by Industry (1981–2020)



Includes investment-grade and speculative-grade entities. Sources: S&P Global Ratings Research and S&P Global Market Intelligence.
Past performance is no guarantee of future results.

If we look back at the table in Section 2, we can see that input price inflation is impacting sectors like Materials and Industrials today. We are seeking to under-index deployment in these sectors and prefer to focus on those that have a proven, historical, ability to maintain EBITDA generation through different macroeconomic storms.

However, we should acknowledge that competitive pressures in any sector could impact a company's ability to respond to changing input prices. This means that we must also focus on sector dynamics and the strength of a borrower's market position.

C. Pricing Power and The Bigger Boat

It is at this point that we would like to stress that we are not quants. We do not believe the total measurement of the credit quality of a sub-investment grade credit borrower can be captured by an algorithm; nor would we rely on rating agencies. We have over 160 credit professionals at KKR because we believe in conducting detailed bottom-up research before committing our clients' capital.

However, for the purposes of illustration here, we are going to generalise: When navigating shark-infested waters bigger is usually better.

In our experience, larger companies tend to have deeper management teams and better governance, a longer history of cashflow generation and, critically in this environment, better market positions and

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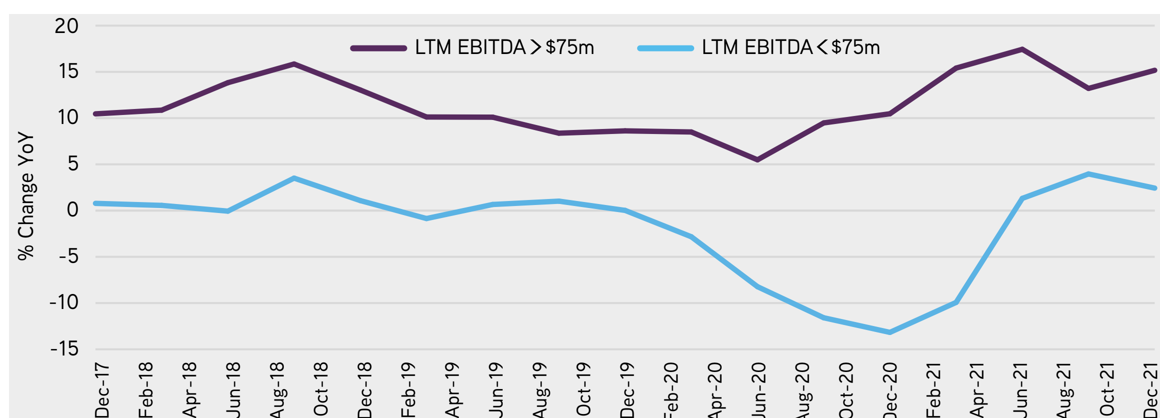
ability to pass through input price increases. So we do have a bias towards larger borrowers. If we look at our last global direct lending fund and historical mezzanine activity, the average EBITDA of borrowers was over $100 milllion.

If we look at historical trends on companies we track, we can see that larger companies have a more consistent ability to grow free cashflow. The chart below takes the average earnings growth rate of companies with LTM EBITDA of less than and greater than $75 million since the end of 2018. While it has been a volatile period from a macroeconomic perspective over that time, larger companies have maintained a positive earnings growth trend throughout. They have been able to grow their franchises, cut costs throughout the COVID crisis and deal with higher input cost. Smaller companies have not been able to do so and have seen earnings contraction over this period.

% LTM EBITDA YoY Growth By Size



As of December 31, 2021. Source: KKR Analysis. Past performance is no guarantee of future results.

Conclusion

While the shark in Jaws was on screen for only four minutes of the total running time of over two hours, its presence permeates the entire film. It does not stop the residents of Amity from playing in the water and having fun. However, when it does appear, it wreaks fear and havoc.

There is no doubt that investors are continuing to invest in credit. We are seeing continued demand for yield from a broad range of investors.

However, we are beginning to see margin pressures on our corporate portfolio and do believe we are past peak earnings for this cycle. While there is certainly no widespread fear or havoc, we do feel like Chief Brody — compelled to warn investors of the potential dangers ahead for many sectors. In order to mitigate the risks, we continue to focus on underwriting to long-term sustainable cashflows and a heavy bias towards asset based finance and large companies with pricing power in asset classes that have floating rates and high credit spreads. We feel now is the right time for everyone to find a bigger boat.

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AUTHORS:

DANIEL PIETRZAK
Partner, Co-Head of Private Credit

MATTHIEU BOULANGER
Partner, Co-Head of Private Credit

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