Fund Research

KKR Credit Income Fund (ASX: KKC)

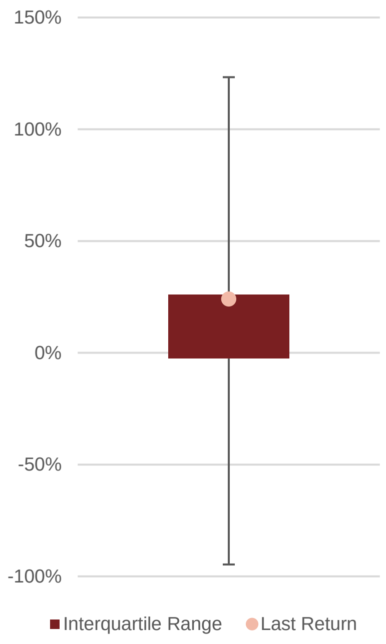
Overview

The KKR Credit Income Fund ('the Fund', ASX: KKC) is a listed investment trust (LIT, 'the Trust') that seeks to provide investors with a regular income stream plus capital appreciation over a full market cycle via exposure to a diversified underlying portfolio of global traded and private credit investments through KKR's credit platform. KKC allows retail investors to easily invest in credit investment strategies that are otherwise generally only accessible by institutional investors. Through the Fund, investors get access to KKR's US$197 billion credit platform and a strategy that is highly diversified across geography and industry. The KKR Credit team comprises ~190 experienced investment professionals around the world that also leverages the expertise across KKR's broader global network of another 530+ investment professionals.

The Trust invests in KKR's Global Credit Opportunities Fund (GCOF) and European Direct Lending (EDL) strategies. The GCOF strategy is focused on traded credits such as syndicated loans and bonds, with a particular emphasis on investing in mispriced securities. The EDL strategy concentrates on private credit investments, which are typically bilateral loans between a lender and a borrower, with no or limited syndication and no secondary market.

The investment objective of the Trust is to provide stable income with a target distribution yield of 4-6% p.a. net of fees and expenses, payable monthly in arrears and a medium-term average total return of 6-8% p.a. net of fees and expenses. However, on 27 June 2023, distribution guidance was upgraded to 8.6% p.a. which is well above the target. Given units in the Fund are in AUD and the underlying investments are offshore, the Manager utilises hedging to help manage currency risk. The Trust, GCOF, and EDL strategies all intend to use leverage exclusively for liquidity and cash management purposes, in contrast to investment purposes.

Figure 1. Monthly Returns* Box Plot



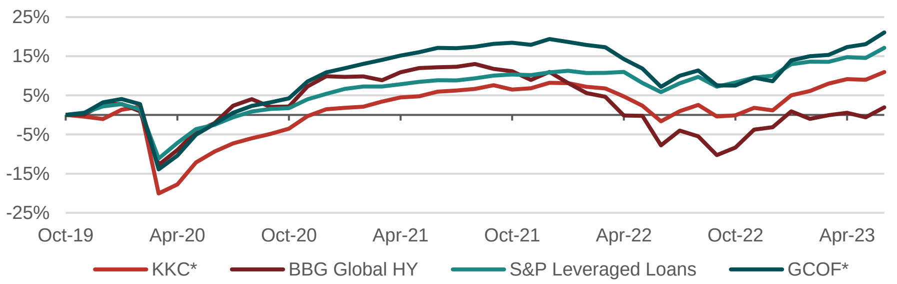
Source: BondAdviser, KKR. Annualised net monthly returns based on NTA. Since inception.

Figure 2. Monthly Net Returns* (%)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2023	3.79	1.04	1.78	1.08	-0.15	1.81							**9.35**
2022	-0.08	-0.85	-0.41	-1.91	-2.25	-3.91	2.65	1.56	-2.88	0.29	1.93	-0.63	**-6.49**
2021	0.37	0.29	1.29	1.02	0.28	1.14	0.25	0.39	0.89	-1.01	0.30	1.29	**6.50**
2020	2.43	0.75	-21.7	2.90	6.82	3.13	2.31	1.43	1.19	1.38	3.32	1.76	**5.72**
2019											-0.42	-0.65	**-1.07**

Source: BondAdviser, KKR. As at 30 June 2023.
** Return is monthly net total return based on NTA plus dividends.*

Figure 3. Relative Cumulative Performance



** Calculated from cumulative net monthly returns of the Fund, based on NTA.*
Source: BondAdviser, KKR, Bloomberg. As at 30 June 2023.

Product Assessment

Approved | Improving

Following a tumultuous period, yields in bank loans and high yield bonds are elevated and have rarely been higher. The Fund is well structured to capture these high forward return opportunities and we expect outperformance in the near-term.

KKR's Credit Income Trust provides investors with exposure to a **global portfolio** of largely **sub-investment grade credit investments**. Consequently, it has **higher expected return and risk than traditional investment grade credit products**. The Fund best suits investors looking for an attractive total return over the medium-term from a diversified portfolio of public and private credit. Whilst the Fund can provide diversification benefits through lower correlations to the domestic bond and private credit markets, it is worth noting the Fund will typically have a higher correlation to the US equity market than domestic fixed income investments given the exposure to high yield assets.

The Fund has performed exceptionally well over the past twelve months, delivering a 12.3% net return over the year to 30 June 2023. This period of strong returns has been supported by a risk-on sentiment from the broader fixed income market, as the Bloomberg CCC Index and Morningstar LTSA Global (US/EU) Leveraged Loan Index produced respective 9.4% and 12.3% returns over the same period.

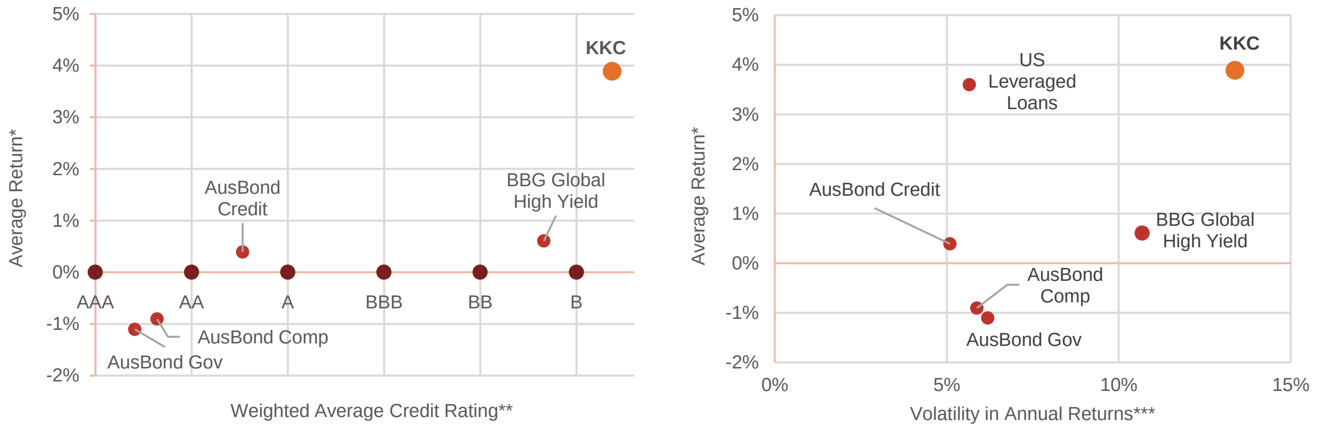
KKC's unit price has traded at a discount to NTA since the COVID pandemic, which unfortunately was only four months after the Fund was listed. In response, KKR initiated some unit price-friendly measures in 2021: **shifting to monthly distributions** from August 2021; and commencing an **on-market buy-back** in September 2021 to help narrow the unit price discount. Following $100 million in buy-backs failing to reconnect the unit price to the Fund's NAV, on 27 June 2023 KKR announced the cessation of its buy-back. In our view, $100 million is a substantial effort for a fund which had ~$925 million in market capitalisation on IPO and we commend the Manager and Trustee for its attempts that were clearly in the best interests of unitholders.

In the same announcement, a 52% increase to the monthly distribution was declared. KKC's unit price has risen 10.8% (to 14 August 2023 close) following this announcement. Additionally, KKR **has established an unlisted credit fund that is able to buy units in KKC.** This Fund is in its infancy and as such the Manager does not intend to engage in opportunistic KKC unit purchasing until it has reached a sufficient size to deal with any redemptions without potentially negatively impacting the KKC share price to meet such outflows. Although the strategy is not yet being implemented, **this is our preferred price support mechanism** and manifestation of such could see the NTA discount be reduced. The discount has narrowed from the extremes of 2020 at the height of COVID-driven uncertainty (-34.4%) to around -14.0% currently.

Exposure to the EDL strategy has risen as anticipated (43% as at 30 June 2023) and is expected to marginally increase further. While credit risk remains significant, an increased contribution from the EDL strategy will support Fund income and **reduce NTA volatility** given private assets are less subject to mark-to-market movements.

KKR have implemented appropriate changes to address previous shortcomings. When we wrote our last report, we stated that under our Research Methodology requirements, the Fund would be eligible for an upgrade to Recommended status should its performance exceed its benchmark on a rolling 24-month basis. This has not been the case with KKC producing a return of 2.33% p.a. over the 24 months to 30 June 2023, falling short of the 6-8% p.a. target. The combination of KKC's impressive past six months, the cycling out of weak performance over the next year, and our expectation of a broad fixed income market rebound in the near term, we view it likely this 24-month returns hurdle will be met at our next research update. We have comfort in the Fund's structural and governance policies being of a competent standard, resulting in there being no other factors precluding the Fund from an upgrade. Subsequently, our Outlook is maintained at **Improving**, which **denotes our expectation that the Product Assessment will be upgraded within the next 12-24 months**.

Figure 4. Estimated Risk-Adjusted Comparison (Underlying Portfolio for Weighted Average Credit Rating)



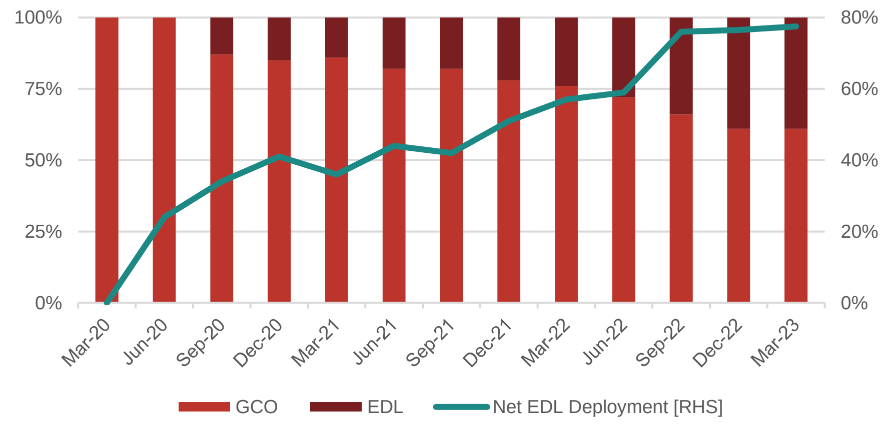
** All returns for indices calculated using annualised monthly returns since KKC's inception in November 2019. Average return for KKC based on NTA. ** Credit Ratings based on public ratings, KKR internal ratings and BondAdviser estimates. *** Calculated based on annualised monthly returns data since inception for KKC in November 2019. Source: BondAdviser, KKR, Bloomberg. As at 30 June 2023.*

Construction and Investment Process

Funds deployed into KKR's EDL strategy have increased in line with expectations to 43% of KKC's portfolio as at 30 June 2023. Deployment of the EDL allocation stands at 78% as at 31 March 2023. The EDL strategy is a key element of the Fund, providing for greater stability in the Fund's NAV and distributions given the private nature of its assets.

KKC is invested in EDL II, KKR's second closed-ended European Direct Lending Fund. The EDL II investment period ends in September 2023 and KKC has committed to EDL III, which is the successor fund. This is being done with a view of maintaining exposure to the EDL strategy as assets in EDL II enter runoff eventually.

Figure 5. Portfolio Strategy Mix



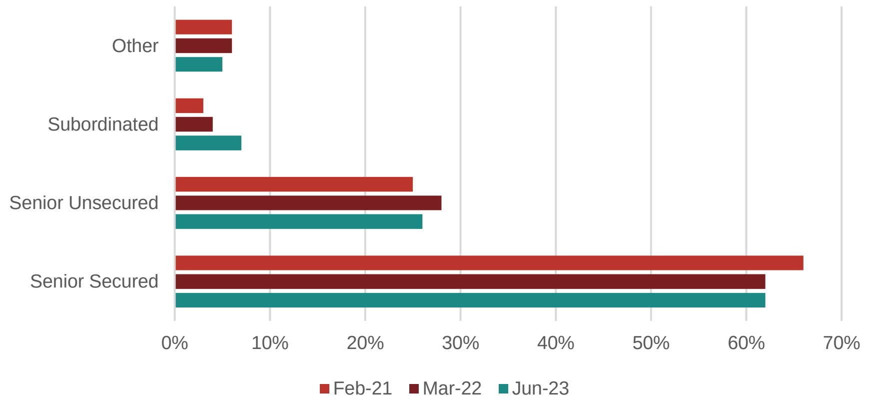
Source: BondAdviser, KKR. As at 31 March 2023.

Portfolio Risk Management

The majority of the portfolio (68%) is comprised with floating rate investments with exposure to fixed rate having been slightly reduced over time in line with the increased EDL allocation, noting all EDL assets are floating rate. This leaves the Fund less at risk from rising interest rates than the broader bond market. With a portfolio duration of 1.0 years, the Fund is still exposed to some interest rate risk, however this has been trimmed over time from 1.8 years at 30-Jun-20 and 1.4 years at 30-Jun-22. As a function of rising interest rates, global bond performance was weak from August 2021 to November 2022. Some of these losses have since been recovered, however bond prices do remain depressed from mid-2021 levels.

In undertaking analysis of the portfolio's current standing, we use the detailed holdings data provided by the Manager for each of the times we have updated research on the Fund, data as at 28-Feb-21, 31-Mar-22, and 30-Jun-23. Figure 6 provides insight into the seniority of the underlying holdings in the portfolio. Since February 2021, the exposure to senior secured ranking investments has fallen from 66% to 62% at March 2022 and held steady since. This slight reduction stems from increased exposure to EDL. The higher ranking an investment is in a company's capital stack, the higher the expected recovery in an event of default.

Figure 6. Underlying Portfolio Asset Seniority Mix - Composition Over Time



Source: BondAdviser, KKR. As at 30 June 2023.

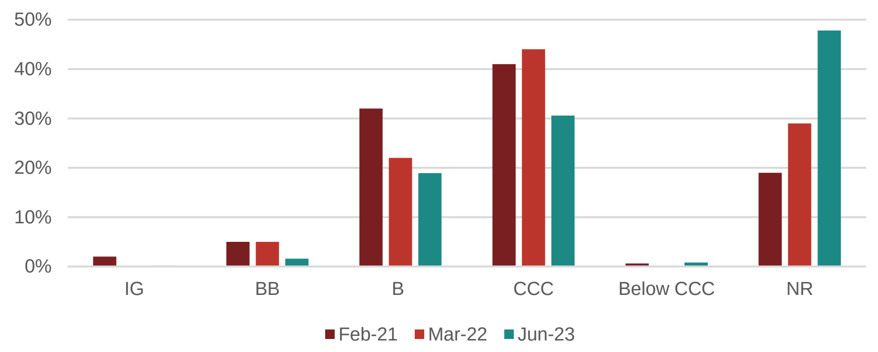
Slightly more credit negative has been the trend in the portfolio's credit rating exposure. As at Feb-21, the portfolio was 39% B-rated or above. That number has since shrunk to ~21%, with a significant uptick in unrated holdings (48% of the portfolio as at 30 June 2023). While this is a function of allocation to the EDL which invests in more unrated securities, the unknown credit quality in the midst of a broad economic downturn generates discomfort and magnifies the pressure on the Manager's ability to navigate such an environment. We view KKR favourably from this perspective as the Manager has demonstrated a strong track record of successfully investing in higher risk credits.

Moving down the credit rating ladder is ostensibly a higher risk play, however this is not of concern from our perspective given this is core to the strategy itself. The Manager emphasises a strategy of taking conviction in out of favour credits. Since the onset of COVID, the Fund has targeted severely downgraded businesses that have recovered from an earnings and capital perspective, but the credit rating is yet to rebound. As a result, the credit ratings of the Fund may not be an accurate reflection of the credit risk of the underlying portfolio companies.

The Fund is opportunistic in nature, whereby capital will be allocated to the best risk-adjusted return propositions. The long-term success of the Manager in being able to accurately identify such opportunities is illustrated by the **highly impressive returns of the KKR Credit Composite strategy** as at 30 June 2023 which is in the **1st percentile against high yield managers over the past 1, 7, and 10 years**.

However, investors should be aware of the high level of risk in these investments, especially if the Manager misidentifies the underlying's creditworthiness. This is a significant factor for investors to consider as conviction in the Fund requires conviction in KKR's credit research and valuation ability. This is because the Fund acts as a contrarian by taking long positions in what market participants are broadly classifying as poor value.

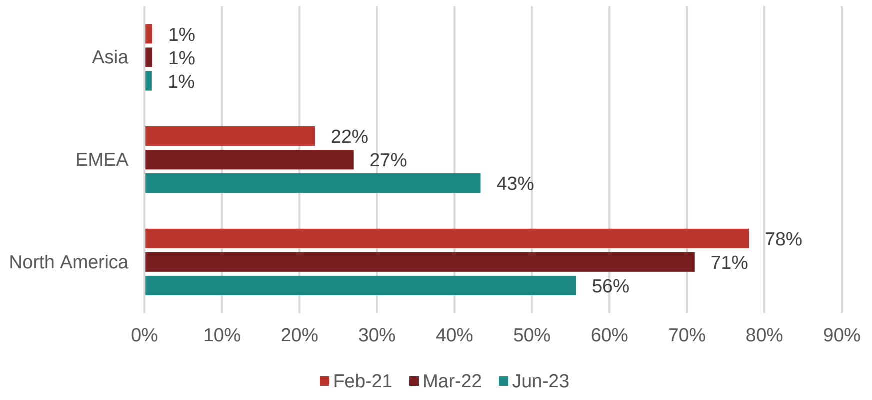
Figure 7. Underlying Portfolio Credit Rating Mix - Composition Over Time



Source: BondAdviser, KKR. As at 30 June 2023.

As deployment into the EDL continues to grow and the strategy becomes a greater portion of KKC, the previously overweight exposure to North America continues to normalise.

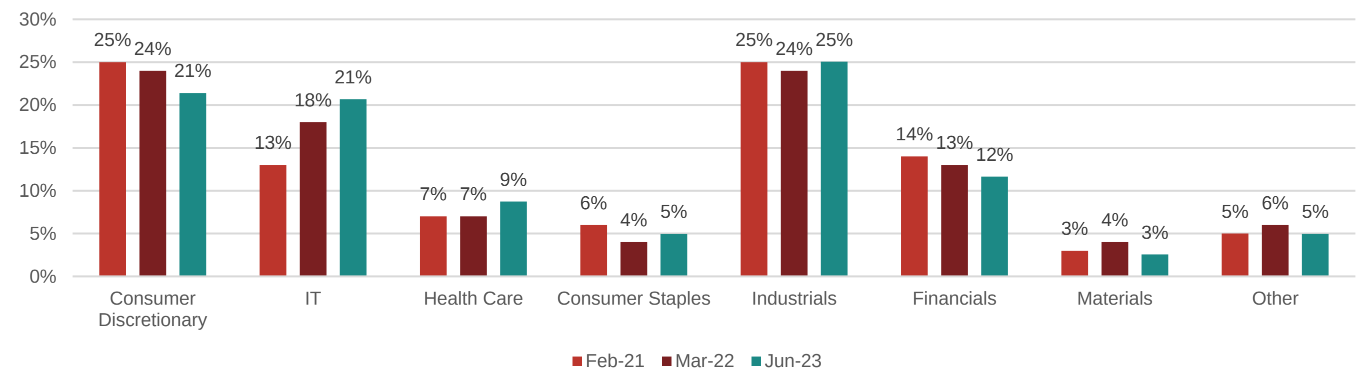
Figure 8. Underlying Portfolio Geography Mix - Composition Over Time



Source: BondAdviser, KKR. As at 30 June 2023.

The underlying sector exposures of the Fund have for the most part remained steady over time. The primary outlier here is Information Technology, which has risen from 13% at Feb-21 to 21% at Jun-23, while there has been a 4ppt reduction in Consumer Discretionary exposure over the same time frame. The Consumer Discretionary reduction is a credit positive trend considering the notable headwinds to the sector, however the exposure does remain large.

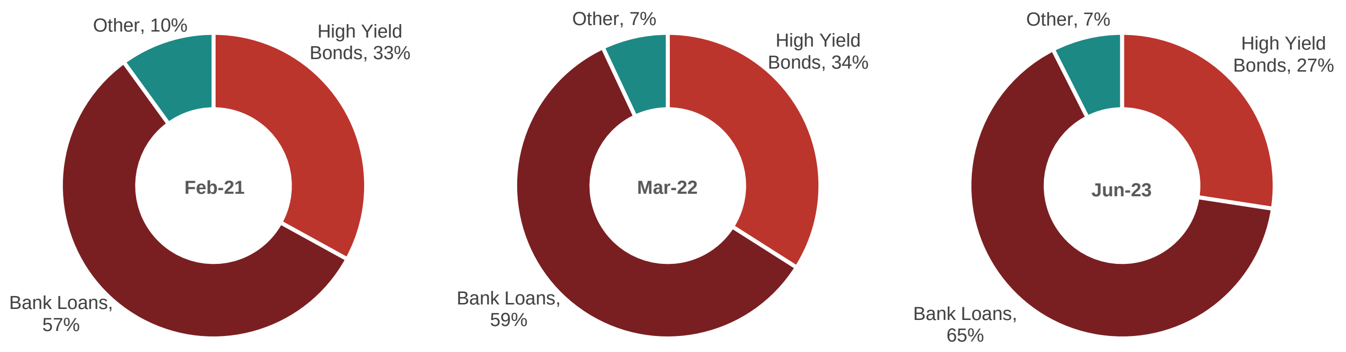
Figure 9. Underlying Portfolio Sector Mix - Composition Over Time



Source: BondAdviser, KKR. As at 30 June 2023.

The portfolio is now comprised of an increased weighting to Bank Loans versus Mar-22 levels. This shift is a reflection of increased exposure to the EDL, capturing the better compensation for risk considering how tight high yield bond spreads have become while yields in Bank Loans are near 10-year highs both in the US and EU.

Figure 10. Underlying Portfolio Asset Type Mix - Composition Over Time

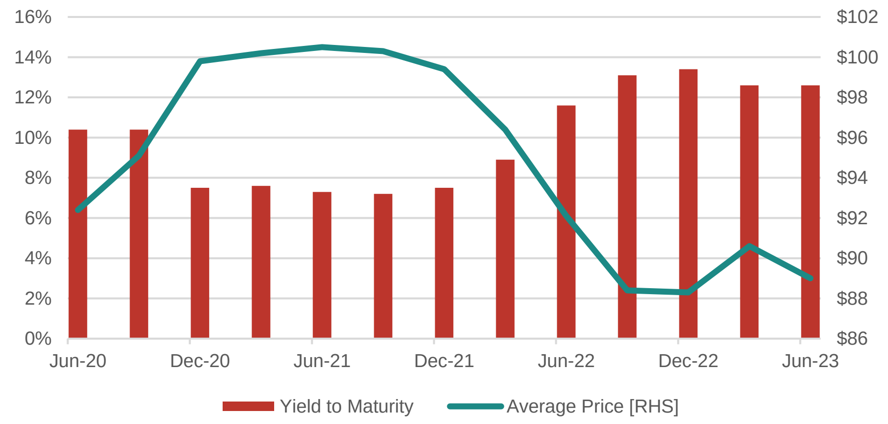


Source: BondAdviser, KKR. As at 30 June 2023.

As alluded to when discussing the general weakness in bond markets towards the end of 2021, the portfolio's average price fell sharply from $100.3 at 31 September 2021 to $88.40 just 12 months later. As goes the yield-price relationship of bonds, the sell-off has provided for attractive forward returns with the portfolio yield now at 12.6%. This is considerably higher than the portfolio yield of 7.2% at Sep-21 prior to the pricing in of higher interest rates. Although the selling that occurred due to the impacts of a high allocation to CCCs relative to the benchmark saw the portfolio underperform, we expect to see a bounce back in returns should the Manager be able to successfully navigate any potential defaults.

It is worth noting that KKR's history with defaults outperforms that of its market with a 1.3% default rate for GCOF versus 2.3% and 1.7% for the JP Morgan High Yield and Leveraged Loan Indices, respectively. Additionally, GCOF boasts an average recovery rate of 62.1% versus 37.6% and 55.4% (first lien only) for the same indices.

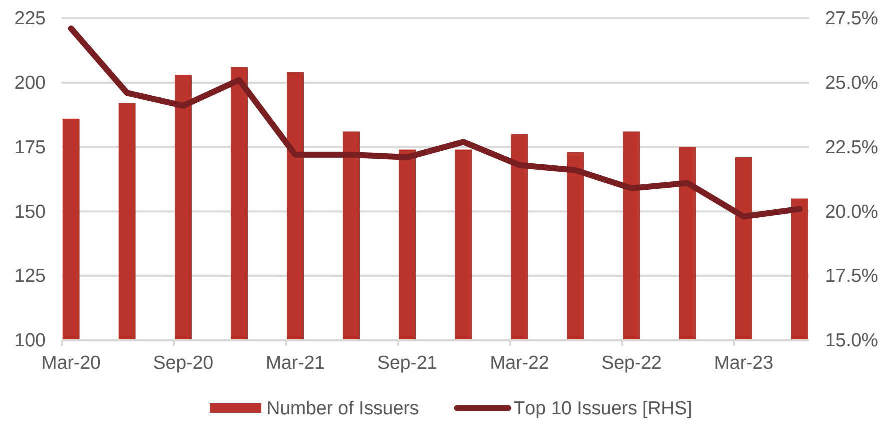
Figure 11. Portfolio Average Price and Yield - Composition Over Time



Source: BondAdviser, KKR. As at 30 June 2023.

The number of individual issuers has fallen considerably of late, from 181 at 31 September 2022 to 155 just nine months later. This is largely a function of EDL II winding down while EDL III begins to deploy capital into select names. The reduction in number of issuers increases counterparty concentration risk. This is a timing issue that we expect to be resolved in the near term. Positively, the largest 10 exposures in KKC's book are on a downtrend, which does partially offset this.

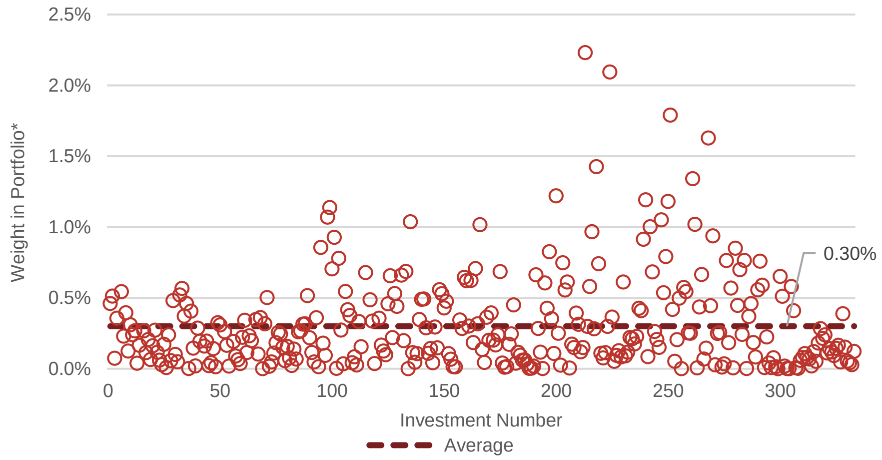
Figure 12. Portfolio Individual Issuer Exposure - Composition Over Time



Source: BondAdviser, KKR. As at 30 June 2023.

On an individual asset basis, excluding cash, the average exposure is 0.30% and the top 5 largest investments are all between 1.4% and 2.2% of the portfolio value. These five largest exposures represent 9.2% of deployed capital. Positively, each of these holdings' underlying companies operate in different sectors.

Figure 13. Individual Investment Exposure



*Source: BondAdviser, KKR. As at 30 June 2023. * Excluding cash.*

The portfolio is primarily exposed to securities with a yield in the low-teens and has a weighted average yield of 12.8%. There are a few outliers in this data (yields greater than 70%) that when excluded arrive at an average yield of 12.0% and a weighted average yield of 11.8%.

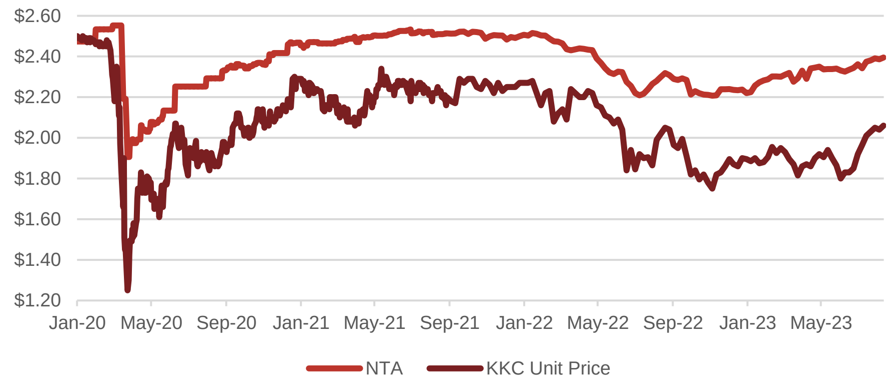
Figure 14. Individual Investment Yield

*Source: BondAdviser, KKR. As at 30 June 2023. * Excluding cash. ** Graph and average estimated yield calculation excludes five outlying assets which have yields of between 70 and 100%.*

Fund Governance

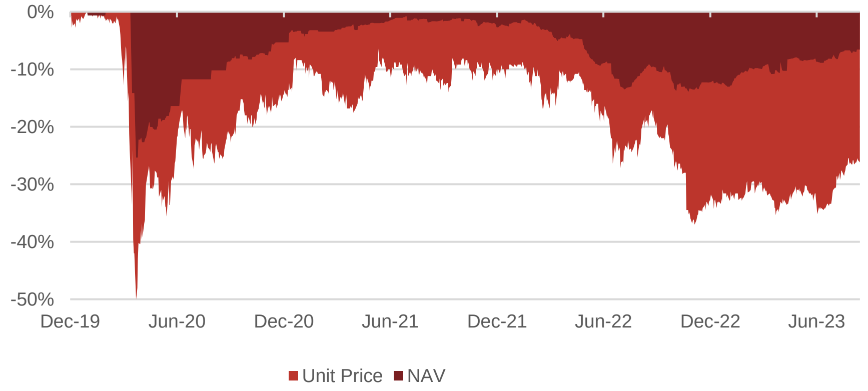
There have been **material changes** to fund governance since our last report.

Figure 15. Net Tangible Asset Against Unit Price



Source: BondAdviser, Bloomberg. As at 14 August 2023.

Figure 16. KKC Drawdown – Unit Price & NAV

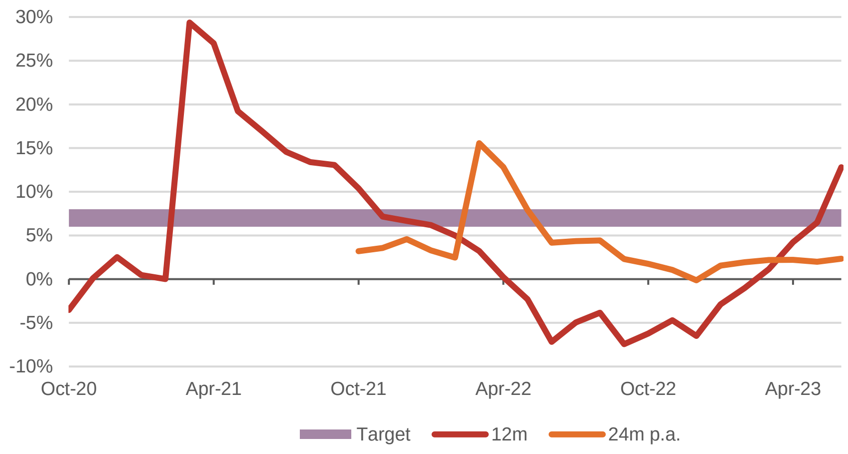


Source: BondAdviser, Bloomberg. As at 14 August 2023. ***Drawdowns are on a daily basis****, noting that differing periodicities will result in differing drawdown values.*

On 27 June 2023, the Manager announced the cessation of its on-market buy-back which started on 29 September 2021. Over the 22 months, a total of $100.4 million worth of KKC units were bought at a discount to the NAV. This represents 10.8% of the Fund's market capitalisation as at 27 September 2021 ($933.9 million, before the commencement of the buyback). We typically view a buy-back policy as positive for unitholders as it provides a form of support in preventing the unit price falling unreasonably. That said, such a function only occurs when the buy-back results in meaningful reaction from the market. This was not the result for KKC as is evidenced by the significant expenditure being met with little reward as the disconnect to NAV remained.

In conjunction with the end of the buy-back, the same announcement was used to inform investors of a 52% increase in the targeted distribution from 1.10 cents per unit (cpu) to 1.67cpu. Following the announcement, volumes traded in the Fund spiked while the unit price rose from $1.85 prior to the announcement to $1.92 on 30 June 2023. This positive momentum has continued to date with the unit price at $2.05 as at 14 August 2023 close.

Figure 17. Rolling Net Returns – Target Return Comparison



Source: BondAdviser, KKR. As at 30 June 2023. Net compounded monthly returns.

The Fund aims to deliver a total net return over the medium-term of 6-8% p.a. Whilst performance has been stellar over the past 12 months, the annualised past 24-month return has been well below the medium-term target, at 2.33% p.a. as at 30 June 2023.

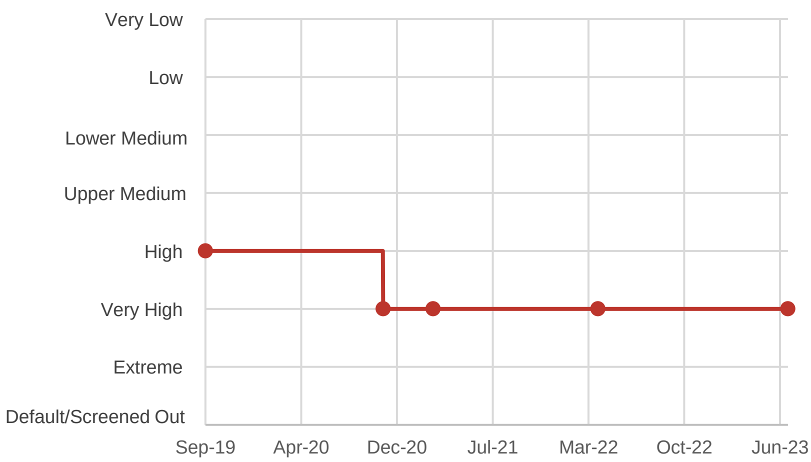
Quantitative Analysis

The underlying portfolio performs **exceptionally well under benign economic conditions**, where credit downgrades are few and recovery rates are higher – this is especially pertinent for funds with significant sub-investment grade exposure. Expected returns based on our modelling have also shifted higher since our last report in 2022, which has largely been a result of elevated risk-free rates.

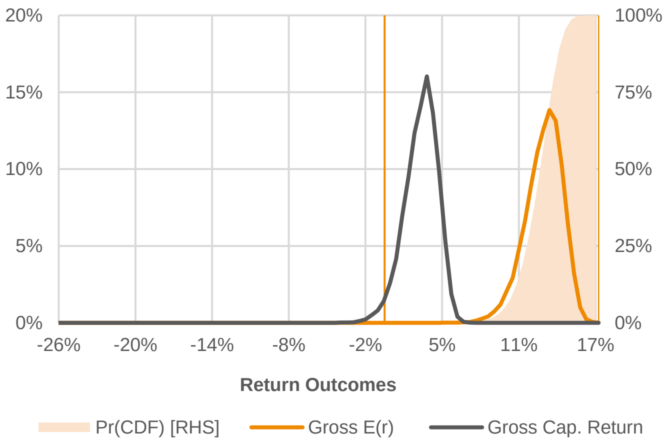
In goldilocks-like 2018 conditions, our modelling amounts to a 12.19% (March 2022: 8.35%) average return, with a 99% VaR of 8.41% (March 2022: 6.02%), implying 99% of simulations produce returns above 8.41% under benign credit default conditions. **It is important to note that such a high average return is dependent on favourable forward economic conditions** and is in part driven by higher underlying asset yields (resultant from a material sell-off over 2022). Further, given a significant proportion of assets are CCC and B-rated, our simulations incorporate significant roll yield given the steepness of high yield curves, which is even more pronounced at the longer-end of the curve.

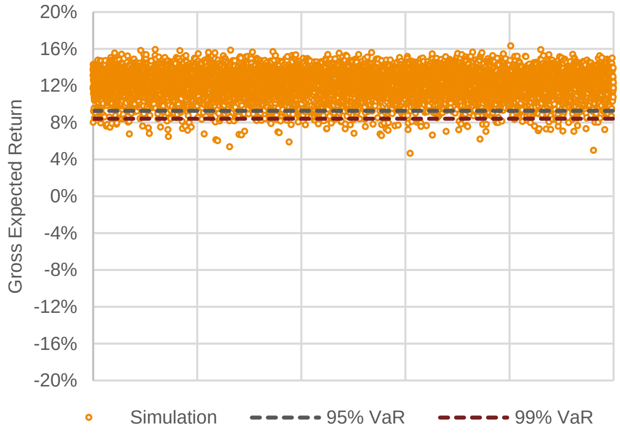
Under extreme stress (i.e., GFC-like conditions), our modelling suggests that the portfolio would perform poorly. Despite the majority of the portfolio being senior secured, such significant levels at the weaker end of the spectrum of high yield (CCC and B) face a higher risk of default – putting downwards pressure on returns. Additionally, a large portion (~40% by our estimates) of the portfolio are unrated syndicated loans, which according to the loans' pricing, yield, and term, we estimate are also on the lower end of the high yield spectrum. Based on our modelling, the simulated outcome in a distressed environment results in a 99% VaR of -12.52% (March 2022: -8.47%), with an average simulated return of -5.51% (March 2022: -4.06%) across 10,000 simulations. These results are worse than in our previous assessment due to the increased weighting to lower-rated credits. It is also worth noting that whilst losses are prevalent in our modelling, given the secured nature of the majority of assets and diversification on a single asset basis, our modelling does not show extreme downside losses (i.e., in excess of 30% as would be the case with low recovery rates). Using internal pricing assumptions due to such a large portion of the portfolio being unrated, the weighted average credit rating of the portfolio is within the "**B**" band. This is confirmed by the modelled results in Scenario 1 and 2, resulting in the Fund's Risk Score being maintained at "**Very High**".

Figure 18. Risk Score



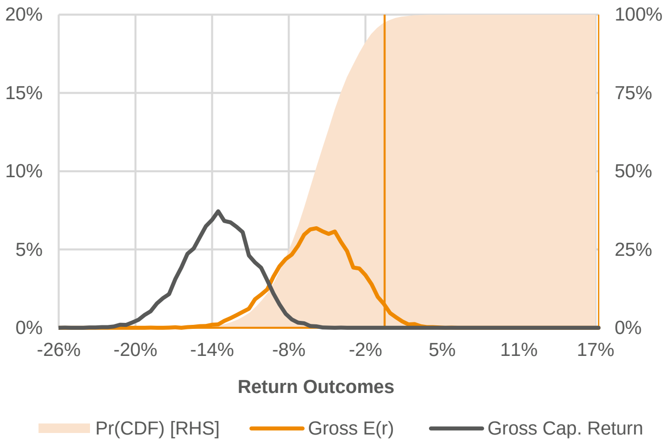
Scenario 1. Baseline Asset Assessment

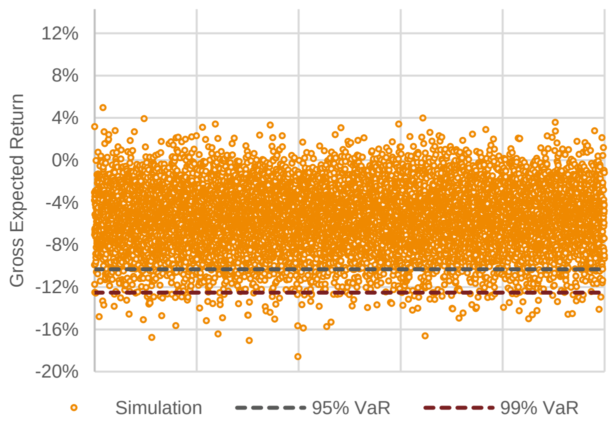




Source: BondAdviser Estimates as of 31 March 2023 portfolio. Excludes impact of management and origination fees. Gross capital returns excludes the value of coupons/income and is only modelling impairment or loss given default, based on historical credit data from Moody's. Impact of traded price is not simulated. For a more detailed explanation of the methodology, please contact BondAdviser.

Scenario 2. Stressed Asset Assessment





Source: BondAdviser Estimates as of 31 March 2023 portfolio. Excludes impact of management and origination fees. Gross capital returns excludes the value of coupons/income and is only modelling impairment or loss given default, based on historical credit data from Moody's. Impact of traded price is not simulated.

Reporting History

KKC Update Report – 26 April 2022

KKC Update Report – 1 April 2021

KKC Update Report – 20 November 2020

KKC Initial Report – 18 September 2019

European Direct Lending Primer – 18 September 2019

Alternative Investment Fund Research Methodology

Click here to view

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Report created on 14 August 2023.