Fund Research

KKR Credit Income Fund (ASX: KKC)

Contents

Overview

The KKR Credit Income Fund ('the Fund', 'KKC') is a listed income trust (LIT, 'the Trust') designed to provide investors with access to high income generating credit investment ideas globally through KKR Credit's product suite. The Trust will incorporate a blend of KKR's existing traded credit and private credit capabilities through the firm's Global Credit Opportunities Fund (GCOF) and European Direct Lending (EDL) strategies. Through the Trust, investors gain exposure to KKR's $72 billion credit platform and a strategy highly diversified across geography, sector and credit quality. The KKR Credit team consists of 130 dedicated investment professionals around the world who are supported by KKR's global network of 480 investment professionals, utilising a "One Firm Approach" that allows KKR to leverage the best insights from across the firm to benefit its clients.

The investment objective of the Trust is to provide stable income with a target distribution of 4-6% p.a. net of fees and expenses, payable quarterly and an average total return of 6-8% p.a. net of fees and expenses. The Trust aims to provide investors with attractive, risk-adjusted returns and access to a diversified portfolio of income generating alternative credit investments through existing KKR funds. As all investments are made outside of Australia, the manager intends to hedge currency risk back to AUD. We also note that although neither the GCOF nor EDL strategies employ leverage for investment, it is used for cash management purposes.

Key Characteristics			
NTA per Unit ^	$2.33	**BondAdviser Risk Score**	Very High
Price^	$2.01	**Product Assessment**	Approved
Net Asset Value^	$859 million	**Outlook / Asset Classification**	Stable / Level 2
Fixed / Floating	Both	**Structure**	Listed Investment Trust
Frequency	Quarterly	**Sub-Asset Class**	Credit
Target Net Return	6.0 - 8.0%	**Responsible Entity**	Trust Company (RE Services) Limited
Benchmark	N/A	**Administrator / Custodian**	JPMorgan Chase Bank
Inception Total Net Return p.a.^,*	-4.74%	**Auditor**	Deloitte
Mgmt Fee / Perf. Fee*****	0.902% / 5.125%	**ASX Code**	KKC

*^ As at 30 September 2020. * Based on NTA returns compounded plus sum of distributions** % of NAV calculated and accrued monthly. Includes 0.88% based mgmt. fee and 0.022% for the the net amount of GST. *** Performance Fee equals 5.125% of the net annualised return for a Performance Period, multiplied by the adjusted NAV, only when net annualised return exceeds RBA cash rate + 4.0% p.a.*

Product Assessment

Approved

KKR's Credit Income Trust (KKC) provides investors with largely sub-investment grade exposure to global credit opportunities. Accordingly, there is a higher amount of return and risk than traditional investment grade products.

KKC is supported by one of the most highly respected private-markets asset managers in the world.

This product is best suited for investors looking to generate an **attractive total return** from a **diversified portfolio of public debt and private loans**. We expect the product will exhibit a low long-term correlation to traditional asset classes, making it a suitable diversifier to retail investor income portfolios, which are typically biased towards domestically sourced, equity-based and/or hybrid income streams. Our basis for recommendation on KKC is a blend of both subjective and objective analysis of the underlying portfolio and the manager's background, experience, analytical capability and proven track record in managing various credit strategies.

A Listed Investment Trust (LIT) structure derives unit holder returns from two sources: distributions and capital returns from the underlying portfolio and share price movements, which drive the prevailing premium/discount to Net Tangible Assets (NTA).

We have been disappointed with KKC's performance since inception in November 2019, both in terms of capital and income performance. Given the sub-investment grade exposure, the strategy was not ideally positioned heading into COVID, but ultimately the NAV fell in-line with US high yield and loan indices. Post the significant sell-off in March **the Fund has recovered well**. However, the Fund has been subject to:

KKR possesses a highly experienced and talented team with deep industry relationships to execute upon the strategy and generate robust returns.

1.) The performance of the traded price was particularly distressing, with investors losing confidence in the product, which we attribute to both margin and fear driven selling.

2.) KKC has remained out of favour from a NTA discount perspective since the upsized IPO in November 2019. We view the buy-back activities (up to 10% of issued units) positively, though note we expect to see less action here, as the internal focus pivots to consistency of income distributions. With fewer outstanding units (less supply and price support), we would expect to see some narrowing of the discount to NTA. However, we ultimately believe that the NTA discount will lessen more considerably, should we start to see more stability in distributions – which we view as likely under the new structure. This is because the product becomes more attractive from an income perspective in an all-time low rates environment.

3.) **Failures to accurately hedge the foreign currency risk has dented confidence and returns**. In March, asset values had declined, resulting in the Fund being materially over-hedged. In attempting to mitigate the risk of the over-hedge, a decision was made to realise derivative losses. This impact is now largely responsible for the differential between initial NTA and current NTA. Going forward, an increased number of hedge counterparties, lower theta (time to expiry) and reduced € obligations for EDL ramp-up should stabilise the hedge book.

Portfolio risk is actively managed through a highly diversified strategy at an asset, strategy and geography level. We believe that KKR possess a **highly experienced and talented team with deep industry relationships to execute upon the strategy and generate robust returns**, albeit with a sizeable hiccup in 1H20.

KKC is supported by one of the most highly respected private-markets asset managers in the world. The optics of continued underperformance of the Trust will be damaging to KKR's reputation in the largely untapped Australian market. Given such, **we remain confident**, especially with the ramp-up of the EDL portfolio, that **KKR will deliver in its objective of providing an income orientated, high-yielding product.**

Investment Strategy

The Fund is designed to provide investors with exposure to high income generating global credit investments which seeks to capitalise on attractive opportunities identified by KKR's global network. These **borrowers are typically higher risk or non-investment grade**, allowing KKR to **generate attractive returns** whilst minimising downside risk through individual credit assessment and loan structuring. The Trust does this through investments in to KKR's Global Credit Opportunities Fund (GCOF) and European Direct Lending Fund (EDL). As these are two funds, and their corresponding strategies are fundamentally distinct and vary significantly from one another, we have elected to analyse each strategy separately.

The Trust gains its exposure to GCOF by investing in a Profit Participating Note issued by the Global Credit Opportunities Feeder Fund, which will then invest in GCOF. This will give the Trust substantially the same financial benefits as would a direct investment.

The Trust will gain exposure to EDL through a direct investment. KKC currently has a minority exposure to the EDL strategy (<20%), however, this is expected to ramp up over the life of the Trust, particularly into 2021.

KKC Restructure – Asset Transfer *(Withdrawal in Specie)*

In October 2020, KKC announced it has sought and obtained a waiver from the ASX to enable it to restructure its investments in GCOF. This is a significant change to the structure but not to the underlying exposure. In essence, the GCOF interest will be sold and replaced with the underlying securities of GCOF. In holding GCOF's underlying assets, as compared to units of a fund, KKC will positively be able to (1) procure more favourable financing on its liquidity facility and hedging costs, (2) potentially increase the frequency of distributions and (3) allow for more flexibility in deploying a buy-back. The mechanics of this restructure are complex, however, economic exposure to GCOF will remain unchanged.

Global Credit Opportunities Fund L.P. (GCOF)

GCOF was launched in May 2008 and is KKR's flagship strategy in traded credit; offering a diversified portfolio of loans, high yield bonds, opportunistic credit, and structured products. These investments are made predominantly in US domiciled sub-investment grade companies. The strategy currently has US$3.1bn AUM, with GCOF comprising US$2.0bn (as at 30 September 2020).

The Fund employs a strategy focused on a concentrated number of investments in high quality, diversified enterprises in which KKR has expertise. This unconstrained strategy, distinct from a strategy which seeks to replicate a broader credit index, enables the Fund to create a portfolio of 60-80 core positions which generate the majority of returns and insulate the portfolio from idiosyncratic risk. However, the correlation of assets simultaneously presents risks in times of focused deterioration as we have seen in 2020.

European Direct Lending (EDL)

The EDL strategy aims to provide senior secured capital to established upper-middle market European domiciled companies in stable industries. The strategy focuses on first lien senior secured investments, targeting companies with an EBITDA between €50m-€100m and an enterprise value of €250m-€1.5bn. The Fund seeks to provide highly negotiated and customised lending through tailored credit and deal structures with tailored covenants and flexible terms. This enables the Fund to deliver attractive returns with significant structural protections, as well as provide long term growth partnerships, as opposed to transaction-based relationships, with its borrowers.

Compared to mark-to-market fluctuations of traded assets in GCOF, we expect the net asset valuation in EDL to be far more stable – a function of the periodic valuations in non-traded assets.

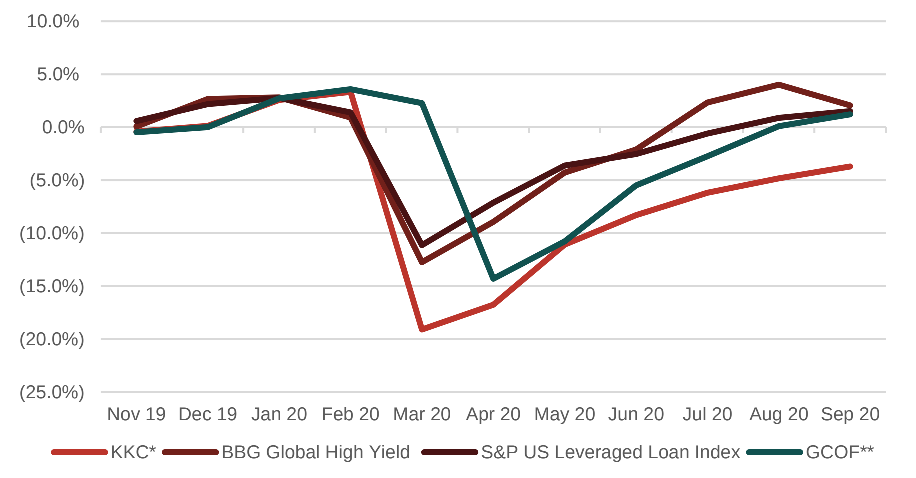
Performance & Composition

Since inception, the performance of the Trust has been weak because of a broad market sell-off due to COVID-19. The net return based on NTA for March was -21.7% (incl. a distribution of 0.2%). The volatility and uncertainty driven by the pandemic drove significant declines in the value of the high yield bond market and broader loan market, which had a significant impact on the mark-to-market pricing of the GCOF portfolio. Although the March result was concerning and disappointing, it was triggered by an unprecedented and unexpected shock to financial markets.

The Trust's positive performance since March lows supports our view that the Manager will be able to return the Trust to target return levels over the long term. In addition, we expect to see consistency of income going forward as the portfolio stabilises and problems with the hedging book subside. Notably, we expect the below target distribution paid in March 2020 to be an ex-ante outlier. This is not only because of the fact that the severe market volatility meant that the manager thought it prudent to maintain a cash balance within KKC to assist any short-term liquidity requirements, but also because the dividend received (interest income) from GCOF was for the period between 21 Novembers 2019 to 31 December 2019 only.

In the 3 months to 31 August 2020 the Trust delivered a total net return of 6.97% as markets, particularly high yield bonds and senior loans, recovered. As the Trust ramps up its exposure to the EDL strategy, which will occur through redemptions in the GCOF strategy, the portfolio will gain significant diversification benefits, especially during periods of market volatility, given the nature of private credit means that they are less exposed to mark-to-market fluctuations in broader financial markets, albeit the traded unit price may not reflect this as we have seen in other private debt trusts this year.

Figure 1. Relative Cumulative Performance



Source: BondAdviser, KKR, Bloomberg. As at 30 September 2020
**KKC Calculated based on composite monthly net total return (incl. distributions).*
*** GCOF Calculated based on composite monthly net total return (inc. distributions).*

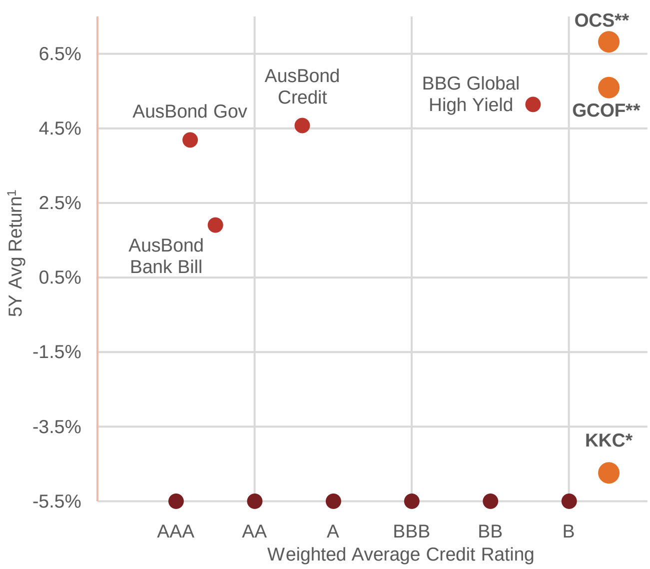
Figure 2. Monthly Net Total Returns* (%)

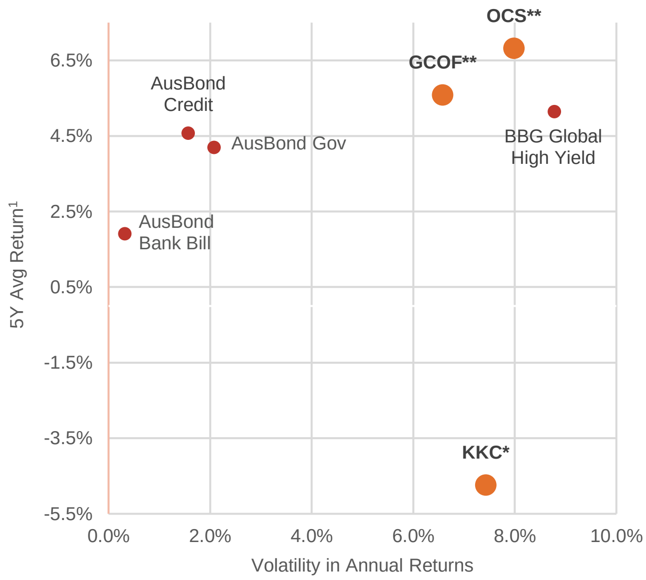
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2020	2.43	0.75	-21.7	2.90	6.82	3.13	2.31	1.43	1.19				**-0.76**
2019											-0.42	-0.65	**-1.07**

Source: BondAdviser, KKR.
** Return is monthly net total return based on NTA plus dividends.*

KKC has seen an improvement to its traded unit-pricing since March and has recovered a considerable portion of the discount to NTA; although it remains well below par (~14% discount at 31 August 2020). Although we expect the discount between trading price and NTA to remain for at least the short-term, we see no rational reason for further deterioration in the discount and rather, especially if the Manager continues to support better pricing through its buy-back of issued units.

Figure 3. Risk-Adjusted Comparison





*[1] Calculated using average annualised returns. *Calculated using total net returns since inception.*
*** Calculated since inception in February 2015 to 30 September 2020 with a weighted average credit rating equal to KKC.*
Source: BondAdviser Estimates, KKR, Bloomberg. As at 30 September 2020. OSC – Opportunistic Credit Composite which is managed to the same mandate as GCOF.

The March underperformance means that the Trust, on a risk-adjusted return (based on NTA) basis measures poorly relative to key investment alternatives which are presented on long-term (5 year) performance. On a credit risk basis, the Trust's weighted average credit rating of B is riskier compared to the major investment grade credit indices and slightly worse than the BB Global High Yield Index, however this is largely a function of the Trust's material non-rated holdings, which drags on the weighted average rating. Despite the lack of an external rating, the Manager thoroughly assesses these investments to gain a deep understanding of their credit profile. And as such we are confident in the additional credit rating risk which the Trust holds.

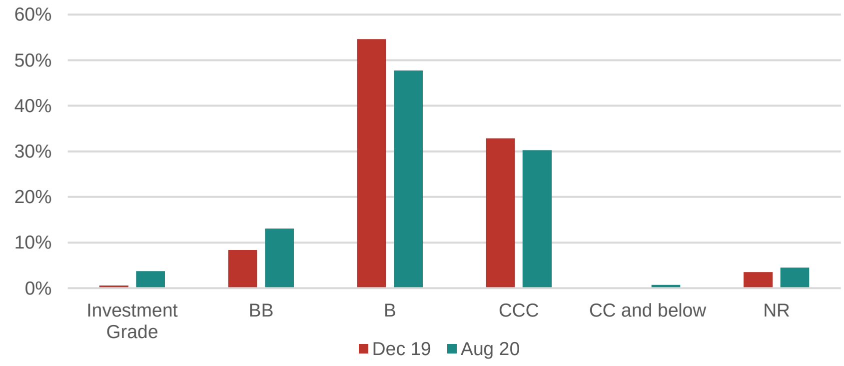
Given the short-term trading history of KKC and the material impact of the March 2020 selloff, we do not view Figure 3 as an accurate representation of our risk return expectations for KKC. For this reason, we have included the independent performance of GCOF and KKR's Opportunistic Credit Composite (OCS), which is a grouping of funds and accounts managed to the same strategy as the GCOF.

Although we only utilise returns over the past five years, the inception of OCS was in 2008, across which is has averaged a net annualised monthly return of around 10%. For GCOF, since inception in 2015, the Fund has averaged a net annualised monthly return of around 6%. Without the predominance of the COVID period, both proxies present materially better than KKC on a volatility in annual returns basis.

We view the OCS and GCOF data points in Figure 3 as a more accurate representation of our long-term risk return expectations for the GCOF portion of KKC.

The Trust's composition remains fundamentally sound and diversified across all major metrics. As illustrated in Figure 4, the Trust's credit rating profile remains stable despite the period of significant volatility during the COVID crisis. The rating profile has flattened marginally since December 2019, with increased holdings in the tails (both investment grade, BB and non-rated) at the expense of lower holdings in the middle (B/CCC). However, the **core of the portfolio remains in B (47%) and CCC (30%) assets**.

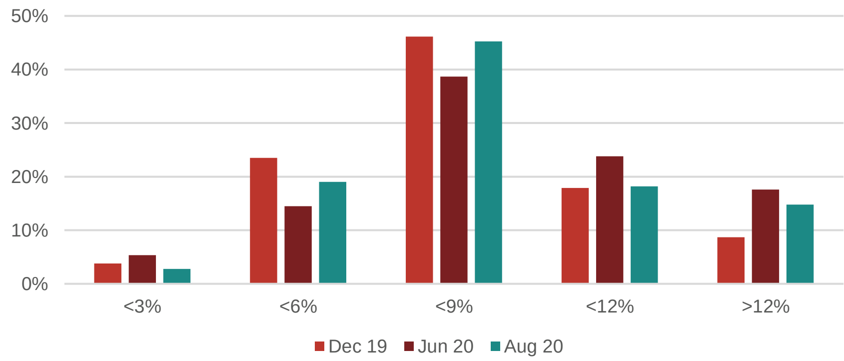
Figure 4. Average* Credit Ratings Distribution



Source: BondAdviser calculated average credit rating based on external ratings, KKR. As at 31 August 2020.

The portfolio is also well diversified on a YTM basis. This spread is indicative of the Trust's strategy of holding a core group of assets which present attractive risk-adjusted returns, supported by a relatively smaller holding of assets at each end. As Figure 5 shows, this distribution has been stable over the life of the Trust, with marginal, non-significant fluctuations through time. The slight shift toward higher YTM assets can be explained in part by the COVID pandemic and its effect on credit spreads, with the price drops across markets during the crisis driving yields for equal companies and assets higher.

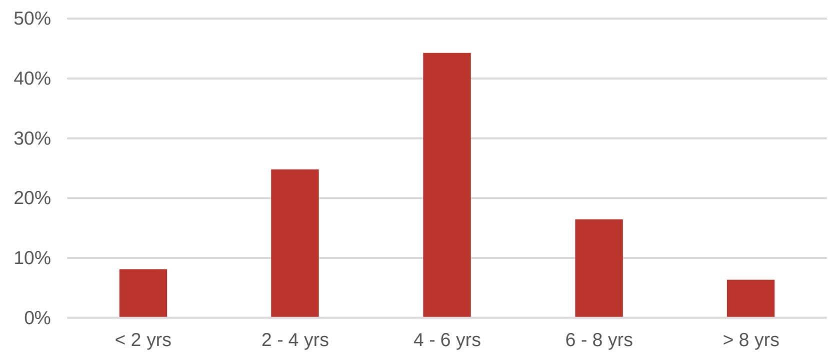
Figure 5. Yield to Maturity Distribution*



** Calculated as a % of the NTA. Source: BondAdviser, KKR. As at 31 August 2020.*

The portfolio is also well diversified across tenor. As shown in Figure 6 the majority of the portfolio is held in assets with an average tenor between 4-6 years, allowing the Manager to talk advantage of positive convexity as rates draw closer to zero.

Figure 6. Term to Maturity Distribution*



** As a % of the NTA excluding equities without a maturity. Source: BondAdviser, KKR. As at 31 August 2020.*

Positive Risk Factors

Proven Processes. KKR demonstrates disciplined practices covering its governance and risk procedures. This includes (i) multiple oversight committees; (ii) regular portfolio reviews; and (iii) investment committee approvals for lending decisions.

Commitment to Capital Preservation. Management has achieved a disciplined track record in credit investment. This is evidenced with historical returns in GCOF and OSC since inception.

Complexity Premium. The private debt market is a niche one with a large and ongoing opportunity set available for experienced operators including KKR. This expertise drives profitability and a significant expansion of assets under management given the progressive regulatory tightening and pull-back by traditional bank lenders.

Strategy Diversification. The dual structure of the Trust offers diversification across strategies, geographies, industries across >150 credit issuers within the total portfolio.

Strict Origination Pipeline Standards. Strong loan origination and structuring is key to overall success. Exhaustive scenario analysis is performed on each deal whereby the optimal loan-to-value ratio (LVR) and capital structure position for KKR to lend at are obtained.

Negative Risk Factors

Credit Quality Deterioration. Weakening credit profiles of counterparty exposures in the Trust portfolio could result in a decline in the NAV. This is partially offset by protective structural features of the arrangements, including equity buffers, and active qualitative strategies.

Operating risk. This is always a threat to portfolio performance. This includes the failure of internal processes and includes human error, misjudgment and fraud. This is particularly relevant given the disappointing performance of hedging currency risk in the Trust.

Correlated Underlying Assets. Significant deterioration in the consumer discretionary and/or the property industries specifically could lead to correlated defaults on loans, which may lead to credit losses and a reduction in NAV.

Liquidity risk. The private debt asset class is illiquid and in a stressed scenario, underperforming or defaulted assets may be difficult to liquidate at perceived fair values. The liquidity risk of the Trust is mitigated by its closed-ended nature, being a listed investment trust (LIT). However, given the specialised nature of the underlying assets, the Manager may be subject to risk in the event of a downturn in the broader credit market. This heightens the risk of a more platykurtic (fat-tailed) distribution of returns, increasing the risk of a material capital loss event.

Interest rate risk. A lower interest rate environment would dampen long-term yields across various debt instruments employed and there may be a risk that the target net distribution of 4.0%-6.0% p.a. will not be met. We note this is a remote possibility currently and supported by the fact that loans within the portfolio are supported by 'floors' in reference rates that are built into funding instruments.

Construction and Investment Process

The Construction and Investment Process of the Trust is function of the processes of its constituent exposures – GCOF and EDL. With these two distinct funds operating wholly separate functions and strategies, their processes are also separate. As such, they are discussed in turn.

Global Credit Opportunities Fund

GCOF is designed to be flexible and take advantage of credit market dislocations, benefiting from a broad mandate to invest in positions with favourable risk-adjusted return profiles. The Fund's opportunistic credit strategy is centred around six key investment themes. The two most heavily weighted strategies are Event Driven and Dislocation/Relative Value themes. Event Driven refers to the portfolio's position in securities with near term catalysts that are expected to appreciate in price, whilst dislocation positions refer to higher-yielding investments resulting from market fluctuations away from the mean. The fund also places a medium-weighting on Proprietary Sourcing and Stressed Credits, whilst Structured Product Investment and Illiquidity Premium strategies are typically assigned the lowest-weightings.

The investment process is administered by KKR's Global Leveraged Credit platform where the Opportunistic Credit strategy is one of five strategies. The Global Leveraged Credit investment team consists of 40 dedicated investment professionals who are aligned by industry with each credit analyst responsible for up to 40 companies. All new investment ideas are presented by analysts through a memo consisting of 10-15 pages with proprietary financial models, due diligence review and recommendation to the Investment Committee (IC). The IC is made up of the three members of the Global Leveraged Credit team's senior leadership, which will then undergo deep due diligence on the credit and will only make an investment when they determine that KKR has a competitive advantage via its sourcing, analysis or diligence findings.

The risk management program for GCOF involves the appropriate trading, sizing, diversification and hedging of positions based upon the position's risk/reward profile, liquidity, price performance, correlation and technical attributes of the different types of investments involved.

European Direct Lending

A defining feature of KKR's EDL team is the firm's size and resources in the European private credit space. There are only a handful of managers in the European debt lending market that can be the sole/lead lenders to the larger end of the European middle market. This is a distinct competitive advantage of KKR and is integral to the firm's ability to source attractive deals in the European market through being the sole/lead lender to large borrowers (>€50m EBITDA).

Subsequentially, a central focus of KKR's EDL team is seeking to be the sole or lead lender in a majority of its deals due to the belief that **greater control results in more favourable structures** and economics which is crucial for capital preservation in downside scenarios. Looking at the EDL fund that KKC has invested into, deals sourced from private equity sponsors comprise 95% of the portfolio (5% non-PE), with 94% structured as first lien senior secured loans with the remaining 6% structured as second lien or unsecured assets.

The investment process is overseen by the Global Direct Lending platform, one of three strategies sitting within Alternative Credit. The European Private Credit investment team is made up of roughly 25 members with a diverse range of backgrounds including direct lending, distressed investing, leveraged credit, law, restructuring and forensic accounting. The EDL team applies a ‘Private Equity style’ due diligence standard that involves rigorous financial analysis of the company in conjunction with a deep market analysis in which the company operates. The EDL investment committee is made up four members who on average possess ~20 years’ experience who have screened ~33% of deals coming through the firm’s origination pipeline since 2015. Through leveraging the firm’s “One-Firm” culture, a wide sourcing funnel creates ample flow that enables the investment committee to be highly selective in the opportunities it pursues. As a result, of the 33% of deals screened by the IC, only 15% meet its rigorous standards for an **overall investment rate of ~4%**. Furthermore, even deals that receive the approval of the IC may fail if its final terms are unattractive, KKR did not back the winning sponsor, or the winning sponsor chooses a different financing option.

Following this, a detailed Investment Committee Paper is prepared by the Investment Team and presented to the Investment Committee, with unanimous consent required for the transaction to proceed. In an additional layer of control, the Risk Management Team must also sign off on loan documents and condition precedents and continue to perform covenant monitoring and early escalation of potential issues. Once approved, the Portfolio Management Committee (PMC) meet regularly (every 6-8 weeks but increased to 4-weeks as a result of COVID) to assess each loan in completing its asset monitoring and compliance duties. This process allows members to apply their unique backgrounds and knowledge to each deal, whilst also receiving a broader perspective on the loan from various stakeholders and non-executive director oversight throughout the process.

Monitoring the firm’s Private Credit portfolio is the Portfolio Monitoring Unit (PMU). The PMU is responsible for the ongoing monitoring and unbiased assessment of ~180 credits with the objectives of ensuring consistent, comparable analysis across portfolios and systems to enhance governance, risk management and data quality. This is achieved through the PMU taking a proactive approach to the existing private credit portfolio through a “high-touch” model which has the PMU interacting with company management and sponsors on a monthly basis in addition to standardised internal reporting. We also note that the PMU works closely with origination teams who remain heavily involved throughout the deal process and are the primary relationship owner with the portfolio company or sponsor.

After each Investment Committee meeting, colour and risk grades are assigned to each investment and are reviewed at each quarterly PMC meeting thereafter. Colour grades indicate the performance of a credit versus the investment thesis/plan laid out by the credit analyst when the idea was pitched to the Investment Committee. Risk grades are synonymous with their name, with a higher number grade indicating a higher potential for capital loss, thus providing an indication of the inherent risk of the asset.

Portfolio Risk Management

Our assessment of risk management considers credit and liquidity risk; however, we also recognise operating risk is always present and this is considered throughout our report. We view effective risk management as key to success, due to the asymmetric nature of credit investment. In *Quantitative Analysis* we simulate scenarios to test the credit profile of the portfolio, contrasting with this qualitative assessment.

While each bond or loan asset has its own unique risk profile, KKR has the scale and diversification required to isolate and control risk at a portfolio level. The structural elements of each individual asset allow KKR to operate within its mandate at an aggregate portfolio level.

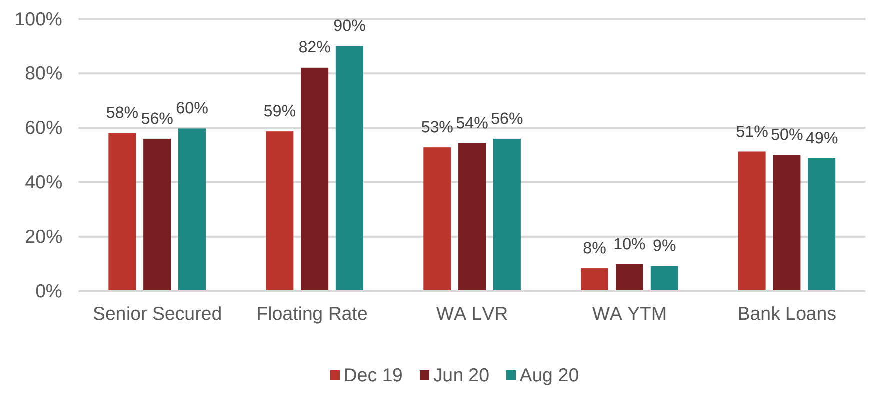
Credit Risk

KKR employs an integrated approach to risk management by utilising a multi-faceted approach that is supported by ongoing monitoring and re-underwriting of the portfolio to ensure capital preservation. The Firm's fundamental credit investment philosophy is followed by investment teams when conducting credit underwriting with rigorous financial analysis. This is enabled by the firm's proprietary technology system "CreditQB" which captures portfolio composition, financial data and commentary in a single system in conjunction with several external systems.

The impact of credit risk for KKC's investments will depend on the nature of the instrument. KKR broadly categorises its debt investments as falling within one of the following two types: (1) traded credits: typically loans, bonds or other debt instruments issued by companies that are syndicated to a group of lenders and that are traded on the secondary market; and (2) private credits: typically bilateral loans between KKR and a borrower with no or limited syndication and which are not traded in the secondary market.

For the Trust's private loans (credits), given these assets are generally held to maturity by the lender and are therefore not typically marked-to-market for profit purposes, credit migration risk (i.e. deterioration in the credit quality of an asset) will not typically impact loan valuation. In this instance, only the potential loss in the event of default will drive changes in asset value. KKR structures these loan agreements to their advantage, embedding covenant packages tailored to the individual borrower and comfort of KKR.

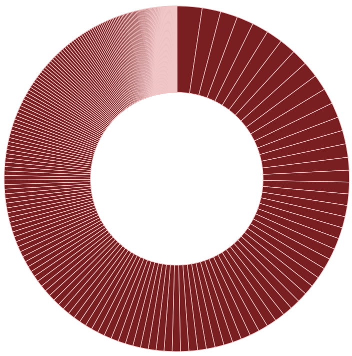
Figure 7. Portfolio Metrics (% GAV)



Source: BondAdviser, KKR. As at 31 August 2020.

Embedding structural protection will involve negotiating security/collateral, debt structure, term and most importantly, covenants with the borrower. Given the excess demand in the private loan market, the Investment Manager benefits from strong bargaining power. Documentation is not standardised (increased flexibility for the Investment Manager) and this adds a complexity premium benefit that is realised by investors.

Figure 8. Asset Diversification (% GAV)



Source: BondAdviser, KKR. As at 31 August 2020.

Traded credit presents different credit risks, given the possibility of market and migration risk impacting the trading price of the asset. This was seen on a substantial scale through March, as the severe uncertainty triggered by the COVID pandemic shocked markets. KKR mitigates this through leveraging its substantial infrastructure of analysts and data to assess the accurate prices and risk levels for these bonds and loans to acquire the fair value of the security and to investment in investments that have attractive risk-adjusted returns. However, as the COVID period illustrates, it is not possible to wholly eliminate risks which arise from extraneous shocks and dynamic market factors.

Importantly, as illustrated in Figure 8. there is extensive asset diversification, with the largest single exposure (excluding cash) worth 2.4% of the portfolio. Additionally, the top ten largest exposures make around 16% of the portfolio. **In the event of default or adverse credit migration, the impact of any single asset will be limited due to the broad diversification.**

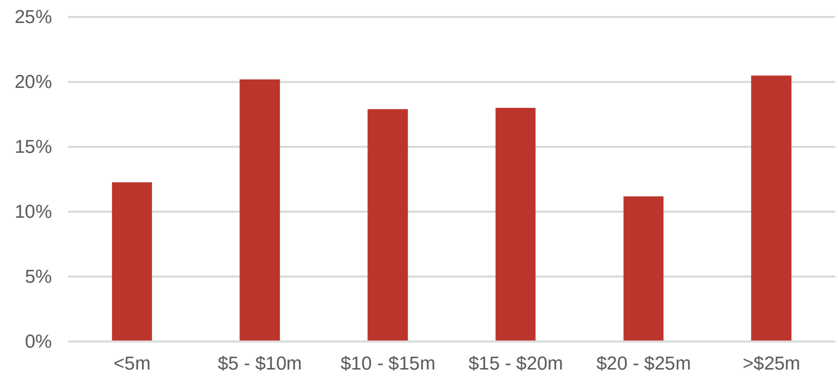
Liquidity Risk

Liquidity risk for the Fund is comprised of two elements: (1) that it is able to provide liquidity to borrowers on request (within the EDL) within the loan commitment period; and (2) is able to meet investor redemptions.

Loan Liquidity

While the Trust does not use leverage as a core part of its investment strategy, it does have a credit facility which it can use to manage liquidity, including enabling the Trust to undertake investment activities. A primary function of this facility is to allow the Trust to facilitate EDL drawdown requests while awaiting redemptions from the GCOF as the Trust allocates capital across the strategies. Whilst GCOF is primarily comprised of liquid securities that are traded in secondary markets, the Trust may utilise the facility for investment reasons (pricing on the disposal of assets is not adequate) or there are periodical liquidity problems in certain assets. The facility may also be utilised for the purpose of satisfying margin requirements in connection with its use of derivatives for foreign exchange hedging.

Figure 9. Asset Size Distribution*



*Source: BondAdviser, KKR. As at 31 August 2020. * Distribution by weight.*

Fund Liquidity

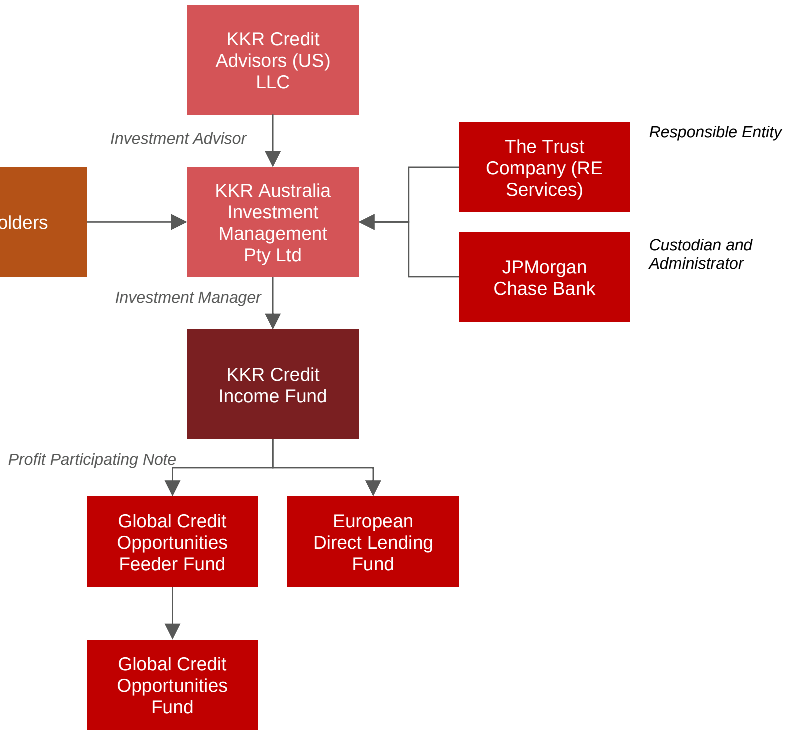
The Trust does not offer a redemption facility, so investors are required to sell their units on the ASX if they wish to exit their investment. This process and the ability of investors to sell their units on the ASX will depend on the liquidity of the units on the market at the time of the sale. This is an uncontrollable factor, determined by investor sentiment. As such, investors are not guaranteed to be able to sell their units at the time, in the volume, at the price they want.

Fund Governance

KKC is a closed-ended listed investment trust (LIT) domiciled in Australia with a single class of units on issue. The LIT is registered with ASIC as a Managed Investment Scheme. The Trust Company (RE Services) Limited is the Responsible Entity (RE) for the Fund. The Trust Company Limited is a wholly owned subsidiary of Perpetual. The RE has entered an Investment Management Agreement (IMA) with KKR Australia Investment Management Pty Ltd, which is the Manager, authorising the Manager to provide investment management and other services to the Trust pursuant to the IMA. In addition, the RE has appointed KKR Credit Advisors (US) LLC as Investment Advisor under the Sub-Advisory Agreement. The Investment Adviser has been retained to provide certain non-discretionary investment management services.

The IMA is complemented by the Trust Deed, which governs the terms of the Trust. These include cash management (redemptions, applications, distributions), valuation (unit pricing and valuation policy) and the responsibilities of The Trust Company (Perpetual) in its capacity as RE. KKC's legal structure is described by Figure 10 below.

Figure 10. Legal Structure



Source: BondAdviser, KKR. Note that this structure may change in line with the Asset Transfer as discussed in Investment Strategy.

Quantitative Analysis

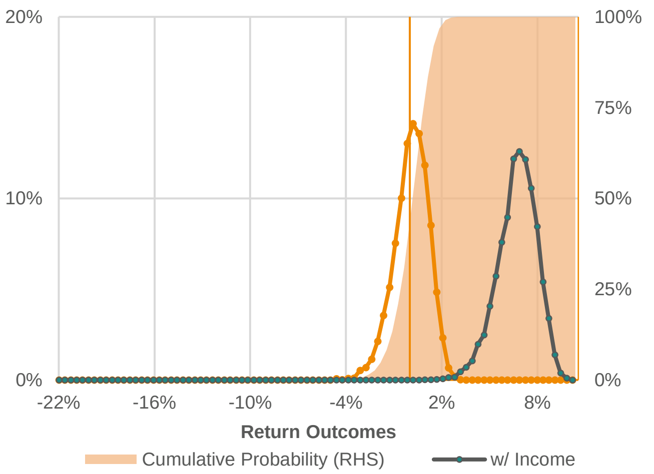
Our quantitative analysis is designed to simulate a baseline asset assessment and stress test of the portfolio. Our simulations show the probabilistic distribution for expected gross capital loss (orange curve) and gross underlying return (grey curve) but do not consider any skill from the manager nor any return component of traded price. The process is consistent across asset and product types and relies on historical data inputs provided by Credit Rating Agencies.

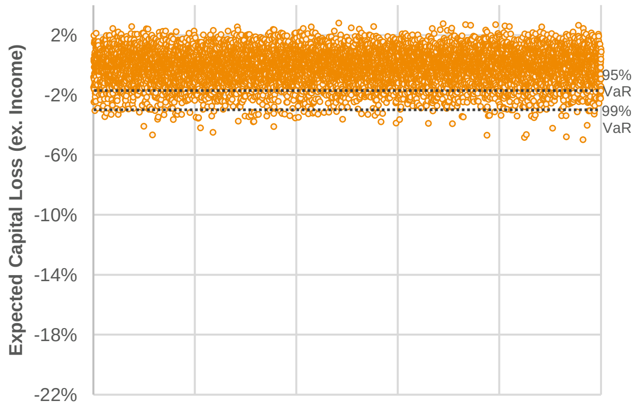
The **portfolio performs well** due to diversification and seniority improving loss given default outcomes. Our modelling output is similar to the output from the portfolio that was tested last year, although the marginal increase in <CCC assets has proportionally increased tail risk.

On the basis of our analysis we retain the risk score of 'B' / 'Very High' for KKC, noting **as the portfolio ramps into EDL, we expect both our modelling and the risk score to improve.**

If required, contact us for a technical breakdown of the methodology and analysis.

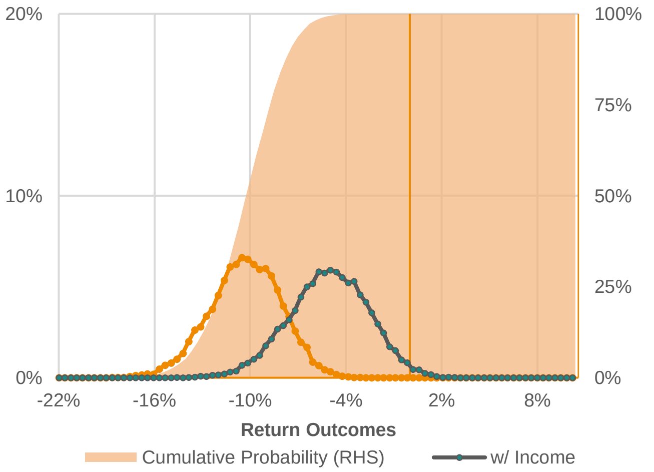
Scenario 1. Baseline Asset Assessment

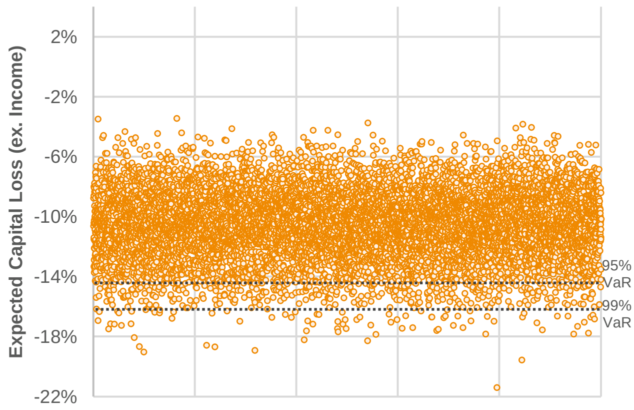




Source: BondAdviser Estimates. Excludes impact of fees.

Scenario 2. Stressed Asset Assessment





Source: BondAdviser Estimates. Excludes impact of fees.

Research Methodology

Overview

At BondAdviser, our focus is on delivering the highest quality data, research and insights so that investors can make intelligent decisions about the fixed income market. At the centre of our approach is a proprietary 5-pillar process for analysing fixed income funds in a rigorous and disciplined manner. Our approach results in a recommendation scale that investors can readily use to identify the most attractive investment opportunities.

Our ability to provide a clear and concise investment recommendation from the very diverse and unique fixed income portfolios and funds within our coverage universe is a key benefit of our research process. We simplify an otherwise complex procedure for investors into a simple, recognisable and consistent recommendation scale.

We use a bespoke combination of qualitative assessments and forward-looking quantitative analysis. In our experience, most other research is backwards looking, which naturally limits its usefulness. By combining our deep understanding of fixed income markets and their emergent trends with our extensive modelling and forecasting capabilities, we aim to solve this limitation and output meaningful, risk-adjusted prospective recommendations for investors.

Research Approach

BondAdviser has adopted a multi-pillar, risk-based approach to the assessment of funds. In our opinion, an investor's exposure to credit risk is not uniform and can be well mitigated by manager skill, experience and supporting governance structures. We identify 5 key pillars of credit risk mitigation and these then form sections of analysis in our reports:

- Investment Objectives, Strategy and Performance
- Portfolio Construction and Investment Process
- Liquidity, Operating & Financial Risk Management
- Governance, Asset Stewardship and Compliance
- Quantitative Analysis

Research Process

The initial screening of funds and assets is based on a globally recognised best practices approach to alternative assets as defined by the Alternative Investment Managers Association (AIMA) and risk management as identified by the International Organisation of Securities Commissions (IOSCO).

All assets and managers must meet minimum requirements as outlined in our initial due diligence questionnaires. Detailed interviews, operational checks, process documentation and data collection then follow. Each of these steps helps to ensure that our recommendations are consistent and are based on a comprehensive understanding of the key drivers of the underlying market segment and asset class(es), the investment manager and broader portfolio.

Classification

We broadly adhere with international and Australian accounting standards and global best practice in designating assets according to their place in the fair value hierarchy defined in International Financial Reporting Standard 13 (IFRS13) - Fair Value Measurement (Australian version – AASB 13). All assets designated as "Credit" fall under three categories based on market observability as outlined below:

- **Level 1 (Active Markets)** - assets that have quoted prices in active markets, providing the most reliable evidence of fair value. As a result, transactions for these assets can generally occur at this price as at the measurement date. Domestically, typical examples of Level 1 assets include Australian Government Commonwealth bonds, listed debt and hybrid instruments and RBA repo-eligible financial instruments.

• **Level 2 (Non-Active Markets)** - assets that have observable prices (directly or indirectly), not included within the Level 1 category (i.e. not quoted on an exchange). Assets referencing credit spreads and interest rates would qualify if the input is observable for the full tenor. This category generally encompasses credit markets which have limited secondary market activity such as corporate bonds, subordinated debt and syndicated loans.

• **Level 3 (Illiquid and Alternative Credit)** – assets that have mostly unobservable inputs and hence valuation models are used, driven in part by assumptions and expectations. There may be an independent overlay and a model risk adjustment to derive an exit (market) price. A limited secondary market is typical and these assets are often referred to as alternative credit. Examples of this segment include "structured" credits such as RMBS, CMBS, ABS and private debt investing.

Product Assessment

The BondAdviser Product Assessment is the culmination of our research process applied to our pillar-based research approach. We conclude whether a fund is screened-out, approved, recommended or highly recommended as broadly defined below:

• **Screened Out** – The fund does not (or no longer) satisfies our minimum criteria for research inclusion.

• **Approved** – Our research allows us to conclude that the fund manager, governance structure, policies and procedures appear to be sound and capable of managing the fund adequately to target its benchmark.

• **Recommended** – We have a reasonable expectation that the fund will achieve its target benchmark.

• **Highly Recommended** – We believe that superior skills, systems and processes mean that the fund has a high likelihood of meeting and probably exceeding its benchmark target. Note that we only provide Highly Recommended assessments after issuing multiple reports over an extended period of time

Risk Score

Our Risk Score is aligned to the same methodology that is utilised in BondAdviser's single-instrument reports. It is not a credit rating and should not be used as such.

• AAA – Very Low

• AA – Low

• A – Lower Medium

• BBB – Upper Medium

• BB – High

• B – Very High

• CCC – Extreme

• D – Default (Fund Closed)

Our overall Risk Score is driven by the underlying credits of a fund coupled with our quantitative analysis. It is mutually exclusive to the Product Assessment. For example, it is possible for a fund to be Highly Recommended and have a risk score of CCC. This could occur where the fund invests in riskier credit assets but we are very confident of its capability to meet or exceed its benchmark target. Conversely, a fund comprising mostly of government bonds may hold a Risk Score of AAA but its governance processes, history and controls are not as strong as peers and warrant only an Approved assessment.

Important Information

BondAdviser has acted on information provided to it and our research is subject to change based on legal offering documents. This research is for informational purposes only. This information discusses general market activity, industry or sector trends, or other broad-based economic, market or political conditions and should not be construed as research or investment advice.

The content of this report is not intended to provide financial product advice and must not be relied upon or construed as such. The statements and/or recommendations contained in this report are our opinions only. We do not express any opinion on the future or expected value of any Security and do not explicitly or implicitly recommend or suggest an investment strategy of any kind.

This report has been prepared based on available data to which we have access. Neither the accuracy of that data nor the research methodology used to produce the report can be guaranteed or warranted. Some of the research used to create the content is based on past performance. Past performance is not an indicator of future performance. We have taken all reasonable steps to ensure that any opinion or recommendation contained in the report is based on reasonable grounds. The data generated by the research is based on methodology that has limitations; and some of the information in the reports is based on information from third parties.

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Report created on 20 November 2020.