KKR

CREDIT INCOME FUND

KKC Investment Update

31 October 2023

Dear KKC Investor,

We are pleased to provide you with credit and markets commentary from KKR's Chris Sheldon (Partner and Co-Head of Credit & Markets) and Rory O'Farrell (Director, Client & Partner Group).

Summarised below are the key points related to KKC which invests in both public, traded credit and private credit through its allocation to the Global Credit Opportunities Fund and European Direct Lending Fund.

You can view the full letter here - **KKR Credit - Market Review - Oct 2023**.

Credit Market Review – October 2023

Credit markets have been in flux for the last two years, but the path forward for the asset class is becoming a little clearer. We see a trend in which private credit is becoming a more permanent allocation for investors, and we believe that flexibility and certainty of execution will continue to be attractive for borrowers even after syndicated markets reopen. We see senior secured direct lending becoming an anchor allocation within private credit given the attractive income available, supplemented by either opportunistic, higher-yielding strategies or strategies less correlated to traditional developed market corporate macro risk.

The Risk of Forgoing Opportunities in Liquid Credit

Private Credit has been getting a great deal of attention lately in both the press and investment circles, but we think it is a mistake to ignore opportunities in liquid credit. Public markets are bigger, more liquid, and less expensive for borrowers than private credit. They also offer an opportunity for investors to deploy capital quickly, and we think the benefits of that are not to be underestimated.

In the earlier part of this year, liquid credit markets offered a rare opportunity to take advantage of high yields, wide spreads, and prices ticking back up on the strength of rising market confidence across public markets. By the end of September 2023, the S&P 500 was up 18%, but the U.S. leveraged loan market was up 10% with far less risk. In hindsight, adding publicly traded assets to a private credit allocation would have not only helped those on the sidelines get capital deployed quickly, it would have also been accretive to a portfolio in terms of both returns and diversification.

That said, opportunity has not disappeared from public markets. While timing the ideal entry point is very difficult, we think the relatively high yields available can be good buffers against price volatility. In Figure 1, it's clear that there is a choice in the leveraged credit markets at the moment: High yield bonds offer more convexity or price appreciation potential, but loans offer more attractive coupons. To our team's way of thinking, a downward move in rates will trigger an upward price movement in high yield and make the floating nature of loans less attractive. So long as one has capital to deploy and the flexibility to act when a move is imminent and fixed-rate debt becomes more attractive, we think it makes sense to take advantage of the income available today. Note that we do see more credit risk today in the syndicated loan market than the high yield bond market. So, as rates stay higher for longer, the trade-off between credit risk and yield will continue.

That brings us to the tinderbox, an idea we discussed in **our last Market Review**. We have said consistently that when capital markets begin to function again, the change in the credit investment environment is likely to be both significant and swift — a tinderbox that catches a spark, pushing more deals to market and attracting investor enthusiasm. That spark is only possible in public markets, where transactions take place in the open and feed animal spirits.

Private credit cannot and will not replace public credit markets. We see them working more in tandem, even in the same deal, say with a large syndicated loan and privately placed junior debt.

Figure 1

Opportunity for Price Appreciation in High Yield vs. Carry in Loans: Yields, Prices and Coupons on Leveraged Credit

	US High Yield		European High Yield		US Loans		European Loans	
	12/31/22	9/30/23	12/31/22	9/30/23	12/31/22	9/30/23	12/31/22	9/30/23
Yield to Maturity	9.01%	8.97%	7.73%	7.64%	9.99%	10.30%	8.56%	8.87%
Price	85.9	87.9	85.9	88.2	92.4	95.6	91.3	96.4

Source: ICE BofA Euro High Yield Index for European HY, ICE BofA US High Yield Index for US HY, Loan data from PitchBook LCD (ELLI for European loans, LSTA LLI for US loans), all as of September 30, 2023

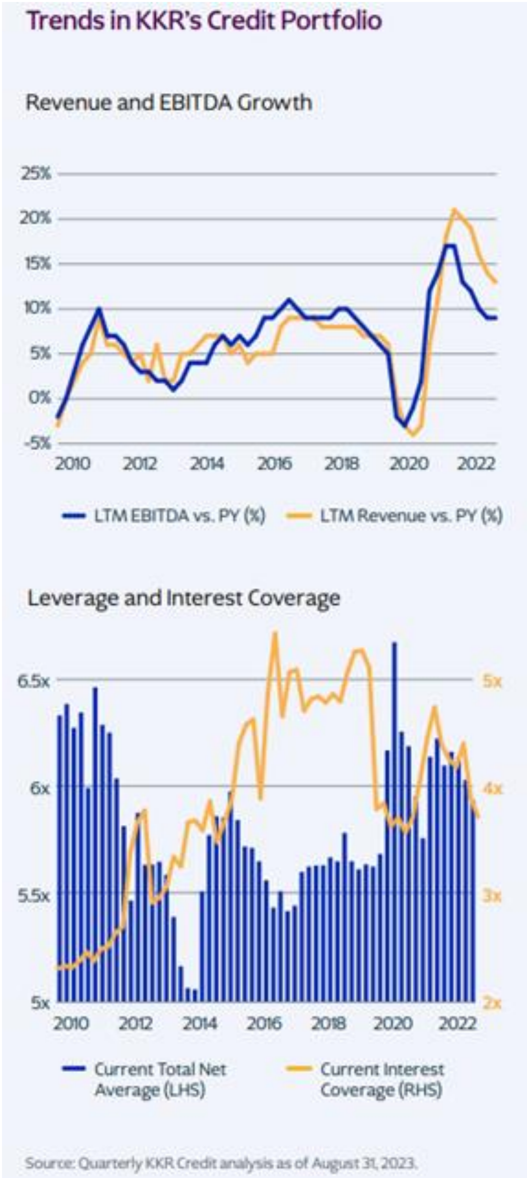
Figure 2

Green Shoots and Some Old Roots

One thing that public and private markets have in common at the moment: Fundamentals are on watch. As one might expect when central banks are trying to tap the brakes on growth, financial metrics are starting to deteriorate. However, our view is that they remain healthy overall, with idiosyncratic defaults and deterioration focused within certain industries or sub sectors.

In private credit, according to one broad measure of the asset class, the percentage of private borrowers in the wider market breaching loan covenants has continued to tick up steadily since the end of 2021, reaching 4.5% in the first quarter of 2023 compared to a two-year average of 3.3%.[1]

As for public markets, Figure 2 illustrates how KKR's global leveraged credit portfolio is performing.



Given the breadth of that business, we consider it a good proxy for the overall market. Interest coverage remains strong despite the increased cost of debt for borrowers, and the portfolio's lagging 12-month EBITDA is still nearly 10% higher than the previous year. While EBITDA growth has slowed, it is close to 2018-2019 levels, a time when we felt growth was strong. However, the momentum of EBITDA is more important than a point-in-time snapshot. We think both EBITDA and revenue will continue to trend downward as inflation puts pressure on cost bases, but we believe there is a great deal of dispersion within those numbers. Some 23% of companies saw EBITDA fall 5% or more in the first quarter of 2023, while half saw it grow more than 10%. (The trends we have observed in our Private Credit portfolios are similar.) We appreciate that companies tend to report on a quarterly lag and will continue to watch this metric closely as the direction of travel of these figures is crucial.

In public markets overall, defaults in high yield bonds and leveraged loans have been rising, but were still contained at 2.29% and 2.99%, respectively in July. We also see both the maturity wall (Figure 3), particularly in the United States, and interest rate coverage ratios as manageable. Given that loans are covenant-light assets, we do not expect to see a large spike in defaults as occurred during the Global Financial Crisis.

From a capital markets perspective, we see the first signs of green shoots in the U.S. IPO market. While activity was still low compared to the period between 2019 and 2021, the first half of 2023 had more IPO activity than all of 2022 (Figure 4), and September 2023 brought three large-scale, high-profile IPOs from ARM, Instacart and Klaviyo that collectively raised some $6.1 billion in proceeds.

We spoke earlier about the syndication machine breaking down over the past 18 months-plus. Loan issuance in 2023 is weak[2], with year-to-date issuance of $178bn[3] —this has been the lowest since 2009. The composition of this issuance looks different from previous years, though, with a higher proportion of amend-and-extend and smaller add-ons and a lower proportion of new M&A activity (Figure 3). The amend-and-extend activity comes as borrowers address near-term maturity issues by extending the life of their loans, typically by two years. With fewer fresh loans hitting the market, aggregate outstanding loans are older and carry greater default risk because they are more likely to have capital structures that were not created to withstand an inflationary environment.

A&E deals are generally offered to existing lenders first, and CLOs are the largest buyers of loans. As we have previously mentioned, many CLOs are moving beyond their reinvestment periods each month, and borrowers are forced to offer deep discounts in the form of original issue discount to attract scarce pools of capital (Figure 4). We think this can be a rich picking ground for opportunistic pools of capital such as KKC.

Figure 3

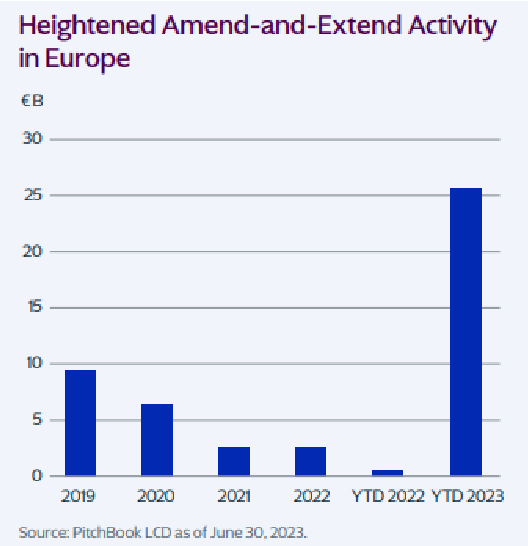
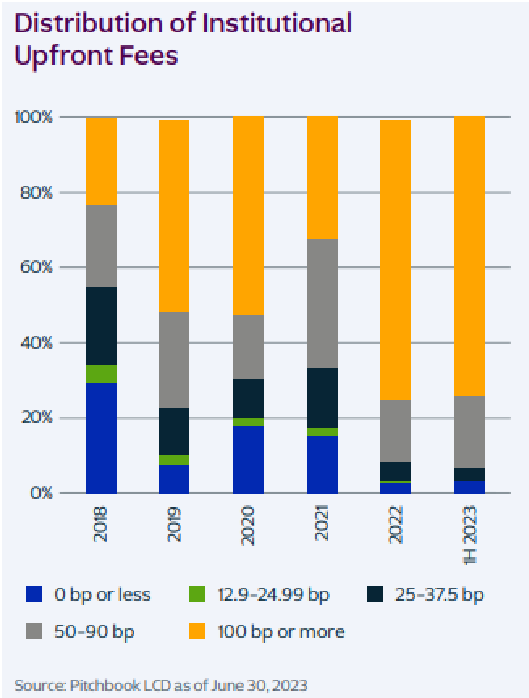


Figure 4



As capital markets reopen, we think the change in the investment environment is likely to be both significant and swift. We believe this vintage of new deals will be attractive and that taking advantage of new issuance across private credit and public credit will lead to differentiated outcomes, particularly if lenders are able to expand the new issue premium with call protection or call premiums. In short, we think it will remain a good time to be a lender.

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[1] https://www.lincolninternational.com/perspectives/articles/leading-indicators-show-risk-for-potential-loan-payment-defaults-in-the-next-twelve-months/

[2] https://pitchbook.com/leveraged-commentary-data/leveraged-loan

[3] Pitchbook LCD as at 30 June 2023

KEY BENEFITS AND RISKS

BENEFITS:

The key benefits of inventing in the Fund include:

- Attractive Target Distribution
- Attractive Target Return
- Diversified exposure
- Alignment of interests with Unitholders
- KKR product access
- Highly experienced KKR Credit team

RISKS

Key risks include:

- Allocation risk in relation to the Investment Strategy
- Illiquid and long term investments in relation to the Investment Strategy
- Potential conflicts of interests of the Responsible Entity and the Manager and its affiliates
- Entities within the “Perpetual Group” may also act in various capacities for other funds or accounts, which may conflict with the role the Responsible Entity plays with respect to the Trust.
- Market and economic risks in relation to an investment in the Trust
- Currency risk in relation to an investment in the Trust
- Pricing risk in relation to an investment in the Trust
- Liquidity risk relating to Units in the Trust in relation to an investment in the Trust
- Operational risk in relation to an investment in the Trust
- High yield investments risk in relation to debt investments
- Credit risk in relation to debt investments
- Interest rate risk in relation to debt investments
- Bankruptcy risk in relation to debt investments

If you are uncertain as to whether an investment in the Trust is suitable for you, please contact your stockbroker, financial adviser, accountant, lawyer or other professional adviser.

About KKR

46	US$519	US$200	~740	US$28.1
years of experience	billion total assets under management[1]	billion credit assets under management	KKR Investment Professionals	billion invested alongside our clients[2]

(1) Figures as of 30 June, 2023. Represents assets managed by KKR or its strategic partners (on a proportionate basis) as to which KKR is entitled to receive a fee or carried interest (either currently or upon deployment of capital) and proprietary general partner capital.
(2) Includes investments/commitments made by KKR's balance sheet, KKR employees and other affiliates. Investments made by current and former KKR employees are retained by those individuals personally. Includes unfunded commitments made by individuals.

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