ASSET-BASED FINANCE

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KKR

Summary

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WITH SPECIAL THANKS TO THE KKR TEAM

- Private Asset-Based Finance ("ABF") is an essential component of Private Credit. Much like leveraged lending is to corporates, ABF is the ubiquitous lifeblood to millions of businesses and consumers globally financing day-to-day operations and lives through diverse credit types such as mortgages, consumer credit, receivables financing, aircraft leasing, among many more.
- ABF is estimated to be a $4.5 trillion market globally and is forecast to grow to approximately $6.9 trillion over the next five years.
- By pursuing new and mispriced lending opportunities, ABF can offer attractive portfolio diversification through exposure to large, diversified pools of hard and financial assets.
- While the economic and social risks linked to COVID-19 today are high, we view ABF as a large, diverse asset class that has been tested over a long history and as the environment normalizes, has the potential to offer investment exposure in interesting and often proprietary investments.
- In this piece, prepared in the midst of the COVID-19 pandemic, we speak to private Asset-Based Finance's origins and the secular changes to lending markets, describe how we view the investable universe through investment case studies, and review the investment structures used to harness the opportunities.

OVERVIEW OF PRIVATE ASSET-BASED FINANCE

Private Credit today is most commonly associated with directly originated and negotiated senior and subordinated corporate lending, i.e., Direct Lending and Corporate Mezzanine Debt. However, banks' retreat over the past decade has had an equally profound impact on non-corporate activity, a segment that comprises a far larger portion of the global capital markets and real economy. Directly originated, non-corporate lending encompasses a broad range of industries and financing types that we refer to as private Asset-Based Finance. Much like leveraged lending is to corporates, ABF is the life blood of millions of businesses and consumers globally financing day-to-day operations and lives through mortgages, credit cards, receivables financing, consumer installment loans, automobile financing, and equipment leasing, to name a few. In many ways, ABF's credit solutions are everywhere, often operating behind the scenes to make the mundane transaction we often take for granted possible. As a result, private Asset-Based Finance is estimated to be a $4.5 trillion market, approximately one and a half times larger than its estimated size in 2007 of approximately $3.1 trillion[1]. For context, the Consumer and Small-Medium Sized Enterprise ("SME") segments alone are approximately ten times the amount of global Corporate Direct Lending assets under management, one and a half times the size of the US and European bank loan and high yield bond markets combined, and nearly the same size as the investable emerging market bond market[2]. These two segments in the U.S. are estimated to account for nearly half the market at 45%, followed by Asia/Australia at 30%, Europe at 18%, and rest of world at 7%.

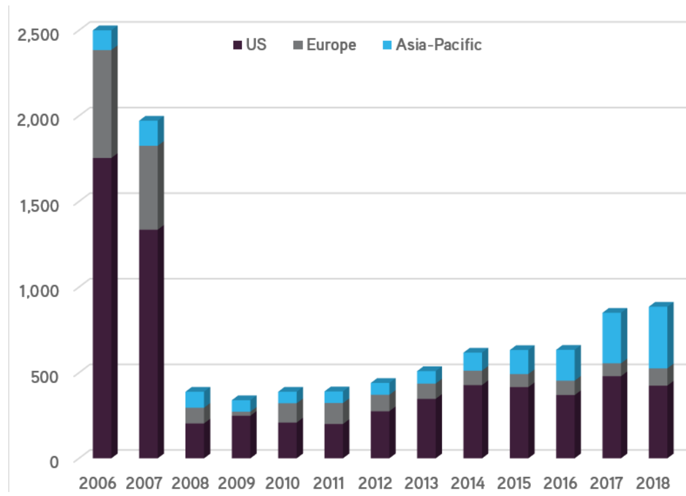
That said, the ABF market stretches well beyond the Consumer and SME segments to include Hard Assets (e.g., Real Estate and Aviation) and Contractual Cash Flows (e.g., Royalty Financing and Life Settlements) which expand the opportunity set significantly (Aviation Leasing alone is a $360 billion segment[3]). With the inclusion of Non-Performing Loans ("NPLs") as well as performing, but non-core bank assets deemed saleable, the ABF market swells by an additional estimated $1.2 trillion to $5.7 trillion, today[4].

ORIGINS OF PRIVATE ASSET-BASED FINANCE

In the prelude to the Financial Crisis, non-bank lenders satisfied the ample demand for credit from borrowers and for loan types falling outside the conventional underwriting criteria of mainstream banks, such as near-prime and sub-prime borrowers and non-standard loan types. Concurrently, the securitization boom catered powerfully to non-banks' "originate-to-distribute" model allowing these institutions to efficiently access debt financing despite having limited capitalization. More relaxed risk frameworks, including friendly off-balance sheet treatments, meant that banks also took exposure to riskier lending segments, often as the ultimate buyers of repackaged specialty credit. The ABF market grew to an estimated $3.1 trillion in this period.

The Financial Crisis and factors that played out in its aftermath marked a dramatic end to this chapter of non-bank lending, setting it up for the recent transformation and growth. Foremost among these factors was the collapse of securitization markets triggered by the credit contagion from subprime U.S. mortgages and exacerbated by the subsequent run on liquidity. The securitization market's implosion enabled non-bank and private capital to take an even greater share of the private Asset-Based Finance markets.

GLOBAL SECURITIZATION ANNUAL ISSUANCE VOLUMES ($ BN)

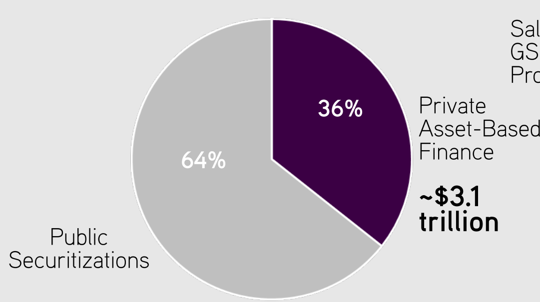


Sources: SIFMA, AFME, JSDA, S&P, ICRA, RBA

The second factor was the crisis's fallout on global banks. The policy response in ensuing years proved relentless ranging from full-scale tightening of regulatory rulebooks to sharply higher capital requirements and tighter guidelines on risk-taking and governance (e.g., the Volcker rule). The resulting de-risking pressure forced banks to focus on narrower, commoditized lending segments underpinned by regimented underwriting, all of which excluded large segments of corporate and non-corporate borrowers.

The securitization market's implosion enabled non-bank and private capital markets to take an even greater share of the Private Asset-Based Finance markets

THE PROFILE OF GLOBAL NON-BANK ASSET FLOWS PRE-CRISIS...



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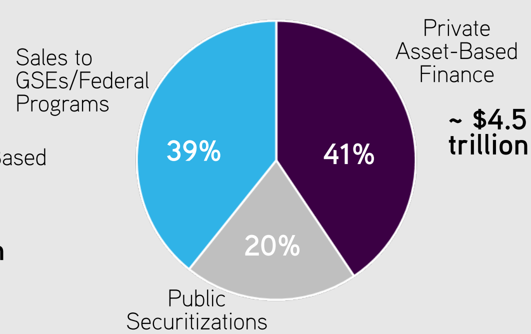


Sources: SIFMA, AFME, JSDA, S&P, ICRA, RBA

OUTLOOK FOR PRIVATE ASSET-BASED FINANCE[5]

Over the next five years, the Consumer and SME segments of private Asset-Based Finance alone are anticipated to grow over 50%, from approximately $4.5 trillion today to around $6.9 trillion, excluding NPLs and non-core bank assets deemed saleable, and from $5.7 trillion today to $9.5 trillion inclusive of them. As global economies eventually emerge from the COVID-19 pandemic, we expect the rebound in demand for credit to be met by renewed constraints on the banking system that will stem from growing non-performing loan balances and renewed scrutiny and calls for restraint from regulators. In addition, we anticipate competition from other non-bank lenders will diminish. Weaker market participants will likely be forced to contract their lending activity due to inadequate capitalization or inability to secure asset financing from risk-averse banks who will likely refocus their attention on the largest, most established operators.

Beyond organic growth and expanding market share, another important channel of ABF's growth is the finance industry's ardent embrace of technology. New cadres of "FinTech" companies (e.g., market place and point-of-purchase lenders) reliant on private capital are streamlining credit consumption by leveraging e-commerce to revolutionize origination and driving scale through novel uses of Big Data and data algorithms for underwriting and risk management.

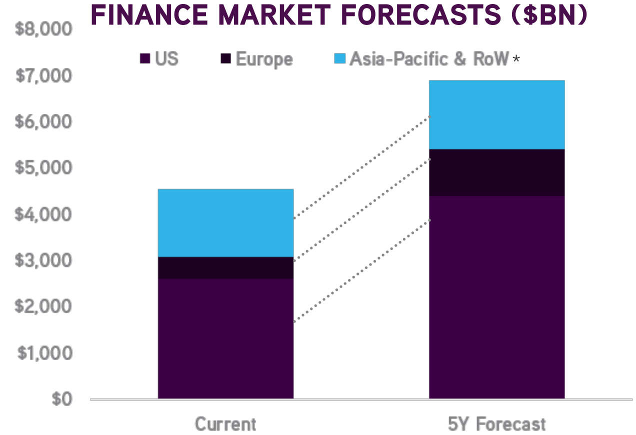
Still, the pace of growth will vary by region given different regulatory frameworks, GDP growth trajectories, and credit cultures.

Europe The continent appears poised to see the greatest growth rate with the ABF footprint expected to more than double in coming years as banks become subject to new regulations (e.g., Basel IV, IFRS 9) and required treatment of NPLs by the European Central Bank ("ECB") which will add further capital pressure. We expect to see increased velocity of bank balance sheet assets as they continue to originate new loans for relationship and fee considerations (while transferring risk to third parties), a further shift to non-bank lenders where capital requirements are lower and banking consolidation/restructuring. Beyond this, the existing stock of NPLs and other impaired assets create both interesting asset acquisition and servicing opportunities for non-banks. On the origination front, recent regulation (i.e., Open Banking/PSD2) is set to release borrower data currently owned by banks, which should be a major boon to non-bank lenders over time as it removes a barrier to market entry.

U.S. The non-bank footprint is forecast to increase approximately 70% over the next five years, driven by opportunities in technology-driven mortgage originations on the consumer side and demand for more complex and "off-the-run" loan types on the business side, such as merchant cash advance.

Asia The region encompasses the two largest non-bank economies in the world, India and China, which should rebound following a period of post-growth consolidation. In other developed Asian countries, banks remain firmly ensconced but non-bank lending has longer term potential. In emerging economies, the SME sector (e.g., trade/supply chain finance) looks like a credible growth source in the near term. In Australia, non-banks, which have taken share from banks in recent years, should benefit from adoption of proposed Banking Royal Commission recommendations that would further clamp down on bank lending governance.

GLOBAL PRIVATE ASSET-BASED-BASED FINANCE MARKET FORECASTS ($BN)



Source: Integer Advisors. *Only China, India, Australia and Indonesia. Data above excludes opportunities in bank NPLs/non-core assets.

Over the next five years, Private Asset-Based Finance is anticipated to grow nearly 25% to $6.9 trillion

THE EVOLUTION OF NON-BANK LENDING

The emergence of non-bank lenders as owners of credit assets post financial crisis has been one of the most notable developments in modern financial history

Private Asset-Based Market Size

Pre-Crisis
Non-bank lenders fill credit demand not addressed by banks

Today
Bank retrenchment and disintermediation accelerates under rising regulations and risk controls

Estimated in 5 Years
Non-bank lenders mature to "go-to" sources for corporate and non-corporate credit

PRIVATE ASSET-BASED FINANCE INVESTMENT STRATEGY

As an investment strategy, Asset-Based Finance invests in directly originated assets that derive returns from recurring, often contractual, cash flows. By pursuing new and mispriced lending opportunities, the underlying investments can deliver risk and return profiles that are differentiated from other types of private credit. Unlike corporate credit, which is typically dependent on the performance and enterprise value of a single borrower, cash flow performance of large, diversified pools of underlying hard and financial assets drive ABF returns. And, unlike traded Asset-Backed Securities ("ABS") underwritten and distributed by dealers, each ABF investment is privately originated and negotiated by an investment manager which can result in a portfolio of proprietary and idiosyncratic exposures. The advantages of the ABF investment strategy is strengthened by diversity, asset security, negotiated terms, and short duration of many of the underlying loans.

> Returns are driven by the cash flow performance of large, diversified pools of underlying hard and financial assets.

To identify and assess ABF investment themes and their related opportunity sets, KKR leverages the intelligence and data gathered from around the Firm, including more than one hundred private equity portfolio companies and one thousand traded credit holdings, in areas such as global macro-economics, demographic and industrial trends, and new technology. Examples of our themes include the Digital Economy, Bank Capital Inefficiency, and the Aging Population[6] . Using relationships and trust developed over years with corporate executives, board members, and advisers, we proactively pursue investments that harness pockets of inefficiency in lending markets to drive differentiated investment outcomes.

Given the diversity of ABF, we organize the opportunity set into four market sectors – Consumer/Mortgage Finance, Hard Assets, Small-Medium Sized Enterprise, and Contractual Cash Flows – that aid portfolio construction and relative value exercises.
In the following pages, we present information about each Segment and illustrate specific examples of investments that KKR has made in each one[7].

KKR Asset-Based Finance Segments and Investment Themes

Consumer / Mortgage Finance

Auto lending, Consumer loans, Credit cards, Home improvement loans, Mortgages, Granular Non-Performing Loans ("NPLs"), Student loans

- Privatization of mortgage finance / strong housing markets
- Basel IV impacts on European banks' balance sheets
- Credit worthy borrower segments underserved by banks (e.g. students and self-employed)
- Digital economy / tech-enabled platforms

Hard Assets

Aircraft leasing, Containers, Green energy, Railcars, Single family rentals

- The "asset light" new consumer
- Demand for alternative energy sources
- Rental vs. ownership
- Highest-quality aircraft assets on lease

Small-Medium Enterprise (SME)

Small business lending, Equipment leases, Receivables financing

- Bank capital inefficiency
- Demand for speed and flexibility as a result of financial technology innovation; tech savvy lending
- Household formation trends in urban areas

Contractual Cash Flows

Financial contracts, Intellectual property Life settlements, Royalties, Regulatory capital trades,

- Aging populations
- Uncorrelated assets
- "Partner of choice" through flexibility and agility

Consumer / Mortgage Finance

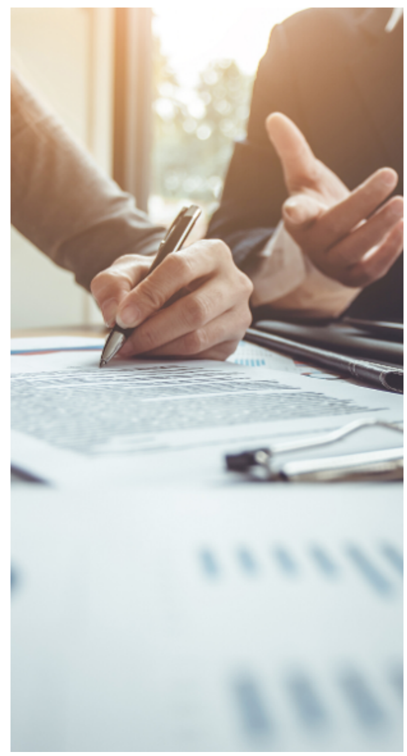
Within the vast Consumer / Mortgage Finance market, our focus is identifying segments of consumer lending where either the collateral is non-standard (e.g., used cars, properties in need of light refurbishment) or where borrowers, while creditworthy, do not have easy access to bank credit (e.g., self-employed individuals, students). Two examples of KKR investments in this segment include financing used vehicles in the United Kingdom and making residential mortgage bridge loans predominantly in the U.S.

FINANCING USED AUTOS IN THE UNITED KINGDOM

Creating U.K.'s first specialty auto lending platform providing loan products across the credit spectrum

RESIDENTIAL MORTGAGE BRIDGE LENDING

Establishing a loan purchasing and management platform to acquire and administer single family and small multi-family real estate bridge loans



NON-PERFORMING LOANS

Acquiring non-performing loan portfolios from European and Asian banks at significant discounts and servicing these loans through debt servicing platforms where we have ownership

FINANCING USED VEHICLES IN THE UNITED KINGDOM

Market Opportunity: Capture the outsized returns available in the U.K.'s used vehicle-lending market relative to those available in other developed markets by improving the delivery of loans to the end purchasers/borrowers, generating average interest in the mid-teens vs. high single-digits charged elsewhere (e.g. U.S.).

Investment Approach: After reviewing potential acquisitions of existing vehicle-lending businesses and forward flow agreements, we elected to build our own origination and underwriting loan platform backing a handpicked management team to deliver the first institutional-quality, tech-enabled, vehicle loan operation in the market. Leveraging the team and tech-focused platform, the goal is to start disintermediating existing broker channels and providing a direct-to-consumer offering that substantially reduces cost of customer acquisition and delivers highly attractive product economics.

Result: Today our platform manages over £700 million in assets across 83,000 loans, generating an average annual interest rate in the high teens from borrowers across the credit spectrum[8]. The business has transformed the used vehicle lending landscape in the U.K. for the benefit of purchasers. Pre-pandemic, the company originated approximately £60 million in loans each month up from around £35 million just 12 months ago and is about to implement additional tech-enabled distribution channels which should contribute to even greater growth in origination volume.

RESIDENTIAL MORTGAGE BRIDGE LENDING

Market Opportunity: Following the U.S. housing crisis, the aging U.S. home stock induced many to purchase homes, perform refurbishments financed by a loan, and sell the improved stock for a profit. We identified this trend early on and sought to tap the huge lending market supporting this industry. "Fix and Flip" lending generates between $15 and $25 billion of new volumes annually across the U.S. generating low double-digit annualized yields with average maturities under one year[9] . This market is highly fragmented (estimated 500 to 600 loan originators) and underwriting is non-standard (e.g., loan terms, documentation, appraisal methodologies).

Investment Approach: As we performed diligence on the sector, we evaluated partnering with existing originators to build immediate volume but feared we would suffer with a heterogeneous loan portfolio and lack of underwriting control. Alternatively, we considered starting our own platform and gain portfolio control but face steep origination frictions. Ultimately, we partnered with an experienced management team and conceived a novel construct that marries the advantages of both options while mitigating the drawbacks.

Result: Today, we have successfully executed our business plan to convert a disparate mix of loans into a homogenous, bank-financeable strategy by incentivizing our originator partners to adhere to our specific underwriting guidelines, loan documents, and best-in-class operational procedures. This, in turn, has allowed us to create a virtuous cycle by driving down funding costs and thereby provide even better terms to these originators. Historically, our platform has originated on average $2 billion in loan volumes annually, making it the largest capital provider in this market.

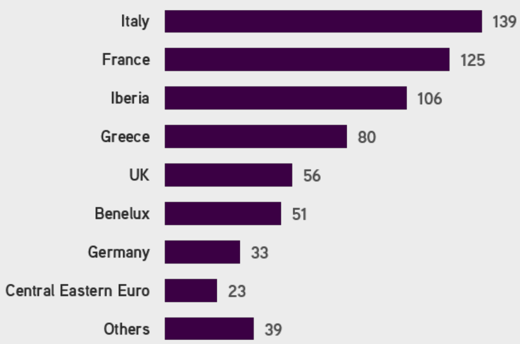
NON-PERFORMING LOANS

Market Opportunity: European and Asian banks are still estimated to have approximately $650[10] billion and $640[11] billion, respectively, of NPLs languishing on their balance sheets, even 12 years after the Financial Crisis. Over the next two to three years, these banks will face increasing pressure to find new homes for these assets driven in part by increased regulatory focus (European Central Bank in particular) on the health of the wider banking system and the impact of new regulations, such as Basel IV, on bank capital models[12]. Private Credit has and will continue to be a natural buyer for these assets, likely in the form of straight asset acquisitions or more bespoke structured solutions agreed on a bilateral basis. In addition, there is a sizeable stock (up to $1 trillion[13]) of performing, but non-core assets deemed saleable, that European banks, in particular, are motivated to divest.

Investment Approach: We have developed strong relationships with banks and advisors across Europe alongside a growing presence in Asia. This has allowed us to access acquisition opportunities bilaterally with the sellers or through auction processes. To date, we have focused on secured non-core loans and assets, which largely involves getting an accurate valuation on the underlying real estate and purchasing the exposure at significant discounts. We have ownership in debt servicing platforms across Europe and Asia we leverage to source and then service these investments post-acquisition.

Result: Since 2016, KKR has purchased four Spanish and one Portuguese non-performing loan portfolios, totalling over €2.4 billion in aggregate outstanding balance that is being managed by our captive servicer. These are monetized through natural loan workouts and securitization take-outs. We have also purchased majority ownership in three debt-servicers, two of which we monetized in the last 12 months.

TOTAL STOCK OF EUROPEAN NON-PERFORMING LOANS



Over a decade past the financial crisis, European banks still have **~$650 billion** of non-performing / non-core assets on the balance sheets that will need to be sold

Source: Deleveraging Europe, Deloitte, October 2019

Hard Assets

Pre-crisis bank balance sheets were natural homes for Hard Assets, such as Real Estate and Aircraft. Today, new capital requirements and Dodd-Frank/Volcker regulations have shifted banks' focus from owning these assets to extending senior financing against them. The single family rental and aviation leasing markets are examples of KKR investments in attractive markets within this segment.

OWNED REAL ESTATE

Providing growth capital to a single-family rental business to capitalize on a generational change in home ownership preferences

AVIATION FINANCING

Establishing an aircraft servicing platform with a leading provider to capture the opportunity set in the $120 billion aircraft operating lease market

OWNED REAL ESTATE

Market Opportunity: Through our research on consumer preferences, we developed a thesis dubbed the "Asset Light Consumer". These consumers are from all age groups (but concentrated in Millennials and Generation X) who seek to rent or share major assets (e.g., cars and homes) rather than own them, preferring to spend their income on "experiences" v.s. "things". We identified the changing preference for home ownership and the technological innovations as factors that have created opportunities for institutional ownership of single-family rental ("SFR") homes where scale and professional oversight can bring operating efficiencies and improve the quality of rental offerings. Regions where housing market fundamentals are positive and yet pockets of demand-supply imbalance exist are interesting investment opportunities. One example is the SFR business, in which consumers are able to rent a home with the option to purchase in the future. Operators purchase and manage thousands of homes across the U.S., typically in regions with high demand and strong population demographics.

Investment Approach: With a favorable macro-economic and demographic outlook for the rental housing sector, the KKR team invested equity for a minority stake in an SFR business to provide growth capital. Given the business's capital intensive nature, KKR was able to support the company through additional capital investments in different forms (e.g., term loans, secondary equity raise, private REITs) at each stage of its growth over multiple years.

Result: Since KKR's involvement, the company has grown to become a major participant in the SFR market, enlarging rental markets in the U.S. where little or no high quality rental units were previously available. The company has purchased and manages more than $4 billion worth of homes and has served over 12,000 customers.

AVIATION LEASING

Market Opportunity: Aviation leasing is a quintessential example of a segment where there is a scalable deployment opportunity but high barriers to entry. The market has been a beneficiary of the long term growth in global air transportation, driven in part by a growing middle class in the emerging markets (a core theme) and by the emergence of low cost airlines. As a result, air traffic over the past two decades has grown at more than twice the rate of global GDP. The spread of COVID-19 and government-imposed restrictions have created unprecedented near-term uncertainty in the aviation market. However, we believe investing in the highest-quality aircraft assets on lease to top-tier airlines allows for attractive returns even if air travel remains depressed for a prolonged period of time. The total value of the global commercial aircraft fleet in operation in 2019 was $870 billion and each original equipment manufacturers ("OEMs") deliver approximately $140 billion of new aircraft. Of the total fleet, 41%, or $360 billion, were on operating leases in 2018. The aircraft operating lease market includes $60 billion of re-leasing activity and $60 billion of new leases on OEM deliveries every year, for a total of $120 billion[14].

Investment Approach: To harness the opportunity set in a meaningful way, KKR recognized the need for a captive aircraft servicing platform. As a result, KKR made a strategic equity investment in a leading aircraft leasing servicer with a near 20-year track record. This company has experience acquiring, leasing, re-purposing, and selling aircraft and engines diversified across commercial and freighter segments as well as new, mid, and end of life assets. By combining their experience and relationships with KKR's investing history and access to capital markets financing, KKR is well positioned to take advantage of the current dislocation and long term opportunities in aviation.

Result: Since closing the investment in late 2018, KKR has purchased, or agreed to purchase, approximately $1.7 billion worth of aircraft assets on lease to a variety of leading airlines across the globe. While these assets are being serviced by our captive servicer, KKR retains full control of the governance and investment decision-making on all new investment activity, portfolio management decisions and disposal activity on behalf of investors.

Small-Medium Enterprise ("SME") Finance

As is well documented, SMEs worldwide have struggled to find efficient financing sources to support their growth as banks struggle in the face of regulatory pressure to serve them efficiently. However, it is within the secured SME lending segment, with security over specific assets such as inventory, equipment, receivables or real estate, where we find most value.

INDUSTRIAL MACHINERIES LEASING

Market Opportunity: Through our European team, we identified a gap in heavy equipment financing available to SMEs in Spain. Banks can provide small revolving credit facilities or financing backed by real estate, but heavy equipment and machinery falls outside of their conventional lending guidelines. The Spanish equipment leasing and rental market is valued at approximately $15 billion and is estimated to grow at 5.5% per annum[15]. Losses in this asset class have historically been low given the lender is essentially super-senior in the capital structure, owns the underlying collateral (hence, can sell in the event of a default), and provides loans at roughly 70% loan to value ("LTV").

Investment Approach: The KKR team created a new, customized financing vehicle seeking to achieve an attractive risk adjusted return by providing senior credit in the form of sale-leasebacks collateralized by industrial machinery. We identified and partnered with a local leasing company to originate and service these leases. The platform has been owned and operated since 2013 by a team that had previously managed a similar business within a European bank that retreated from the market. The company currently acts as a servicer of approximately 500 lease contracts that have been syndicated to other investors. We structured this joint venture to align our incentives by obtaining a minority equity stake in the company, board observer seat, blocking rights, and a call option on a further equity stake.

Result: Although a more recent investment, the vehicle has already financed eight transactions generating an unlevered, high single-digit annual yield, a blended 62% LTV, and modest underlying leverage (below 4.5x Debt/EBITDA) of the corporate borrowers[16].

It is within the secured SME lending segment where we find the most value

Contractual Cashflows

Investments backed by cash flow producing assets such as intellectual property, royalty streams and customized financial contracts fall within this eclectic segment. Intellectual property and royalty financing is particularly relevant in industries like Media and Healthcare. While such rights can create the predictable, long term cash flow streams attractive to banks, borrowers often struggle to obtain bank financing due to the non-standard nature of the assets (e.g. music, films, pharmaceutical royalties) which don't fit within approved capital frameworks. It also includes financing secured against financial contracts typically in the insurance and asset servicing sectors, where KKR Credit has made an investment. As a result, this ABF segment is a natural opportunity set for non-bank lenders.

CONTRACT FINANCING IN THE LIFE INSURANCE INDUSTRY

Market Opportunity: Life settlements represent a large and attractive opportunity uncorrelated to broader markets. The opportunity fits within our investment theme focused on demographic trends, including the aging U.S. population. Through our research, we learned that more than ~$100 billion worth of insurance policies lapse each year with no financial benefit to policyholders. Surprisingly, only around $4 billion worth of policies actually settle each year. In addition, insurance carriers offer surprisingly low values to surrender policies. Life settlement providers advance a meaningful portion of the policy's value to the holders which far exceeds their other options. The industry has significantly evolved and institutionalized over the last decade with the imposition of regulation promoting transparency and consumer protections. The life settlements industry today offers what many view as a valuable financial solution to the large and growing segment of the aging US population who no longer have need for their policy and may struggle with increased costs for medical and long term care.

Financing backed by non-standard or uncorrelated assets is a natural opportunity set for non-bank lenders

Investment Approach: Rather than purchase settled policies in the open market, KKR Credit formed and capitalized a capital vehicle with one of the leaders in the life settlements industry. This approach, while more involved and operationally complex, enables KKR Credit to tap a primary source of market information and access policies at wholesale prices. We believed this approach would result in a more favorable risk/return proposition. The KKR vehicle's primary strategy is purchasing policies with a hold-to-maturity objective and opportunistically purchasing and trading policies in the tertiary market. KKR maintains control over the underwriting quality and audits its compliance policies and procedures.

Result: Since closing the investment in mid-2019, KKR has deployed $120 million of capital, representing approximately $475 million in face value of policies across both strategies. Additionally, we have traded to third-parties over $200 million worth of contracts.

REGULATORY CAPITAL TRADE

Market Opportunity: Regulatory Capital trades (or "Capital Relief" trades) are typically defined as synthetic securitizations through which banks transfer the risk of a reference pool of credit exposures to non-bank investors. Banks seek the exposure transfer with the goal of enhancing Tier I capital buffer (mainly in Europe) or transferring credit risk (mainly in the U.S.). The volume of banks seeking to complete regulatory capital trades typically increases following periods of stress on financial systems such as the Financial Crisis and now, in the current pandemic. In 2019, approximately €10 billion of European tranches were placed with investors.

Investment Approach: One example of a regulatory capital trade is a transaction we completed with a bank in northern Europe seeking a credit risk transfer in the form of a credit linked note referencing loans originated by the bank's European and U.S. Leveraged Acquisition Finance ("LAF") business. KKR Credit gained comfort with this opportunity given LAF is this bank's core business and its most profitable one. In addition, we expected that the subordination structure and excess spread would provide downside protection and mitigate losses. The pricing of the instrument and thickness of the tranche are other important factors. KKR Credit has deep institutional knowledge of the LAF business and its inherent risks because the LAF book is materially similar to KKR Credit's own portfolio of private credits. We leveraged our European private and traded credit investment teams who reviewed each eligible borrower. Additionally, we reviewed the bank's historical loss data on a no-names basis data tape.

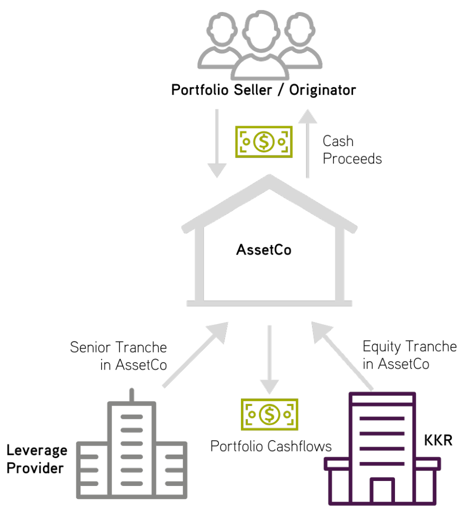
Result: This portfolio has performed ahead of expectations, with minimal credit losses that have been absorbed by excess spread of the structure, illustrating a core ABF downside protection feature. Furthermore, we believe the investment is well positioned to weather significant forward losses associated with the current COVID-19 pandemic, considering it is below the projected loss threshold and has an untapped first loss cushion, in addition to excess spread.

The volume of banks seeking to complete regulatory capital trades typically increases following periods of market dislocations, such as the GFC and the current pandemic

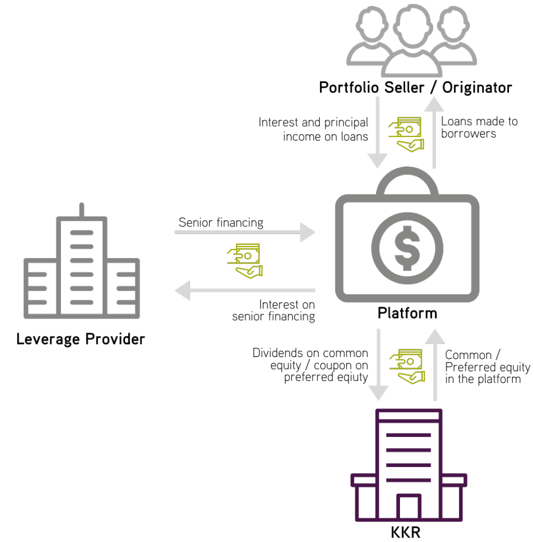
ACCESSING MARKETS AND OPTIMIZING RISK & RETURN[17]

Investment managers, including KKR, typically access ABF opportunities through Portfolio Acquisitions, Platform Investments, or Structured Investments. Investments are then carefully structured and negotiated with borrowers or investment partners to seek an attractive and differentiated balance of risk and return for investors.

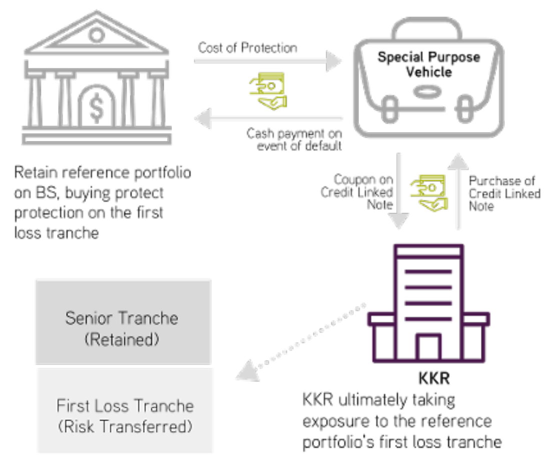
Portfolio Acquisitions: Portfolio acquisitions involve the direct acquisition of or investment in a portfolio of income-generating assets. Investment managers typically source portfolio acquisitions through bank or finance company contacts, both proactively and on a reverse inquiry basis. This diagram illustrates a typical forward flow purchase agreement with a non-bank originator:



Platform Investments: Investment in a platform can be a more effective way to access certain lending opportunities. In these cases, mezzanine or equity investments are made into a new or existing origination and, or servicing platform and its related assets. The financing is used to fund the growth of a pool of assets or servicing of a static pool of assets. The creation of a platform is typically done in partnership with a deeply experienced management team with subject matter expertise in an industry. While more complex, investing in a platform can have long term benefits such as above market yields that are protected from erosion by barriers to entry, equity upside potential through warrants in the business, and uncorrelated returns. Downside protection is another potential benefit as the investment manager can proactively adjust the underwriting strategy and origination pace to shape the asset pool through market cycles. This includes ceasing, temporarily or permanently, new loan origination and allowing the loan book to liquidate. The diagram below illustrates a typical platform investment:



Structured Investments: Structured Investments are customized financial contracts backed by a discrete stream of cash flows. These investments typically take the form of private mezzanine or regulatory capital relief trades which became increasingly in demand post Financial Crisis. Structured investments are typically developed in conjunction with a bank or asset manager seeking a specific solution. The illustration below is an example of a regulatory capital relief trade for a bank:



NICHE VERSUS BROAD APPROACHES TO INVESTING IN PRIVATE ASSET-BASED FINANCE

Investment managers generally pursue ABF through either a niche-asset class approach or broad, multi-asset class approach. Each has pros and cons. A narrow approach targets a specific geographic region or market sub-segment, such as aviation leasing or receivables financing. This approach benefits from a manager's networks and expertise but can expose investors to consequences including cyclical/secular downturns in that region/niche or manager "home bias" that clouds investment decisions. Another potential challenge, particularly for larger institutional allocators, is deploying significant capital due to smaller opportunity sets.

A global, multi-asset class approach pursues an array of segments and geographies, affording managers greater ability to evaluate relative value across a range of deals and selecting only those that meet their criteria and contribute to a diversified portfolio. This approach is preferable in our view. It can shield managers from pressure to deploy capital during downturns or when valuations are unattractive. Particularly during periods of dislocation, such as in the era of COVID-19, we believe being limited to a niche within ABF can present challenges for a manager. Of course, a multi-asset approach requires that managers have a large, well-resourced global platform with investment and structuring expertise plus operations and financing resources. Boots on the ground and access to large and flexible pools of capital are also critical but high bars to reach.

CONCLUSION

We believe ABF is worth examining now as a strategy that can stand on its own merits, on absolute and relative bases, and has a long runway to deliver on a number of attractive characteristics, including:

Access to a diverse and growing opportunity set

Fueled by a persistent and possibly widening global supply/demand imbalance for non-corporate credit and new technology-enabled innovations streamlining access to credit solutions.

Attractive exposures

- Specialized strategy pursuing new and mispriced lending opportunities and opportunity to negotiate towards potential origination premiums, excess spreads, and equity upside of ownership in lending platforms.
- Access to the benefits of (i) privately negotiated transactions where lenders often maintain an upper hand due to a less competitive market, (ii) investments backed by large diversified pools of hard and financial assets, (iii) short duration of many of the underlying loans.

Portfolio diversification

Exposure to credit markets and proprietary transactions that can be idiosyncratic and largely disconnected from broadly held asset classes which results in low-to-moderate correlations.

REFERENCES

1. Represents the global stock of private financial assets originated and held by non-banks, related to household (including mortgages) and business credit. Excludes loans securitized or sold to agencies and assets acquired in capital markets or via other secondary/ syndicated channels. Source: Integer Advisors and KKR research estimates based on shadow banking data from the Financial Stability Board.
2. Sources: Global Direct Lending – Preqin. Represents assets under management and dry powder of closed and investing funds and SMAs and funds currently fundraising that have held initial closes, as of September 30, 2019; European Bank Loans - S&P European Leveraged Loan Index; European High Yield Bonds - BofA Euro High Yield Index; US Bank Loans - S&P LSTA Leveraged Loan Index; US High Yield Bonds - BoA US High Yield Master II Index; Emerging Market - Barclays Emerging Market Hard Currency Aggregate Investment Grade and High Yield Index and Barclays Emerging Market Local Currency Government Bond Index, as of March 31, 2020.
3. Source: Boeing Capital Corporation, Current Aircraft Finance Outlook, 2019, KKR Estimates.
4. Source: Integer Advisors estimates. NPL market size sourced from EBA. Non-core asset stock estimates based on PwC Portfolio Advisory Group projections.
5. Source: Integer Advisors estimates based on FSB and EBA data.
6. KKR may use some or all of the themes described.
7. Examples are for informational purposes only.
8. Past performance is not an indication of future results.
9. Source: Attom Data Solutions, 2019 year end report and KKR Estimates.
10. Source: Deleveraging Europe, Deloitte, October 2019.
11. Source: Deleveraging Asia, Deloitte, September 2019.
12. Source: KPMG "Impact of Basel IV on European Banks," 2018.
13. Source: Estimates based on PWC Portfolio Advisory Group projections.
14. Boeing Capital Corporation, Current Aircraft Finance Outlook, 2019, KKR Estimates.
15. Source: PwC transaction due diligence report, February 2019. Sources include IHS Markit, data for NACE Rev.2 Division 77 "Rental and leasing activities."
16. Past performance is not an indication of future results.
17. Source: KKR. For illustrative purposes only.

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