KKR

April 2024 Market Review

KKR Credit & Markets

From Consensus to Allocation

Written by:

Christopher A. Sheldon
Partner and Co-Head
Credit & Markets

Rory O'Farrell
Managing Director,
Client & Partner Group

Executive Summary

Market consensus is building around the idea that inflation and rates have peaked and a hard landing is unlikely. However, what credit investors seem less settled on is when, how, and where they should allocate.

This month, we make three key points:

1. Private credit has earned its right to stay: Direct lending is becoming a mainstay in investors' asset allocations, as well as a regular tool in the toolkit for borrowers. This holds true even as syndicated markets reopen.
2. The ship has not sailed in liquid credit markets: Despite strong performance in 2023, we believe investors can still attain high levels of income with limited risks of outright losses, plus the added benefit of immediate deployment. Dispersion is likely to increase, making credit-picking increasingly important.
3. We are in a golden age of credit allocation: The tremendous growth private credit has experienced over the past decade has made a more diverse array of options available to investors. Asset-based finance, capital solutions, and Asia-Pacific credit markets offer a different risk-and-return profile and diversification to corporate private credit in developed markets.

Key Themes

01
A Permanent Spot for Private Credit

02
The Ship Has Not Sailed in Liquid Markets

03
A Golden Age for Credit Allocation

A consensus is building in the markets: A hard landing is unlikely, either in the United States or Europe. Inflation seems to have peaked, and interest rates will follow them down at some point. Yet, this consensus has not translated into broad conviction among credit investors about where and how to invest.

Markets are in transition, with the most notable shift being the rebalancing between private and liquid credit markets. Private credit received an incredible amount of public attention in 2022 and 2023, but some of the enthusiasm may have been overwrought. The asset class has clear benefits for investors and borrowers alike, but we think the fervent interest and blue-sky predictions that circulated were sometimes rooted in an unusual set of circumstances. However, investors and borrowers also gained a new appreciation for how beneficial and resilient the asset class can be, and the private credit frenzy accelerated a shift that we feel was coming anyway: the acceptance of private credit as a permanent allocation in investors' portfolios.

We hear often that investors are nervous about putting money to work now, as the economy slows and corporate margins begin to deteriorate. Our view remains that the economy is slowing, defaults will rise, but not skyrocket, and that dispersion will increase, creating opportunities for credit selection (and manager selection). We expect that levels of both defaults and EBITDA margin contraction will vary significantly across sectors and regions, concentrating in some pockets of the market more than others. For investors who are worried about their overall exposure to corporate credit or slowing developed economies, we see interesting ways to diversify within private credit.

The coming adjustment to an environment in which rates are declining, rather than rising, is also top of mind for investors. The timing and magnitude of rate cuts is impossible to predict, making it difficult to decide when and how to put on duration. In our own portfolios, we have been allocating incrementally to high yield for several months now, and we are also increasing exposure to CLO liabilities as a way to pick up incremental income and offset the sensitivity to getting the timing right on rate cuts.

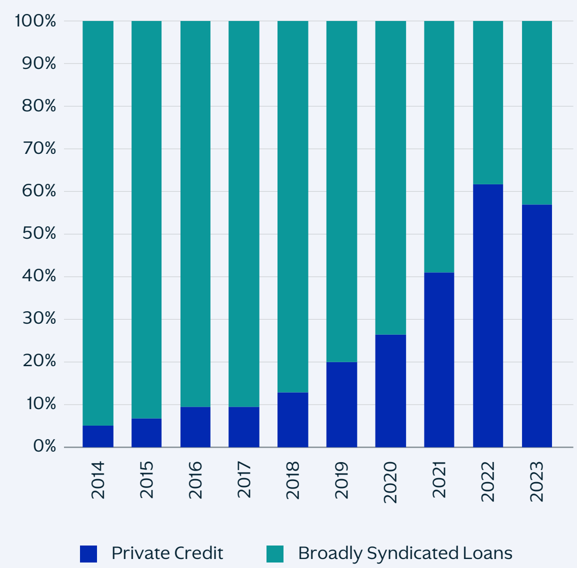
A Permanent Spot for Private Credit

The shift to private credit (specifically, direct lending) as a means of financing transactions in 2022 and 2023 was dramatic. In Europe, for example, the share of transactions financed by direct lending more than doubled between 2020 and 2023, from 27% to 56% (*Exhibit 1*). That divide has always been unsustainable, borne of the fact that borrowers didn't have much choice when syndicated markets and CLO markets were shut.

Now that those markets are opening, it is becoming more attractive to finance in syndicated markets. We see private credit deals being taken out and replaced with leveraged credit capital solutions and expect the trends to continue as M&A activity increases. As this trend continues, the average EBITDA among private borrowers is likely to fall.

EXHIBIT 1

Private Credit has Continued to Take Market Share from the Syndicated Market in Europe



Source: ION Analytics and PitchBook LCD as of December 31, 2023

None of this is bad news or even unexpected. We think direct lending will remain an important part of the borrower's toolkit, offering increased flexibility and certainty compared to syndicated markets and will remain an important part of the financing toolkit. Private lenders should benefit from overall growth in the market due to increased transaction activity, and we are optimistic for a strong vintage in 2024 and 2025.

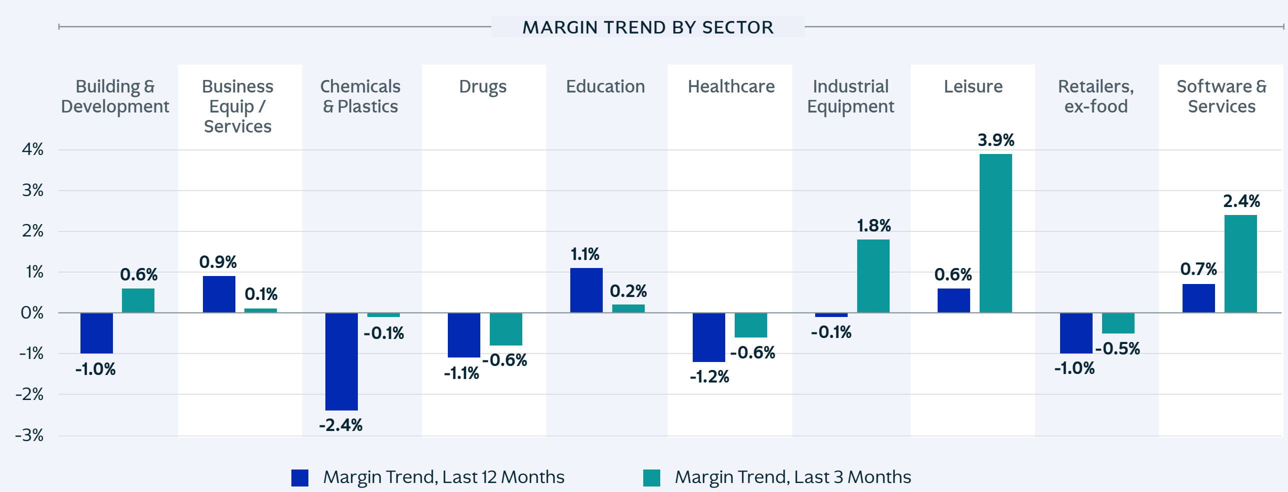
The potential for a mutually beneficial coexistence between liquid and private markets seems particularly apparent in junior debt, as we explored in some detail recently. We anticipate many large issuers who finance in liquid markets will run into a gap between the amount of senior debt they can raise and their contributed equity levels. In addition, syndicated markets are not aggressively pricing CCC risk, given that a high proportion of the loan market is held in CLOs and high yield is more than 50% BB-rated. Private junior debt can often finance that level of risk more easily and potentially at a more attractive price point. We often hear investors ask how we justify taking the additional risk of subordinated debt at a 14%-15% return when senior private loans pay 11%-12%. Our answer is that at a time when interest rates are moving lower and financing in public markets looks relatively cheap for many large borrowers, private junior debt offers more significant call protection and often access to larger borrowers than senior secured direct lending.

As for investors, we think they took note of the advantages direct lending offered in the volatile environment of 2022 and have also started to consider it to be a permanent allocation. In 2022, private credit investments offered high income, low defaults, and less volatility. That compared favorably to public markets, which also offered high income and low defaults, but came with higher volatility.

As we see the market changing, we also see it maturing and expanding. As investors continue to worry about corporate margins, we see an increasing desire to add to private credit exposure without adding just to direct lending. However, we believe that dispersion in corporate performance will increase, creating pockets of momentum in certain sectors and regions. While the EBITDA margin growth of KKR's European leveraged credit portfolio over the last 12 months was broadly flat-to-negative, for example, momentum has improved over the last three months and EBITDA margins have varied widely by industry (*Exhibit 2*).

EXHIBIT 2

Trends in EBITDA Margins in KKR's European Leveraged Credit Portfolio



Regardless of one's opinion on the future path of corporate margins, diversification is always important. Asset-based finance offers exposure to non-corporate debt, and our team is seeing unique opportunities in both the United States and Europe from disruption in the banking sector. U.S. regional banks have pulled back on lending and are selling performing assets in both core and non-core businesses, often with very attractive risk profiles. In Europe, capital-constrained banks increasingly seek capital relief solutions.

Investors may also wish to consider liquid and private credit opportunities in Asia Pacific as a way to diversify their existing portfolio. The region's economies account for nearly two-thirds of total global real GDP growth, and our Global Macro & Asset Allocation team expects the region's GDP growth to outstrip that of Europe and the United States going forward. Both private and liquid markets are less developed than in the West and therefore less competitive. In liquid markets, our team recently noted that movements tend to be sentiment-driven, creating opportunities for fundamental credit-pickers. Meanwhile, private lenders benefit from a significant unmet demand for capital. Bank financing represents 80% of lending, and capital markets are still relatively immature. Lenders with local expertise can find excellent opportunities to lend to high-quality, market-leading companies that need capital to execute their growth plans.

EXHIBIT 3

2023 US Liquid Credit Performance

Source: Bloomberg as of December 31, 2023. High yield bonds represented by the ICE BofA US High Yield Master II Index; leveraged loans represented by the Morningstar LSTA US Leveraged Loan Index; investment grade bonds represented by the ICE BofA US Corporate Index.

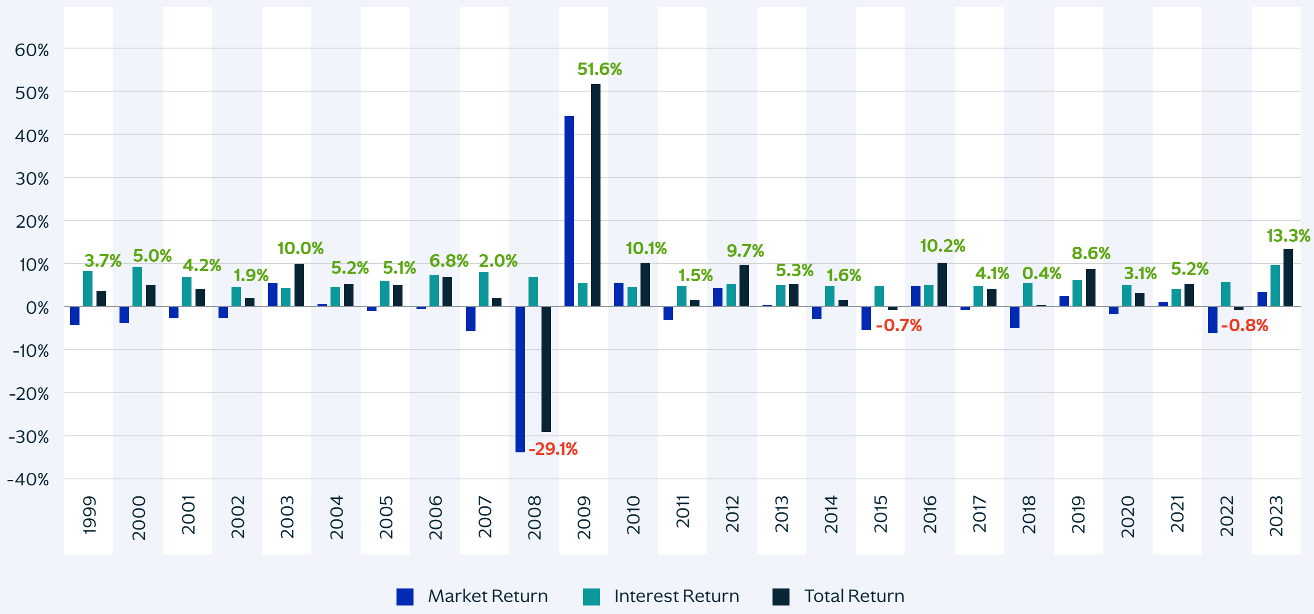
The Ship Has Not Sailed in Liquid Markets

Investors are in our experience keenly aware of the attractive returns they could have earned last year by deploying into credit (*Exhibit 3*), particularly liquid credit, where it was possible to put money to work quickly. Despite the limelight private credit received last year, only scaled players with access to broad origination were able to benefit from getting materially deployed and accessing the returns available.

Though some may feel that the best days have passed, we still believe that the liquid market is attractive for investors who wish to deploy quickly and gain access to high levels of current income with what we feel are limited risks of outright losses. Even in a market downturn, history suggests the risk of negative returns are limited in liquid credit. *Exhibit 4* shows that there have only been three years since 1999 in which US loans have had a total return loss (2008, 2015 and 2022). Typically, interest income can compensate for any negative market loss in a given year. Even if default rates in leveraged loans hit 10% with a 50% recovery, resulting in a 5% market loss for the year, investors can earn a 4% positive return if loans are yielding 9% cash on cash. Given our view that base rates will remain elevated and our expectation of a soft landing, we think a high-single or low-double digit return can be achievable in the short-to-medium term.

EXHIBIT 4

Historical Annual Performance of US Leveraged Loans



Source: S&P LSTA LLI as of February 28, 2024

However, agility and idiosyncratic credit-picking likely will be paramount as dispersion increases. Our Leveraged Credit team anticipates rolling recessions, with different industries under pressure at different times. Rising costs and slowing demand have been difficult for inflation-sensitive issuers and certain portions of the consumer economy, for example. In 2023, many management teams successfully passed on rising costs, but those that didn't were often punished in the markets. We expect this to continue. Having full coverage of the market can allow managers to be nimble, spot trends, and actively trade, but it is difficult to avoid all pitfalls. Managers with a robust process and well-resourced team in place to handle restructurings are in a better position to maximize returns from negative scenarios while still maintaining focus on the broader portfolio, in our opinion.

As for defaults, we continue to expect that they will rise for existing deals with capital structures that are older and less fit for purpose, but will remain manageable and somewhat concentrated. Companies have been refinancing debt coming due in 2024 and 2025, and the private credit market is also helping to address near-term maturities.

Aside from fundamentals, the question we hear most often in liquid credit is when and how to add duration and fixed-rate exposure. Last quarter, we advocated for adding incremental high-yield exposure. In our flexible pools of capital, we continue to reduce our own overweight to leveraged loans. We expect fewer rate cuts than consensus in the United States. However, we maintain our leveraged loan overweight because the asset class offers attractive cash-on-cash income relative to bonds, where a greater portion of potential returns comes from convexity. As the year progresses and the insight into the timing of rate cuts potentially changes, the ability to toggle among asset classes as both spreads and risk-free rates adjust could be a differentiator.

Conclusion: A Golden Age for Credit Allocation

We urge investors to resist the urge to get too granular. It's possible to obsess over entry points, interest rate moves (particularly with rates as high as they are), and the likely path of the economy to the point of foregoing the opportunity to get money deployed. Those who sat on the sidelines in liquid leveraged credit markets learned this lesson well in 2023.

With interest rates likely to remain elevated for the foreseeable future, it is still a good time to be a credit investor. Credit has become a much larger asset class with a very wide variety of instruments available for both institutional and individual investors, and the hunt for capital in 2022 accelerated the evolution of private credit (direct lending) into a portfolio mainstay. What we think is exciting is that as the asset class matures, it is easier to build diversified exposure in terms of corporate/non-corporate exposure, by region, and by level of risk. Liquid markets still offer attractive opportunities, and there, too, we think it helps to be able to dial exposure to sub-asset classes up and down as the market shifts. Instead of worrying about the perfect timing for deploying into a "golden age for private credit" or any other credit asset, we think it is time to think more about a golden age for credit allocations. That means taking advantage of the growing number of options available for getting deployed and building diversified portfolios.

Christopher A. Sheldon

Bob and Carl Play a Game of Risk

Illustration by: Jerry Capria, KKR Credit.

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

Twitter: @KKR_Co

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