October 2023 Market Review

# KKR Credit & Markets

## Finding Equilibrium in Public and Private Credit

Written by:

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

**Rory O'Farrell**
Director,
Client & Partner Group

## Key Themes

In this letter, we'll focus on the opportunities in both private and liquid credit markets.

# 01

**A Clearer Path Forward for Private Credit**

# 02

**The Risk of Forgoing Opportunities in Liquid Credit**

# 03

**Green Shoots and Some Old Roots**

# Executive Summary

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, such as capital solutions and junior debt, or strategies that are complementary by being less correlated to traditional, developed market corporate macro risk, such as asset-based finance or Asia credit strategies.

However, we think the permanence of private credit does nothing to diminish the need for public credit markets. Both have a place in a healthy, functioning borrowing system and can serve different purposes. Public credit allows for quick deployment, and the relatively high yields currently available in public markets have the potential to cushion against price volatility. The liquidity of public markets creates the potential to shift quickly when market conditions change. 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. This is most evident in high yield bonds, private junior debt, and other subordinated capital solutions. In short, we think it will remain a good time to be a lender.

As for the capital markets and overall environment, we see some green shoots emerging. U.S. IPO activity has ticked up. Our debt capital markets team has seen a ramp-up in syndicated public debt markets and expects this trend to continue in the remaining months of 2023, and we have noticed that our clients have more appetite for allocating to credit in both liquid and private markets. We think that the interest rate outlook is a tad bit clearer, and that while credit fundamentals have not yet bottomed, they may be closer to doing so. Though there will no doubt be bumps in the road from here, we note that at this point in the calendar, there is pressure to get invested and to do deals. Fear of missing out is a powerful motivator.

# A Clearer Path Forward for Private Credit

Credit markets have changed in fundamental ways over the last 15 years—shifting corporate borrowing away from syndicated markets and towards private credit. Banks began shrinking the scope of their lending activity after the Global Financial Crisis, and the pullback has continued post-COVID and in the face of the U.S. regional banking scare in March 2023. As a result of the most recent retrenchment, the loan syndication machine broke down, conditions for high yield issuance became unpredictable, and the IPO well ran dry. What was left? Private credit, which has steadily taken share from syndicated markets and moved out of the realm of the middle market to become a viable means for financing larger deals. Meanwhile, private asset-based finance strategies have seen a growing number of attractive opportunities to lend against portfolios of high-quality assets as regional banks have started to look to shed portfolios of loans or exit from lending against certain assets.

The Hunt for Capital that has boosted private credit's fortunes has attracted focus, excitement, and anxiety in investment circles, but it has also raised several important questions.

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1. From M&A to IPOs, capital markets must reopen at some point. Are there any signs that this is underway?
2. If public markets do reopen, what does that mean for both private credit and liquid credit?
3. Is the rise of private credit sustainable? Or is this a bubble?

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The answer to the first question is that we do see some signs of green shoots, which we will discuss later. And as that happens, we are also starting to have a clearer view of the path forward for private credit. We hear more and more clients describing the $1.5 trillion private credit asset class becoming a permanent allocation within their portfolios, whereas they may have thought of it in the past as an opportunistic allocation, part of a tactical allocation within fixed income, or as part of an "alternatives" bucket. Typically, we have seen the core allocations within private credit take on the role of an income strategy that can be supplemented by opportunistic, higher-yielding private credit strategies; private strategies that are uncorrelated to developed market corporate risk, such as asset-based finance or Asia credit; or both. It's also important to consider that private equity funds hold more than $2 trillion of dry powder and will need both public and private credit to finance deals. As such, we think that the pace of growth in private credit is indeed sustainable, but that it need not usurp liquid credit's traditional role.

Our colleagues, Henry McVey, Head of the Global Macro, Balance Sheet, and Risk team and Chief Investment Officer of the KKR Balance Sheet, and Racim Allouani, Head of Portfolio Construction, Risk Management, and Quantitative Analysis, have explained in their asset allocation work why the inclusion of Private Credit makes sense from an asset allocator's perspective. In the face of rapid inflation and higher-for-longer interest rates, traditional fixed income simply isn't playing the role of the volatility dampener that it used to in a 60/40 portfolio. Private Credit offers exposure to a very different kind of asset: one in which lending terms are directly negotiated, interest rates are floating, and diversification is possible given the scale of the market.

On the other side of the transaction, we think Private Credit is also a permanent option for sponsors and borrowers. Large financings that would have almost certainly taken place in syndicated markets in the past have instead been executed in private credit markets. A negotiation with one lender or, in a bigger transaction, a small group of like-minded lenders, offers a level of certainty and flexibility that syndicated markets often can't, and the potential benefits of that became obvious with syndicated markets shut.

However, we think a common portrayal of the relationship between private credit and liquid credit as a PacMan game wherein one side tries to eat the other for lunch is flawed. Going forward, we think the challenge for investors will be to find the equilibrium between these two markets, which we believe will exist side by side.

# 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 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 yield available can be good buffers against price volatility. In *Exhibit 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.

**EXHIBIT 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

# 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.

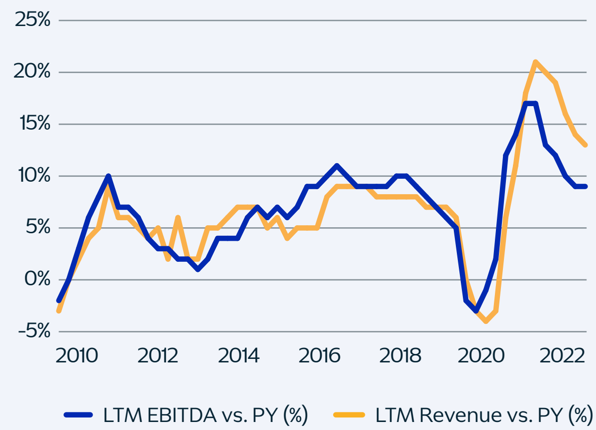
In private credit, according to one broad measure of the asset class, the percentage of private borrowers in the wider market breaching loan covenants has continued to tick up steadily since the end of 2021, reaching 4.5% in the first quarter of 2023 compared to a two-year average of 3.3%.[1] The same measure showed interest rate coverage ratios decline in the first quarter of 2023 from 1.86x the year prior to 1.56x. However, the Proskauer Private Credit Default Index, which tracks 977 loans worth $145 billion, showed that defaults actually declined slightly in the second quarter of 2023 to 1.6%. We expect defaults to continue rising in the next few quarters, but the data may not move up in a straight line. In fact, while we think these trends in the broader market are worth watching, we wouldn't read too much into the quarterly changes. Performance is going to be idiosyncratic and credit by credit. Another bias to call out here is that covenants tend to exist more in the lower to mid-portion of the middle market and as deals grow in size, loans tend to lose their covenants as they become more of a replacement for syndicated debt.

As for public markets, *Exhibit 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 EBIDTA is more important than a point-in-time snapshot. We think both EBITDA and revenue will continue to trend downward as

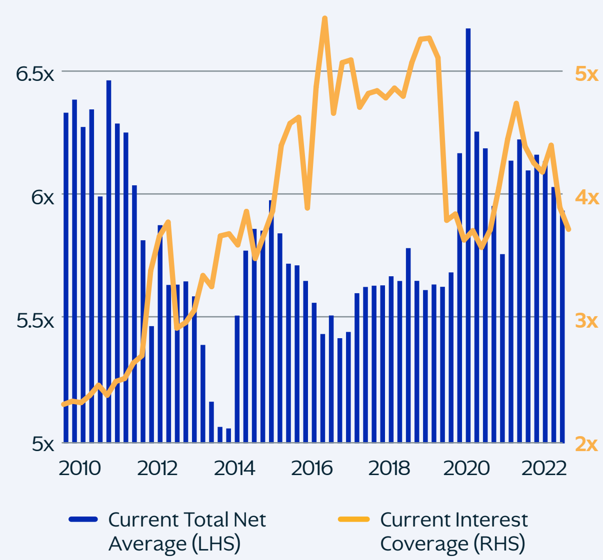
**EXHIBIT 2**

## Trends in KKR's Credit Portfolio

Revenue and EBITDA Growth




Leverage and Interest Coverage




Source: Quarterly KKR Credit analysis as of August 31, 2023.

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

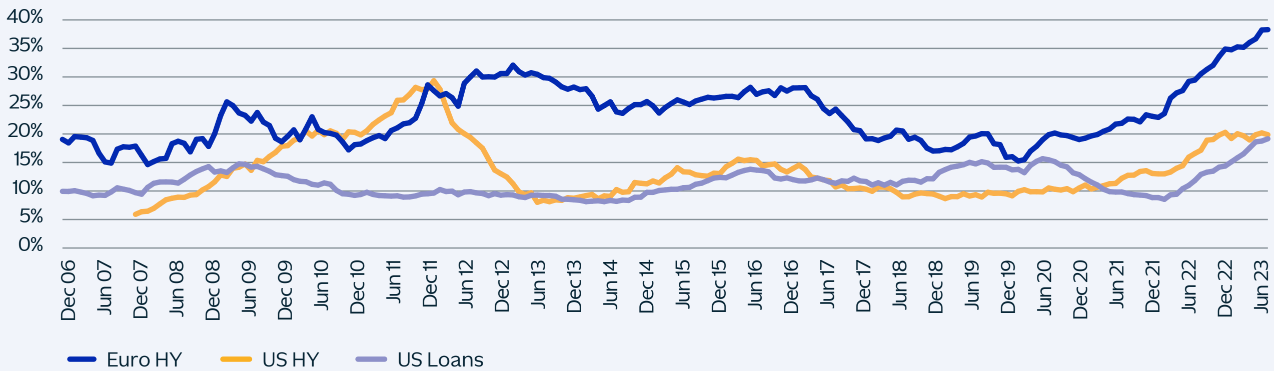
inflation puts pressure on cost bases, but we believe there is a great deal of dispersion within those numbers. Some 23% of companies saw EBITDA fall 5% or more in the first quarter of 2023, while half saw it grow more than 10%. (The trends we have observed in our Private Credit portfolios are similar.) 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 (*Exhibit 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 (*Exhibit 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.

**EXHIBIT 3**

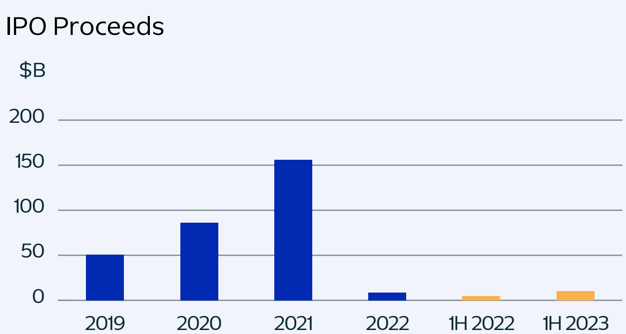
## Proportion of the High Yield Market Maturing in 3 Years

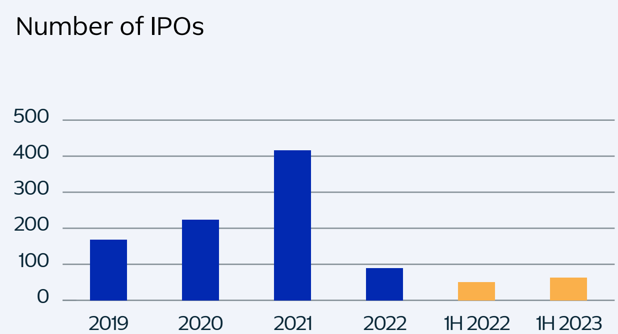



Source: ICE BAML and LSTA as of June 30, 2023

**EXHIBIT 4**

## IPO Activity Slightly Higher in 2023




Sources: EY analysis, Dealogic. Data as of June 30, 2023

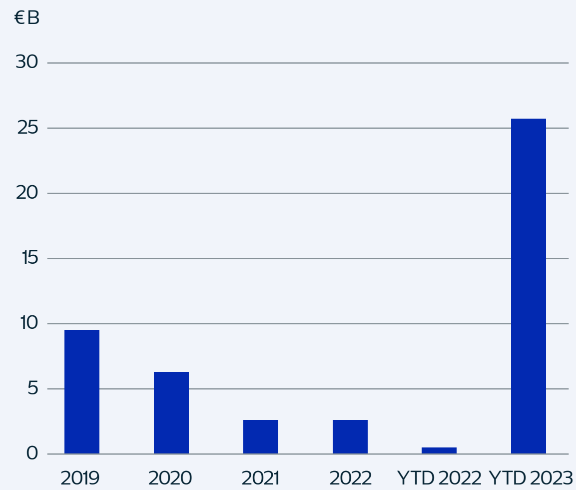
The KKR Capital Markets team expects U.S. IPO activity to steadily increase over the next 6-12 months. However, market availability will likely remain window-driven for issuers. In the near term, deal profiles will skew towards industry-leading companies with relatively large market capitalizations —the kinds of companies that offer investors enhanced liquidity alongside a growth story that incorporates less volatility in forward earnings. Sustained positive aftermarket trading performance from recent transactions will be an important factor to monitor in supporting further risk-on appetite for new opportunities. As the IPO market thaws, valuation discounts should narrow from the 30%-plus rates that prevailed in most of 2022 and 2023. IPO activity has not enjoyed the same bounce in Europe, however, with the pace in the second quarter of 2023 coming in weaker than at any point since 2009 and policymakers even taking steps to make listing locally more attractive.

We spoke earlier about the syndication machine breaking down over the past 18 months-plus. Leveraged loan issuance in 2023 is weak,[3] with year-to-date issuance of $178bn[4]—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 (*Exhibit 5*). 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 OID to attract scarce pools of capital (*Exhibit 6*). We think this can be a rich picking ground for opportunistic capital.

**EXHIBIT 5**

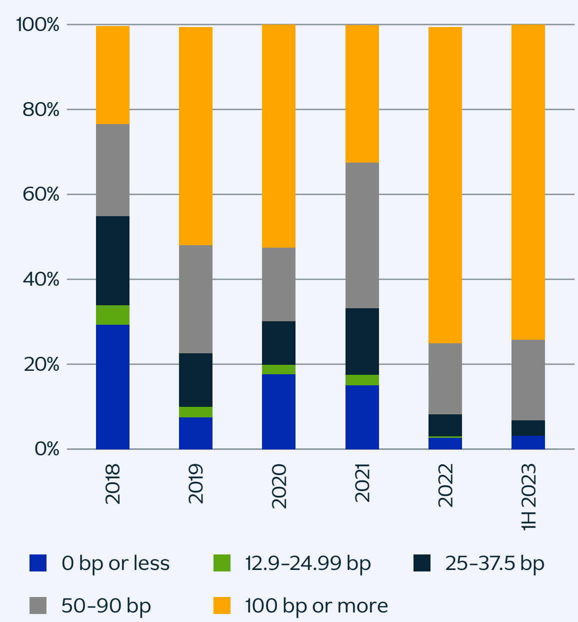
### Heightened Amend-and-Extend Activity in Europe




Source: PitchBook LCD as of June 30, 2023.

**EXHIBIT 6**

### Distribution of Institutional Upfront Fees




Source: Pitchbook LCD as of June 30, 2023

3. https://pitchbook.com/leveraged-commentary-data/leveraged-loan
4. Pitchbook LCD as at 30 June 2023

While amend-and-extends represent some activity, they are not new deal activity. On that front, Cade Thompson, our KKR Head of Debt Capital Markets, has said that the pipeline of deals in the syndicated markets is expected to rebuild and that banks are increasingly interested in underwriting deals again. He expects syndicated debt activity to ramp up this fall but notes that extensions and refinancing deals may still comprise a large portion of capital markets activity if interest rates, inflation, and economic conditions stay more or less where they are.

Another place we see a pickup in activity is among capital allocators. We have observed a greater appetite for putting money to work in both leveraged credit and private credit over the last few months, as well as for coinvestment opportunities. We do not think this is the private market equivalent of "buying the dip." From what we see, the trend is not to look back to older deals, but rather to fresh deals with capital structures that are built for today's environment of higher interest rates and higher inflation.

We attribute some of this pickup to a growing sense of urgency: Private equity sponsors are sitting atop a growing pile of dry powder, which has now reached $2.49 trillion. We suspect that many of those who waited to act in March or April are feeling pressure here in the month of October to get deals booked for 2023.

There's also a sense of a fog lifting in the marketplace. The future path of interest rates has been driving financial markets for the past two years. Having raised rates 11 times since 2021 to reach 5.375% in July, we think that the U.S. Federal Reserve will likely pause for the rest of the year, despite the September dot plot showing the possibility of one more 25-basis-point hike. Though U.S. inflation remains well above the central bank's 2% target, it has also been steadily cooling, and the U.S. economy faces some potential headwinds from the auto workers' strike, the resumption of student loans, and other factors. In Europe, where core inflation in particular is less settled and the European Central Bank (ECB) has been slower to raise rates relative to the U.S., we feel fairly confident that the ECB will continue to hike.

**EXHIBIT 7**

## Leveraged Credit Performance by Level of Risk

| Asset Class | MTD | YTD |
|---|---|---|
| US HY | -1.16% | 5.97% |
| US BB | -1.44% | 3.82% |
| US B | -0.98% | 6.73% |
| US CCC | -0.63% | 12.91% |
| EUR HY | 0.32% | 6.11% |
| EUR BB | -0.08% | 5.20% |
| EUR B | 0.48% | 8.23% |
| EUR CCC | 4.47% | 3.90% |
| US Loans | 0.96% | 10.16% |
| US BB | 0.63% | 7.27% |
| US B | 1.06% | 11.31% |
| US CCC | 1.59% | 15.03% |
| EUR Loans | 1.09% | 11.66% |
| EUR BB | 0.77% | 8.34% |
| EUB B | 1.14% | 12.29% |
| EUR CCC | 1.03% | 6.68% |

Source: S&P LSTA, BAML and KKR Credit Analysis as of September 30, 2023

It's one thing for us to have more clarity, but for the gears of the capital markets to turn again, market participants must have it, too. The muted reaction to the Federal Reserve's last rate hike, in July 2023, pointed to a market less worried about the Fed's every incremental move than it used to be. In August, the gap between yields on BB and CCC bonds narrowed to 6.53%, the narrowest in more than a year, showing a level of confidence in the U.S. economy in the same week Fitch Ratings downgraded U.S. debt. Year to date, the 6% returns in U.S. high yield bonds have been driven by lower-rated credits, as CCCs have outperformed B and BB bonds (*Exhibit 7*). The opposite dynamic held true in Europe, where the rising-rate environment is still very much in play. U.S. leveraged loan prices also rose to their highest point since May 2022 in August 2023, and continued to rise in September amid hawkish sentiment, large inflows into the asset class and heavier capital market activity.

That said, we do not think the outlook is crystal clear yet. We think we are closer to a bottom and that the interest rate outlook is more solid. However, fundamentals are very likely to continue to deteriorate from here and will bottom before markets do. The path forward will have bumps, and we see this as a period in which credit selection is paramount. The return available in high quality credits are attractive enough that we still see no advantage to reaching for complexity or risk.

## Carl Gets Impatient


Illustration by: Jerry Capria, KKR Credit.

## Conclusion

The fragility, uncertainty, and volatility that have become consistent features of the market environment make it hard to interpret signals: Is a pipeline of new capital markets activity the sign we've been waiting for? Or are bank failures and credit downgrades the alarm we've been anticipating? We tend to lean toward the former, but those questions are only going to be perfectly clear in hindsight.

We continue to believe waiting is the wrong approach. It takes time to deploy into private credit, but commitments need to be made now to access future deal flow. Meanwhile, liquid credit offers an opportunity to put money to work immediately.

We believe that factors such as rate stabilization, increased market activity and demand for capital should provide a clearer view to how the short term will play out. Our idea is: Just start.

**Christopher A. Sheldon**

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