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CORPORATE PARTICIPANTS

Craig Larson *KKR & Co. Inc. - Head of IR*

Scott C. Nuttall *KKR & Co. Inc. - Co-President, Co-COO & Director of KKR Management LLC*

William J. Janetschek *KKR & Co. Inc. - Member & CFO of KKR Management LLC*

CONFERENCE CALL PARTICIPANTS

Alexander Blostein *Goldman Sachs Group Inc., Research Division - Lead Capital Markets Analyst*

Andrew Paul Disdier *Sandler O'Neill + Partners, L.P., Research Division - Director*

Ben Herbert

Christopher Meo Harris *Wells Fargo Securities, LLC, Research Division - Director and Senior Equity Research Analyst*

Craig William Siegenthaler *Crédit Suisse AG, Research Division - MD*

Devin Patrick Ryan *JMP Securities LLC, Research Division - MD and Senior Research Analyst*

Gerald O'Hara

Michael J. Cyprys *Morgan Stanley, Research Division - Executive Director and Senior Research Analyst*

Michael Roger Carrier *BofA Merrill Lynch, Research Division - Director*

Patrick Davitt

Robert Andrew Lee *Keefe, Bruyette, & Woods, Inc., Research Division - MD and Analyst*

PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by. Welcome to KKR's Second Quarter 2018 Earnings Conference Call. During today's presentation, all parties will be in a listen-only mode. Following management's prepared remarks, the conference will be open for questions. (Operator Instructions) As a reminder, this call is being recorded. I will now turn the call over to your host, Mr. Craig Larson, Head of Investor Relations for KKR. Craig, please go ahead.

Craig Larson - *KKR & Co. Inc. - Head of IR*

Thanks, Valerie. Welcome to our second quarter 2018 earnings call. Thanks for joining us. As usual, I'm joined by Bill Janetschek, our CFO, and Scott Nuttall, our Co-President and Co-COO. We'd like to remind everyone that we'll refer to non-GAAP measures on the call that are reconciled to GAAP figures in our press release, which is available on the Investor Center section at KKR.com. The call will also contain forward-looking statements which do not guarantee future events or performance. Please refer to our SEC filings for cautionary factors related to these statements. And like previous quarters, we've also posted a supplementary presentation on our website that we'll be referring to over the course of the call.

Beginning first on page 2, this marks our first earnings call since our July 1 conversion from a partnership to a corporation, as well as since our July 9 Investor Day. We know many of you did join for Investor Day, and we thank you for that. For those of you that might be newer to KKR, we would encourage you to review the webcast presentation or the presentation and the transcript itself, all of which are available on our website. There's a wealth of information across all of those materials.

Let's turn now to pages 3 and 4 of the supplement. Page 3 shows a summary of our 4 key metrics since 2013, while page 4 provides more specificity around these figures for the quarter, as well as on a trailing 12-month basis. Let's begin with page 3.

We continue to see strong underlying trends across the firm. From our perspective, the alternative sector continues to grow and we're continuing to take share. Beginning in the top left-hand pane, AUM is up 29% year-over-year, reaching $191 billion. This growth in underlying assets is driving the continued growth in our management fees, as you see in the top right-hand corner of the page, and for the trailing 12 months, management fees reached $980 million.

And behind strong performance, our book value per share on a marked basis was $15.59 as of June 30. This is a 10% increase over the first 6 months of the year compared to the MSCI World, which appreciated less than 1% over the first 6 months of the year. And these statistics, as we've noted previously, are particularly important, as they're the ones that are ultimately going to drive the earnings power of the firm looking forward and all our record figures for us as a public company.

In terms of our after-tax distributable earnings, looking at the bottom right-hand chart, we reported $1.4 billion over the trailing 12 months. The trends that you see here really reflect 2 things. First, in the early years, we saw meaningful gains as legacy balance sheet co-investment holdings were realized. You see this dynamic in the top lighter shaded portion of the bars that show realized investment income, and it's most pronounced, as you see, in 2013 and 2014.

And second, as we discussed in some length during Investor Day, a number of the businesses that we've created are relatively young, so we have dollars in the ground with a carry right, and they're continuing to season, continuing to mature. So we're under-earning our carry potential and our distributable earnings potential as a firm as that happens. In our view, longer term, the growth opportunity we have, given this backdrop, is a compelling one.

Let's look at more of the details on page 4. So for the quarter, this morning we reported after-tax distributable earnings of $405 million or $0.49 on a per-adjusted-share basis. Comparably, this is $0.29 in Q1 and $0.34 in Q2 of 2017. And on an LTM basis, after-tax DE came in at $1.4 billion, or $1.73 per adjusted share.

Management fees reached $261 million in the quarter, up 14% year-over-year. This growth, combined with an active quarter in our Capital Markets business, which Bill's going to talk about shortly, led to a strong fee-related earnings quarter. We reported FRE of $231 million for the quarter and $883 million on an LTM basis. FRE, similarly, is also up 14% year-over-year.

Our fee-paying AUM reached $139 billion as of June 30, up 23%. And in terms of our distribution, we've announced our final $0.17 distribution for the second quarter as a partnership. As we highlighted during our call last quarter, as a corporation we expect to pay an annualized dividend of $0.50 per share, and this will begin in the third quarter.

Stepping back as we evaluate our performance more broadly, there are really 5 things that we need to do well. We need to generate investment performance, raise capital, find attractive new investments, monetize existing investments, and use our model to capture more economics across everything that we do. I'll update you on our progress on the first 2, and Bill's going to cover the remaining 3.

In terms of investment performance, let's look at page 5 on the supplement. We've had continued strong performance across our asset classes over the last 12 months. In private equity, our 3 flagship funds appreciated 20% on a blended basis, and our overall private equity portfolio appreciated 6.7% for the quarter and 17.5% over the last 12 months. Our real asset strategies are performing as well, with our more mature real estate, infrastructure and energy flagship funds up 8, 14, and 12% respectively. And in credit, we saw strong performance in our Special Situations and Mezzanine funds in particular.

Turning to fundraising, in the second quarter, our AUM increased to $191 billion, driven by the closing of the FS transaction, and over the last 12 months we've raised $40 billion organically, driven by core, infrastructure, real estate, private credit, as well as our strategic investor partnerships. All told, the majority of this new capital came from non-PE strategies, and it's attractive. It's largely all performance fee eligible.

In terms of our fee-paying AUM, the FS transaction contributed $13.2 billion of new fee-paying AUM, and that's reflected in the public markets segment. And capital inflows over the quarter helped contribute to the $57 billion of dry powder that we have as of quarter end. And also of note, we have $19 billion of LP capital commitments that become fee-paying on an as-invested basis at a weighted average rate of approximately 100 basis points. This provides direct line of sight towards future management fee growth. And with that, let me turn it over to Bill.

William J. Janetschek - *KKR & Co. Inc. - Member & CFO of KKR Management LLC*

Thanks, Craig. I'll start with the third thing we need to do well, which is find new investment opportunities. We invested $4.6 billion across the firm and across geographies during the second quarter. Of the $4.6 billion, public markets deployment was $2 billion, with the majority coming from our direct lending strategy.

On the private markets side, we invested $2.6 billion. The largest contributor was a new Core investment, Heartland Dental. We also deployed approximately half a billion dollars in other private equity strategies, with 2/3 of that focused in Asia.

Shifting to monetizations, we continue to see a sizable level of exit activity across our PE business. This led to $342 million of realized carried interest for the quarter. As I mentioned at Investor Day, this quarter we completed a number of strategic sales and secondaries. On a blended basis, these PE exits driving realized carry were done at 3 times our cost. I would also like to highlight that our realized investment income for Q2 was $169 million. This income was driven by several secondaries in strategic sales, together with dividend and interest income.

And finally, the last thing we need to do well is use our model of AUM, Capital Markets, and balance sheet to capture greater economics for our investors and the firm from all of our activities.

This was another active quarter for KCM, with just over $100 million in transaction fees. As Adam Smith and others on our team noted at Investor Day, the breadth and depth of KKR Capital Markets has continued to expand, and a number of case studies were reviewed that highlighted how we use our model to capture more of everything we do.

Our acquisition of Upfield, a carve-out of the Spreads division of Unilever, is the latest example of this. We were the sole sponsor in a EUR 7 billion enterprise value transaction that required approximately EUR 2 billion of equity. KKR Capital Markets was instrumental in syndicating 1.2 billion of equity to third parties, as well in helping to underwrite and place the debt financing. This model is powerful. It allows the firm to create more economics by facilitating transactions. The economics of the Upfield transaction will be reflected in our Q3 financials.

We have announced two additional investments, BMC and Envision, which follow a similar framework. These are expected to close in the back half of the year. We expect Q3 to be another strong quarter for KCM. Page 6 of the supplement summarizes our core fundamentals across the 5 categories. The power of our model is evident in our results, and we are pleased with the progress and the momentum we're seeing across the firm.

And finally, 2 clarifying items. First, as we discussed on last quarter's call and at Investor Day, the after-tax DE number we reported, $405 million, does not include the impact of $729 million of one-time losses. These losses were realized in relation to the conversion. Recognizing the loss in Q2 will save our shareholders cash taxes that they would have had to pay on flow-through income, as we were still a partnership at the time of recognition. And as a reminder, these losses have already been reflected in prior quarters in book value and have no meaningful impact on cash.

And second, let me spend a minute on Infra. Infra III entered its investment period at the end of Q2, so the fund is additive to fee-paying AUM this quarter, but there is no management fee. We expect the final close to be in Q3 at approximately $7 billion of LP capital. In total, this will lead to management fee uplift of approximately $80 million on an annual basis, and again, beginning in Q3. And with that, I'll turn it over to Scott.

Scott C. Nuttall - *KKR & Co. Inc. - Co-President, Co-COO & Director of KKR Management LLC*

Thank you, Bill, and thank you, everyone, for not only joining the call today, but also for joining our Investor Day earlier this month. We enjoyed taking a deeper dive into our business with you. Given the detailed nature of those presentations, I'm going to keep it short today and reiterate the 4 key takeaways on page 7 that Joe and I discussed at Investor Day.

One, our industry is growing and we're taking share. The alternative asset management industry is large and has been growing at double-digit rates over the last 10 years. Within that very attractive industry dynamic, we're taking share, driven by diversification of both products and geographies. We're growing our assets under management at over 20% in a market that's growing 12%.

Two, our model of third-party AUM, plus balance sheet, plus Capital Markets is differentiated from our peers. As Bill mentioned earlier when he hit on KCM's growth and specifically the Upfield example, our unique model gives us the opportunity to create and compound shareholder value substantially and sustainably.

Three, many of our businesses are young, inflecting, and they operate in large end markets. Our U.S. private equity business is our one mature business, with most of our businesses started in the last 10 years. This points to significant and global opportunities for growth with scale benefits. Infrastructure is a great example of this, with our Infra fund growing from $1 billion to $3 billion to $7 billion over the past 7 years.

And finally, we're committed to equity value creation. Our alignment of interest is absolute, as KKR employees own or control about 40% of our stock. We believe our recent change to a C-Corp is an important milestone for unlocking that value. Although it's still very early, we're pleased with the significantly increased dialogue around our stock and we're enjoying building relationships with a broader group of investors. And with that, we're happy to take your questions.

QUESTIONS AND ANSWERS

Operator

Thank you. (Operator Instructions)

Craig Larson - *KKR & Co. Inc. - Head of IR*

Just before we begin with questions, if we could ask everyone to ask one question and then one follow-up, that would be helpful for us in making sure we work our way through the queue.

Operator

Thank you. Our first question comes from Bill Katz of Citigroup.

Ben Herbert

It's Ben Herbert on for Bill. Thanks for taking the question. Just wanted to follow up on the Capital Markets business, and with the BDC now in the fold, are we at kind of a stepped-up run rate going forward, kind of putting to the side Unilever, Spreads, BMC, and Envision Healthcare in the second half here?

William J. Janetschek - *KKR & Co. Inc. - Member & CFO of KKR Management LLC*

Well, it's Bill Janetschek, that's hard to predict. It's a Capital Markets business, so Capital Markets is driven by the activity of the firm, and so, again, we're not going to be able to predict what the income would be a quarter out or two quarters out, as it's a dynamic business.

Scott C. Nuttall - *KKR & Co. Inc. - Co-President, Co-COO & Director of KKR Management LLC*

And the only thing I'd say, Ben, is that with Franklin Square's capital in-house on the private credit side, we can now make even larger underwritings, and we think be even more competitive at the large end, where we think the risk reward is particularly attractive. And we do think, all else equal, it will allow us to have even more third-party syndication fee revenue coming out of Capital Markets. And you're right to point to the large private equity transactions we've announced, but that's a bit separate from what we're doing in Franklin Square.

Ben Herbert

And then maybe the follow-up would be, I didn't see the aggregate PE portfolio accretion in the release this quarter. Would you mind providing that metric?

Craig Larson - *KKR & Co. Inc. - Head of IR*

So I had mentioned just in the remarks the numbers. It was 6.7% for the PE portfolio as a whole for the 3-month period.

Operator

Our next question comes from Craig Siegenthaler of Credit Suisse.

Craig William Siegenthaler - *Crédit Suisse AG, Research Division - MD*

Thanks, good morning. First, just on Infra III. Given that this fund will be more than 2 times the size of II with the upcoming final close, how long do you think it could take to deploy this fund, and can you provide us a quick update on the investing backdrop for Infrastructure?

William J. Janetschek - *KKR & Co. Inc. - Member & CFO of KKR Management LLC*

Hey Craig, this is Bill Janetschek. As it relates to Infra II going to Infra III, we will be investing in Infra III starting in the third quarter. We've already got a signed deal that has not yet closed and will be putting money to work. When you look at the Infrastructure platform and you look historically at the pace of deployment for Infra I and Infra II, you could size that time period at anywhere in between 3 to 5 years.

Craig Larson - *KKR & Co. Inc. - Head of IR*

And Craig, just on the backdrop in the opportunity set, I think it's interesting when you reflect back on 2017 most specifically, we syndicated more capital than we invested in our funds, and it wasn't because we didn't like the investments, it was because we felt undersized against what's really just an enormous opportunity. And I think as we look at deal flow today and the opportunity set, again, it's just an enormous opportunity that we're excited about over the long term.

William J. Janetschek - *KKR & Co. Inc. - Member & CFO of KKR Management LLC*

And to put some numbers around that, when you look at where we are today, signed but, yeah, not yet closed transactions for Infrastructure, looking out probably over the next 3 months is going to be roughly about $600 million of equity.

Craig William Siegenthaler - *Crédit Suisse AG, Research Division - MD*

Got it. And just as my follow-up, and I know I just asked this kind of 2 weeks ago but I want to see if there's been any update, what are your thoughts on adjusting corporate governance and putting a small amount of voting rights into the float in order to qualify for the Russell 1000 next year?

Craig Larson - *KKR & Co. Inc. - Head of IR*

Well, Craig, so we're in the very early days as it relates to where we are as a C-Corp, and we'll have an opportunity to evaluate that in the spring of next year and we'll see where we are and we'll keep everybody updated. You know, as I'd said, as I think about the opportunity for us to expand shareholders, I think that -- I'd put them in 3 buckets. I think there is a great opportunity for us to expand our penetration within those firms that know us, but we're only appropriate for a fraction of the assets within those complexes.

The second of those are new investors and the new opportunities, and it continues to feel to me like we're only scratching the surface as it relates to that opportunity. And then the third piece of that really relates to the passive opportunity. You know, we've sized that amount as we think at least 20 million shares initially. And again, we'll see how we progress over time. But to me, the real drivers -- I think is actually going to be in the first 2 of those buckets as opposed to the third.

Operator

Our next question comes from Patrick Davitt of Autonomous Research.

Patrick Davitt

Hey, good morning, thank you. We saw some pretty significant declines in some of the credit-related balances on the balance sheet. Is that just deals rolling off or is there some negative mark issues going on?

William J. Janetschek - *KKR & Co. Inc. - Member & CFO of KKR Management LLC*

This is Bill Janetschek. The good news is it's just the rotation out of the 1.0 CLO book into the 2.0 CLO book. And so, a couple of the older CLOs we'll call when we had more equity invested, and so you'll actually see a decline of roughly $90 million, but that has nothing to do with the performance. As a matter of fact, the CLO portfolio was up on the balance sheet about $20 million this quarter.

Patrick Davitt

Could you give kind of a broader update of the credit performance within the quarter, not just the LTM?

William J. Janetschek - *KKR & Co. Inc. - Member & CFO of KKR Management LLC*

Sure. When you look at Special Sits, Direct Lending, Mezzanine, CLOs, the leveraged credit, all of those categories that make up the credit total that you're referring to on page 9, when you look at the quarter and for the first 6 months of the year, most of those strategies are actually performing well above benchmark, and so we're quite pleased with the performance of our credit portfolio in our funds and on our balance sheet.

Craig Larson - *KKR & Co. Inc. - Head of IR*

I think, Patrick, if you were to look at the high-yield index, the HFRX Special Sits index and the LSTA, both for the quarter as well as on a year-to-date basis, the blended balance sheet performance over both those periods is ahead of all 3 of those.

William J. Janetschek - *KKR & Co. Inc. - Member & CFO of KKR Management LLC*

And Patrick, before you ask the question, because you're talking about just credit, if you take a look at all of the platforms on our balance sheet for the quarter and for the first 6 months, all of those platforms are up.

Operator

Our next question comes from Andrew Disdier of Sandler O'Neill.

Andrew Paul Disdier - *Sandler O'Neill + Partners, L.P., Research Division - Director*

So it was nice to see Infra III enter the investment period, but did notice that there were 2 other funds that exited their investment period, one being Global Infra II. And then I guess looking out into 2020, have a number of other funds having the same dynamic, particularly Euro IV. So I guess the questions are, one, why did Global Infra II go from an ending investment period of October 20 at the last prior update; and then, two, will this dynamic occur with Euro Fund IV and V?

William J. Janetschek - *KKR & Co. Inc. - Member & CFO of KKR Management LLC*

It all depends on the pace of deployment in our funds. So when we report in the fund table, we show the beginning period and the ending period, and depending on the fund lifecycle, some are 3, some are 4, some are 6 years. With Infra II, we deployed that capital quicker than the investment period, which is good news. You know, to Craig's earlier point, we saw a lot of opportunity in Infra over the last couple years, and we wish we had a bigger fund because we could have actually deployed more capital.

As it relates to Europe IV going to Europe V, what'll typically happen is once you get about 2/3 through the investment period, where at a certain point in time you're about 65% invested, that's when you actually go out and start raising capital for that next fund. And so, that is the case with Europe IV rolling into Europe V.

Scott C. Nuttall - *KKR & Co. Inc. - Co-President, Co-COO & Director of KKR Management LLC*

But to be clear, this is all good news, right? Because new fund turns on, old fund's still paying us fees based on remaining invested capital, so it's a net increase in our fee revenue from this dynamic.

Andrew Paul Disdier - *Sandler O'Neill + Partners, L.P., Research Division - Director*

Got it. Yeah, wasn't sure if there was an LP dynamic or something else we missed, but understood.

Scott C. Nuttall - *KKR & Co. Inc. - Co-President, Co-COO & Director of KKR Management LLC*

No, normal course.

Andrew Paul Disdier - *Sandler O'Neill + Partners, L.P., Research Division - Director*

Cool. And the comp forecast of low 40% in the hope that it can come down over time, could you help us think about some of the assumptions driving that ratio? So as I think about some of the revenue and expense components, are there realized investment income assumptions being --

you know, high-margin money, are there kind of those dynamics going on within that broader assumption of low 40%? So just wondering if you're incorporating a stepped-up realization rate.

William J. Janetschek - *KKR & Co. Inc. - Member & CFO of KKR Management LLC*

What we're trying to do is keep the model simple. We have 3 revenue streams and we have 1 compensation load, and what we've said certainly over the last several quarters, and we highlighted this at Investor Day, is we're focused on keeping that comp number across all of that revenue in the low 40s. And when you take into account occupancy and G&A, which usually trends anywhere between 8% and 9% we've talked about having our operating earnings roughly at 50%. And so, that's what we've communicated certainly over the last several quarters, that's what we've actually reported over the last several quarters, and that's what we expect to show prospectively.

Scott C. Nuttall - *KKR & Co. Inc. - Co-President, Co-COO & Director of KKR Management LLC*

So there's no realized gain expectation embedded within that statement. You should expect us to be in the low 40s. That's really what we're telling you, kind of as an absolute measure, almost regardless.

Craig Larson - *KKR & Co. Inc. - Head of IR*

And I'd just say, as a final point on page 4, we do note when you look at compensation and benefits as a percentage of total revenues, it was 40% for Q2 as well as over the trailing 12 months.

Andrew Paul Disdier - *Sandler O'Neill + Partners, L.P., Research Division - Director*

Yep, understood. Appreciate the color. Thanks.

Operator

Our next question comes from Michael Carrier of Bank of America.

Michael Roger Carrier - *BofA Merrill Lynch, Research Division - Director*

Thanks guys. Hey, Bill, just on the outlook, I think you mentioned for KCM, the back half looks good. I might have missed it, but did you say anything on the realizations for the third quarter or just the outlook for the second half?

William J. Janetschek - *KKR & Co. Inc. - Member & CFO of KKR Management LLC*

No, Michael, I haven't given that number yet, but I knew it was coming. And so right now as we stand here today, based upon those investments out of -- in realized or those expect we expect to realize -- and remember, we're only 3 weeks into the next quarter -- we're at $175 million of gross realized investment income and gross realized carry.

Scott C. Nuttall - *KKR & Co. Inc. - Co-President, Co-COO & Director of KKR Management LLC*

And as a reminder Michael, we're going to give you an update on that as we get through the quarter, as things progress.

Michael Roger Carrier - *BofA Merrill Lynch, Research Division - Director*

Right, okay. And Bill, maybe just one more on that. So I think on the fund side, we have pretty good visibility when we look at performance and kind of seasonality, some of the products. Just when we think about the balance sheet and where it's invested and where maybe some of the returns are, is there any way for us to be thinking about that over, say, the next 12 months in terms of how much that can contribute to DE relative to maybe the past 3 years? Like should it be similar or has kind of the mix, the profile changed much?

William J. Janetschek - *KKR & Co. Inc. - Member & CFO of KKR Management LLC*

It all depends on performance and it all depends on realization, but probably the simplest way to model this is if you go to page 9, we highlight the categories of those investments on the balance sheet, and you can make your own assumptions as to what the rate of return is. But you could assume that so goes our funds, so goes our balance sheet. Most of the capital that we're investing in the balance sheet is also in a fund, and so you would expect in private equity that all these investments would be sold on a run rate of, say, every 5 years. Credit is obviously more accelerated. So we can't give you a very specific answer, but generally speaking, nothing different.

Operator

Our next question comes from Alex Blostein of Goldman Sachs.

Alexander Blostein - *Goldman Sachs Group Inc., Research Division - Lead Capital Markets Analyst*

Hey guys, good morning. Now with FS in the run rate in the second quarter, could you guys spend a minute I guess on how you're thinking about growing this specific franchise? I know it's kind of part of the whole direct lending platform, but with kind of just zoning in on this part specifically, how you're thinking about growing this part of the business.

Craig Larson - *KKR & Co. Inc. - Head of IR*

Yeah, I guess there's really two ways to answer that Alex. First is FS obviously brings to us a significant expansion of our private credit platform, which also feeds our third-party Capital Markets business. So I think in the first instance, what we're focused on doing is deploying that incremental capital well, and as I mentioned going out and really leaning into situations that we like. So you'll see us financing larger companies where we think the risk reward is more attractive, and that's allowing us, and we've seen it already, even though we just closed not long ago, we've seen already the ability to step up for larger transactions, which also feeds the syndication machine. So, so far, so good.

It's also allowing us to think about, how do we further expand the platform around private credit with our partners at FS, how can we create incremental BDC capacity in partnership with them, and that also allows us to also scale our private funds business alongside. So I think, you know, we kind of went from number 8 to number 1 or 2 in private credit globally, and scale begets scale in that business, and I think it feeds both AUM and Capital Markets fees.

But the second way to answer your question is around what it does for us in retail. Franklin Square obviously has a history of distributing to the retail investor. It just so happens our partnership with them today is focused on the BDC channel and private credit, but we think there are many opportunities for us to expand outside of private credit with our new partners. And so, we're talking about a variety of different product areas where we can create vehicles together to broaden our retail presence in partnership with them. So it really is both on credit and on retail, and in addition, obviously, expanding materially our permanent capital. So it's got a lot of different dimensions to it.

Alexander Blostein - *Goldman Sachs Group Inc., Research Division - Lead Capital Markets Analyst*

Okay, thanks a lot. And then second, Bill, just a nitpicky question, I guess. But if I look at the interest expense came down a little bit sequentially, I wasn't sure whether it's currency or something else related, but maybe just an update on what the run rate should be going forward.

William J. Janetschek - *KKR & Co. Inc. - Member & CFO of KKR Management LLC*

It's approximately where it is. The nit in that is, remember, we had some debt on our capital structure that got refinanced, and I don't know what you're looking at, but if you're looking at 2017, 2018 that would be a subtlety. But again, when you think about the number that you're seeing in the second quarter, it should be approximately that number.

Operator

Our next question comes from Rob Lee of KBW.

Robert Andrew Lee - *Keefe, Bruyette, & Woods, Inc., Research Division - MD and Analyst*

Thanks, good morning. Maybe a little bit of a modeling question, but Bill, any kind of additional color on how we should think about the effective tax rate ramping, you know with you get the step-up in basis, and we know it's going to ramp over a multiyear period. But any additional color, what we should be thinking, balance of this year into next year, at least?

William J. Janetschek - *KKR & Co. Inc. - Member & CFO of KKR Management LLC*

Right now, no change in thought from when we had this conversation on the last quarter call. Right now, we've said that the tax rate was roughly 7%, and over time will grow to 22%. We do have these tax benefits by stepping up assets on the balance sheet in our carry, as well as having a goodwill number that we're going to be able to amortize over a 15-year period. And you could see that in this quarter, but remember it's just this quarter. The effective tax rate was really actually even lower. It was about 4%. But you should think of, when you're modeling this, for anywhere in between 7% starting in the third quarter, which should migrate to 10% probably throughout the next fiscal year. But again, if anything happens to the assumptions that we have that change that, we'll certainly communicate that before we actually have to tell you why it's happened.

Robert Andrew Lee - *Keefe, Bruyette, & Woods, Inc., Research Division - MD and Analyst*

Great. And maybe just as another little modeling question as a follow-up, with the BDCs and kind of part 1 fees, some of your peers include that in management fees. I believe your intention is to leave that in incentive fees. I just want to make sure I have that correct.

William J. Janetschek - *KKR & Co. Inc. - Member & CFO of KKR Management LLC*

That is correct. Right now we're showing true management fees in that line, and we're showing the incentive fees in that separate line. And that's why you could see, if you're looking at page 7, you'd see actually incentive fees in 2018, both for the quarter and for the first half of the year, higher than what we reported, and a lot of that has to do with Franklin Square coming on board.

Operator

Chris Harris from Wells Fargo is our next question.

Christopher Meo Harris - *Wells Fargo Securities, LLC, Research Division - Director and Senior Equity Research Analyst*

Now that DE is the primary earnings metric, I'm just curious if there is an accounting requirement that you guys need to abide by in regards to when you need to realize losses, or is that really completely under your discretion?

William J. Janetschek - *KKR & Co. Inc. - Member & CFO of KKR Management LLC*

That is completely under our discretion.

Christopher Meo Harris - *Wells Fargo Securities, LLC, Research Division - Director and Senior Equity Research Analyst*

Okay. In regards to the realized losses for Q1, I know we've already talked about these, but can you go into a little bit more detail? Were these investments that were almost pretty much like written off, or were these some investments that you actually monetized, so still had some value, just kind of had taken a loss from where you originally acquired them?

William J. Janetschek - *KKR & Co. Inc. - Member & CFO of KKR Management LLC*

Right, you referred to Q1 but I think you meant Q2.

Christopher Meo Harris - *Wells Fargo Securities, LLC, Research Division - Director and Senior Equity Research Analyst*

Oh, sorry, Q1, yeah.

William J. Janetschek - *KKR & Co. Inc. - Member & CFO of KKR Management LLC*

And what we did from a planning perspective is that we had several investments, mostly in energy and credit, that, over the course of several years, had been written down significantly. There was really no opportunity for any increase in value, and so from a planning perspective we took the opportunity to sell these investments and recognize that loss. And it's nothing other than that, but again, the whole premise around this was around just tax planning.

Craig Larson - *KKR & Co. Inc. - Head of IR*

And Chris I know we've talked about this, but again, it was already recognized in the marked book value per share as that has been reported over time, and no cash impact, et cetera.

Christopher Meo Harris - *Wells Fargo Securities, LLC, Research Division - Director and Senior Equity Research Analyst*

Yep, understood. Okay, thanks for clarifying.

Operator

Our next question comes from Michael Cyprys of Morgan Stanley.

Craig Larson - *KKR & Co. Inc. - Head of IR*

Valerie, let's go to the next question, I guess.

Operator

Thank you. One moment, please. One moment.

Devin Patrick Ryan - *JMP Securities LLC, Research Division - MD and Senior Research Analyst*

First question is on the roughly $60 billion of AUM that is at or above cost but that's not yet paying carried interest. I'd love to just get any sense from you guys if you can on how far away you are from carry generating, if you can give us any of kind of the main buckets there. Any order of magnitude would be helpful.

William J. Janetschek - *KKR & Co. Inc. - Member & CFO of KKR Management LLC*

Sure, and what you're referring to is something that we called out certainly at Investor Day for those of you who weren't at Investor Day or read that presentation. But the punchline is we have a lot of investments that have been investing for just a few years, and so all these platforms are relatively new, like Health Care Growth and TMT Growth, and it's going to take some time to actually see the fruits of the labor as we ramp up those platforms.

And in addition let's not forget in that AUM number, now the large flagship funds like North America XII and Asia III, where we've got significant capital to deploy and then have that monetization. And so, when you look at the -- and this would be, for reference, on page 218 in the investor presentation, this is something we're really excited about because what we're trying to drive home is that 25% of the AUM is driving 91% of the realized performance income, and so when you look at all the other categories, where, to use a baseball analogy and not a hockey analogy, we are talking about being in early innings in the strategies, and so we're really excited about it.

Scott C. Nuttall - *KKR & Co. Inc. - Co-President, Co-COO & Director of KKR Management LLC*

But I'd say, some of these, it's not like it's years out. Some of this is relatively imminent, and we're actually starting to see realizations out of several of those vehicles on that page. So it's not something that you're going to have to wait years for, some of this is coming quite soon.

Devin Patrick Ryan - *JMP Securities LLC, Research Division - MD and Senior Research Analyst*

Okay, great. Yeah, that's really helpful and it was kind of good disclosure. And then I guess the follow-up here is kind of another high-level modeling, and from the Investor Day I think you guys laid out a pretty compelling case as to why industry growth should remain elevated and then why KKR can continue to take share and grow at a faster pace than the industry. And so, as I play this out and kind of think it through, kind of the longer-term model, what's the assumption on fee yields like in aggregate? Do they hold the line? If not, why, and I guess I'm just trying to kind of think through some of the moving parts of the balance between kind of a mix shift in assets versus also the dynamic of just fee yields on kind of successor funds, as those obviously should be getting bigger over time here.

Scott C. Nuttall - *KKR & Co. Inc. - Co-President, Co-COO & Director of KKR Management LLC*

I think the way you should think about it is, we have not -- as long as we have performance, we have not seen meaningful fee compression on an apples-to-apples basis. So if it's a longer-term, more opportunistic strategy, we really haven't seen a lot of compression in our business, where we have, and we talked about this before, agreed to reduce fees if we get -- is if we get serious scale from investors or serious longevity. So some of these recycling strategic partnerships, but the aggregate revenue outcome's greater. As we mentioned at Investor Day, we see growth opportunities across the firm. We mentioned several of our different platforms that we've created in the last 2 to 10 years, where we think we can double, triple, quadruple or more from a growth standpoint. And as we look at the opportunity set, we think it is significant virtually everywhere we look, but we are not looking at it saying for every dollar of capital we raise, we're going to have to think about big fee pressures. I think you will see a little bit of mix. I mean, obviously if we raise leveraged credit capital, that comes in at a lower fee than Health Care Growth capital. But, you know, ignoring the mix changes over time, we see a lot of opportunities for growth in the fee line. And we'll keep you posted as we see the capital raising progress across different strategies. So, within this strategy, no real change. It's really a question of how quickly do we grow different pieces.

Craig Larson - *KKR & Co. Inc. - Head of IR*

And then, Devin, I appreciate the question and the way you framed it in terms of the long term. Just for specificity, to highlight, in this quarter you would have seen that blended fee rate actually tweak down marginally in private markets, and the dynamic you saw there actually relates to Infrastructure most specifically, where we had all of that AUM turn on at June 30, but we didn't have any of the management fees over the course of the quarter. So, again, appreciate the long-term answer, but just wanted to highlight that as it related to the quarter itself.

Operator

Our next question comes from Michael Cyprys from Morgan Stanley.

Michael J. Cyprys - *Morgan Stanley, Research Division - Executive Director and Senior Research Analyst*

Hey, good morning, can you hear me now? Hey, Scott, just wanted to follow up on your point you were making earlier on the alternatives industry growing over the past decade. Just curious as you think about that, how much of that growth do you think is secular versus cyclical, given the dynamics at play over the past decade with QE? And as you look forward from here and interest rates continue to rise, how do you think about any sort of risk that demand for alternatives softens in a higher interest rate environment?

Scott C. Nuttall - *KKR & Co. Inc. - Co-President, Co-COO & Director of KKR Management LLC*

That's a good question, Michael. Look, I think what we've seen, and it's not just been since the crisis. We obviously saw good growth in the industry pre-crisis as well. I think it is definitely a secular shift as opposed to a cyclical one, and it's been not just, as you know, the traditional longer-term investors in alternatives, there's been a serious expansion of the pools of capital that invest in alternatives on a global basis. So we've seen dramatic growth, we talked a lot about sovereign wealth funds, more recently insurance and retail, but also high net worth investors and family offices, and so the types of investors have grown materially. We do not think that's a cyclical phenomenon, we think that's a secular one. And they are focused on asset allocation, and it has really become a big part of the conversation of how much of a portfolio should be invested in alternatives. That was not nearly as predominant a part of the conversation 10, 15 years ago, and we don't think that's going to shift based on what happens with interest rates. And if you think, there's a lot of things that we do that are somewhat tied to interest rates. Look at our private credit platform, as an example. That's a LIBOR-plus return stream. So a lot of things that we're doing that actually benefit as rates go up, and we've had that conversation with investors. They see it's an illiquidity premium. But it's a premium to a floating rate. So the short answer is we think it's secular and we have only seen it strengthen, and as rates have started to move, there's been no abatement whatsoever.

Michael J. Cyprys - *Morgan Stanley, Research Division - Executive Director and Senior Research Analyst*

Great, thanks. And just as a follow-up question, on private credit, just given that it's getting later cycle, how do you think about building out that part of the business at this point in the cycle? And if the cycle were to turn, if we do go through a credit downturn cycle, how do you see that playing out across the industry in terms of the private credit business?

Scott C. Nuttall - *KKR & Co. Inc. - Co-President, Co-COO & Director of KKR Management LLC*

Look, I think it's a really good question. The later cycle comment, I'd say is true in the U.S., but remember, we have a global business and a global team. So as a reminder for everybody, more than half of our investment professionals as a firm are outside the United States. So we think it's not nearly as late-cycle in Europe, and then obviously Asia is a huge opportunity for us, not only in terms of private credit, where we're focused on launching a business more formally this year, but also across real estate, where we see a big opportunity, Infrastructure over time as well. So I think the first answer to your question is to focus on globalizing what we're doing in credit and private credit in particular, and we think we see a big opportunity to do that. And so, you know, that helps us find new opportunities for growth on a global scale. Obviously, with respect to the U.S. part of the answer, what you focus on doing is making sure you're financing businesses that perform well in a late cycle environment, and you do your underwritings presuming that you're going to be lending to a company through some kind of a pullback, which as a reminder we think is a relatively shallow one probably starting in 2020. But we're focus on pricing transactions assuming that we're going to be entering that kind of environment. And even with that overlay, we're finding a lot to do.

Michael J. Cyprys - *Morgan Stanley, Research Division - Executive Director and Senior Research Analyst*

Great. Thanks so much for your color and answering my questions.

Operator

Our next question comes from Patrick Davitt of Autonomous Research.

Patrick Davitt

Hey, thanks for the follow-up. There was an article a couple weeks ago about the latest generation funds at some of your competitors having much better or more constructive fee structures for the GP, and I'm curious if there's any reason to believe that you wouldn't have a similar experience in your next generation.

Scott C. Nuttall - *KKR & Co. Inc. - Co-President, Co-COO & Director of KKR Management LLC*

Well, I think it kind of depends on which strategy you're talking about. I think, as an example, you know, in our Infrastructure platform, we have experienced the same phenomenon. You know, the Infrastructure I fund had lower fee in carry than Infrastructure II and III, and so we've kind of earned the right to improve the economics for ourselves in that platform. And sometimes what we'll do when we're creating a new business is we'll go to market with something that is a bit lower fee in carry, and then earn our way into getting to a higher outcome. And that's what really what happened with Infrastructure. I've got no reason to believe that we don't have the opportunity to do that in other places, so I think it is something that -- you know, we'll update you from time to time. I think private equity, our more established strategies, probably less likely. But some of the younger businesses, that can happen.

Operator

We have a question from Gerald O'Hara of Jefferies.

Gerald O'Hara

Great, thanks. Just circling back on the strategic partnership initiative mentioned a moment ago, can you perhaps provide any update around how those conversations are tracking, or perhaps where you see the demand for various different products or investments, or just more broadly, the opportunity set there?

Scott C. Nuttall - *KKR & Co. Inc. - Co-President, Co-COO & Director of KKR Management LLC*

Yeah, on the strategic partnership front, several conversations ongoing. As we've talked about in the past, it takes time to get one of these formed, so nothing to announce today but we'll keep you posted as conversations progress. But I would say as a general matter, we continue to make progress, talking to investors who want to do more with fewer. So kind of broader-based multiproduct mandates is something that's become more the norm in a conversation than the exception, and that trend continues. The real question in terms of strategic partnerships of how many of those can you do large scale with recycling and multi-asset class, and that's something that we are quite focused on as a firm, and actually have a team dedicated around that effort now, and that was not the case a couple years ago. So we see there's so much opportunity, we've actually created a dedicated team to get after it.

I'd say more broadly, in terms of the fundraising environment, it continues to be quite strong. A lot of interest in what we're doing and we have a lot of opportunities in the market today and several slated to be launched over the next 6 to 12 months.

Gerald O'Hara

Great, thanks. And then perhaps one follow-up on Marshall Wace, if we could. The firm has effectively doubled since acquisition. Can you maybe give us some sense of how the growth trajectory might evolve from this point forward? Are there additional kind of channels for distribution, or perhaps even under-penetrated channels that you see opportunity in? Just trying to get a sense of where that business might be headed. Thank you.

Scott C. Nuttall - *KKR & Co. Inc. - Co-President, Co-COO & Director of KKR Management LLC*

Thanks for the question. Look, there is, we think, significant opportunity for continued growth. As we shared in Investor Day, we've seen a lot of growth in the last few years since we created the strategic partnership, and the fun thing about it is we think that we're just getting started. There's lots of opportunity globally with respect to new product creation and distribution channels. I was actually having a conversation this morning with our partner there about the opportunities for growth from here, and we think they're significant. And as a reminder, this obviously has been a big opportunity for us. It's helped us grow our AUM and our fee-related profits, and at nearly $40 billion, give or take now, we still think there's meaningful upside from here.

Operator

I'm showing no further questions at this time. I'd like to turn the conference back over to Mr. Larson for any closing remarks.

Craig Larson - *KKR & Co. Inc. - Head of IR*

Thanks, Valerie. Thank you, everybody, again, for joining us in early July and also on this call. We look forward to giving you updates the next quarter. If you have any questions, please circle up with us, of course, over the course of the day. Thanks again.

Operator

Thank you. That does conclude today's conference. Thank you for your participation and have a wonderful day. You may all disconnect.

Editor

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