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KKR - Q3 2016 KKR & Co LP Earnings Call

EVENT DATE/TIME: OCTOBER 25, 2016 / 2:00PM GMT

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PRESENTATION

Operator

Good day ladies, and gentlemen. Thank you for standing by. Welcome to KKR's third-quarter 2016 earnings conference call. (Operator Instructions)

I will now like to hand the call over to Craig Larson, head of investor relations for KKR. Craig, please go ahead.

Craig Larson *- KKR & Co. L.P. - Managing Director, IR*

Thank you, David. Welcome to our third-quarter 2016 earnings call. Thank you for joining us. As usual, I'm joined by Bill Janetschek, our CFO, and Scott Nuttall, global head of capital and asset management.

We would like to remind everyone that we will refer to non-GAAP measures on the call which are reconciled to GAAP figures in our press release, which is on the investor center section of our website at kkr.com.

This 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 importantly, like previous quarters, we have also posted a supplementary presentation on our website that we will be referring to over the course of the call.

This morning, we reported strong third-quarter results. These results reflect a lot of the themes we have been talking about over the last few quarters, so, because of this, we will be able to move quickly through the results for the quarter and move into Q&A.

For the quarter itself, economic net income was $669 million, or $0.71 of after-tax economic net income per unit. After-tax total distributable earnings were $461 million, or $0.57 per unit, and our book value increased to $11.95 per unit. We have again also announced our regular $0.16 per unit distribution.

If you could turn to page 2 of the presentation for a moment, this highlights the main themes that we will expand on over the next 10 or 15 minutes. Strong underlying investment performance, continued healthy monetization activity, as well as continued success from a fund-raising AUM standpoint and the resulting impact this has on our management fee profile.

Overall, we continue to feel extremely well-positioned in this market environment and believe the positive fundamentals we're seeing across the firm, with the added benefit of long-term locked-up capital and a significant balance sheet, will allow us to continue to grow and create value over the long term.

And with that, I will turn it over to Bill.

Bill Janetschek - *KKR & Co. L.P. - CFO*

Thanks, Craig. We had strong investment performance both on a quarterly and year-to-date basis across our carry-paying funds. This performance, which Scott will discuss in more detail, contributed to the positive results we have reported this morning.

Focusing on our total segment financials, management, monitoring and transaction fees were $277 million in total, up 5% from Q2, with management fees again exceeding $200 million. Transaction fees generated from equity investments in several large North America private equity deals, most notably Epicor and UFC, were the key contributors to total fee growth.

Turning to total performance income, we reported $424 million, which was anchored by a robust level of realization activity, with $350 million of realized carried interest in the quarter.

Page 3 highlights this activity. In total, realization events at several portfolio companies drove the 15% increase in cash carry compared to last quarter. And this quarter's exits were broad-based. On a blended basis, the PE exits were done at 2.6 times our cost and an IRR of 26%. Strong marks across portfolio also contributed favorably to the total performance income as unrealized gains were up nicely this quarter.

Shifting to investment income, exits in Walgreens and Zimmer in particular drove the realized gain given our sizable co-investment and fund exposure in these companies. Total investment income of $330 million was also helped by the positive marks seen across other strategies, including CLOs, energy and alternative credit, driving $137 million of unrealized gains.

Bringing it all together, on a total reportable segment basis, fee-related earnings came in $142 million. After-tax Distributable earnings were $461 million, with after-tax ENI of $598 million.

Moving to AUM and fee-paying AUM, page 4 of the supplement highlights the growth in AUM over the last 12 months. As Craig mentioned, our AUM is up 17% over this period, driven by $28 billion of organic capital raised. We've now raised close to $12 billion of capital for Americas XII, and we are confident the ultimate fund size will be in excess of $13 billion. We have also made good progress on second-generation funds.

In the quarter, AUM increased slightly despite the active monetization backdrop. Inflows in private equity, real estate credit, CLOs, alternative credit and hedge funds were the big contributors.

The right-hand side of page 5 provides a few compelling stats on the $21 billion of capital we've raised that is not yet earning economics. All of it is carry or incentive fee eligible, with effectively all of it locked up for eight-plus years from inception. And while you haven't yet seen the impact on our management fees, this capital will contribute roughly $250 million annually in gross fees once invested or, in the case of Americas XII, once the fund is turned on. This dynamic positions us well for management fee growth, and we have a direct line of sight on that growth.

Moving to deployment, we invested over $3.7 billion of capital this quarter, primarily within private markets. The largest contributors were three private equity investments made out of NAXI, which is now 75% invested, as well as two Indonesian investments out of Asia II.

On the public market side, most of the $1.5 billion in deployment came from investments made across alternative credit vehicles primarily within Direct Lending and Special Sits. And as you'll recall, we are entitled to economics on our alternative credit vehicles on an invested, as opposed to committed, basis. Given this dynamic, deployment in these strategies contributed to the increase in public markets fee-paying AUM this quarter.

In total, the $3.7 billion in deployment still leaves us with approximately $38 billion of dry powder across the firm as of September 30, a 40% increase year over year.

Finally, looking forward, the pipeline for future monetizations remains full, as we've already announced six strategic sales that have or are expected to close in Q4. These sales are diversified across geography with three in Asia, two in Europe and one in North America. On a blended basis, these exits, which have an average holding period of only 3.5 years, are expected to yield 2.1 times our cost, an IRR of 27%, and subject to closing, will contribute over $150 million of Distributable Earnings.

And with that, I will turn it over to Scott.

Scott Nuttall - *KKR & Co. L.P. - Head of Global Capital and Asset Management Group*

Thanks, Bill, and thank you, everybody, for joining our call. We had a very good quarter. It was a quarter that evidences the power and simplicity of our model.

If you cut through it, we really need to do five things well: generate investment performance; raise capital; find attractive new investments; monetize existing investments; and use our model of AUM, capital markets and balance sheet to generate significant economics from our investment activities. I'm going to touch briefly on each of these.

Let's hit investment performance first. Take a look at page 6 of the supplement. In private equity, our portfolio appreciated nearly 6% in the quarter. And if you look more closely at our benchmark private equity funds, on a year-to-date basis, our North American, European and Asian PE funds shown in the center of the chart are up 16%, 18% and 23% respectively.

In our non-PE strategies, we are also seeing strong investment performance. Of particular note, our infrastructure strategies continue to perform, with our Infrastructure fund up 4% in the quarter and 19% on a year-to-date basis. We saw a rebound in our energy portfolio given the improved operating environment in the quarter. And we also saw strong performance across our alternative credit funds, with our Special Situations, Mezzanine and Direct Lending funds up 4%, 5% and 3% respectively in Q3.

The second thing we need to do well is raise capital. We have raised $28 billion in the last 12 months and have line of sight to significant management fee growth from our capital commitments not yet earning economics. Over a five-year period, our AUM has grown at a 17% annual growth rate.

And as you can see on page 7 of the deck, our AUM is long-dated and diversified by strategy. More than 60% of our fee-paying AUM is in strategies outside of private equity. And over 70% of the capital is locked up for at least eight years from inception.

The third thing we need to do well is find new, compelling investment opportunities. And this was a very active deployment quarter for us across the firm with a total of $3.7 billion deployed across businesses and geographies.

The fourth thing we need to do is monetize our existing investments. Bill walked you through it, but the bottom line is we are continuing to see significant monetization activity across our PE business, and we are beginning to see more activity across our non-PE businesses.

Our carry is more recurring than the markets perceive. We have consistently returned an average of $10 billion annually to our fund LPs for the last several years, and this is the 26th consecutive quarter as a public Company that we have realized performance income in our financial statements.

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. KCM and the balance sheet do not show up in our AUM, but they are powerful economic contributors for the Firm and allow us to move quickly and in scale to source investments, maximize our value creation, seed new efforts and scale our third-party AUM more quickly. KCM had a really good quarter, as did our balance sheet investments, which appreciated 5% in Q3.

And we're making good progress evolving our balance sheet asset allocation and using the balance sheet as a strategic weapon to facilitate AUM growth and increase our participation in the profitability of the Firm.

Now please take a look at page 8, which brings it all together.

This quarter really showed the power of our model. We generated strong performance, we continue to raise capital, we are making new investments, we are monetizing existing investments and we're using our model. The result is significant economic net income and distributable earnings with very good visibility ahead. In essence, we feel our model is performing well and our fundamentals are strong.

And with that, we are happy to take your questions.

Craig Larson - *KKR & Co. L.P. - Managing Director, IR*

And David, it's Craig. Just before we open it up for questions, just as we look at the queue here, we see we actually have a pretty long list of people. So if we could ask everyone in the queue to please limit themselves to one question and a follow-up and then get back in the queue if necessary, we would appreciate it.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Ken Hill, Barclays.

Ken Hill - *Barclays Capital - Analyst*

I wanted to touch on realizations. It's another strong quarter for realizations, distributable earnings. I just wanted to see what the potential was and how you are thinking about the fixed dividend to move higher over time, and if you can maybe elaborate a little bit more on the internal criteria you guys are evaluating to make that decision. Thanks.

Bill Janetschek - *KKR & Co. L.P. - CFO*

Hey, Ken, this is Bill Janetschek. We're not going to comment on the change in our distribution this quarter. That will be something that we will address in future quarters. We only announced just three quarters ago. So stay tuned.

Ken Hill - *Barclays Capital - Analyst*

Okay. So that's something we can, I guess, expect annually, then? Or is there any set timeline for that?

Bill Janetschek - *KKR & Co. L.P. - CFO*

As I said, we are not going to address the change in our distribution this quarter, and it's something that we will address in future quarters.

Scott Nuttall - *KKR & Co. L.P. - Head of Global Capital and Asset Management Group*

So, no announcement to make today, Ken. When we made the change, we said it's probably something that we are going to visit more or less annually. We will keep an eye on flow-through tax burden to our investors, but nothing to announce today and we will keep you posted.

Ken Hill - *Barclays Capital - Analyst*

Okay. Just a follow-up from me, then, on fundraising. 12 months, you guys mentioned some really strong trends this quarter. Seemed to slow a little bit. Just wondering if you can give an update, then, on the outlook here near-term and even longer-term as to how you're looking at the fundraising environment.

Scott Nuttall - *KKR & Co. L.P. - Head of Global Capital and Asset Management Group*

I would say, Ken, the fundraising environment remains very strong and a good one for us. We've got a lot of different products that we are talking to investors about. And the overall backdrop is great. I would say people are looking for places to invest to generate returns and, in particular, yield. And that plays to our strengths, and we are seeing more allocations to alternatives and investors looking to do more.

So we have a number of products in the market including wrapping up our Americas XII fund, our second opportunistic real estate fund, our second Private Credit Opportunities fund. We have two products in growth equity. We've got various things going on in real estate credit, and then some successor funds that are coming in direct lending and Asia. And that is on top of everything we are doing in hedge funds and leveraged credit. So, continues to be a lot of activity and a lot of different things that we're talking to investors about on a global basis.

Ken Hill - *Barclays Capital - Analyst*

Appreciate the color there. Thanks.

Operator

Chris Harris, Wells Fargo.

Chris Harris - *Wells Fargo Securities, LLC - Analyst*

First question on management fees, appreciate the disclosure around your capital commitments and what that could do to management fee revenue. But I guess one part of the equation we don't have is how monetizations might impact the outlook for that. So, any kind of guidance? Or, directionally, can you guys help us out thinking about your management fee earnings growth potential over the next one or two years? Thanks.

Bill Janetschek - *KKR & Co. L.P. - CFO*

Sure, Chris. This is Bill Janetschek. When you look at -- looking out certainly over 2017, as we have mentioned, our NAXI fund is roughly about 75% invested. We will always have a certain amount that we'll set aside for reserve. So it won't be long before the Americas XII fund turns on, and that would be sometime certainly in the first half of 2017. And once that does happen, based on supplemental information we have provided last quarter, you will see an increase in fees on a run rate basis of roughly about $95 million.

Now, what that doesn't take into account is your very excellent point in that it doesn't address some of the runoff on the existing funds that are going from the post-investment period where we collect a reduced fee to those -- and that capital actually being monetized and us not collecting a fee. I would say that if you wanted to swag somewhere in the neighborhood when you're looking at 2017, 2018, even with the runoff, the management fees, based upon information we know today will be higher.

Chris Harris - *Wells Fargo Securities, LLC - Analyst*

Very helpful, thanks. I will get back in the queue.

Operator

Gerald O'Hara, Jefferies.

Gerald O'Hara - *Jefferies LLC - Analyst*

Just a question on the buyback. Looks like it slowed a little bit in the quarter, or I guess the period that was disclosed. Perhaps you could talk just a little bit about the evaluation process there and kind of how you weigh that against other capital deployment opportunities. Thank you.

Scott Nuttall - *KKR & Co. L.P. - Head of Global Capital and Asset Management Group*

Thanks, Gerald. It's Scott. I will take it. Look, I think just by way of background, we announced the $500 million authorization about a year ago. And in total between shares bought back and tax cancellation, we bought back or canceled about 37 million shares so far. So, the share count is down net -- probably a little bit certainly on or slightly ahead of pace of where we had expected to be.

And to answer your question, look, we really view cash as a strategic asset for us. So we've got a number of growth and innovation opportunities across the Firm. And you've seen us over the last several years seed a number of new efforts, most recently things that we've done in growth equity and in real estate credit off the balance sheet.

And so there's nothing new to announce today. I think we have said in prior quarters that you should model our share count flat over time, and that is certainly what we expect to deliver. So, nothing new to share with you today.

We are really focused on how we invest that capital and build the Firm for the long term as opposed to any short-term trading dynamics. But that is how we'd suggest you think about it to keep the share count flat over the longer term.

Gerald O'Hara - *Jefferies LLC - Analyst*

Great, thanks. And just a follow up, sort of looking at some of the fund performance, it looks like lending partners -- lending partners II in fact, had a pretty sizable move quarter over quarter in terms of fair value. Is that -- perhaps you could just give a little bit of color there on what the dynamic is, and perhaps even what the opportunity set from the investments are there would be helpful. Thank you.

Scott Nuttall - *KKR & Co. L.P. - Head of Global Capital and Asset Management Group*

Sure. Nothing out of the ordinary. Some exits and some strong underlying portfolio company performance in the quarter and, frankly, just a little bit of ramping up the portfolio, as that is a younger fund. So nothing that we would point you to except the underlying trend that we've been seeing for the last several years. Which we do see a lot of opportunities in direct lending, both in the US and Europe. And as we've said in prior quarters, we have raised our European direct lending fund not long ago. We will be in the market shortly with our third lending partners fund. But overall, just good portfolio performance and strong opportunities in the market as we continue to see the banks pull back.

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Bill Janetschek - *KKR & Co. L.P. - CFO*

And Gerald, just one thing to add, and this is just a subtlety. But remember in direct lending, in the vehicle itself there is some leverage, so we typically put up $1 dollar of equity and borrow roughly about $0.50 on the $1. So to the extent that there is performance, you're going to see better performance due to the subtlety of leverage in the vehicle.

Gerald O'Hara - *Jefferies LLC - Analyst*

Understood. Thanks for the color.

Operator

Alex Blostein, Goldman Sachs.

Alex Blostein - *Goldman Sachs - Analyst*

Question around the balance sheet. Given the improvement pace of realizations, maybe spend a minute on how you envision the composition of the balance sheet evolve over the next 12 to 18 months. What is the optimal mix that we should think about on a go-forward basis again once you kind of get through the current pace of realizations? And I guess, more importantly, the impact that this may have on net interest income and dividends -- that line has been, I guess, a little bit weaker this quarter than last quarter. So, is a $25 million-ish quarterly run rate still the right number to think about?

Scott Nuttall - *KKR & Co. L.P. - Head of Global Capital and Asset Management Group*

Great question, Alex. This is Scott again. I will take it. In terms of what you've been seeing the last several quarters -- so remember when we did the KFN merger a couple years ago, we said at the time that we wanted to adjust the asset allocation to bring down our overall credit exposure because KFN had a heavy credit bias in that balance sheet, and redeploy into what we saw as higher-returning strategies. And you have really seen us do that.

So just by way of background, when we -- around the time we closed the KFN deal, we had about $1.6 billion of CLO exposure on the balance sheet. That number is about $600 million now. And a significant amount of that freed-up capital from that change amongst others has gone into what we think are going to be higher-returning strategies and also areas that have allowed us to raise third-party capital alongside the balance sheet and we think generate a very attractive ROE.

So, relative to where we are today -- one good place to look is on page 18 of the press release, which is where we've got our uncalled commitments. And as you can see -- if you look at this over the last several quarters, you can see we have been increasing our commitments to private markets' strategies in particular, and the largest of those has been the Americas Fund XII commitment. It now shows up on the table at $1 billion.

And so, over time, I think you should expect us to see the private equity component of the balance sheet continue to go back up probably closer to historical levels in that 35% to 40% range. You will probably see a bias for credit to continue to come down and where we have it be more biased to alternative credit. You can see the large commitment we've got to the Special Situations Fund II strategy as an example of that. And then also have commitments to our health care growth strategies, technology growth and various real estate strategies where we think that there is higher return opportunities.

So, you will see us getting into an asset allocation range that looks something closer to that, think roughly 35%, 40% PE, and the rest spread across other asset classes with a continuing reduction of our credit exposure over time.

Bill Janetschek - *KKR & Co. L.P. - CFO*

Alex, to answer your last question as far as run rate is concerned, obviously, with the call of 2007-1, Scott mentioned you can see the CLO that we had on balance sheet has been monetized. And so from the interest in dividend run rate point of view, I would say that the $70 million that you are seeing right now in the quarter is going to be pretty close to what you would expect that number might go down to $60 million. But you're doing it on a net basis, taking into account the run rate interest expense of about $50 million. So I would say that the number we have here for the third quarter is going to be close to the run rate that you should expect.

Alex Blostein - *Goldman Sachs - Analyst*

Got it. Very helpful. Thanks, guys.

Operator

Mike Carrier, Bank of America.

Mike Carrier - *BofA Merrill Lynch - Analyst*

Just given the performance both in the funds but also on the balance sheet in the quarter, just wanted to get a little bit more insight. I know we can do a lot in terms of tracking the public investments. But when you look on the private side, just any trends in terms of whether it's top-line/EBITDA growth and then how the CLOs -- the energy part of the portfolio did in the quarter.

Scott Nuttall - *KKR & Co. L.P. - Head of Global Capital and Asset Management Group*

Sure, Mike. It's Scott. Happy to take that. In terms of the -- and let me take the second piece first. The CLOs in the quarter had a good, strong quarter, up 5.6% give or take in the quarter, for our CLO portfolio. And we continue to see good performance in the underlying portfolios that the teams are managing there. So I would say overall, very pleased with the performance we've had. And that is in the context of -- as we mentioned of calling a bunch of older CLOs and reducing our overall exposure to that book. So, attractive returns.

Importantly, that 5.6% in the quarter does not include the management fees we get in our CLO business. So when you incorporate those, it's actually a very attractive overall ROE business for us.

In terms of the private equity portfolio performance, continues to be strong. If you look at a trailing 12-months basis, revenue is up about 8% across the global portfolio, EBITDA also up about 8%. And so, significantly outpacing the public markets on those metrics.

Mike Carrier - *BofA Merrill Lynch - Analyst*

Okay, thanks. And then -- well, I guess anything on energy. And then the follow-up was just on hedge funds, so obviously there's a lot of focus on the industry. You guys, it seems like the trends have held up better than what we are seeing throughout the industry. So, any update there when you look at your hedge fund exposure in terms of performance or on the flow trends like demand for those products?

Bill Janetschek - *KKR & Co. L.P. - CFO*

Mike, this is Bill. I will take the first on energy, and then I will pass it over to Scott on hedge funds. But when you take a look at slide 6 in the supplement, you can see that the Energy Income and Growth fund was up 14% for the quarter, 6% over the last nine months. And more specifically to your question around the balance sheet, happy to report that $50 million of income off the balance sheet was from our energy portfolio this quarter.

Mike Carrier - *BofA Merrill Lynch - Analyst*

Got it. Thanks.

Scott Nuttall - *KKR & Co. L.P. - Head of Global Capital and Asset Management Group*

And on hedge funds, Mike, I'd just give a couple of comments. I think obviously the industry has had a lot of media attention as of late, and, as a broad perception, it is under pressure. Our hedge funds business actually grew this quarter. So we saw growth both with respect to KKR Prisma and also across our strategic partnerships, in particular Marshall Wace, which has continued to scale its assets.

So, what we're seeing is that while there is this broad perception of the industry being under pressure, the big, we think, are getting bigger. And if you look at the hedge fund industry as a whole, the assets have actually increased. So, there is more of a concentration on the large end, and we're getting a little bit of a benefit of that.

Mike Carrier - *BofA Merrill Lynch - Analyst*

Got it. All right. Thanks.

Operator

Craig Siegenthaler, Credit Suisse.

Craig Siegenthaler - *Credit Suisse - Analyst*

There was an article in early October that suggested that you would not be launching a new growth fund in China but would instead focus on larger buyouts. I just want to see if there is any validity to the article because it looks like China Growth II only has $250 million left of uncalled capital. So I'm just trying to see if we should wait for Asia Fund III as your next large fund in Pan-Asia.

Scott Nuttall - *KKR & Co. L.P. - Head of Global Capital and Asset Management Group*

The short answer, Craig, is that you should. We have made a decision not to launch a China Growth II Fund and concentrate our efforts on private equity in Asia through Asia III. Really, the China Growth vehicle that we had created, we think, is performing nicely. But we've seen a significant increase in competition at the smaller end of transactions in China and have decided on a go-forward basis to focus our efforts where we think the puck is going, which is around some of the larger transactions on a go-forward basis, which would be coming out of Asia III.

Craig Siegenthaler - *Credit Suisse - Analyst*

Thanks, Scott. That was it for me.

Operator

Glenn Schorr, Evercore.

Kaimon Chung - *Evercore ISI - Analyst*

Hi, this is Kaimon Chung for Glenn Schorr. So just regarding your realization activity, there's been more secondaries on stuff that's been public and some strategic sales but no IPOs. So how much of a function is that due to the IPO market drying up or a function of the market environment versus just the preference for strategic sales?

Scott Nuttall - *KKR & Co. L.P. - Head of Global Capital and Asset Management Group*

Happy to take that. If you actually look on a year-to-date basis, I think there's always a lot of focus around whether a company has gone public. If you look year to date at our monetizations in private equity, over 60% of the monetizations have actually been from secondary offerings in our public portfolio companies. So, we have had a lot of activity in the public markets. You're right; there have been fewer companies that have actually gone public, but we have a lot of public companies that we've been selling down.

And there has been a lot of strategic activity. And oftentimes we will look at whether we should run a dual process and consider an IPO or a strategic sale. Frankly, the strategic M&A bid has been very strong, especially out of Asia. So, we have seen a lot of cross-border M&A out of Japan and China, which we have been selling into.

So, no great trends there except to say that we have got a large public portfolio. It's about 35%, 40% of our portfolio in public stocks on the PE front. You continue to see us sell those down over time. And where we can access opportunistic M&A, we will do it.

Kaimon Chung - *Evercore ISI - Analyst*

Thanks.

Operator

Chris Kotowski, Oppenheimer.

Chris Kotowski - *Oppenheimer & Co. - Analyst*

I noticed the realized performance compensation accrual -- it had been running between 40% and 41% the last 2.5 years. Was up over 45% this quarter. What happened there?

Bill Janetschek - *KKR & Co. L.P. - CFO*

Hey, Chris, this is Bill. Subtle bump-up this quarter. And, as you probably know, the way we compensate the KKR executives is they are entitled to 40% of the carry, and that is unencumbered by management fee returns to our LPs. And so typically in a private equity fund, first you return costs, then you return management fees and then you take carry.

We actually don't burden that KKR executive carry pool by that amount. And what has happened in the preferred returns that actually have had monetizations where we have been paying out cash carry, and a good amount of that happened in the third quarter of 2016, you saw an increase in that number. I will tell you that for modeling purposes when you look at that number next quarter, it will be probably in that 41%, 42% again.

Chris Kotowski - *Oppenheimer & Co. - Analyst*

Okay. So just -- don't use 45%-plus going forward?

Bill Janetschek - *KKR & Co. L.P. - CFO*

Correct. Do not use 45% going forward. You should run it anywhere between 41%, 42%.

Chris Kotowski - *Oppenheimer & Co. - Analyst*

All right. Then, next, on -- looking at your balance sheet, you raised over $1 billion of cash in the quarter. Why are you building cash? And I guess in particular, in light of not having reloaded the buyback authorization, why build so much cash?

Bill Janetschek - *KKR & Co. L.P. - CFO*

Well, I will address it first, and I will see if Scott wants another attempt at addressing the buyback question. But why it happens is obviously with the secondaries that we exited this particular quarter in Zimmer and Walgreens, we were participants in co-invests. And so we had significant cash from those monetizations.

In addition, as Scott mentioned earlier, with CLO 2007-1, we called that CLO a couple quarters ago, monetizing that, and we're seeing a good amount of cash coming through from that. And so that's why you see the $2.9 billion this quarter. Obviously with the 2007-1, we are in the business to continue to underwrite CLOs, certainly investing at least the amount that we need for risk retention. And so we will deploy some of that capital, although it won't be this quarter, in CLOs.

Scott Nuttall - *KKR & Co. L.P. - Head of Global Capital and Asset Management Group*

Chris, it's more timing than anything else, so that we did have some monetizations in the portfolio, and the cash balance ticked up as a result. But we have also increased our uncalled commitments for the better part of $1 billion in the relatively near term last few quarters. So if you kind of look out going forward, once those new commitments are drawn down, I think you'll see the cash balance come down as well.

Bill Janetschek - *KKR & Co. L.P. - CFO*

One other subtlety, Chris, is that, as you may have seen, we announced that we are going to be taking out a senior note in KFN at roughly $260 million this quarter, and that will happen on November 15. So you will see just by default the cash number go down by that approximately $260 million.

Chris Kotowski - *Oppenheimer & Co. - Analyst*

Okay. Thank you.

Operator

Devin Ryan, JMP Securities.

Devin Ryan - *JMP Securities - Analyst*

Just maybe starting, there was a press article a few weeks ago essentially saying the Firm is going into a legal process with one of the investment companies. And not looking for any specific detail in that investment, but just lump some thoughts around how you think about the internal process processing, situations where maybe there are some red flags that are not in the numbers. And then also the marks when there appears to be a binary outcome, if it is a legal case or something like that, how do you think about valuation in those situations?

Scott Nuttall - *KKR & Co. L.P. - Head of Global Capital and Asset Management Group*

Hey, Devin, it's Scott. I think you're probably referring to Aceco, which is an investment that we have in South America. And I think that the short answer on that -- and it's hard to generalize more broadly. The short answer on that is that investment was written off a few quarters ago. So, nothing to worry about in terms of impact on a go-forward basis. That is part of the NAXI fund, which is performing very well as you can see in the numbers. So we're not going to be able to talk about the investment in more detail given the pending litigation. But, just broadly speaking, I would not worry about it in terms of further impact on the financial statements.

Devin Ryan - *JMP Securities - Analyst*

Okay. That's what I was looking for. Thank you.

And then with respect to CLOs, you touched on upcoming risk retention. It seems that we are hearing more about firms that are looking at some new strategies, even kind of off-balance-sheet structures, to reduce the capital burden. So, just curious if you have any updated thoughts there. You may look to do some other things to reduce the amount of capital you'd need to hold.

Scott Nuttall - *KKR & Co. L.P. - Head of Global Capital and Asset Management Group*

Nothing to share with you today. We are looking at the same things you are in terms of just different approaches around risk retention. I think the approach we've taken in the past is the overall ROE of that business is very attractive for us, even without some of those strategies which, if we were to go down that path, would just further increase the ROE. So we're looking at it, but nothing more to share with you today than that.

Devin Ryan - *JMP Securities - Analyst*

Got it. Okay. Thanks, guys.

Operator

Brian Bedell, Deutsche Bank.

Brian Bedell - *Deutsche Bank - Analyst*

Bill, can you just run through the management fee calculation again? I think you are talking about NAXI [Americas] XII potentially contributing, I think you said, $95 million. And then with NAXI, when that runs off, I didn't quite get what the contra to that would be. And then on slide 5 of that $250 million -- so then run-rating NAXI [Americas] XII flow, would we be up to that -- pretty close to that $250 million run rate in 2018?

Bill Janetschek - *KKR & Co. L.P. - CFO*

Sure. I will break it down into the two parts that you asked. My point was with regard to NAXI going from the investment period to the post-investment period and then Americas XII coming on, you would see an increase in the management fees of an additional $95 million. Not $95 million attributed just to Americas XII.

As you know, the way our funds work is that you collect typically 1.5% during the investment period and 75 basis points in a post-investment period. And so one fund turning off and one fund turning on, and that fund being approximately $4 billion larger than the NAXI fund, is going to generate that additional revenue.

Brian Bedell - *Deutsche Bank - Analyst*

Got it, okay. That's clear. And then at the $250 million run rate, do you expect to be sort of up to that in 2018, or is it a little bit longer?

Bill Janetschek - *KKR & Co. L.P. - CFO*

When you look at the supplement, you can see that 53% of what we're talking about is coming from Americas XII. And so once that actually turns on -- and whether or not that would be in the first quarter or second quarter of 2017, we're not going to predict -- but that will generate fee income from Americas XII.

The remaining 47% -- remember, it is all long-dated, locked-up capital that the fee is in excess of 1.2%. And traditionally, depending on what strategy is behind that 47%, it could be Special Sits II or Direct Lending III or II. It will actually be turned on over probably the next two to 2.5, three years.

Scott Nuttall - *KKR & Co. L.P. - Head of Global Capital and Asset Management Group*

Yes, I think that's fair. If you look at that 47%, I think the only additional color I would give you is that a lot of the strategies that are in there are strategies where it's a fund II, fund III type dynamic. Whereas that the funds that are coming online are much larger than the funds that might be getting liquidated. So -- for this period of time. So I think you would see a nice net lift for the management fees from that piece of it as well.

Bill Janetschek - *KKR & Co. L.P. - CFO*

And we are referring to page 5 on the supplement. The really good news about this is that the blended fee rate is above that 1.2% and it is very locked-up capital.

Brian Bedell - *Deutsche Bank - Analyst*

Right, right. Okay, that's great color, and I appreciate that. Then just a follow-up question on -- maybe Scott, if you could talk a little bit about deployment opportunities for Americas XII as you get past XI, and also how much you might be leaving in XI for follow-ons as well.

Scott Nuttall - *KKR & Co. L.P. - Head of Global Capital and Asset Management Group*

Okay. In terms of leaving in XI for follow-ons, I think it's going to be probably close to the typical approach that we take in terms of the reserve. So, call it rough justice 10%-ish give or take.

Bill Janetschek - *KKR & Co. L.P. - CFO*

Right. Might be a little lower, but 7.5% to 10% is good enough.

Scott Nuttall - *KKR & Co. L.P. - Head of Global Capital and Asset Management Group*

In terms of the deal environment, I would say in the US, to answer your question, this has been a really busy year if you think about it. So there's been quite a bit of deal flow this year: Epicor, UFC, RES; we just announced another retail deal. So we've been taking advantage of investment opportunities where we find them. More idiosyncratic, and at the same time, as you heard, we are exiting given the strength of the equity and debt markets.

So, the volatility we've seen this year has led to some interesting opportunities. We are finding different markets are bifurcated. You have got some companies that are valued very well and some less well. The market really likes simplicity. And we largely get paid to assess and understand and invest in complexity, and we're finding complexity is pretty cheap right now. So, good deployment opportunities for the course of this year, and has us optimistic about the opportunity set for Americas XII as well.

Brian Bedell - *Deutsche Bank - Analyst*

It sounds like you could be more aggressive on the deployment pace in this type of environment before maybe things get too frothy, or more patient longer-term?

Scott Nuttall - *KKR & Co. L.P. - Head of Global Capital and Asset Management Group*

Look, I think it's hard to give you a blanket statement. Our job is to figure out how to monetize the environment. And where we can, you have seen us be aggressively selling down some of our public positions. We have been accessing the M&A environment. We have been accessing the financing markets for dividend deals.

But also, we found some pretty interesting investment opportunities. You just got to look a little bit harder. The valuations have been very high in some instances, which has caused us to back away, but we've managed to find some opportunities that we really like where we think we can make the businesses better operationally. And so that is where you have seen us deploy.

So, hard to give you a blanket statement. It's a little more complicated than that, but we are seeing both deployment and exit opportunities.

Brian Bedell - *Deutsche Bank - Analyst*

That's great color. Thank you.

Operator

Robert Lee, KBW.

Ann Dai - *KBW - Analyst*

Hi, this is Ann calling in for Rob.

Scott Nuttall - *KKR & Co. L.P. - Head of Global Capital and Asset Management Group*

Hi, Ann.

Ann Dai - *KBW - Analyst*

Thanks for taking our question. I just wanted to clarify some of the comments around fundraising and maybe what is coming up and just make sure that we haven't missed anything. It seems like earlier you spoke about Direct Lending III coming to the market, maybe at some point having a new Asia Fund on the way. I think I saw some reports of maybe a small health care fund. And obviously NAXI is substantially underway on its fundraising. So, is there anything big that we are missing here? And any other comments around what we might expect to see?

Scott Nuttall - *KKR & Co. L.P. - Head of Global Capital and Asset Management Group*

No, I don't think you are missing much. Americas XII should be wrapping up relatively soon. We still expect that fund in aggregate to be over $13 billion in size, including our capital. You mentioned health care growth. We are also in the market with a technology growth fund that we should be wrapping up fundraising for in the relatively near term.

We have a second real estate opportunistic fund; REPA II is in the market. Our second mezz fund, which we are calling PCOP, or Private Credit Opportunities II, is in the market. And you are right on direct lending and Asia. The only other thing I would point you to is real estate credit, where we are raising capital around those strategies both in longer-term, more permanent format and temporary fund format.

Ann Dai - *KBW - Analyst*

Great. Thanks so much.

Operator

Michael Cyprys, Morgan Stanley.

Michael Cyprys - *Morgan Stanley - Analyst*

Just wanted to dive in a little bit on the balance sheet with Americas XII. Looks like you are committing over 8% to that fund. Probably like closer to 7% when it's all done. But it's meaningfully higher than the predecessor funds, which are more in the 3% range.

So I guess just how are you thinking about rationale for putting such a large check in a fund for a very well-established strategy? And how do you think about balancing -- putting such a large amount in the single fund versus seeding other, newer strategies? Some may push back and take the view that there is a lack of attractive opportunities out there, and so you put it into a larger fund here. But just curious, maybe why not buy back more stock then if that's the case?

Bill Janetschek - *KKR & Co. L.P. - CFO*

Mike, this is Bill. As Scott mentioned earlier, when you look at the balance sheet and the asset allocation -- private equity, we are targeting anywhere in that 40%, 45% range. And as we have been monetizing a lot of the co-investments like a Zimmer, like a Walgreens, in order to make sure we capture that asset allocation, we're going to have to be making bigger commitments to invest side-by-side with our funds. Because, in a lot of cases, when we make an equity investment, there is no discretionary allocation that the balance sheet may or may not be entitled to. So we are just increasing that amount.

And you shouldn't really look at it as far as percentage. You should also look at it as applicable to the size of the number because we continue to do our job and there is performance there, we're going to continue to grow and compound that balance sheet, and that number over a much larger number is going to be a lower percentage.

Michael Cyprys - *Morgan Stanley - Analyst*

Got it, okay. So you're thinking about it more from an asset allocation perspective.

Scott Nuttall - *KKR & Co. L.P. - Head of Global Capital and Asset Management Group*

Correct. Yes, I think that's right. I think the -- if you look at the NAXI fund, it's 25%. Still a relatively young fund, and 25% IRR inception to date. So, yes, we think that it's helpful in terms of raising capital from third parties, as we are big investors in everything that we do. And we like to make sure that we are eating our own cooking in a big way.

But, frankly, when you also just cut through it, we think it's a very attractive return opportunity. And, to Bill's point, we are focused on keeping our asset allocation in the appropriate range. The underlying fund will be highly diversified, as they always are. So we think it's a good way to get more exposure to our private equity business.

Michael Cyprys - *Morgan Stanley - Analyst*

Great. And if I could just ask a follow-up quickly there just on the credit side. Certainly as the balance sheet -- asset allocation shifts towards PE, away from credit, it sounds like that suggested interest income could come down, which today helps support the dividend. So just curious how you're thinking about growing a more recurring fee and yield income. You have done Marshall Wace and KFN historically. What strategic actions could you take to accelerate the fee and yield income growth? What's the appetite for that today?

Scott Nuttall - *KKR & Co. L.P. - Head of Global Capital and Asset Management Group*

I think a couple things. One, if you look at the places that we generate the more recurring portions of our cash flow, a huge portion of it is our fee-related earnings. And so a big portion of what we're focused on day to day is scaling these newer businesses that we have created over the last five to 10 years. And page 5 of this supplemental deck tries to get some of that across.

But we see a big opportunity to continue to grow our management fee line and get leverage over the expenses that sometimes with these newer businesses, oftentimes you add before the revenue shows up. So I think a big part of answer to your question is just continue to get the management fee line growing, and get leverage over that expense base and continue to grow our fee-related earnings.

As we deploy the balance sheet more broadly across our asset allocation model, I think this move out of credit more into private equity and real assets has been more one-time. We were overweighted credit post the KFN combination, and so you are really just seeing us move to our longer-term asset allocation approach.

So, as you have seen, we have got the interest and dividends coming down purposefully as part of that, but we've got plenty of coverage of the dividend. And you continue to see us grow our AUM and be thoughtful strategically where we see opportunities. Nothing near-term on the strategic front that we would point you to.

Michael Cyprys - *Morgan Stanley - Analyst*

Great. Thank you very much.

Operator

At this time, I am showing no further questions. I would now like to turn the call back over to Craig Larson.

Craig Larson - *KKR & Co. L.P. - Managing Director, IR*

Thank you, David, and thank you, everybody, for your interest. If you have any follow-ups, please follow up with Sasha, Danny or me directly. And we look forward to chatting with everyone next quarter. Thanks again.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude today's program. You may all disconnect. Everyone have a great day.

Editor

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