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KKR - Q3 2013 KKR & Co. L.P. Earnings Conference Call

EVENT DATE/TIME: OCTOBER 24, 2013 / 3:00PM GMT

THOMSON REUTERS

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by. Welcome to the KKR third-quarter 2013 earnings conference call. (Operator Instructions)

I would now like to hand over the call to Craig Larson, Head of Investor Relations for KKR. Craig, please go ahead.

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

Thank you, Catherine. Welcome to our third-quarter 2013 earnings call. Thank you for joining us. As usual, I am joined by Bill Janetschek, our CFO, and Scott Nuttall, Global Head of Capital and Asset Management.

We would like to remind everyone that this call will 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. We will also refer to non-GAAP measures on the call which are reconciled to GAAP figures in the back of our press release.

We are pleased to give this update and have been looking forward to this call. It has been quite an active quarter for us. As you will hear, we reported record AUM and fee paying AUM this morning. We raised over $6 billion of fee-paying AUM this quarter on an organic basis and over the last 12 months our total fee paying assets under management have increased by $23 billion, or 46%.

Second, we have been particularly active on the investment front. Within Private Markets, we invested $1.8 billion of fund capital this quarter, the largest figure for any quarter in almost two years and essentially equal to the amount we invested over the first nine months of 2012. In addition, we have announced several investments that have yet to close.

Scott, shortly, is going to walk through with you some of the drivers of this activity.

Finally, we are continuing to build out our franchise as evidenced by the announcement last week of our agreement to acquire Avoca Capital, a leading European credit investment manager with about $8 billion in assets under management.

Turning to our financial results, we reported economic net income of $614 million this quarter, which equates to $0.84 of after-tax ENI per unit, 22% higher than the $0.69 per unit we reported for the third quarter of last year. Fee-related earnings were $106 million, up 8% quarter over quarter and 25% year-to-date.

And we've also reported total distributable earnings of $251 million for the quarter and almost $950 million for the first 9 months of 2013. Finally, we have announced a $0.23 distribution per unit for the third quarter which brings our year-to-date distribution figure to $0.92 per unit.

With that, I will now turn it over to Bill to discuss our financial performance in more depth.

Bill Janetschek - *KKR & Co. LP - CFO*

Thanks, Craig. We ended the third quarter with assets under management of $90 billion, up 8% from last quarter and 36% from the same time last year. The majority of AUM growth was due to the $4.7 billion of new capital we raised in our Private Markets segment, which includes an incremental $800 million of NAXI commitments as well as $1.8 billion of new capital raised in Public Markets.

As of September 30, our fee-paying assets under management were $74 billion, an increase of 8% from last quarter and 46% from last year. Similar to AUM, the new capital raised in the quarter positively impacted our fee-paying assets under management. Keep in mind, these figures do not include approximately $3 billion of committed capital that will be included once it is invested.

To underscore how this fee-paying AUM growth is translating into higher fee streams, we reported record management fees for both the quarter and nine-month period. Third-quarter management fees are almost 40% greater in 2013 than 2012.

In addition, both fee-paying AUM growth and increased transaction activity have led to record fee revenue for both the quarter and the first nine months of 2013. To give you a sense, total fee revenue in the third quarter of 2013 is over 25% higher than the same time last year.

Turning to our segment results. In Private Markets, fee-related earnings were $44 million, up 4% from the second quarter, driven by greater transaction fees related to heightened deal activity. The 6% appreciation in our Private Equity portfolio, combined with higher fee-related earnings in the quarter, translated into ENI of $245 million, an increase from the $72 million we reported last quarter.

Our publics were up 17% in the third quarter, which compares favorably to the 8% increase in the MSCI World, while the private PE portfolio of companies were up about 3.5%.

Touching on Public Markets, fee-related earnings were $20 million, down from both last quarter and last year, which was primarily driven by lower incentive fees. As a reminder, Prisma incentive fees crystallize generally on June 30 and December 31.

We also incurred a one-time $10 million expense associated with the closed-end fund we raised in the third quarter, which hurt our fee-related earnings. Before this one-time expense, fee-related earnings would have been about $30 million, up over 25% from the third quarter of last year.

Third-quarter ENI in this segment was $28 million for the quarter, which includes $8 million of net accrued carry. And we now have an excess of $50 million in accrued carry on our balance sheet from our Public Market mandates.

Moving to Capital Markets & Principal Activities, fee-related earnings were $41 million, almost double the $21 million we reported last quarter. This 95% increase was driven by $700 million of syndicated capital, which resulted in higher transaction fees in the third quarter.

We reported third-quarter ENI of $340 million in this segment, up meaningfully from the $32 million we reported last quarter. This increase was driven by the performance of our balance sheet investments, which appreciated by about 7%. In particular, our balance sheet increased from significant appreciation in some of our large public holdings, like ProSieben, HCA, and NXP, where the balance sheet has additional exposure through its co-investments.

Today our balance sheet has nearly 40% of its assets in marketable securities, which compares to about 23% in our private equity funds. The increase in the carrying value of our balance sheet investments resulted in September 30 book value of over $10 per unit, which is up 4% from last quarter and includes a 19% increase in unrealized carry, bringing that total figure to close to $1 billion.

2013 year-to-date we generated $750 million of fee and carry. In addition, our balance sheet generated about $650 million of earnings, including about $400 million of realized income. In total, this is $1.4 billion of earnings on an average book value of $7.1 billion, or a 20% unannualized return on average equity in nine months.

Turning to our distribution, total distributable earnings were $251 million for the quarter. As Craig mentioned earlier, our third-quarter distribution of $0.23 per unit is comprised of the traditional fee-related earnings and cash carry of $0.10 and $0.07, and $0.06 of realized balance sheet income.

Our year-to-date distribution of $0.92 is up 77% from last year, or 31% apples to apples, including only the fee and carry components. Before I move on, I want to give you an update on netting.

The Europe II Fund continues to accrue carry and is currently marked at 1.4 times cost. As of September 30, our netting hole in E II decreased from $625 million to about $150 million. This progress is due largely to the cash gains from the NXP and TDC secondaries that we executed in September, as well as the share class merger and subsequent stock price appreciation in ProSieben.

As of today, all we need is one significant realization out of E II and that fund should be in position to pay out cash carry, which would mean that all of our mature private equity funds would be in position to pay cash carry.

With that I will turn it over to Scott.

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

Thanks, Bill. When we think about the third quarter, we see four main things of note -- fundraising, investment activity, monetizations, and Avoca. I'm going to start with fundraising.

We raised $6.5 billion of capital organically in the third quarter and $20 billion over the last 12 months. Focusing on the quarter, the $6.5 billion spans a number of accounts and strategies in both the Private and Public Market segments, and gives us comfort that we are gaining some traction as we grow and diversify our product offerings as well as our investor base.

In Private Markets, the $4.7 billion raised includes three main strategies. First, we held a close on our Energy Income and Growth Fund for $1.4 billion, including a $250 million GP commitment from our balance sheet for this first-time strategy.

Second, we closed on an additional $200 million of third-party capital for our Real Estate Fund, which together with our GP capital brings the total fund size to $700 million, and when you include KFN's commitment, $900 million. Third, we raised an incremental $800 million of capital since June 30 for our North American Private Equity Fund, which brings NAXI's total to about $8.3 billion, including employee capital, as of September 30. While we expect a handful of final commitments prior to year-end, this $8.3 billion is above the $7 to $8 billion expected range that we first communicated a year ago.

So what does this mean for our Private Equity business? Well, when you look at the buying power of our Asia II, NAXI, China Growth, and Europe III funds, it equates to a $21 billion global private equity fund. And if you look across all of our private equity funds and co-investment vehicles, we now have over $17 billion in dry powder.

The other $1.8 billion, or 30%, of the capital raised in the quarter was in Public Markets. About half this amount was in permanent capital vehicles, including Corporate Capital Trust, our BDC, and KKR Income Opportunity, our first closed-end credit fund. We also closed on an additional $450 million of capital for our Special Situations Fund.

Now let me discuss investment activity for a few minutes. As Craig mentioned earlier, we are encouraged by the firm's pace of capital deployment. In Private Markets, we put $1.8 billion of fund equity to work in the quarter. Approximately 85% of this was in Private Equity and includes the capital we invested in larger North American buyouts like Gardner Denver and PRA International. It also includes RigNet, which is an investment out of our Europe III Fund, as well as investments out of our Real Estate and Energy & Infrastructure platforms.

But we have also announced several new deals recently, which have yet to close, for an additional $2.5 billion of committed equity capital. We've seen broad-based activity across Asia, Europe, and the US.

In Asia, we announced a partnership with Panasonic Healthcare in Japan and an investment in Haier, the leading Chinese home appliance manufacturer. In Europe, we announced an investment in SBB/Telemach, the leading South East Europe TV and broadband operator. And in the US, we announced two investments that will be made out of NAXI, Mitchell International and Crosby and Acco. When these two deals close NAXI will be 30% invested.

So when you add all of this up, we've invested or committed $4.3 billion in private equity since June 30 and over $6 billion since the beginning of the year, double the $3 billion we invested for all of 2012.

If you look at recent deal activity, we've been able to use our experience from prior successful transactions to source and execute new investments behind themes we believe in. Our investment in Asia Dairy, a JV to help build new dairy farms in China, is patterned on our investment in Modern Dairy, which we largely exited early this year at three times cost and IRR over 30%.

Our investment in Crosby had similarities to Capital Safety, one of our 2012 industrial deals benchmarked at 1.6 times cost, also with an IRR over 30%. And we just closed our investment in Weststar, a helicopter services business in the same industry as our Europe III investment in Avincis, which is currently marked at 1.6 times cost.

We've also been active in public markets. To give you a sense, if you look at mezzanine and special situations we deployed $700 million of capital in the third quarter, up over 50% for the same time last year.

In direct lending you will see a similar trend. We deployed about $800 million in the third quarter, or more than 2.5 times last year's figure. And year to date we've invested a total of $2.7 billion in these three strategies, up 70% from last year.

And the investments continue to perform. Our mezzanine, direct lending, and special situations vehicles have IRRs in the range of 14% to 19% year to date.

MerchCap, our third-party capital markets business, has also been quite active recently. Since its inception in January, our origination team has sourced nearly 300 client opportunities. These efforts have yielded over 40 completed transactions, significant fees, and about $2.5 billion in originated credit investments for the firm.

The third area I want to touch on briefly is monetization activity. While we've been active making new investments, we've also been busy selling. We've returned over $15 billion of cash to our fund investors since the beginning of 2012, $6 billion of which occurred in the first nine months of this year.

As Bill mentioned, about 23% of our private equity portfolio is in public securities. And if Walgreens elects to exercise its option to acquire the remaining interest in Alliance Boots, that figure would effectively jump to 33% or $12 billion.

The last topic I want to focus on is the Avoca transaction, which we expect to close in Q1 of 2014. With this transaction our global credit business will go from $20 billion to $28 billion in AUM. Our dedicated credit professionals in Europe will increase from 11 to about 80 and 180 investors will join the KKR franchise, of which very few are investors with KKR.

Most importantly, we will now have a platform in Europe that can pursue liquid and illiquid investments. The pro forma footprint and capabilities of our European credit business will mirror those we have in the US, and we believe this will lead to even more deal sourcing for our private credit and special situations efforts.

We are particularly excited about this transaction as we believe the European credit markets offer significant opportunities for us as banks deleverage and take time to rebuild their capital bases. Our balance sheet continues to afford us the flexibility to pursue strategic and inorganic growth opportunities like Avoca, which we view as a good way to deploy capital at a high return.

In summary, when you think about our activities over the last 12 months, we've announced or closed the Prisma, Nephila, and Avoca transactions. Our fee-paying AUM has increased 46%. We've invested or committed over $7 billion out of our private equity funds and over $3 billion out of our private credit vehicles.

We have significantly increased fee-related earnings in cash carry and we've generated attractive returns on our balance sheet. This has translated into meaningful distributions and a high return on equity for all of us as shareholders. So we've been investing a lot of money, generating attractive returns, raising a lot of capital, and generating significant distributions.

We are also pleased with the strong early progress of Prisma and Nephila and look forward to our new partnership with Avoca, which will bring us more scale in European credit at an opportune time.

Thanks for joining our call. Operator, can you please open the line for any questions?

Q AND A

Operator

(Operator Instructions) Bill Katz, Citi.

Bill Katz - *Citi - Analyst*

Just a follow-up on the realization opportunity set, maybe a big picture question. With the Avoca transaction as you mentioned, Scott -- you've done a couple big ones now -- where are you in terms of your footprint, if you will, as you think about the core businesses you need to gain traction on?

I guess the ultimate question is, are we at a point now, given the strong ROE that's being generated off the balance sheet, that instead of funding some of this growth that could actually start to turn to real-time realizations?

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

Sure, thanks, Bill. I think in terms of where we are with respect to our core businesses, I think we still see a lot of growth ahead. If you look at -- as we discussed, private equity arguably is our one scale business. And we've got a number of other businesses that are in the earlier stages of their lifecycle.

If you look pre-Avoca at the $35 billion or $36 billion that we manage in non-private equity assets, the vast majority of that is in North America. And if you look at the firm's global footprint, we continue to see an opportunity to expand those businesses globally. So as we have discussed, the assets that we manage in European credit will go from $3 billion to about $11 billion just as a result of the Avoca transaction alone, and we see more opportunities in credit to expand geographically.

We see those same opportunities in the energy, real estate, hedge funds, and so we think there's a significant amount left to do in terms of continuing to build the franchise organically and inorganically. Even in private equity, we're spending time in places like Latin America, which is relatively new to the firm, so we could grow there both organically or inorganically too. So I think we continue to see opportunities to expand the footprint across the firm.

As it relates to the balance sheet question, look, I think the way that we think about it is we are quite pleased with the ROE that we've been able to generate. Last year, as you know, the return on equity for the firm as a whole was over 30%. We are 20% unannualized for the first nine months of this year, so we have been pleased in terms of how we have been able to deploy the capital off the balance sheet and put it to work at attractive returns.

We think of our businesses a bit differently. We think the balance sheet really gives us an opportunity to generate very attractive returns in its own right investing in what we do, both acquisitions and our own investments.

Then the asset management businesses, with the fee-related earnings and the carry, augment that return on equity quite meaningfully with very little capital requirement. That's how you get to 20% to 30% ROEs with no net leverage at the HoldCo. So, we see a lot of opportunities ahead.

Bill Katz - *Citi - Analyst*

Just a follow-up question, when you think about all that dry powder being deployed I guess an actual question is -- and you highlighted some returns on the Public Markets side. On the Private Equity side what are you underwriting as a target IRR for that dry powder?

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

Sure. It kind of varies a bit by region. We think about reward relative to the risk we are taking, so if you look at what we are underwriting in terms of, for example, some of the more emerging markets like deals we're investing in in Asia there is less leverage in the balance sheet, but arguably more underlying risk in terms of the emerging markets in which we are investing, or more company risk.

So the returns vary region to region, Bill. But in terms of what we've been generating as of late, kind of 20%-plus kind of returns in that part of the world and maybe high teens to 20% in the more developed parts of the world.

Bill Katz - *Citi - Analyst*

Okay. Thanks for taking my questions.

Operator

Chris Kotowski, Oppenheimer & Company.

Chris Kotowski - *Oppenheimer & Co. - Analyst*

Yes, good morning. You made a number of investments this quarter where you took minority stakes, like RigNet 27% and Haier I think was 10% and TPSF was 9.5%. And that seems like it's a departure for you, whereas you used to take control positions. I wonder, can you discuss what the rationale and logic and strategy is there?

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

Sure, Chris, it's Scott. I'd say a couple of things. If you actually look at how our Asian private equity business has developed since inception, the majority of what we have done has been in minority investments and so that's how we've, frankly, found the best opportunities to invest in that part of the world. So they would be a bit different than how you would think about our traditional private equity business in North America and Europe.

So the Asian investments, minority, very little leverage, if any leverage, in the capital structures and that's been the predominant strategy to date. If you look, though, at a lot of the other investments we've made -- we made several in the US -- virtually all of those would have been in the more traditional format of control buyout investing.

In Europe, the investment we just made in SBB/Telemach is also in that vein. RigNet was a minority stake, but a meaningful minority stake, and the stock has traded well thankfully. So that was out of a European fund.

That's how I would bifurcate. Asia more minority; rest of the world is probably more used to what you are seeing from us.

Chris Kotowski - *Oppenheimer & Co. - Analyst*

Okay. Just in general, you highlighted how much more active you are this year than last year, the $6 billion this year. Just given how far the public equity markets have moved over the last two, three years, I get the sense a lot of other private equity companies are becoming more cautious on acquisitions and deploying less capital. I guess, what is driving your kind of contrarian stance relative to that?

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

Sure. I'd say -- let's talk about it by region. So if you look where the capital has been deployed relative to our historical activity level, Asia has been extremely active. We put $1.8 billion of investments in the ground or committed to them since the beginning of the year, which is our highest level of activity since we began our Asian business.

There I tell you what we're really seeing, Chris, is the equity markets in Asia pulled back and so we've been capitalizing on that emerging market volatility. There have been concerns around slowing growth; we think it's a bit overdone, so we're actually seeing valuations be quite cheap, especially places like China where the valuations are more attractive than have been in the last five years.

As I said, we don't use much leverage there so we've got an attractive equity point and the valuations aren't being moved up by the credit market. So we are really leaning into that opportunity, so Asia would be one thing I would point you to.

The second thing would be Europe. We have seen a number of our competitors pull back from Europe. We actually think the competitive environment is a bit better. Deal flow is starting to pick up.

Our pipeline there is quite good, so we've actually been expanding our European private equity presence and efforts. I don't know if that's contrarian, but we think it's actually a pretty interesting time to buy in Europe ahead of what we think will be a recovery over the next several years.

North America, valuations have been moving up and it has been harder to find value, but what we have found is that we got a longer-term horizon and conviction around themes. That's why I went through how some of the investments are patterned on prior successful investments.

If we can bring our operational capabilities to bear, we think there are opportunities to really make some interesting investments and those are the ones we've been making. But it's been highly selective. Out of hundreds of opportunities there may be one or two that are worth pursuing. And so we are seeing opportunities in a more targeted set of areas like healthcare, technology, parts of energy, and industrials.

I'd say Asia and Europe -- leaning in while the markets are a little bit afraid and the US -- being selective and highly value conscious.

Chris Kotowski - *Oppenheimer & Co. - Analyst*

Then last thing for me is obviously KFN reported results that were somewhat short of market expectations last night and we are seeing the incentive income come down there. Is there any kind of forward outlook that you can give us on that line?

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

Unfortunately, can't really talk to that too much, Chris. I think, as we said, our Public Markets businesses have incentive fees that come from several of our strategies including Prisma and our underlying liquid investments. KFN is one of those, but we're not going to be able to give you any forward guidance there, unfortunately.

Chris Kotowski - *Oppenheimer & Co. - Analyst*

Okay, fair enough. Thank you, that's it for me.

Operator

Michael Kim, Sandler O'Neill.

Michael Kim - *Sandler O'Neill - Analyst*

Good afternoon. Just first in terms of fundraising, it does seem like demand is picking up a bit with some firms upsizing fund sizes more recently. So just curious if you could give us some color on what you are seeing from a fund-raising standpoint as you are out there meeting with potential LPs?

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

Sure. I'd say the backdrop is pretty good, Michael. We are seeing more interest in alternatives and we have talked in the past about how a number of institutional investors globally have increased their allocations to alternatives. And so there have been two things that I think we've all been benefiting from.

One is that during the downturn the percentage allocation to alternatives has increased and now the denominator, by virtue of what's happening with the Public Markets, is increasing. So you have got a higher percentage applied to a bigger denominator and that's creating an opportunity for these firms to look at it and say, well, we need to put more money to work to actually meet the alternative asset allocation that we've now created for ourselves.

So that backdrop is healthy because there's an interest in putting capital to work. And I think we've now swung largely, not completely but largely, from the fear part of the spectrum to more to the greedy part, which is good from a fund-raising standpoint.

The second set of contributing factors would be returns and cash back. Returns across the alternative asset space have been quite strong. You can see even in our private credit strategies we are generating mid- to high-teens returns. And there has been a lot of cash back, probably more so than institutional investors have modeled if you go back a couple years. And that's helping the dynamic quite a bit as well.

The third thing I would tell you is the fundraising sources have become much more broad-based. We have talked -- specifically to KKR, we have invested meaningfully in distribution and building relationships over the last few years. I think that is starting to bear some fruit.

One interesting statistic that we track is that we've been spending more time raising money from individuals. Year-to-date, of the $17 billion or so that we have raised in the last nine months, 25% of that figure came from individual investors.

And that's high net worth platforms, direct high net worth efforts, etc. And so that is another interesting element. So it's really quite broad based and encouraging in terms of the traction that we are just starting to see.

Bill Janetschek - *KKR & Co. LP - CFO*

Michael, this is Bill, if I could just add -- we mentioned on the call earlier that in the quarter we raised $6 billion and over the last 12 months we raised over $20 billion. We have now significant platforms that we are raising capital for and so, by way of example, in Private Markets the capital that we raise in that segment is from six different broad mandates. More importantly, on the Public Markets side, we actually have nine platforms which we raise capital on.

So as we continue to grow our platform base hopefully we are going to be able to see continued AUM and, more importantly, fee-paying AUM growth.

Michael Kim - *Sandler O'Neill - Analyst*

Okay. Maybe if I could just kind of follow up on those comments in terms of thinking about the trajectory for growth playing out. Looking ahead, obviously, you are wrapping up fundraising for NAXI and you just closed to Asia II, so just wondering how you are thinking about maybe the transition from raising some of those legacy funds to building out your newer businesses and how that could impact the trajectory for growth.

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

Sure. I think just to run through it quickly, we've got several vehicles that we are finishing fundraising for in the coming quarters. You mentioned NAXI, but we also have our special situations vehicle, real estate, the Energy Income and Growth Funds that I mentioned, that $1.4 billion I talked about was a first close and we will continue to be raising capital there. So there's probably those four or so episodic strategies that we'll be finishing up.

If we look into the forward calendar, Michael, our European private equity business is going to be launching the Europe IV fundraise here shortly. We are starting to run low on capital in our infrastructure business, so you see an Infra II Fund in the not-too-distant future.

And by virtue of just how much activity we've had in the private capital space in the mezzanine and direct lending in particular, I think we are likely to pursue capital raising in the not-too-distant future in the mezzanine and direct lending spaces as well.

Then keep in mind, we do have a larger and larger aspect of our business where we are raising capital continuously. Obviously, strategies like high-yield, leveraged loans, CLOs, Prisma, our hedge fund strategies, both (inaudible) and Nephila, and so I think that just hopefully gives you a flavor. There's a lot of things coming.

There's no doubt that the $20 billion we have raised in the last 12 months benefited in part from the fact that we were out with both Asia and NAXI. But just to give you a sense of that $20 billion in terms of what would be included in those numbers, it's probably $8 billion or $8.5 billion of the $20 billion. So there's a lot coming and we've clearly benefited from those too, but we continue to see a very full pipeline.

Michael Kim - *Sandler O'Neill - Analyst*

Okay. That's helpful. Thanks for taking my questions.

Operator

Howard Chen, Credit Suisse.

Howard Chen - *Credit Suisse - Analyst*

Good morning. I was hoping to follow up on Avoca. Given that they are just new to the family, was hoping you just could discuss, Scott, why this fit made sense versus other firms you may have looked at. What's performance been like on an absolute and relative basis, and what's the fee model been like? Thanks.

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

Sure. So I guess, first, with respect to the firm and the fit, as we headed into this year one of the strategic objectives we had was to have a greater presence in European credit. If you looked at how we built our European credit business organically, it had really been just more on the private credit side, so largely special situations and mezzanine in particular. But we did not have a liquid credit capability.

And if you contrast that to the way we built the North American business, where we have both, there was clearly a disconnect there. The way that we run our credit business is that we actually have the liquid and illiquid teams working together and cross-staffed, so feeding ideas to one another. So if we are invested in a liquid credit that underperforms that creates a calling opportunity for the illiquid origination team, as an example.

And so we set out to find a platform that would be complimentary to what we had already built organically in Europe and, frankly, Avoca fit the bill perfectly. Minimal overlap and a significant amount of synergies, we believe, because their business had really been formed on leveraged loans, CLO's, liquid opportunistic credit.

They have a long/short credit capability in Europe and they have a convertible bond capability in Europe. We had none of those capabilities.

We were very active in private credit. They do not have a private credit capability. So by putting the two efforts together, we actually have a footprint now that is very consistent with the business that we've created in the US.

Critically, as we think about these things, the cultural fit is great. The team is wired the same way we are and we have spent a significant amount of time with them. Happily, our Capital Markets team in Europe had known the people at Avoca for several years so there'd been a long history.

Their performance has been very strong. They've beaten benchmarks across all their strategies since inception and so we feel like we really have a best-in-class partner. The performance of the CLOs have been very strong.

And to your last question about the fee model, because it is more focused on liquid credit you will find that the majority of their strategies are going to be more consistent with the economics that we get on our liquid credit business. So very little of what they do today will have a carry component and it will largely be a fee-only component, similar to what we see in our loan and high-yield business. I think as they scale the hedge fund platform and some of the other platforms that will change over time.

Howard Chen - *Credit Suisse - Analyst*

That's really helpful. Thanks for going through all that, Scott.

A follow-up question, switching gears a bit, I was hoping you could talk bit more about the steady transaction fee generation. I know it's been a product of some of the initiatives that you're working on. So could you drill into that a bit and provide a bit more color on how those fees breakdown among the various components, whether it be all of what are doing, the syndication, monitoring fees, etc?

Bill Janetschek - *KKR & Co. LP - CFO*

Hey, Howard, this is Bill. As it relates to monitoring fees, you can see that that monitoring fee is pretty stable. It's up a little bit this quarter.

The run rate number on that is anywhere in between $30 million, $31 million. And so as we sell some portfolio companies we are taking on new companies through acquisitions and so we would see that to be pretty steady.

On a transaction fee side, that ebbs and flows. What happened this particular quarter is that with Gardner Denver it was a very big equity check, and so we placed a good amount of that equity in our traditional private equity fund, but we also had our client and partner group as well as our Capital Markets group syndicate out a halfway decent amount of that equity. And so that's why you saw the transaction fees on the Capital Markets side double from last quarter.

I would say that in the fourth quarter, based upon the transactions that we've announced, you will see the transaction fees be pretty robust on the private market side. But because of the size of the equity checks, we will be syndicating some of that capital in Capital Markets, but not as much as you are seeing here in the third quarter.

Howard Chen - *Credit Suisse - Analyst*

Thanks, Bill. Then final question, Scott, you provided some really helpful color on deployment. Just given the consistency of the themes you noted and the pipeline you're looking at, I know you guys look at a lot of things all the time, is there still a glide path that you see that you can continue this pace for a while? Or should we anticipate that you go into a bit of a digestion phase?

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

Sure. It's a great question, Howard. As you know, it's very hard to predict, especially on the private side, what deal flow is going to look like. We've announced over $4 billion of new equity investments since June 30. I would be loath to tell you that we are going to see that level of activity continue, so hard to predict.

But the good news is the pipeline continues to be full. It's just very hard to predict how many things will actually get done, so I certainly wouldn't annualize the last few months.

Howard Chen - *Credit Suisse - Analyst*

Okay, thanks.

Operator

Matt Kelley, Morgan Stanley.

Matt Kelley - *Morgan Stanley - Analyst*

Morning, guys. I wanted to ask just about -- coming back to the deal pipeline and also what you think in terms of exits, anything notable you think in our economic or legislative/political environment that could make exits pickup and deployment pickup? Or is the debt ceiling more of a talking point than you guys might see from a kind of corporate stepping in with cash on balance sheet to buy assets perspective?

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

Hi Matt, it's Scott. I'm not sure you could really extrapolate much from what is going on in Washington to our deal pipeline or our exits. I think, as a general color matter, we have seen some strategic M&A dialogue pickup across our portfolio.

Obviously, if there's uncertainty in the environment it's harder for CEOs to have the confidence to follow through on that, so on the margin that may move to more public market exits than strategic. But I'm not sure that I can tell you that we could extrapolate much from the behaviors in Washington to our own pipeline.

What I will tell you is we do see some underlying strength over time potentially in different parts of the economy in the US and Europe. We are seeing things pick up in China a little bit and so we're kind of investing through the noise and kind of extrapolating to what we think the next several years can look like. And that's perhaps why we've been a little bit more active as of late.

Matt Kelley - *Morgan Stanley - Analyst*

Okay, that's helpful. Then if I can ask a two-part question on your real assets.

First, I noticed on your balance sheet the seed of the Real Estate Fund actually went down versus prior quarter, unless I am looking at this wrong. So I wanted to ask about that; if there's kind of a one-timer in there or anything.

Then separately, just as real assets becomes a bigger part of what you're doing are you starting to think about that a little bit as a different segment as you get more scale there? How are you kind of thinking about the business from an internal perspective there?

Bill Janetschek - *KKR & Co. LP - CFO*

Matt, this is Bill. I'll take the first question and then I'll pass the second over to Scott.

Remember that the Real Estate Fund, as well as the Energy Income, these are drop down funds, so in Real Estate we actually have purchased and put all of those assets on our balance sheet. When we had our first close we are, in essence, selling a portion of the invested capital in that fund to new LPs as they are coming in.

What you saw in the third quarter is that we had a second close and so what we ended up doing is rebalanced that fund. And we, in essence, sold part of the invested asset that we had as the GP over to new LPs coming in and you will see that number go down.

So, likewise, in the fourth quarter you can see that the royalties and drilling number, that's what we have put on our balance sheet to date. Energy Income closed in the latter days of September and so you will see 50% of those assets being sold off to that fund, and so you will actually see a drop-down in the invested assets. But remember, keep in mind that our commitment to the energy income strategy is still going to be about $550 million.

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

And, Matt, on the second question, with respect to how we think about it, if you look at page 16 of the press release you can see the breakdown. I think over time you'll see real assets and the public market strategies continued to increase as a percentage of the whole.

We have talked about this in the past, but we continue to focus on having our balance sheet generate more recurring cash flow. And so the real asset strategies generate quite a bit of current cash return as do the credit strategies.

And by virtue of the distribution policy that we have where we are paying income right off the balance sheet every quarter, we think over time that will lead to a distribution that is more recurring in its makeup, augmented by the carry and balance sheet gains. And so you will see those percentages pick up over time would be my guess.

Matt Kelley - *Morgan Stanley - Analyst*

Okay, great. Thanks very much.

Operator

Mike Carrier, Merrill Lynch.

Mike Carrier - *BofA Merrill Lynch - Analyst*

Thanks, guys. First question, just on the exit new outlook, if you look at the portion of the private equity business or the capital that's in the ground that's not public yet, if we aren't -- and this is more of an industry question. But if we don't see much of the pickup on the M&A side, and given where those investments are in terms of maturity of them, where your returns are sitting, would we expect to see more exits through the IPO channel?

Just trying to figure out, when you guys look at the opportunities before you in terms of the different exit strategies what we could see sort of over the next 12, 24 months.

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

Hey, Mike, it's Scott. First, let's just do a little bit of level setting. We mentioned the $15 billion that we've given back since the beginning of 2012.

Just to give you a sense of the breakdown, about 60% of that was public company secondaries, so it's been a majority of it. About 30%, give or take, was strategic exits and the rest was kind of dividend recaps and other dividends that we received. So that gives you a sense for the breakdown.

We do think that we have a number of our companies that are getting into the more mature phase, so there's more of an opportunity potentially for an exit. But the way that we look at it today, as I mentioned, if you include Boots, about $12 billion of $36 billion or so of private equity fair value is already public.

And I know there's a lot of focus on IPOs, but we actually focus on how those companies are trading and how much value we have created in those public positions, because that is a more readily available monetization opportunity, whereas IPOs are traditionally more primary or mostly primary in construct.

From a strategic exit standpoint, the environment has been a little open-shut, but we are having at least as much dialogue today as we have had at anytime in the last few years. So I'd say that we are hopeful there, but very hard to predict what will come to fruition.

But if you think about it, 30% of the $15 billion was strategics. We are not relying on that as the exit opportunity.

The other way that we look at it is that the real question is how are we doing creating value in the portfolio? How many of our companies are trading, valued up significantly relative to the cost and getting closer to that time where it makes sense to start to consider monetizing them?

And on that score we actually feel quite good because a number of the investments that we've got in the portfolio are now marked up to 1.5 to 2 times cost-plus, and are starting to get more into that lifecycle where you can think about monetizations, recognizing that we don't want to leave too much on the table either.

Bill Janetschek - *KKR & Co. LP - CFO*

Right. In addition, another opportunity to have realization is doing recapitalizations of our companies. To Scott's point, a lot of the portfolio companies that are mature, but not fully mature.

There is a position where due to company performance that company is actually delevered, and so we have an opportunity to maybe take advantage of where the fixed income market is today and do a recapitalization. Case in point, we did a recap on Pets. We recently did a recap on Visma, and so there is always that opportunity as well.

Mike Carrier - *BofA Merrill Lynch - Analyst*

Okay. That's helpful color. Then, Bill, maybe just on -- a few items, some on the P&L. I think the first one, just on the fee credits, just seemed a little elevated this quarter. Not sure exactly what drove that.

Then on the expenses, you guys flagged the $10 million on the public side. Anything on the private side? You seem maybe a little elevated. It might have just been correlated with the transaction fees, just wanted to get a little color on that.

Then on the incentive fees, I get the seasonality. But any way to size up maybe the number of products now or the amount of assets, given some of the transactions that you guys have done with either Prisma or Nephila in terms of trying to gauge, whether it's the fourth quarter or the second quarter, what the range or what the potential is there?

Bill Janetschek - *KKR & Co. LP - CFO*

Sure. As it relates to fee credits, when you take into account -- and if you look at page seven we are talking about Private Markets. You take the monitoring fees and the transaction fees; the fee credit in this quarter was about 53%. In the prior quarter it was about 54%.

So the way to think about this from a modeling perspective is that's probably a good number to use. To the extent that we are going to be investing a lot of the capital through our traditional funds, we do have fee sharing arrangements with each one of those mandates and so that's probably a good estimate to use.

As far as incentive fees, that is something that we were just talking about earlier today. When you think about the incentive fees for Prisma, generally speaking, they have about 50% of their funds where it would have an incentive fee that crystallized June 30 and another 50% that will crystallize in December.

So when you're looking at our financials quarter to quarter you shouldn't see or expect to see any incentive fees come through in the first quarter or the third quarter. You'll see that in the second quarter and the fourth quarter for Prisma.

Nephila, to the extent that they are entitled to an incentive fee, their funds crystallized in December. And so if we're going to see an incentive fee from Nephila, you will see that come through in December. Same holds true for KES.

And so our hedge fund, even though we might be accruing some sort of incentive fee, the crystallizations in those funds don't take place until December and that's when you will see that come through. So as we do launch and raise additional hedge funds that will be something that you will see not come through in the first nine months, but you will see come through in the fourth quarter.

Mike Carrier - *BofA Merrill Lynch - Analyst*

Okay. Anything on the expense side? And thanks.

Bill Janetschek - *KKR & Co. LP - CFO*

On the expense side, one thing to note is the expense number was up pretty significantly from the second quarter to third quarter. We did put a footnote in on the Public Market side.

We raised a closed-end fund and for that we actually paid a 3% underwriting fee/expense number for the $300 million that we raised in that mandate. And so that amounts to $9.7 million of the increase in expenses.

But that closed-end fund is still a product that we are very interested in because it's permanent capital. Once we raise the capital we are going to receive an ongoing management fee of a little bit north of 1% on gross assets, not just the investment capital. So to the extent that there's a little bit of leverage in that particular closed-end fund, we are receiving a 1.1% fee on a higher amount.

The other expense number that ticked up this quarter was on the private market side. The broken deal expense was about $5 million higher than in the prior quarter.

Reason being is we have seen a lot of opportunities. Some of those we've either signed and closed on or will close on, but some we just end up being unsuccessful. And so what ends up happening is we look at a lot of deals in the second and third quarter and some of that expense is coming through our P&L.

Mike Carrier - *BofA Merrill Lynch - Analyst*

Okay, that's helpful. Thanks a lot.

Operator

Patrick Davitt, Autonomous.

Patrick Davitt - *Autonomous Research - Analyst*

Could you talk a little bit about what you're seeing within kind of the portfolio in terms of economic growth kind of globally and by sector? And within that question, to what extent your CEOs have seen a change in business around the shenanigans in DC over the last few weeks?

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

Sure, Patrick, it's Scott. I'd say if you look at the portfolio company growth and you kind of normalize for mix, because obviously we have new companies entering the portfolio and some exiting, not a big change. Maybe a little bit of a tick down in the last few months, but not a big change in terms of revenue growth and EBITDA growth figures. Nothing that I would point you to as anything to draw a message from.

Probably the more interesting aspect to the second part of your question is we do have a number of our companies that are facing the consumer. We did see during the period of the government shutdown a bit of a pullback by the consumer during that period, which we expect will have some impact on kind of GDP in the US in the second half. Hard to know how big that will be, but clearly there was a bit of a correlation between what was going on in Washington and what the consumer decided to do for that period of time.

In terms of what we're seeing though, it is an interesting period as we look, especially at the US economy. Because we are seeing strength in autos, energy, housing, some parts of the manufacturing space, and we are seeing consumers away from the couple-week Washington shutdown, spend money on more big-ticket items like cars.

But having said that we are not seeing as much pull-through as we would normally expect given the indicators that we look to around housing, credit spreads, etc., are moving in the right direction. So it's an interesting time. We do see the private sector kind of improving a bit and the real question is what is the consumer going to do.

But nothing too much to take from the portfolio, which continues to perform nicely. Then just it will be interesting to see if the consumer comes back now that Washington is back in business.

Patrick Davitt - *Autonomous Research - Analyst*

Okay, great. Thanks. Then on the retail effort you mentioned how much fund raising had kind of come from individual investors. Is there a conflict in terms of your fundraising with your more traditional LPs there?

As you and your competitors ramp up this retail distribution effort do you get the sense that your more traditional LPs are concerned that they are getting opportunities that they aren't, or that they are taking opportunity away from those more traditional pools of money?

Bill Janetschek - *KKR & Co. LP - CFO*

Have not run into that, Patrick, and it's really because what we're offering -- the terms we are offering individuals are the same as what we are offering institutions for the same product. As we discussed in the past, if institutions are investing in size they tend to get a fee break relative to the smaller investors. So the easiest way to handle that is to make sure that people have the same terms.

And institutions are going to be more able to invest in the longer-dated illiquid products than individuals, so a lot of the fundraising for individuals will be more short dated. Institutions will be longer dated. And as we package the longer-dated product for institutional channels like high net worth platforms, basically what we are doing is we have the same fee construct as we do for institutions, which mitigates any potential conflict.

Patrick Davitt - *Autonomous Research - Analyst*

Okay. Thanks a lot.

Operator

Chris Harris, Wells Fargo.

Chris Harris - *Wells Fargo Securities - Analyst*

Hey, guys. Just a few quick follow-ups here on Avoca. Can you guys share with us what the margin of that business is like? Then, I know as part of the deal you issued a little bit of equity. Pro forma for that is this still an accretive deal for you guys out of the box?

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

Chris, it's Scott. I'd say first on the margin, we are not going to be able to disclose that. The overall margin of the business is pretty consistent with the margin of our Public Markets business, so it's not dramatically different. And in terms of the accretion, we'd expect it to be accretive day one.

Chris Harris - *Wells Fargo Securities - Analyst*

Thanks guys, that's all I had.

Operator

Robert Lee, KBW.

Robert Lee - *KBW - Analyst*

Good afternoon, or just about morning, everyone. I apologize; I got on the call a little late. I'm just trying to understand the strong capital formation in the Private Markets, the $4.4 billion in fee paying, could you just kind of quickly walk through what that was?

I know there was the energy, real estate, another $800 million from NAXI, but I'm still coming up a little short. So maybe what else was in there?

Bill Janetschek - *KKR & Co. LP - CFO*

Just to give you a breakdown, so you're referring to the in Private Markets $4.7 billion, so Scott and I mentioned earlier, NAXI was at $800 million. We also raised another $200 million. Energy income was $1.4 billion and so that's from what I'll say from our traditional co-mingled funds.

In addition, were raised about $2.3 billion of capital in Private Markets. $1.1 billion of that is committed and will show up actually on the table and $1.2 billion of that is capital that we are managing but is in a committed pool. It's just capital that we are going to be managing.

Both of these are in separately managed accounts, and in both we're entitled to a management fee and one of them we are actually receiving a carry no different than our traditional private equity funds. And so that gives you the full round out of that $4.7 billion.

Robert Lee - *KBW - Analyst*

Great, that's helpful. I'm just curious; you've periodically given us an update on kind of the progress of your LP base in terms of how it's been growing and expanding. I'm just wondering if we could maybe get some update now kind of where you feel you stand with the number of LPs you have and maybe an update on the US versus non-US complexion of it.

And also maybe some color on how that's -- does that continue to change with some of these recent fundraisings?

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

Sure, Robert; it's Scott. I think in terms of the number, I think last time we talked about it it was in the mid-600 range. It's probably somewhere between 650 and 700 today and continues to creep up as we've been closing these funds.

We don't have the individuals on a per individual basis otherwise the number would be a lot bigger, so you can think of that as the more institutional number just continues to march up.

In terms of the overall complexion of the investor base, this year we've been quite busy US, Europe, and Asia. So we've been able to open a number of new investor relationships in all three regions, continue to gain traction with the sovereign wealth funds. Now that we have a focused effort on insurance, getting some traction there. But we are continuing to have broad-based success, I would say.

The numbers that I'm talking about, by the way, in terms of number of investors exclude Avoca because that will bring more investors to us. But just apples to apples I would say we are probably better part of 700 now relative to where we were in the mid-600 range.

Robert Lee - *KBW - Analyst*

All right, great. That was actually the only two questions I had right now. Thanks.

Operator

Mark Irizzary, Goldman Sachs.

Mark Irizzary - *Goldman Sachs - Analyst*

Actually, I had a question related to capital formation this year, Scott, and what you see in terms of the mix of LPs. Could you just talk about the co-mingled funds in terms of maybe new asset formation from existing LPs versus new LPs versus the rest of the products?

Are you seeing sort of a shift in sort of more the new investors coming into new products and maybe the re-up rates on some of the fundraising on the commingle side?

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

Sure, Mark, I'd say if you look at the figures in terms of -- just to pick a couple of vehicles for a second. If you look at the Asia Fund as an example, in terms of new clients probably 45% of the number of investors in the Asian Fund are new clients for KKR. It's about 24% of the dollars, but somewhere between 40% and 50% of the number of clients just to give you a sense.

For the North American Fund, you are going to be probably more 10%-ish of the capital as opposed to 23%, 24%. And instead of 45% probably 30% or so in terms of the number of investors are new. So it's not surprising when someone is new to us they going to be smaller than the incumbents who are usually rolling capital and profits back in, but we are encouraged to see that 30%, 40%-plus of the number of clients just in those two vehicles are new to the firm.

If you look at the breakdown by region, if you look across those two vehicles, just to give you a general sense, we are probably seeing about 60% of the number of investors and about kind of 45% by dollars from North America. If you stick with dollars for a second, you're seeing numbers coming out of the Middle East in the 20% or so range and then Asia and Europe make up the rest.

Mark Irizzary - *Goldman Sachs - Analyst*

Okay, great, thanks.

Operator

Thank you. I'm showing no further questions. I would like to turn the call back to Craig Larson for any further remarks.

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

Thanks, everybody, for joining the call. If you have any follow-up questions, please feel free to follow up with either Sara or myself. Speak to you next quarter.

Operator

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

EDITOR

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