KEYNOTE ADDRESS: FINDING OPPORTUNITY IN THE CURRENT MARKET

- Johannes Huth, **KKR**

Christopher Elvin: Let's start with the market environment. What are your views?

Johannes Huth: In almost every meeting we have with investors today, we are asked where we think we are in the market cycle. How can we put money to work in an expensive environment, are we concerned by the overhang of dry powder in the industry, and so on.

In part, the high valuation environment is a reflection of the economic resurgence that has occurred, largely uninterrupted in the developed economies, since the Global Financial Crisis of 2008-2009. The question of high valuations with respect to private equity is perhaps particularly pertinent given the continued outperformance of the asset class relative to public equity, and this strong relative performance is driving more investors to increase their allocations to the asset class. At the same time, a highly favourable exit environment has been generating sizeable distributions, much of which we believe will be channelled back into successor funds. All told, the volume of unused commitments in the private equity industry has been estimated at ~$1tn today, 76% of which is held in 2015-2017 vintage funds.[1]

In addition to these increasing amounts of private equity capital available, loose monetary policy and an environment of "easy money" mean that we see increased engagement from strategic investors in Europe, including foreign buyers that often have a significantly lower cost of capital than our own. As a result, we find that the average purchase price multiple for deals in Europe has increased to an average of 10.6x EV/EBITDA in 2017, higher than the 9.7x recorded in 2008.[2]

The reality is there have been concerns over high purchase prices for at least the last three years, but to have held back from the market during this timeframe would undoubtedly have been a mistake - there have been some excellent deals executed during this period that have already demonstrated impressive results. The European private equity market is large, and is less well penetrated than it is in the US. To put this in context, European private equity investments in recent years have accounted for between 0.2% and 0.3% of total European GDP, as compared to over 1.0% in the US.[3] We are not, therefore, deterred by the volume of dry powder, and regard buyers prepared to pay higher multiples as an opportunity, rather than a threat. Provided we can continue to find businesses where we can help optimize performance, we think we can deliver strong investment returns to our investors, regardless of the point in the market cycle.

CE: How do you view political risk in today's investment environment, in particular the potential impact of Brexit?

JH: I think that in reality Europe is politically more stable now than at any point over the last decade. The one exception I would make to this observation is the UK's decision to leave the European Union. The result of the Brexit referendum unleashed considerable volatility in the sterling exchange rate, and it is clear that the full consequences of this event are yet to play out. Consistent with this, our team of macro specialists are following the economic indicators of the UK very closely. Of particular note is the UK's substantial current account deficit, which leaves it vulnerable to shocks, and is in contrast to the eurozone which has a substantial current account surplus. Additionally, the UK consumer appears to be in especially shaky territory: UK unsecured consumer credit has grown by an extraordinary 50% in the last five years, a rate which we believe is untenable over the longer or even medium term. While an outright recession in the UK is not our base case for now, it is worth remembering the extent to which periods of economic contraction in the UK have been both deep and prolonged, with GDP declining on average between 2% and 4% from peak to trough. Our assessment of the UK does not mean to say that we are not investing there, however we remain cautious. We favour UK companies with a large proportion of their revenue base coming from overseas, and where the investment thesis is about expansion globally. We seek to avoid domestically oriented businesses with significant exposure to the UK consumer. Our ultimate goal is to build diversified, pan-European portfolio, which will include exposure to the UK.

Outside the UK, the picture looks more robust, politically as well as economically. Looking back on the elections we have seen in 2017, radical political forces were marginalized in both the Netherlands and in France, and it is our view that Germany will continue to provide stability within the eurozone. We think that the economy is currently well positioned, and our macro team are forecasting GDP growth in the eurozone of 2.0% for 2018. Although ECB tapering is top of mind for many investors, we do not believe that this will derail Europe's recovery. Indeed, even with the proposed tapering, we expect the ECB to add over a third of a trillion euros to its balance sheet in 2018. Together with other tailwinds, such as lower unemployment and a relatively weak euro supporting exports, we feel optimistic about the European economic outlook.

CE: You have spoken about market cycles – what did you learn from 2008/2009?

JH: We made a number of changes to our investment approach following the last market downturn. Firstly, the majority of deals we are doing in Europe today are different from the deals we were pursuing in the 2006-2007 period – these typically targeted higher levels of leverage and were often executed in consortia with other

[1]Preqin
[2]LCD News; Q3 2017 Review
[3]Invest Europe, "2016 European Private Equity Activity", 2016.

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financial sponsors. This sometimes comes as a surprise to people, but in contrast to our reputation for "mega-buyout" deals, our average equity cheque since 2009 has been €200m. Over the same period, our average entry leverage has been relatively conservative, at 3.3x net debt/EBITDA. That said, we can leverage our balance sheet and established co-investment program to enable us to review a very broad spectrum of opportunities, and will still consider large deals – like the recent carve-out of the spreads business from Unilever. However, our most typical deal today is in what we term the "upper mid-market", or roughly between €500m and €2bn in enterprise value. We think this is an attractive area of the market given the wealth of deal flow we see, and because this size of business is often best positioned to benefit from the resources that we can bring as a partner.

Secondly, we deepened our local footprint in our core European markets and established local investment and portfolio management committees. We still have global representation on these committees in the form of KKR's co-founders, Henry Kravis and George Roberts, and co-president, Joe Bae; however, the majority of both committees are members of our European teams. I believe this helps to ensure deeper accountability from the investment team, and means that our local expertise is genuinely shaping our investment decisions.

Beyond these enhancements to our investment approach and process, we have proactively developed significant resources that can help support our investment businesses. I have mentioned our macro team already, who bring a very important dimension to our understanding of each opportunity we consider. They provide a top-down perspective that helps identify investment themes and secular trends, and they assist with portfolio construction, where their work can help us avoid unintended overexposure to key macro risks. Additional capabilities include the incorporation of ESG criteria into our investment screening and management practices, an area in which we believe we have become thought leaders for the industry.

CE: How is KKR positioning itself for investment opportunities in Europe today?

JH: Our starting point is always asking: what can we bring to an investment beyond being simply providers of capital? We have an experienced private equity team in Europe, but KKR also has a wealth of resources globally that we believe make us better investors and more attractive partners to the businesses we invest in. For example, we have one of the largest private equity businesses in the US and Asia; we have a group of operating experts, KKR Capstone, with over 50 people worldwide; and we have a network of over 100 portfolio companies globally, with approximately $100bn in annual revenues, which can help our European companies gain access to new markets.

We think that the power of our firm-wide resources makes us an attractive partner to businesses, and we see this thesis being proved out in our deal track record. Over two-thirds of the portfolio companies we have invested in since 2009 have been partnership transactions, where a family owner, founding entrepreneur or corporate shareholder has rolled a significant portion of their stake in a business into a new partnership with us. We work together with our partners to implement value creation initiatives that impact top-line growth as well as EBITDA margin expansion, support accretive M&A, and utilize our global footprint to help internationalize local European businesses. Often, we find that we are selected as the partner of choice by the owners of a company on the basis of the toolkit that we can bring, even in instances where we are not offering the highest price.

CE: What do you believe the main challenges are for LPs looking to invest in 2018?

JH: Investors drafting their asset allocation plans for 2018 face difficult choices about where to find the best risk-adjusted returns for their capital. As a practitioner of private equity, I think that the continued outperformance of private equity relative to public equity makes as strong a case as any for allocations to the asset class. I think another important point is that consistent and disciplined deployment to funds across vintages is critical, given how notoriously difficult it is to time markets. One of the advantages of illiquid funds is that they are structured to invest across market cycles, in our case over investment periods of six years, so by committing to a given vintage investors should get some comfort from the fact that not all their capital is being put at risk on day one.

In my view, one of the greater potential challenges to investors in 2018 will actually be getting access to the right managers. We have seen record volumes of capital distributed to investors, the demand for re-ups has been high and target allocations are growing. Many limited partners are placing pressure on managers not to drastically increase the size of their funds, but at the same time we have also had the experience, in KKR's most recent series of private equity fundraises globally, of having to cut back on investor allocations. As such, I believe that some growth of fund size – within reason – is appropriate, as this is a reflection of the continued (and in our view sustainable) growth of the private equity industry as it continues to perform and evolve.

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