

Asia: A Changing Landscape

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I recently traveled in Japan and China with Frances Lim, who heads up our macro effort across all of Asia. During the trip, we spent time with our KKR colleagues across Private Equity, Growth Equity, Real Estate, Credit, and infrastructure, and our own Global Macro team, including Changchun Hua and Allen Liu in Beijing. We also met with government officials, CEOs, external macro experts, and investors.

Without question, it was time well spent, especially given that this was my first trip back to China since just before COVID. It was also great to be able to compare and contrast the two largest Asian economies. See below for specific read-outs from our visits to Japan and China, but our larger macro conclusions from our latest *Thoughts From the Road* are as follows:

1. **There is no 'one' Asia, so a more nuanced approach is required.** Our visit to Japan felt more akin to visiting Europe or the United States. Labor shortages, sticky services inflation, and tightening monetary policy were the key areas on which our discussions focused. In China, by comparison, inflation is low (PPI is actually negative), international travel is much more muted (six customs officials with no lines or waiting versus 25+ entry points in Japan but with an hour or more waiting time), and export growth is strong (up 15% in China versus no growth in Japan). When I compare this trip to my visit to South East Asia last fall (See *TFTR Asia: Beating to a Different Drum* from October 2022), it is an important reminder that both a local and differentiated approach is now needed in a region with the world's largest consumption economy (*Exhibit 12*).
2. **However, consistent themes emerged that are applicable globally.** In our view, there are four 'big' themes to consider. First, we left Asia more confident that our work (see *Eye of the Tiger*, February 2023) around global shifts in the labor market will lead to important investment opportunities. Wages are up in both Japan and China as demographic headwinds shrink labor supply. This reality, we believe, is why more automation, especially in the corporate sector, is inevitable. Second, our 'security of everything' thesis is certainly alive and kicking in Asia. Without question, every CEO with whom we spoke expressed concern about 'security', including energy, data, transportation, food, and water. Indeed, there was a greater recognition that we have moved, as my colleague Vance Serchuk likes to say, from a period of benign globalization to one of great power competition. Third, the energy transition is front

and center with politicians, business executives, and citizens, though we do acknowledge that the pace of change still differs mightily by country and sector. Importantly, though, even in emerging markets like China, as one example, government mandates for a cleaner environment are being superseded by consumer preferences, including the rise of environmentally friendly brands. Finally, untapped, under-earning savings is a mega theme, in our view. Globally, there is too much money sitting in deposit accounts, earning too little return, to support the hundreds of millions of 65+ individuals in Japan, China, Europe, and the U.S.

3. **Better Asian growth will provide some ballast to the tightening financial conditions that we are seeing in the fallout from Silicon Valley Bank.** Specifically, while our colleague Changchun is already ahead of consensus at 5.8% GDP growth in China this year versus three percent in 2022, there may actually be some additional upside to this forecast. Importantly, the 1Q23 GDP 'beat' of 4.5% versus consensus expectations of four percent and a year ago results of 3.0% growth, support our positive tilt, especially our view that consumption has bottomed. Our bottom line for global investors: While positive economic momentum out of Asia may not be enough to help the small domestic businesses in the United States that rely on regional banks for capital, it is definitely going to help the big multinationals that are represented in the large equity indexes in the U.S., Europe, and Japan.

4. **We remain bullish on our 'Keep It Simple' thesis in 2023.** The current macro environment is full of significant and complicated headwinds, and our trip did not alleviate any of our concerns. However, there are some substantial dislocations in the capital markets, and as we have written about extensively, dislocations create opportunities. Without question, it is a great time to be a lender, corporate carve-outs are accelerating as return on equity declines against rising shareholder activism, and there are some high quality public companies trading at cheap multiples. Said differently, we believe it could be possible to make a very good return in this market without having

to stretch for risk. However, we continue to believe that we are in a new investing regime, a regime that requires a different skill set and approach than simply repeating what worked from 2010 to 2020. Finally, the technical picture is incredibly compelling at a time when the fundamentals are not. Buybacks are booming, there is very little supply, and only eight percent of the top 25 central banks will be tightening by year-end compared to 84% at the end of 2022. Hence, our view is that investors should be transitioning from a 'Walk to a Jog' when it comes to deployment. Both 2023 and 2024 are likely to be very good vintages in the alternatives space, we believe, despite the higher cost of debt capital.

In the following section we provide greater detail and key insights from our trip to Japan and China.

First, we left Asia more confident that our work around global shifts in the labor market will lead to important investment opportunities. Wages are up in both Japan and China, as demographic headwinds further shrink labor supply. This reality, we believe, is why more automation, especially in the corporate sector, is inevitable. Second, our 'security of everything' thesis is certainly alive and kicking in Asia. Without question, every CEO with whom we spoke expressed concern about 'security', including energy, data, transportation, food, and water.

Japan: Key Insights

- The BOJ: Fine for now, but...** Just before we landed in Tokyo, new central bank governor of the Bank of Japan Kazuo Ueda stated in his first meeting that “When looking at current economic, price, and financial developments, it’s appropriate to maintain yield curve control.” We applaud his decision not to upset the economy and markets during this important transition in leadership. However, one lesson we as a team have learned over the last two years is that being late to lift rates causes central banks difficulties too. One can see in *Exhibit 3* that the U.S. waited too long this cycle to raise rates, given low unemployment and higher than expected inflation. We hope that this risk does not materialize in Japan. At the moment, our base case is that the Bank of Japan starts to step back Yield Curve Control (YCC) from the 10-year point to the 5-year point by the fall of 2023 (meaning, overall, less control over the yield curve). Thereafter, it will move away from YCC completely. Against this backdrop, Frances and Changchun forecast the 10-year JGB yield to rise to 1.25% by year-end 2023 and then settle around 1.5% over the longer term. However, to keep monetary conditions easy, by comparison, TIBOR rates will only rise modestly towards 0.3% over the next 12 months and then increase only to around 0.5% over the longer term. With inflation running around two percent, this backdrop means that we will see sustainable negative real yields. So, our bottom line is that, despite some softness in the depth of the market, now is a good time to be an issuer relative to where we think rates are headed in Japan. It also means that in order to earn an adequate return on a real basis as Japan potentially exits deflation, both individual and corporate savers, especially deposit holders, will have to find alternative investments to Cash.

Both individual and corporate savers in Japan, especially deposit holders, will have to find alternative investments to Cash.

Exhibit 1

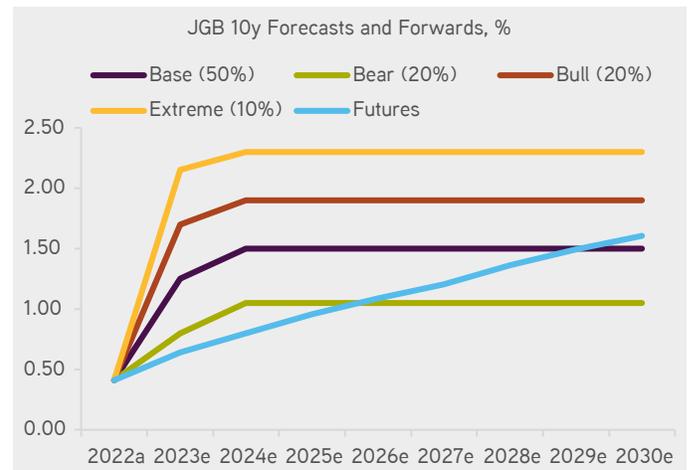
Yield Curve Control (YCC) Looks Increasingly Out of Step with Fundamentals in Japan



Data as at April 14, 2023. Source: Bloomberg, Haver Analytics.

Exhibit 2

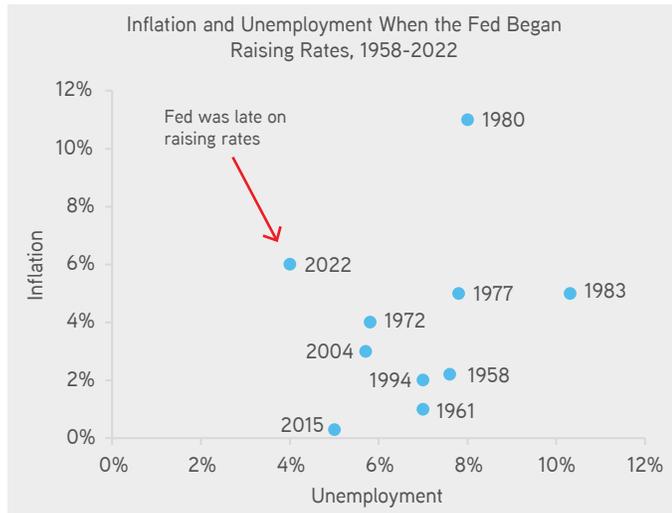
We Expect the BoJ to Exit YCC Which Has Implications for 10-Year Yields



Data as at April 14, 2023. Source: Bloomberg, KKR Global Macro & Asset Allocation analysis.

Exhibit 3

While Japan Has More of a Structural Inflation Issue, There May Be a Lesson for the Bank of Japan From the Federal Reserve's Decision to Wait So Long On Raising Rates



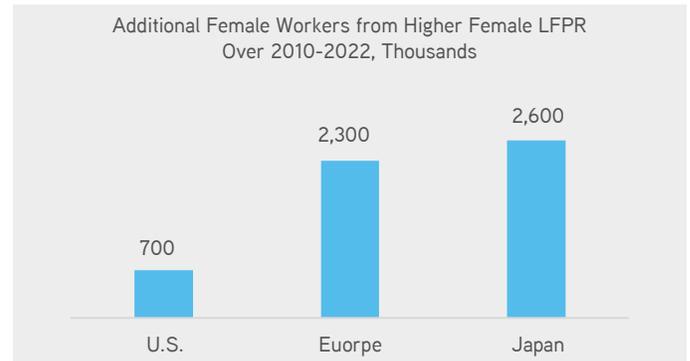
Data as at March 29, 2023. Source: Bloomberg, Haver Analytics.

2. **Sluggish labor force growth will drive outsized demand for automation.** Our arrival at Tokyo's Narita airport was overwhelming, as there were long lines of foreign travelers waiting to gain access to Japan. It could not have been any more different than our arrival in Beijing, which has still not seen much of a rebound in international travel. From what we could tell at the airport (and confirmed by the formal macro data we sifted in Tokyo), not many of the foreigners in the long queues to enter Japan were coming to work. To us, our visit established that in today's post COVID world, demographic headwinds in Japan are accelerating at a time when the influx of foreign workers remains quite muted. However, it is not just a hangover from COVID. Working in Japan became much less attractive for foreigners when the currency weakened to over 150 in late October 2022. The government also has less wiggle room than in the past to bring workers off the sidelines. Most importantly, Japan has already boosted its female workforce participation rate to record levels, while simultaneously extending the

length of time that 55-65 year olds are staying in the workforce. One can see this in Exhibits 4 and 5, respectively. These developments have enabled Japan to grow its workforce even as its overall population has declined. However, on a go-forward basis, it will be hard to sustain this momentum as older-worker and female participation rates are now among the highest in the developed world. This backdrop, while challenging for overall GDP growth (though maybe not GDP-per-capita), makes us even more bullish on our automation/digitalization thesis.

Exhibit 4

Japan Has Added Nearly 2.6 Million Female Workers to Its Workforce Since 2010...



Data as at December 31, 2022. Source: U.S. Bureau of Labor Statistics, Eurostat, Japan Statistics Bureau.

Exhibit 5

...and Leads the U.S. and Europe in 65+ Participation Rates



Europe data based on the 'Euro-Area 19' subset of E.U. members. 4Q22 uses latest data available in Japan and Europe. Data as at February 3, 2023. Source: U.S. Bureau of Labor Statistics, Eurostat, Japan Statistics Bureau.

Exhibit 6

To Date, Japan Has Offset Significant Demographic Headwinds by Improving Participation Rates. However, We Are Not Sure What Other Levers They Can Now Pull

Contributions to Workforce Growth (Millions)			
	U.S.	Europe	Japan
4Q10 workforce	153.7	157.9	65.7
Demographics	9.6	-3.2	-3.2
Change in Participation	1.4	12.7	6.8
Change in Prime-Age Male Participation	-0.6	-0.1	0.0
Change in Prime-Age Female Participation	0.7	2.3	2.6
Change in 55-64 Participation	0.1	8.6	1.8
Change in 65+ Participation	1.2	1.8	2.4
4Q22 Workforce	164.7	167.3	69.4

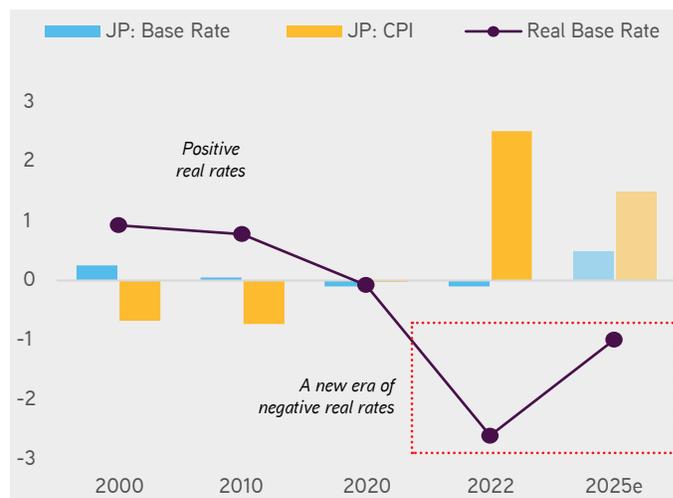
Europe data based on the 'Euro-Area 19' subset of E.U. members. 4Q22 uses latest data available in Japan and Europe. Data as at January 10, 2023. Source: U.S. Bureau of Labor Statistics, Eurostat, Japan Statistics Bureau.

3. **Though not at the same levels as in the U.S. or Europe, even Japan will have stickier, longer-term inflation, which has significant implications for asset allocation across both institutional and individual accounts in this economy.** To review, our view at KKR is that, despite crashing growth in money supply around many parts of the world (which we clearly acknowledge as short-term disinflationary), we see that structurally tight labor markets, the security of everything (including more redundancy around supply chains), and the energy transition are all working in tandem to inspire a higher resting heart rate of inflation this cycle. If we are right, then Japanese investors can no longer 'win' by allocating to Cash because Cash no longer delivers a positive real rate of return. This shift represents a sea change, in our view. Truth be told, we left Japan with the belief that – for the first time since I began visiting in the mid-1990s – the country may be exiting structural deflation. If we are even close to being right with our premise, then many allocators of capital as well as local business leaders who oversee trillions of yen on their corporate balance sheets may be underestimating that, while the country's new central banker Ueda will be accommodative in the near-term, the real return advantage gained in the past by owning Cash may be deteriorating. To be sure

this viewpoint is a provocative one. However, as *Exhibit 7* shows, the trend lines already suggest that Cash will need to be replaced with higher risk investments that can earn a higher real return.

Exhibit 7

We Are in a New Era of Negative Real Rates in Japan, Which Makes Cash Less Interesting. This Backdrop Will Likely Fuel a Shift in Asset Allocation



Real Base Rate defined as Japan base rate minus CPI year-over-year. Data as at March 31, 2023. Source: Bank for International Settlements, World Bank, Haver Analytics.

4. **We remain bullish on corporate carve-outs in Japan, but we left thinking the story may actually be improving.** We have long observed many tailwinds associated with corporate carve-outs, including the potential for significant operational improvements, benefits of low cost financing, and a renewed focus on shareholder returns. For KKR, our recent acquisition of a large J-REIT manager provides an interesting new wrinkle to this thesis because we now see a growing number of conglomerates in Japan re-assessing not only their corporate footprints but their real estate footprints too. Said differently, conglomerates are now unlocking value in more ways, including through restructuring of both corporate and real estate holdings. To be sure, this development is still in its early days, but we remain confident that Prime Minister Abe's legacy of increased corporate governance/shareholder returns will continue to gain momentum.

Exhibit 8

Japan Has Emerged as One of the Most Compelling Pure Play Examples of Our Thesis About Corporations Shedding Noncore Assets and Subsidiaries

Number of Listed Companies by Number of Consolidated Subsidiaries						
	# of Comp.	Under 10	10 -49	50 -99	100 -299	300 or More
Nikkei 400	400	51	157	91	77	24
TSE First Section	1,956	882	802	155	90	27
TSE Second Section	539	467	71	1	0	0
Mothers	239	226	13	0	0	0
JASDAQ	773	693	79	1	0	0
Total	3,907	2,319	1,122	248	167	51

Data as at December 31, 2017. Source: The Economist.

China: Key Insights

1. **A different kind of China.** Though I have been traveling to China since 1995, this visit was my first since right before the initial spread of COVID in 2019. A lot has changed since then. For starters, I could not get to Beijing directly from New York and this likely speaks in part as to why business travel between the two countries remains subdued: it just takes a lot more time (my return

flight to the U.S. through Milan took +20 hours). Further, the logistics of getting a PCR test in Tokyo on the way in to China and further proof of a negative COVID test in Milan added additional layers of complexity. Business cards are increasingly exchanged less and less by the younger generation; rather, they share QR codes via WeChat when they meet. WeChat is also replacing email, especially when it comes to file sharing. Separately, as one might guess, concerns around heightened geopolitical tensions are also playing a part, a message consistently relayed to us by U.S. officials based in China as well as local Chinese. It was the question on every investor's mind. The Chinese economy is also in a much different spot than in the United States. *Exhibit 9* is a great snapshot of this dichotomy, we believe, as it shows the wildly divergent fact patterns around inflation, M2 growth, and nominal GDP (note the U.S. actually is having faster nominal GDP growth than China). Of these variables, the reality that M2 growth accelerated to 12.7% year-over-year while inflation continues to be so low speaks to the excess capacity that now exists in the Chinese economy. It also underscores what we heard from locals, that excess liquidity from growth in M2 is being used to refinance or pay down debt at existing companies, not stimulate new demand and/or capital investment in services.

Exhibit 9

The Global Recovery Is Asynchronous



Latest values shown. Real yield calculated as 3M rate - L3M YoY CPI inflation. Data as at March 31, 2022. Source: Bloomberg.

Priorities have also changed. In prior visits, for example we spent a lot of time focused on companies that were using the Internet for purchases, gaming, and leisure. These companies are now more mature and more heavily regulated; they also face more competition for advertising dollars. Today by comparison, the 'hot' sectors are focused on security, domestic chip production, and high-end manufacturing. Currency safety is also a new priority in China, especially after the recent spate of U.S. sanctions on Russia. This viewpoint is significant because it is coming at a time when most global investors are heavily overweight the U.S. dollar. Finally, multinationals are no longer doing business in China because China is the manufacturer to the world; rather, they are primarily there to gain access to China's one billion consumers, especially the rising middle class (which is expected to grow to between 490-570 million citizens in 2035 from 340 million today). However, as 'common prosperity' has become more of a domestic focus, sentiment polls from foreign executives doing business in China suggest their ability to perform as well as in the past has declined materially. While some of this decline is from intensifying domestic competition, the reality is that in China the after-effects of COVID are weighing on the animal spirits that often define a rising GDP-per-capita economy.

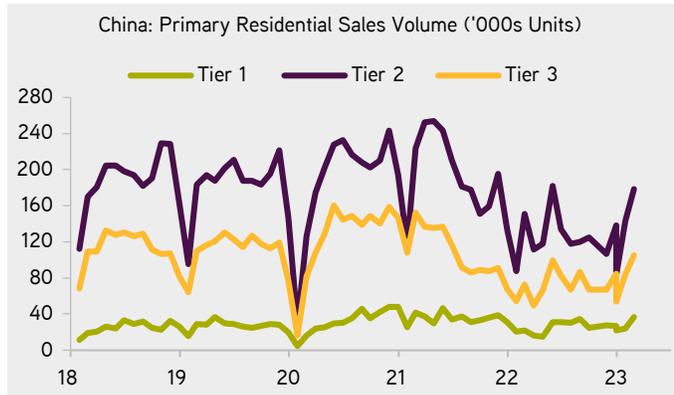
- 2. China's economy feels like it has bottomed and is headed higher. But, we think this time is different.** As the recent March 2023 export data showed (exports increased almost 15% compared to an estimate of minus seven percent) and as the 1Q23 GDP data illustrated, there are some very good things happening in China's economy. Malls are busy, domestic travel has accelerated, and there is some 'revenge spending' taking place. All told, retail sales grew 10.6% in March, nearly double the two prior months in the quarter. That said, there are several headwinds that we think could cap growth from surging a lot higher. First, the 'hangover' from a long battle with a zero-COVID policy likely has tempered Chinese consumer confidence (or at least it has quelled animal spirits); it will take time to fully restore, we believe. As such, the government also may need to do more via tax

cuts or spending incentives to encourage its citizens to draw down their savings, especially middle and high income consumers. The residential real estate market is a good example of how both these factors are impacting growth. According to one expert with whom we spoke, demand for housing is being adversely affected by several important trends: 1) birth rates are down more than 50% over the last six years; 2) marriages are down 33% versus five years ago; 3) the penetration rate for existing homes is already really high as the number of persons per household is estimated to have fallen to 2.8, which is close to U.S. levels, from 3.4 in 1991; and 4) the urban rental multi-family market is becoming a credible alternative to home ownership, especially in high end markets such as Beijing and Shanghai. This reality does not even consider the supply side of the equation, which continues to be adversely impacted by the substantial building of homes in second tier cities. All told, we think that there still could be at least several million unsold homes still available in these cities. Another important takeaway is that China needs to do more to transition its economy. Specifically, when bank lending increases, the capital allocation process still leads to growth in the old economy, including SOEs and Real Estate. By comparison, we think that there remains a substantial opportunity to shift more of the economy towards services. In addition, small to medium sized businesses, which account for the lion's share of job growth, also need better access to capital.

As the recent March 2023 export data showed (exports increased almost 15% compared to an estimate of minus seven percent) and as the 1Q23 GDP data illustrated, there are some very good things happening in China's economy. Malls are busy, domestic travel has accelerated, and there is some 'revenge spending' taking place.

Exhibit 10

China Property Sales Are Recovering...



Data as at March 31, 2023. Source: UBS, CEIC, National Bureau of Statistics.

Exhibit 11

...But Inventory Levels Are Still Really High



Data as at February 28, 2023. Source: UBS, CEIC.

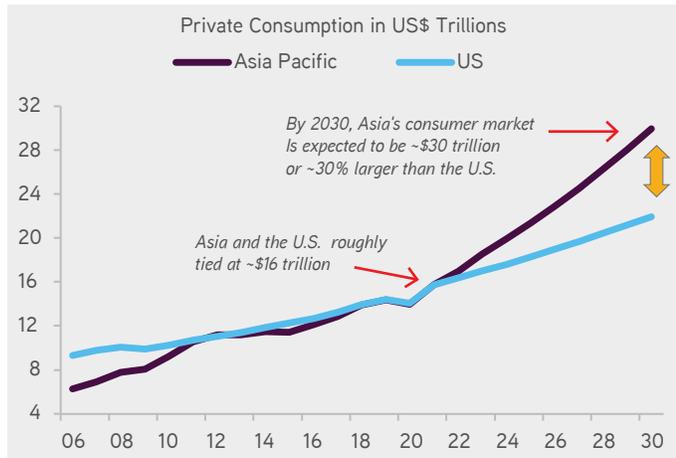
- There are still some really compelling investment opportunities.** Over the course of a few days we met with many incredibly talented executives who are building world class businesses with strong growth and compelling profitability potential. It was also clear that the country is working hard to get the message out that 'China is open for business.' In terms of examples of where we found interesting opportunities, the nascent REIT market, which we view as a play on both helping banks improve their balance sheets as well as the substantial appetite by

individuals for more efficient savings vehicles, caught our attention. Second, though the housing market remains soft, China is enjoying its own version of domestic 'nesting', an investment concept that we have been pursuing aggressively in the United States and Europe. Our basic thesis is that after big global shocks like World War II, 9/11, etc., families tend to spend more time at home, and in doing so, they make changes/improvements to their residences. In China, however, the nesting concept is heavily weighted towards reorganization of homes to be both more energy and technologically efficient, including upgrading to robot vacuums, more eco-friendly dishwashers and air conditioners, and lighting. The demographic story in China is also gaining momentum. We left thinking that there are likely several similar fact patterns to those we invested behind in Europe, the U.S., and Japan, where we could leverage our prior investment experience, albeit with a more technologically advanced approach. For active elders with savings, there is also a boom in nutrition, injury recovery services, and mobility. Finally, as China becomes more domestically focused, it feels like there was an emerging opportunity in intermediate goods manufacturing where global best practices could be applied.

Second, though the housing market remains soft, China is enjoying its own version of domestic 'nesting', an investment concept that we have been pursuing aggressively in the United States and Europe. In China, however, the nesting concept is heavily weighted towards reorganization of homes to be both more energy and technologically efficient.

Exhibit 12

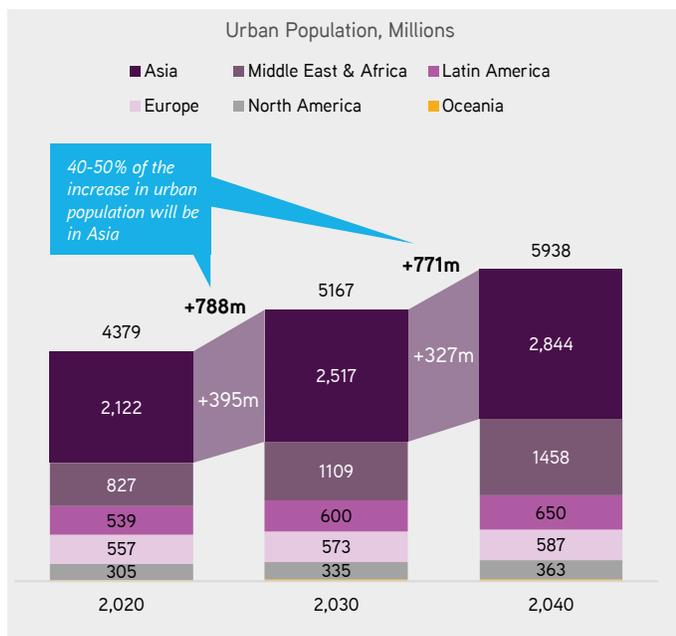
Asia's Consumer Market Is as Large as the One in the U.S., But Is Growing Faster



Asia Pacific includes China, India, Japan, Hong Kong, Korea, and ASEAN (Indonesia, Malaysia, Philippines, Thailand, Singapore, and Vietnam), Australia and New Zealand. Data as at May 31, 2021. Source: World Bank, IMF, OECD, Haver, KKR Global Macro & Asset Allocation analysis.

Exhibit 13

The World Is Still Urbanizing, and Asia Makes Up Half of the Increase in Urban Population



Data as at May 15, 2019. Source: United Nations, Department of Economic and Social Affairs, Population Division, World Urbanization Prospects, Haver Analytics.

Conclusion

Broad, wholesome, charitable views of men and things cannot be acquired by vegetating in one's little corner of the earth all one's life. - Mark Twain

As a firm, we believe having built the largest alternative presence in Asia starting in 2006 has given KKR a competitive advantage. The opportunity set remains robust, though our trip did confirm that we will need to bring all the firm's resources — its deal teams, its global macro effort, its operational improvement team, and its public affairs effort — to help navigate what is a more complex macroeconomic and geopolitical environment.

The good news is that Asia likely will not have the fiscal and monetary stimulus 'overhang', including the tug of war between pesky services inflation and higher short rates that we are now seeing in the West, especially in the United States. Moreover, the sheer scale of Asia's consumer growth potential, which has now surpassed that of the United States, will provide alternative managers with a significant opportunity. However, as we detailed in this piece, a local presence to fully understand the shifting nuances of emerging consumer behavior, including the trends towards more digitalization, more environmentally friendly brands, and more services, is likely a prerequisite for success. At the same time, we believe there is no doubt that Asia's population in key markets like Japan and China will spend significantly on a wide array of retirement and healthcare offerings during the next decade.

Finally, it bears repeating that Asia, and in particular China and Japan, are sitting on massive amounts of low yielding deposits at a time when demographics and monetary policy suggest investors will need both more current income and more appreciation in the coming years. So, similar to the successful 'savings play' that we made in the United States with the Global Atlantic acquisition, we will need to think through the best ways to unlock this value in Asia.

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