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A TIME OF TESTING: THE CHALLENGES OF 2009

Introduction

Thank you very much, John, for your kind introduction. I'm very pleased to be back in Germany for the Super Return. This forum has always offered great opportunity to exchange ideas, and I am honored to be with you this morning. In fact, with some commentators already writing our industry's obituary, I guess we are all very fortunate to be here in Berlin -- when, instead, we should be back at home working on our epitaphs.

But we're not. We're here in Berlin. And, we are definitely *not* witnessing the end of our industry. But we *are* in the midst of trying times – a "time of testing", one might call it. And we are not alone. Every industry, in every economy, in every geography, is being tested by this extraordinary global economy.

Today, our industry is faced with a series of challenging – and legitimate – questions:

- Can we continue to effectively manage our portfolios?
- Can we raise capital and do deals in this environment?
- Does our basic business model still apply?
- Can we earn the trust and support of the public, shareholders and governments?

This morning, I'd like to share with you, first, my perspective on the economic outlook and how it affects our industry. Then, I'd like to try to answer these questions and address the challenges that they present to our industry.

The downturn of the global economy has thrust us – and all businesses around the world -- foursquare, into the midst of this "time of testing". How we, as an industry, respond to the challenges of our times will, in large measure, determine our future. When the dust settles and the skies clear – and, make no mistake, that day will come – how we have responded to this "time of testing" will matter greatly.

As an industry, we don't have all the answers. But we have invested in and re-focused hundreds of companies over the past three decades. Not only have a vast majority of these companies emerged stronger and fueled innovations, but they have also created opportunities and security for millions of employees. Our investments have enhanced the retirement security of millions of pensioners and provided educational opportunities for countless students through endowments.

Our role in being a positive change agent for companies, large and small, is today as important as ever. And I firmly believe that our industry is well positioned to meet today's challenges head-on and to emerge from this period as a strong contributor to global economic growth and development. However, this will require us to learn, to listen and to change.

The Current Economic Environment

Let me begin by briefly discussing my views on the current economic environment.

Just last fall, I had the pleasure of addressing a SuperReturn audience in Dubai. We were, then, in the midst of the now well recognized, but no less remarkable, transformation of the financial world – a transformation that began with the stunning collapse of Bear Stearns and has continued with unprecedented government interventions in the financial markets around the globe.

Despite extraordinary government interventions around the world, the economic data clearly shows we are headed for a long, protracted economic slowdown.

Although the monetary and fiscal policies have provided an effective short-term fix, the system has not normalized and remains highly risk-averse. Of greater concern is that these unprecedented actions have not stemmed the rapid decline of economies throughout the world.

What does all this unwelcome news tell us? It tells us that we are living in a "time of testing", and that the challenges of operating in this environment are very real, indeed.

The single biggest problem that these turbulent times have revealed is that we face more than a financial crisis. This is about far more than dollars and cents. We face a crisis of trust and confidence. The root of today's crisis is a breakdown of trust: between financial institutions, among companies and with the hard working public.

It is this loss of trust and confidence that has cascaded through the global markets, undermining credit availability for businesses and households and eroding the value of savings. Even with numerous interventions, massive capital infusions, investors have yet to regain faith in the system.

There can be no solution until that trust is restored and we will all be tested on how we comport ourselves on the path to restoring it and how we alter our behavior as a result of it. Business as usual will not work.

Managing Our Portfolio

Let's turn, then, to the questions and challenges that, as a result of these economic realities, confront our industry today. Recently, I was asked, "Henry, what are the three most important things for our industry in 2009, as we try to operate under these conditions?" I didn't have to think very long to answer. I said, "Number 1: portfolio; Number 2: portfolio; and Number 3: portfolio."

Nothing, and I mean "nothing", is more important than effectively managing our portfolio companies right now. Our investors demand it. The employees of our companies are depending on it. And governments and communities rely upon it.

No matter where an institution sits in the financial landscape, we are stewards of the capital our investors and clients entrust in us. We have to prove our prudence with every step we take. For our industry, we have to prove that we will be careful with the capital that has been put in our care and that we will do what we said we would do when they first committed their capital to us. We have to prove that the risk -- of putting our investors' capital into an investment, of changing the capital structure of a company and employing leverage -- will be managed responsibly from the first glimmer of opportunity in an investment to the last day of our ownership.

Effectively managing our portfolio means that we must bring financial skills and operational expertise to our companies to help them through this period. It means efficiently managing balance sheets, preserving capital, and seeking new opportunities.

It means sticking to a long-term perspective and focusing, laser-like, on operations in the most effective way possible: by aligning the interests of investors, employees, and ourselves to make the company better than before we took ownership of it.

For KKR, at the center of this focus on our portfolio companies is a group that we call KKR Capstone. KKR Capstone is a team of operational experts, skilled identifying ways to improve long-term viability and – once formulated – implementing a new operational plan. For nearly a decade, this team has been a critical part of our value creation strategy. But in today's economic environment, its role has been expanded, and its work has taken on added importance. For the smarter and stronger we can make our portfolio companies, the more likely they will be to weather current economic storms.

This intense focus on our portfolio companies involves both addressing weaknesses and bolstering strengths. We believe that there are key aspects of our portfolio that – despite the weakness of the global economy – contribute to its

long-term strength. That is, having investments with defensive outlooks, superior management teams and a proven method of value creation.

First, many of our companies – specifically some of our more recent and larger investments – have a defensive outlook. For example, Alliance Boots is the leading player in the UK pharmaceutical market, an industry that has historically held up well during periods of economic weakness. Dollar General is a retail chain of over 8,200 stores that offers convenience and value. Its stores are able to capitalize on consumers' tendency to trade down in difficult economic times. Energy Future Holdings is the largest producer of energy in Texas. Weak economic conditions don't change the importance of necessities like electricity and heat.

Second, our portfolio companies have been able to attract world-class management teams. In difficult times, the quality, integrity and experience of a management team is critical. By and large, our management teams have gone through tough times before. They have long-term outlooks and the confidence to work closely with KKR Capstone and their boards, knowing that the best solutions and approaches are those developed by experienced teams with broad expertise, working together.

Finally, we have a time-tested model of value creation. In every case, across all of our portfolio companies, we have detailed operational plans to create value. Most of our returns come from partnering with strong management teams, improving earnings and paying down debt. In fact, historically, only a small portion of KKR's value creation has come from multiple expansion. EBITDA growth and de-leveraging has accounted for the bulk of value creation.

These strengths – a defensive outlook, superior management teams and a proven model of value creation – should help our portfolio companies to weather the storms of the current economic crisis. And we never lose sight of the fact that building on these strengths and addressing perceived weaknesses is our main priority. It's an approach that reflects our view of the three most important things for our business in a "time of testing": portfolio, portfolio, and portfolio.

Raising Capital and Doing Deals

The second challenge facing our industry today is: can we continue to raise capital and make investments?

Like most everyone here today, I have been through good times and bad times. In good times, markets reached record highs, historic investments were made, and we enjoyed great success. In difficult times, we learned the hard lessons that should guide our behavior and approach today. While nobody can realistically say that they have been through exactly what we are experiencing today, we all

have the collective experience of our most difficult and trying investing environments to draw upon to help us confront today's challenges.

One thing is true about a tough economic environment: it forces us to think creatively about our business, to recalibrate. First, we have to accept the fact that deals will be smaller. The financing for large transactions simply is not available in the current environment. That's a fact. And the most recent World Economic Forum statistics bear this out. In the third quarter of 2008, the average deal size was $244 million, a sharp drop from a year earlier when the average deal size was $637 million.

So that's the current reality. What does it mean? It means we must adapt. We must change the way we think about deals because in a "time of testing", if we don't adapt, we simply will be left out. General Eric Shinseki, former Chief of Staff of U.S. Army and the current Secretary of Veterans Affairs once said: "If you don't like change, you're going to like irrelevance even less." That goes for all of us. We can adapt, be part of the solution or fold up our chairs and exit stage left.

In practical terms, adapting means knowing new deal structures in this environment will have less leverage. We'll need to make our capital go further. And we'll make new and different kinds of investments such as deals involving minority stakes that are structured with downside protection and meaningful governance rights -- that is, deals where we can still have an impact on performance and operations. We are already seeing a significant rise in these types of transactions. In the third quarter of 2008, for example, 31% of the deals involved minority stakes, six times the percentage of just a year earlier.

It's important to recognize that we already apply our investment approach to many different asset classes. Because ours is not just a business model; it's a discipline. And, at KKR, 33 years of careful study and investing in core industries have provided us with an understanding of where industries are heading and what companies need.

Rather than spending months and sometimes years studying a company only to conclude it wasn't right for a buyout, we recognize that some of these businesses are right for mezzanine or fixed income investments. Investing up and down the capital structure, in companies we know and understand well, makes sense in all environments, but particularly today.

In the current environment, patient investors are in a unique position to achieve equity-like returns in an ever-expanding group of asset classes, many of which offer less risk and greater structural protection than have historically been available to equity investors. As a result, we have augmented our efforts in this

area through a continued focus on our fixed income business and we have built out a new effort in mezzanine financing.

In fixed income, we have been pursuing initiatives to expand our assets under management and deploy capital in bank loans and high yield debt. These assets are trading at all time lows in the secondary market, creating an attractive buying opportunity, and new issues are being structured and priced with better risk and return characteristics for investors.

Mezzanine is a logical extension of both our fixed income and private equity businesses. Mezzanine finance has become an increasingly attractive form of investment in recent years, and interest in mezzanine products has grown considerably given the favorable position of mezzanine in the capital structure and the historically attractive risk-reward characteristics of the asset class. Given the constrained credit environment and deleveraging in the senior part of the capital structure, we think that mezzanine will be an increasingly important source of financing for companies in the coming years.

A third investment category where we can expand our private equity experience and see a need for capital in today's environment is infrastructure. The global investment demand for infrastructure is enormous, with studies estimating a need for more than $3 trillion in annual infrastructure projects. We have already been investing in infrastructure assets for several years through our Energy Group because the need for capital has risen so significantly and this is an asset class that offers stable returns.

The final growth area I'd like to mention is our capital markets business, which includes a specialized team that is evaluating refinancing opportunities to optimize the value of our portfolio. This team is working directly with our deal teams to structure tailored strategies for each of our companies and to find equitable solutions that satisfy both debt and equity holders. In short, they help us and our companies facilitate the formation of capital.

In each of these cases, there is an opportunity for long-term growth. But we will stick to our core approach: we won't do a deal unless we believe it is good for our investors <u>and</u> unless we see a path to build long-term sustainable value in the company or asset.

That means we approach new investments with great care and caution. A well-priced company, alone, is not necessarily an opportunity. The overarching question is this: Can we create value for that company and if so, how will we do it? This is particularly important today because we are operating with an acute understanding that our limited partners, like all investors, are being squeezed by plummeting prices in every asset class. They are judging us on how we manage

current investments, and they expect a judicious approach to new allocations of capital.

We will also have to pay heightened attention to exit strategies. Fortunately, we have the choice as to when we exit an investment. We are a patient investor with long-term capital and we actively manage the companies in which we invest. This gives us tremendous flexibility for selecting the right time, and the best means, for exiting investments, and it helps free us from the short-term pressures of the public markets. While our companies may periodically experience temporary fluctuations in their near-term values based on the way in which comparable public companies trade, these fluctuations reflect short-term market dynamics and do not necessarily reflect the ultimate value to be realized from the investment.

We enter an investment knowing that we are going to hold it until our work is done and the timing for an exit is right. On average, we hold companies for five to seven years and, in some cases, we've had portfolio companies for more than a decade. At some point, the IPO market will revive and provide, as in the past, an exit strategy for certain investments. Opportunities may also arise to sell companies to strategic investors in business combinations or through other means. In the meantime, however, we need to work to build value and improve the assets that we hold for the long-term. If we are successful in this endeavor, value will eventually – and inevitably – be created, and we will be well positioned to realize that value when the time proves right.

In the end, the measure of a successful deal is not just about the returns. More than ever, it must be about improving the asset. What will not be different is the necessity of the industry to do the right deal and aligning interests so that there are beneficial outcomes for all stakeholders.

Our Investment Model

The third challenge facing our industry in this "time of testing" is this: Is our business model still relevant? Does it still work?

As an integral part of the financial services sector, our industry must shoulder some of the responsibility for the problems that have beset the global markets. Having said this, there is no doubt in my mind that we have an important role to play in the coming years. But no one can blame the commentators for asking the question. And the best way to respond to that question is by reminding the public of the benefits and the value that our approach brings to companies and their stakeholders.

There are certain characteristics of our model that are even more relevant today, in this "time of testing," than in the past. In my view, those characteristics are: a

shared risk and responsibility; an alignment of interests; and a focus on building sustainable enterprises with long-term value.

As the general partner for our funds, we take responsibility of our investment by putting our own capital into the investment. Since our inception, we have invested nearly $2 billion across our funds, and we require that management invest in their companies, so that their interests are also fully aligned with those of our investment partners.

We have a responsibility to work with management to make our businesses work and ultimately make them stronger and more resilient than they were before we acquired them. Ultimately, management is only “rewarded” if the company does well, if management meets specific performance targets, and if the overall value of the business increases.

To make this work, we don’t sit idly as owners. The work doesn’t stop after the ink dries on the transaction agreement. In fact, only then does the real work begin. As owners, we serve as independent directors on the boards of our portfolio companies, bringing to them a level of corporate governance not found on some corporate boards. Our directors invest their own capital, time and energy to help their companies meet rigorous operational goals and, thus, to enhance long-term value for investors. Above all, we are accountable to our investment partners, which ensures that we will take action, if needed, to protect the value and to ensure the success of the investment. In the end, we are putting our own money at risk, side by side with our investment partners, keeping us involved and active owners.

Apart from the value of the model itself, I believe that we, as an industry, have an important role to play during this period of severe economic dislocation.

First, we all recognize that a yawning capital hole has opened up in the financial system, which is now woefully under-capitalized. According to Nouriel Roubini, U.S. financial losses from the credit crisis may reach $3.6 trillion. It is impossible to estimate the amount of new capital needed, but it may well be beyond the capacity of public capital markets or combined infusions by governments. Where, then, is this new capital to come from?

Lawrence Summers, for one, wrote on behalf of President Obama to the House and Senate leadership that the new Administration will “…seek to replace investments made by the U.S. government with private capital as quickly as possible.” This stated intent on the part of the Obama Administration matches up well with the fact that the private equity industry has some $400 billion in capital, on the sidelines, waiting to be invested.

Whether it involves shoring up financial institutions or building infrastructure, there is a possibility of a new partnership. In concert with government efforts, we can play a significant role. For the past 30 years, some in the public and private sector have eyed each other warily, from a distance. Some critics in the private sector argue that the public sector has sacrificed efficiency, while others have argued that the private sector too often fails to consider broader values and considerations beyond short-term profits.

Solving the economic challenges we face today will require both: more efficiency and a broader commitment to our shared values. It will require making our dollars or Euros go further and also ensuring that our enterprises are sustainable – in every sense of the word. Today's "time of testing" will require that government, the public and the private sector set aside any mistrust, work more effectively together and follow through on the commitments we have made.

Furthermore, our model can provide important benefits in a way that does not create systemic risks. One reason, at the heart of the current crisis, is the risk associated with institutions that, by their nature or by their means of financing, created systemic risk. This is not the case for our business model. Our funds are not commingled. A default in the portfolio doesn't ricochet throughout the firm. Each company in KKR's portfolio is independently managed and financed. Each has its own board of directors. There are no cross-holdings; cash flow from one company cannot be used in another company.

So, are we still relevant? Does our model still work? Absolutely, it does. The tenets of this model still hold and do, indeed, provide a constructive investment example: employing strict due diligence, compensation structures based on alignment of interests, corporate governance that includes independent and personally invested directors, and an unrelenting shift to long-term perspective. All these characteristics still hold today and, if faithfully adhered to, can help define our industry's role in the new economy.

Sustaining the Public's Support

However, our ability to be part of the solution to today's problems,–requires regaining the trust and confidence of the public. And passing this test will require us to change.

We only win confidence by working as partners with management to build sustainable enterprises that thrive long after we exit.

But that's not enough. We have to recognize the simple fact that private equity isn't really private. We impact numerous stakeholders. We need to talk to each and every one of them more and listen to them better. This includes our

investors, the employees who work in our facilities, the communities in which our companies operate, NGOs, regulators and others.

Trust is built by demonstrating a commitment to these very stakeholders - over and over. One example of this is our acquisition of TXU, the largest electricity provider in Texas, now known as Energy Future Holdings. About two years ago, our partners and we did more than purchase a company. Our due diligence went way beyond financial health and viability of the company. We took a very close look at all of the stakeholders impacted by the transaction, and we incorporated it into our thinking and our process. Before the deal was announced, we partnered with key global environmental leaders who endorsed and supported the transaction.

That dialog with environmentalists was an industry “first”. Something I say with both pride – for having been a part of it – and regret – for not having taken this step more often throughout our history. Still, out of this effort came a commitment to the environment. The Company committed $400 million in conservation and energy efficient activities, created a Sustainable Energy Advisory Board and was praised by global environmental organizations for its stewardship of the climate. Equally important, this level of due diligence is something that we are incorporating as a routine into our investment processes going forward. We have not perfected this but we are improving it more and more every day.

Over the course of the last year, we have expanded our partnership with the Environmental Defense Fund and created a “Green Portfolio Project.” As its name suggests, the Project is an effort designed to cost-efficiently improve environmental performance at other portfolio companies, and KKR Capstone is facilitating the Project’s implementation throughout much of our portfolio. Starting with companies in our U.S. portfolio, we have committed to measuring our impact on the environment -- from green house gases to water use to energy consumption. Later this month, we are announcing our first major milestone -- that Sealy, US Foodservice and Primedia, companies that employ thousands of individuals, are leading the effort in our pilot program. Among other things, they are maximizing the efficiency of truck and other fleet routing, driving as much productivity from as few trucks as possible.

These efforts go beyond the environment. We are proud to have companies like Legrand Group whose shares are listed in the FTSE4 Good Index, which is made up of stocks representing listed companies considered ethical and responsible on the basis of strict societal and environmental criteria. And, as part of its participation in the UN Global Compact, Legrand, in 2005, began publishing a Charter of Fundamental Principles that sets out its values and its Sustainable Development commitments vis-à-vis all of its stakeholders. PagesJaunes was

named one of the Global 100 Most Sustainable Corporations in the World for 2007 by Innovest Strategic Value Advisors.

Another company, Northgate Information Solutions, is committed to sustainable growth that promotes social, economic and environmental improvement. To this end, Northgate now has corporate responsibility taskforce to develop a comprehensive and corporate approach to social, environmental and ethical issues.

If we are to build sustainable enterprises, we must work with other stakeholders as well, and do this consistently. We must reach out more to unions and work councils at companies to look for collaborative, win-win situations that make more workers feel like owners. And we must be more transparent about our operations. At KKR, we were proud to have helped draft the Walker Guidelines that provide a model of transparency for the UK. And we are working, here in Germany, on compliance with the BVK transparency guidelines.

Conclusion

In sum, no “time of testing”, or the changes it precipitates, is ever easy. No “time of testing” allows us to simply look the other way. And no “time of testing” is successfully met, unless those tested take a hard, inward look, address their shortcomings, and bolster their strengths. This is a “time of testing” for every sector, every industry, and every market in the world today. We are no exception.

The economic news is grim. We know it intuitively. We see it in the statistics. We feel it every day. In a few short months, investor confidence and trust, necessary ingredients for a well functioning financial system, were shattered, shaken to their very core. And that trust and confidence have yet to return. Today, we see the beginnings of a new relationship between government and the private sector, a relationship that would have been unimaginable, particularly in the United States, only a year ago. All these seismic changes – economic troubles, fractured trust, and government interventions – present significant challenges.

In this environment, we ask ourselves (and others ask us, as well): Does our basic business model still apply? Can we still do deals? Will we retain the trust and garner the support of the public, of government, of stakeholders in the broadest meaning of that term? I offer a resounding “Yes!”… but not an unqualified “Yes!” A resounding “yes” because I firmly believe that our basic approach is as sound as ever, and perhaps needed more than ever today. But not an unqualified “yes” because we must be mindful of the fact that, in a “time of testing” such as is ours today, we cannot accept the status quo. We must

acknowledge the reality that we have to adapt, to accept and take on a greater responsibility, and to work to rebuild the shattered trust of the marketplace.

Only by committing ourselves to these tasks can we be part of the solution to today's economic and financial challenges. And only by being part of the solution can we prosper and contribute to the economic and social welfare of the markets in which we operate. When the dust settles from this "time of testing", when the skies clear – and they will – how we, as an industry, have responded to these challenges will mark us for years to come. Let us be certain that, through our efforts, we are marked by simple, yet extraordinarily important, words: transparency, responsibility, and, above all, trust. For, if we can – in the face of these challenges – accomplish this, we will emerge from this "time of testing" stronger and more relevant than ever before.

Thank you.