MAKENA

CO-INVESTMENT WHITE PAPER

Lessons Learned and an Approach Ahead

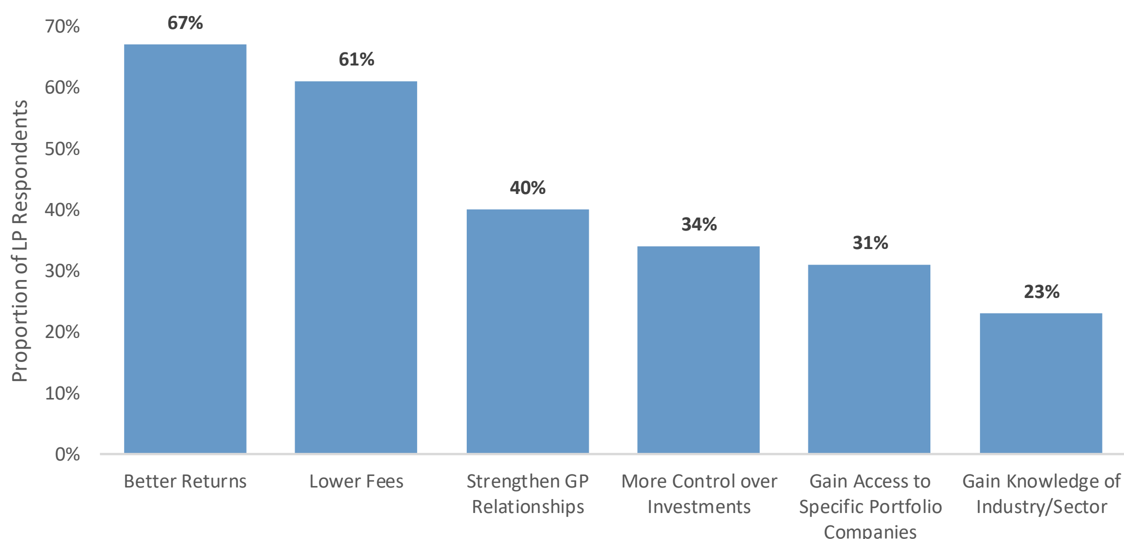
January 2019

Over the past 15 years, there has been tremendous growth in the availability and participation in co-investments by institutional investors. Multiple surveys indicate that over half of all Limited Partners ("LPs") are seeking to co-invest alongside managers to augment returns, reduce fees, and build stronger General Partner ("GP") relationships. Co-investment benefits are well documented, but it is important to note that a successful co-investment program requires specialized diligence skills and a methodical, systematic decision-making process to avoid adverse selection pitfalls.

Since inception, Makena has been an active co-investor committing nearly $1.3 billion to 57 co-investments across 33 unique managers in our Private Equity, Real Estate, Natural Resources, Absolute Return, and Listed Equity asset classes[1]. Over time, we have honed our co-investing framework to optimize our execution capabilities and diligence process. Our co-investing philosophy mirrors our six investment principles with a core focus on providing increased exposure to our highest conviction managers in their core areas of expertise.

Benefits of Co-Investments

The growth of co-investment activity can largely be attributed to the mutual benefits that accrue to both LPs and GPs. For LPs, co-investments offer incremental exposure to attractive deals outside of the fund structure. They are offered on a fee-free or reduced fee basis which effectively reduces an LP's overall fee burden and can reduce the portfolio's J-curve. When LPs co-invest alongside GPs, they augment their understanding of their managers' underwriting practices and generally strengthen those relationships. Furthermore, there tends to be a higher level of GP capital allocated to portfolio companies with co-investment capital, a practice that further enhances the alignment of interests between LPs and GPs. In addition, LPs can utilize co-investments to tilt their portfolio toward specific regional or sector exposures as desired. As shown in the graph below, a 2015 Preqin study found that LPs primarily valued the return accretion and lower fees but also found other portfolio and relationship benefits valuable.[2]

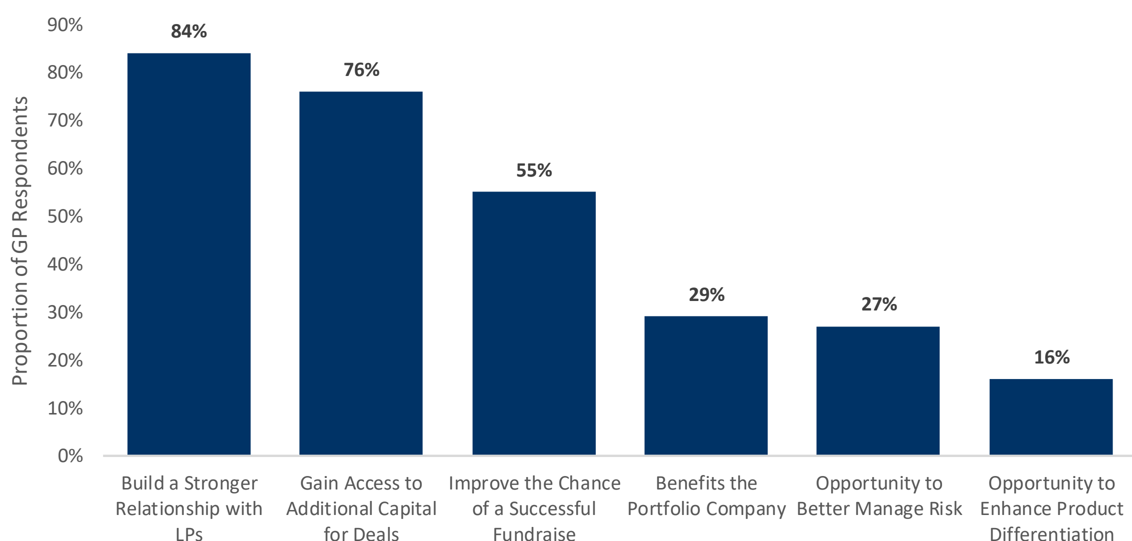


[1]Excludes co-investment funds and top-up funds. As of 12/31/2018.
[2]Source: Preqin Special Report: Private Equity Co-Investment Outlook November 2015

For GPs, co-investments allow them to execute attractive deals while maintaining a desired level of diversification at the fund level. Co-investment capital allows GPs to garner more control of portfolio companies which better positions them to further develop those companies and unlock additional value. According to the Preqin survey, GPs primarily valued the ability to enrich their LP relationships and access accordion capital (see graph below).

Perceived Benefit of Offering LPs Co-Investment Rights[2]

2015 Dataset



In an environment of increasing co-investment appetite, access to such opportunities can become scarce or sizing subscale for certain portfolios. As the co-investment market has matured and become more competitive, co-investment rights, processes, and structures have been increasingly codified. However, co-investment allocation practices generally remain at the discretion of the GP which provides a competitive advantage to those with deep manager relationships and nimble, experienced teams that underwrite opportunities expeditiously. In a competitive deal market, GPs particularly value LPs who have a clear and streamlined co-investment process.

Obstacles in Co-Investing

As with any investment, co-investments are not without their challenges. Co-investments provide the opportunity to overweight particular deals, but generally LPs are unable to co-invest in every deal of a fund, leading to selection biases which have the potential to produce idiosyncratic exposures such as sector or geographic tilts. In addition, co-investments are commonly offered on the largest deals of the fund which could overweight the LPs portfolio to larger cap opportunities, not necessarily the higher quality deals. To mitigate these risks, Makena's co-investment framework assesses not only the manager and deal quality, but also the deal profile as compared to the manager's prototypical deal. Co-investing is a rather time and resource intensive process as LPs generally have a narrow window of time to assess the opportunity. This resource burden can be an obstacle for sub-scale co-investment programs. Lastly, co-investments can be alluring due to the potential for access to no-fee, no-carry capital deployment, but Makena's focus is to invest in the highest risk-adjusted return opportunities net of fees, agnostic of the wrapper. We believe this philosophy is key to long-term returns particularly as others potentially focus myopically on fees or other factors.[2]

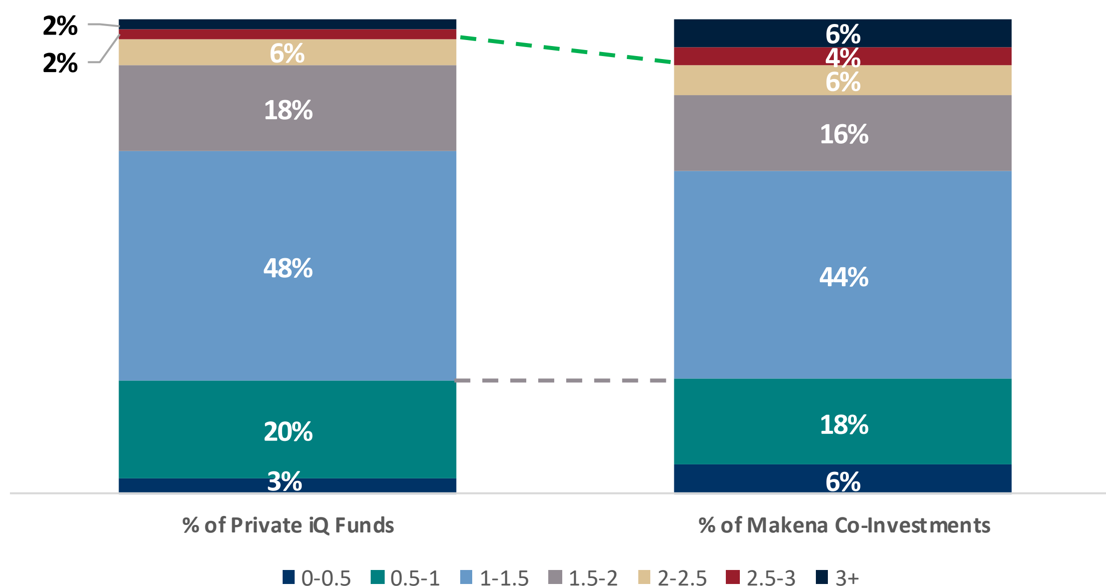
---

[2] Source: Preqin Special Report: Private Equity Co-Investment Outlook November 2015

Makena's Co-Investment Framework

Consistent with our endowment-style investment approach, we remain focused on the long-term in an exceedingly short-term-focused market and seek to partner only with truly extraordinary investment managers. This philosophy carries through to co-investing activities. Many co-investments that are in the market are in "hot" sectors or are seeking to capitalize on fads of the day rather than strong, long-term businesses. As with our manager selection process, our approach to co-investment opportunities is heavily dependent on our manager talent. We always take a bottom-up approach to underwriting, seeking to identify only those deals with compelling risk-adjusted return profiles and where there is a tight alignment of interests between our client capital and that of the GPs. Our approach is characterized by the following six key criteria:

1. *Partner with High-Conviction Talent:* As with our traditional fund investments, we spend a lot of time underwriting the quality of the investment professionals at our managers and their incentive structures. In co-investments, this review goes further into the talent within the target portfolio company and their talent retention and alignment systems.
2. *Attractive Risk Return Profile:* In co-investments, we assess not only the base returns but also the distribution of potential outcomes. This latter step is especially important in our underwriting of co-investments. When overweighting an investment, we are assiduously focused on downside protection and seek opportunities with a positive skew to their distribution of outcomes. This analysis is vital to our underwriting as co-investments can have a much broader range of outcomes than funds and therefore have the potential to add significant risk to the portfolio. Venture deals tend to have a binary outcome; therefore, they rarely meet our co-investment underwriting criteria.
3. *Sizing Matters:* We have found that equal weighting of co-investments provides the optimal exposure to these outsized return opportunities while mitigating downside risk. This sizing strategy is largely a function of the wider dispersion of outcomes and higher probability of outsized single investment returns than in fund investing. As shown below, Makena's percentage of co-investments above a 2.5x ROI was over double that of all Private iQ funds over the same period. Across our experience co-investing, an equal weighted portfolio generally outperforms opportunistic sizing. Due to capacity constraints and other factors, it is difficult to fully equal-weight all co-investments, but we have a standard size range which effectively provides a similar benefit.



4. *Strong Alignment with Manager:* In a world of increasing co-investment demand, some GPs have been offering opportunities across their portfolio without regard to their conviction in the opportunity or governance over the target portfolio company. Makena prefers to co-invest in opportunities where the manager has significant capital invested in the co-investment alongside that of the LPs. This capital alignment provides the manager with the appropriate incentive to drive value in the company for the Fund and the co-investors. At a more granular level, we seek to invest in the same security and share class as the manager to further mitigate potential conflicts.
5. *Deep Firm Expertise in Target Industry or Geography:* We focus on the manager's depth of experience in the sub-sector of the target company. We prefer to partner with managers who have a demonstrable track record of success in the industry, business model, and/or geography of the target portfolio company. When we look back on our track record, our disappointing outcomes occurred when there was a dimension of style drift – managers venturing outside of their area of industry expertise and/or geographic comfort zone.
6. *Preferred Economics and Terms:* Co-investments are usually offered with preferred economics as the manager requires the capital to consummate or retain control of the transaction. The standard no-fee, no-carry terms can provide 200-500bps of return accretion versus a fund wrapper assuming the same return profile. While this can and has been accretive to our portfolio, it is hardly the sole driver of co-investment returns. The key to a successful outcome is always the quality of the underlying asset and the prospects for the GPs to add value. Because we focus on the quality of the asset above all else, we will selectively invest in co-investments with fee or carry. In these situations, we are mindful that the carry of the co-investment is uncrossed against other investments which can potentially be a windfall to GPs if the headline percentage mirrors that of the fund. Outside of fee breaks, co-investing often affords certain strategic benefits such as board seat representation, leverage limits, and other provisions relating to increased control.

Makena's Co-Investment History & Outlook

As noted above, Makena has committed nearly $1.3 billion to 57 co-investments across 33 unique managers in our Private Equity, Real Estate, Natural Resources, Absolute Return, and Listed Equity asset classes[3]. We recently committed to our first Listed Equity co-investment in a unique transaction which has further broadened our program. While our co-investment program has expanded over time, we remain highly selective in our co-investment partners and deals in-line with the framework outlined above.

Over the past five years, Makena has built out our co-investment portfolio, generating over 400bps of outperformance over our fund investments. Outperformance relative to asset class benchmarks[4] has been achieved as approximately 70% of our active commitments[5] have been to 1st and 2nd quartile investments. Co-investments have also been useful in portfolio capital management. In comparison to our benchmark, our co-investment portfolio has distributed over a third more capital for all active vintages. This quick return of capital provides us the opportunity to redeploy into new attractive investments and improves our liquidity management.

Because of the accretive return opportunities from co-investing, Makena remains convicted in maintaining or opportunistically growing our co-investment program. We have also experienced ancillary benefits in managing and underwriting our co-investment portfolio as it expands our knowledge of the manager's underwriting process as well as the evolution of investment trends. Co-investing has become a core component of our investment portfolio, but we are not attached to a particular investment wrapper and will always remain committed to finding the best risk-adjusted investment opportunities and talent irrespective of structure.

---

[3]Excludes co-investment funds and top-up funds. As of 12/31/2018.
[4]Makena uses Private iQ as the private benchmark
[5]Includes past 10 years of investments

Makena Capital Management, LLC ("Makena") prepared this document solely for the person to whom it has been given for informational and discussion purposes only. This document and the information contained herein are strictly confidential and may not be reproduced, distributed or communicated, in whole or in part, to any third party without the express approval of Makena. Makena reserves the right at any time to amend or change the contents of this presentation without notice to you.

Under no circumstances should the information presented be considered an offer to sell, or a solicitation to buy, any security referred to in this document. Such offer or solicitation may only be made pursuant to the current offering documents for the Makena Fund (the "Fund" or "Funds") which may only be provided to accredited investors and qualified purchasers as defined under the Securities Act of 1933 and the Investment Company Act of 1940. This document should be read in conjunction with, and is qualified in its entirety by, information contained in the Funds' offering documents.

Makena believes that the research used in this presentation is based on accurate sources (including but not limited to economic and market data from various government and private sources and reputable external databases), but we have not independently verified those sources, and we therefore do not guarantee their accuracy. The opinions, projections, and estimates contained herein reflect the views of Makena only and should not be construed as absolute statements and are subject to change without notice to you.

Certain statements in this presentation may constitute forward-looking statements that should not be relied upon as representations of the future performance of any Makena Fund. The past performance of any Makena Fund is not necessarily indicative of future results. The projected performance results presented in this document, if any, are hypothetical and for informational and illustrative purposes only and should not be construed as a guarantee of actual or future performance results of any Makena Fund. Actual performance results may vary significantly from projected performance results due to many factors, including, but not limited to, new issue eligibility, different liquidity terms, timing of investment and other factors.

Certain performance numbers in this presentation may be unaudited, preliminary and based on estimates. Final reported and audited performance numbers may vary considerably from these estimates. Estimated gross and net performance numbers could change materially as final performance figures and underlying investment costs and fees are determined and allocated. Unless otherwise noted, performance is shown net of underlying manager fees and net of the standard Makena fees per the applicable limited partnership agreement, including any incentive fees earned or estimated that a "day one" investor would pay. Asset class performance is shown net of underlying manager fees but gross of Makena fees. Please refer to the offering documents of the Makena funds for complete information regarding fees and expenses. Past performance is not indicative of future results.

Comparison of the performance of any Makena Fund to a benchmark or benchmarks is for illustrative purposes only and the performance of the Makena Funds may differ materially from the performance of the benchmarks due to diversification, asset allocation, volatility or other factors.

If MSCI data is presented be aware that MSCI has not approved, reviewed or produced this report, makes no express or implied warranties or representations and is not liable whatsoever for any data in the report. You may not redistribute the MSCI data or use it as a basis for other indices or investment products.