PSERS PRIVATE INVESTMENT PROGRAM

Recommendation for Investment in
Gleacher Mezzanine Fund II, L.P.

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Gleacher Mezzanine Fund II, L.P.

EXECUTIVE SUMMARY

Gleacher Mezzanine Fund II, L.P. ("Fund II") is being formed to provide investors with substantial capital appreciation and current income by investing primarily in private middle market companies through a combination of subordinated debt, preferred stock and non-control common equity securities ("Mezzanine investments"). Fund II is seeking capital commitments of $350 million.

Fund II will be managed by four seasoned investment professionals, Elliott Jones, Mary Gay, Phillip Krall and Craig Pisani (the "Principals"). The Principals began working together in 1996 at Gleacher NatWest Inc. ("Gleacher NatWest"), a subsidiary of National Westminster Bank Plc ("NatWest"), investing the bank's capital in mezzanine investments and senior bank loans. The Principals bring a combined 85 years of experience in finance, credit analysis, transaction structuring, due diligence and investing to the management of Fund II.

Fund II will continue the successful investment strategy of Fund I and will leverage the Principals' broad network of relationships to identify and access the highest quality Mezzanine investments. The Principals expect to invest Fund II in a variety of situations including leveraged buyouts and recapitalizations as well as to provide growth and acquisition capital. By continuing to focus on core middle market transactions, defined as companies with transaction values between $50 million and $300 million, Gleacher will be able to source a greater number of potential investments while facing less competition from other investors.

The Principals have successfully demonstrated their ability to construct balanced portfolios of mezzanine investments that can achieve superior returns with reduced risk in a variety of market environments. Mezzanine investments typically have a fixed coupon or dividend, are senior in repayment rights to most equity securities and usually pay a current return in cash. The Principals also expect each investment to include equity or equity participation rights that offer the potential for capital appreciation. In addition, the Principals will diversify Fund II's investments by investment size, sponsor, industry and geography.

The Principals utilize their extensive experience to identify potential investments, with a primary focus on investing alongside high-quality private equity firms. The Principals will execute a rigorous analytical process that they have developed over the team's 10-year history. This process involves assessing the strength of management, the level of business, industry and financial risk, the potential return and the quality of the equity investors in the transaction. The Principals perform on-site, primary, in-depth due diligence to prove or disprove their investment thesis.

An active management approach to mezzanine investments helps to ensure that each portfolio company continues to perform as anticipated by the initial investment thesis. The Principals regard their active involvement with fund portfolio companies as an opportunity to increase the value of investments. At all times, the goal of the Principals will be to ensure that Fund II realizes any opportunity to enhance its returns. The Principals may proactively encourage the sale of a company where appropriate and will utilize their contractual rights to minimize losses or to optimize exit opportunities whenever possible.

Fund II will be managed by a proven team that has worked together consistently for a decade making successful mezzanine investments. Their approach to portfolio construction, continued focus on the core of the middle market and investment skills developed over years of experience provides the opportunity to achieve strong returns for investors in Fund II under a wide range of potential market conditions.

HISTORY

Gleacher Mezzanine. The Principals have been making mezzanine investments as a team for a decade. In April 1996, Elliott Jones joined Mary Gay and Phillip Krall at Gleacher NatWest from The Chase Manhattan Bank, N.A., where he had founded its mezzanine debt business. Craig Pisani joined shortly thereafter, and the Principals began building the middle market financing effort of Gleacher NatWest. At Gleacher NatWest, the Principals managed an active and broad-based acquisition finance business. This included investing in and/or underwriting for mezzanine debt, senior secured debt, high yield debt and private equity co-investments.

In April 1999, the employees of Gleacher NatWest repurchased the firm from NatWest, a large U.K. based financial services firm, which had decided to focus exclusively on its U.K. domestic market. After the employee buyout, the attractiveness of mezzanine investing and their successful investing history led the Principals to focus entirely on mezzanine investments. They closed Fund I in May 2001 with $300 million in total commitments, primarily from institutional investors.

The Principals are forming Fund II to continue their successful efforts investing in mezzanine investments. While they intend to continue leveraging the established resources of Gleacher Partners, Fund II will be an independently managed vehicle in which the Principals have ultimate investment authority.

Gleacher Partners. The Principals are currently affiliates of Gleacher Partners, which was founded in 1990 by Eric Gleacher to provide major corporations with strategic, mergers & acquisitions and restructuring advisory services. Mr. Gleacher previously founded the mergers & acquisitions department of Lehman Brothers in 1978, and headed global mergers & acquisitions at Morgan Stanley from 1985 to 1990. In October 1995, NatWest acquired Gleacher & Co. as part of a strategy to establish a major presence in the U.S. investment banking market. The company was renamed Gleacher NatWest and gained the ability to provide its clients with capital, including mezzanine financing. In April 1999, the employees repurchased the firm from NatWest with the financial support of Halifax Bank of Scotland, the successor to Bank of Scotland. The re-acquired business was renamed Gleacher & Co. LLC and, subsequently, Gleacher Partners LLC. In April 2003, Halifax Bank of Scotland divested its interest in Gleacher Partners, and the employees took full ownership of the firm. Certain principals of Gleacher Partners are affiliated with an asset-management business that currently includes funds-of-hedge funds.

INVESTMENT HIGHLIGHTS

Fund II represents an attractive investment opportunity for the following reasons:

Experienced Team of Principals. The Principals have invested in mezzanine investments together since 1996 and have a combined 85 years of experience in finance, credit analysis, transaction structuring, due diligence and investing. In addition to their mezzanine investment track record, they have completed numerous senior bank debt and equity transactions during their careers. This varied experience gives them the ability to understand the perspective of each party to a leveraged transaction and to solve problems constructively as they arise. The team's shared commitment to detailed analysis has allowed it to establish a track record of successful investments with limited credit losses. Fund II will represent the third pool of capital for mezzanine investments to be managed by the Principals as a team.

Attractive Mezzanine Attributes. A portfolio of mezzanine investments has the potential to generate superior returns in a variety of environments. For investors, mezzanine investments combine attractive elements of both equity and fixed-income investments. These investments are senior to common equity, have a fixed minimum return, include equity participation, offer investors and issuers a greater degree of flexibility in achieving their goals and mitigate the "J Curve" effect in a private equity portfolio.

Middle Market Focus. The Principals are targeting an amount of committed capital that will allow them to continue their successful focus on the core of the middle market. The number of transactions that might present attractive mezzanine investment opportunities increases as company size decreases. In addition, many established financing providers have grown too large to focus on this market segment. Many new entrants also have limited experience in this segment. By focusing on middle market transactions, they will be able to source a greater number of potential investments while facing less competition from other investors.

Extensive Deal Flow. The Principals' experience and reputation in the market allow them to generate a substantial and continuous flow of attractive mezzanine investments. The Principals work through their networks and direct calling efforts to develop strong relationships with numerous market participants, such as private equity firms, management teams, senior lenders, other mezzanine providers and investment banks. As well-known, sophisticated mezzanine investors, the Principals are often sought out as preferred partners. The Principals generally avoid heavily contested auction situations and broadly marketed deals and will stress patience in all aspects of their investment activities.

Consistent and Repeatable Process. The Principals have developed a rigorous investment process that applies their experience and skills to each investment opportunity. This process involves careful analysis of business and financial information and first-hand, in-depth due diligence to ensure the accuracy of that analysis. The Principals' investment experience provides them with the pattern-recognition skills to quickly identify, evaluate and aggressively pursue attractive investment opportunities.

Significant Investment by Principals. The Principals, Gleacher Partners and their respective affiliates will invest 2% of Fund II's committed capital up to a total of $8 million.

MEZZANINE INVESTMENTS

A portfolio of mezzanine investments has the potential to generate superior returns in a variety of environments. For investors, mezzanine investments combine attractive elements of both equity and fixed-income investments because they are generally positioned between senior secured debt and equity. Mezzanine investments typically include subordinated debt with a contractually required return, and either equity participation in the form of warrants to purchase stock in the future, direct equity co-investments, or both. Mezzanine investments are attractive for issuers because they provide private companies a flexible form of capital that can be used for a variety of purposes, including buyouts, recapitalizations, growth capital and acquisitions. Furthermore, because mezzanine investments are privately negotiated, each one can be tailored to meet both the unique needs of the issuer and the risk-return profile of the investor.

Mezzanine investments are an attractive asset class for several reasons:

Senior to Common Equity. Mezzanine investments are primarily comprised of subordinated debt representing a contractual right to receive fixed future payments of both interest and principal. While these claims have a lower priority than those of senior debt, such as bank loans, they are senior to the rights of the company's equity holders. Claims for interest and principal are usually required to be paid in full before any equity proceeds may be realized, and these claims enjoy substantially greater protection in the event of a restructuring or reorganization than do equity securities. In this way, the value of mezzanine investments can be "cushioned" by the common equity, which is the first capital to absorb losses should the company's enterprise value decline.

Fixed Minimum Return. Mezzanine investments typically have a fixed coupon or dividend payment due periodically, often quarterly or semi-annually. This feature provides a minimum level of return, reducing the risk that the value of the investment will fluctuate or decline. This fixed return, typically set between 11% and 16%, can prove more attractive than equity returns in slower growth situations. Furthermore, while common equity holders typically receive no cash return on their investment until a liquidity event occurs, interest and preferred dividend payments on mezzanine investments usually accrue from the beginning of the investment, reducing their duration and risk. Assuming no voluntary pre-payment, the typical mezzanine investment will return approximately half of the invested capital by the end of the fourth year of the investment.

Equity Participation. While mezzanine investments include attractive attributes of debt, they also may include a small equity investment or the right to make an equity investment in the future, often in the form of warrants. Equity participation allows mezzanine investors to capitalize on an issuer's growth without committing a large portion of their capital to an equity investment, creating the potential for strong incremental returns with reduced risk. Investment managers vary their approach, choosing to emphasize or de-emphasize equity participation in making mezzanine investments.

Flexibility. Mezzanine investments are negotiated between investors and issuers. Thus, each party can seek to meet its requirements in terms of cost, risk and expected return on investment. Unlike pure private equity or senior debt, however, mezzanine investments offer the parties a greater degree of flexibility in achieving their goals. Mezzanine investments allow parties to develop an optimal balance of equity and debt terms to address issuer concerns such as cash flow availability, dilution and discretion in managing the business, while addressing investor concerns such as the amount of equity at risk, minimum expected return and the timing of exit. This higher degree of flexibility makes mezzanine investments attractive both for companies seeking private capital and investors seeking strong returns with reduced risks.

Reduced "J Curve." Private equity investors generally must wait a significant period of time before receiving investment returns while continuing to fund capital contributions, a condition which is called the "J Curve." As mezzanine investments typically offer quarterly or semi-annual cash payments, they can mitigate the "J Curve" effect in a private equity portfolio.

THE GLEACHER MEZZANINE APPROACH

The Principals will continue to employ their proven and repeatable process for making successful mezzanine investments, which includes the following elements: (i) a focus on the middle market, where a large number of opportunities are pursued by relatively few mezzanine providers; (ii) portfolio construction which balances the potential for equity appreciation with current return and downside protection; (iii) deal-sourcing that capitalizes on the Principals' extensive and longstanding network; and (iv) a disciplined approach to investment selection, execution, monitoring and exit.

Target Market. Fund II will target superior returns through a combination of substantial capital appreciation and current income by making mezzanine investments primarily in private middle market companies, typically alongside reputable private equity firms. As with Fund I, the Principals will invest Fund II in a variety of situations, including leveraged buyouts and recapitalizations and as growth and acquisition capital. While Fund II will not have a specific industry focus, the Principals historically have avoided investments in real estate, commodities and industries undergoing rapid technological change.

The Principals are targeting an amount of committed capital for Fund II that is only modestly larger than the amount raised for Fund I, as this target size will allow them to continue their successful focus on the core of the middle market. They define this segment as companies with transaction values between $50 million and $300 million. The number of transactions that might present attractive mezzanine investment opportunities increases as company size decreases. In addition, many established financing providers have grown too large to focus on this segment. Many new entrants also have limited experience in this market segment. By focusing on the middle market, they will be able to source a greater number of potential investments while facing less competition from other investors.

Target Portfolio Construction. In Fund II, the Principals will use the same portfolio construction strategies that they employed in successfully investing Fund I. The Principals will seek to structure individual investments to properly balance cash yield, equity appreciation and downside protection. In particular, they will allocate funds invested between current-pay instruments, principally debt, and equity and equity-linked securities, including payment-in-kind ("PIK") securities, preferred stock and common stock. Debt securities will generally be subordinated to senior debt, and will have target cash coupons ranging from 11% to 13%, with additional investment returns generated by deferred interest or equity securities.

As in Fund I, each investment in Fund II is expected to include equity or equity participation rights that offer the potential for capital appreciation. While tailoring each investment's mix of securities to the level of risk and expected return in the particular case, the Principals will generally seek to commit approximately 80% of Fund II's invested capital to current-pay instruments and 20% of Fund II's invested capital to equity and other non-cash-paying securities. Fund I's successful results were achieved without investing in an unusual amount of high-yielding, non-cash-paying securities. Instead, approximately 87% of capital was invested in cash-pay subordinated debt, thus lowering the risk profile of the portfolio.

The Principals will attempt to limit the risk in Fund II by balancing portfolio and company-level risk and diversifying by investment size, sponsor, industry and geography. Individual Fund II investments are expected to range from $10 million to $25 million. The average investment size for Fund I was $11 million across eight sectors, including food, durable consumer products, non-durable consumer products, specialty retail, healthcare, business services, industrial products and automotive services. As with Fund I, Fund II will not employ leverage, except to bridge investments or fees prior to calling capital commitments from limited partners.

Investment Process. Their substantial industry experience provides them with exceptional access to investment opportunities and unique insights into the types of investments that should generate attractive returns. The Principals have worked together for a decade making mezzanine investments and have developed a disciplined, repeatable process for executing, monitoring and exiting investments.

Identification and Sourcing. The Principals' experience and reputation in the market allow them to generate a substantial and continuous flow of attractive mezzanine investments. The Principals work through their networks and direct calling efforts to develop strong relationships with numerous market participants, such as private equity firms, management teams, senior lenders, other mezzanine providers and investment banks. In addition, as well known, sophisticated mezzanine investors, the Principals are often sought out as preferred partners. The Principals generally avoid heavily contested auction situations and broadly marketed deals and will stress patience in all aspects of managing Fund II.

Every Principal is actively involved in identifying potential investment opportunities. Initial screening is carried out by one or more of the four Principals. If the transaction is potentially attractive, the Principals will meet together preliminarily to decide whether to pursue the opportunity. The Principals' investment experience gives them the pattern-recognition skills to identify, evaluate and aggressively pursue attractive investment opportunities.

The Principals seek to invest primarily in companies with defensible market positions sponsored by high quality private equity firms. These companies typically exhibit a number of key attributes that help to reduce the potential risk to a mezzanine investment while enhancing its return potential, including:

- Experienced management team
- Strong free cash flow
- High margins
- Differentiated products or services
- Limited seasonality or cyclicality
- Long-term contractual relationships
- Reputable private equity investor(s)

The Principals also seek potential growth in equity value, which may result from:

- Increases in EBITDA driven by sales growth or cost savings
- Multiple expansion resulting from growth initiatives or market conditions
- Debt reduction

Their expertise enables them to evaluate these characteristics and distinguish compelling mezzanine investments from the numerous opportunities in the private equity market.

Analysis and Due Diligence. The team will execute a rigorous analytical process that they have developed over the team's 10-year history. This process is designed to identify and substantiate the particular attributes of each potential investment. Each investment undergoes an extensive credit review process, including analysis of business and operational dynamics as well as both historical and projected financial information. Areas of additional focus include management or sponsor experience and capability, industry and competitive dynamics and tangible and intangible asset values. The Principals also seek to verify any understandings established during due diligence by personally contacting customers, suppliers and competitors. The Principals perform on-site, primary, in-depth due diligence to prove or disprove their investment thesis. The Principals often utilize the substantial resources of Gleacher Partners to assist in analyzing potential investments, and sometimes engage independent experts to aid in this process. In reviewing each investment, one or more of the Principals will actively participate in conducting company visits, analyzing data room materials and reviewing any consultant reports.

In the Principals' experience, many investments that would be attractive to pure private equity investors or senior lenders may not necessarily constitute sound mezzanine investments. This emphasis on credit quality and analysis seeks to ensure that each investment meets their specific criteria. While two Principals typically lead a transaction, each of the Principals is generally involved in every investment. The Principals rarely delegate responsibility for due diligence to junior staff members and work closely together, sharing the various aspects of the due diligence and decision-making process within the group. This hands-on, collaborative approach distinguishes the Principals' process from that of other firms in which each partner makes separate investment decisions.

Investment Monitoring and Exit. The Principals will execute an active management approach to ensure that each portfolio company continues to perform as anticipated by the initial investment thesis. The monitoring process often includes attending boards of directors' meetings and communicating frequently with management and the other investors in the company. The Principals also evaluate monthly or quarterly financial reporting packages that cover operational and financial performance. The Principals conduct a regular valuation analysis and continually monitor future liquidity and covenant compliance.

The Principals regard their active involvement with portfolio companies as an opportunity to increase the value of investments by providing advice on financing and exit alternatives. The Principals begin considering exit alternatives during due diligence and continue to review and revise their expectations throughout the life of the investment. At all times, the goal of the Principals will be to ensure that Fund II realizes any opportunity to enhance its returns. Should the portfolio company's performance change, the Principals may re-evaluate the investment and seek either to influence changes in company operations or personnel or to sell all or part of its investment. The Principals may proactively encourage the sale of a company where appropriate and will utilize its contractual rights to minimize losses or to optimize exit opportunities, whenever possible.

MANAGEMENT

The Principals have invested in mezzanine investments together since 1996 and have a combined 85 years of experience in finance, credit analysis, transaction structuring, due diligence and investing. The Principals have invested $288 million in 29 mezzanine investments together as a team since 1996 and have completed numerous senior bank debt and equity transactions during their careers as well. This varied experience gives them the ability to understand the perspective of each party to a leveraged transaction and to constructively solve problems as they arise. The team's shared commitment to rigorous analysis has allowed it to establish a track record of successful investments with limited credit losses.

Elliott H. Jones, 58, Managing Director. Mr. Jones joined Gleacher Partners in 1996 after 22 years at The Chase Manhattan Bank, N.A. In 1987, he established The Chase Manhattan Bank, N.A.'s subordinated debt principal and placement group. In this capacity he supervised, originated, structured and monitored a portfolio of subordinated debt investments as well as placed approximately $500 million of junior securities. After joining Gleacher Partners in 1996, he acted as both principal and as agent for senior and subordinated debt, high-yield debt and equity financing for middle market sponsored buyouts and growth capital. Mr. Jones received an MBA from Columbia University and a BA from Colgate University. Mr. Jones served as a Lieutenant in the U.S. Navy.

Mary Gay, 40, Managing Director. Ms. Gay has extensive experience in originating, structuring and executing mezzanine investments, senior bank facilities, high-yield debt securities and private equity investments. Prior to joining Gleacher Partners in 1996, she spent six years in National Westminster Bank's Acquisition Finance Group and three years at Ernst & Young as a consultant in the General Management Consulting Group. Ms. Gay received an MBA from New York University and a BS from the University of Richmond.

Phillip Krall, 45, Managing Director. Mr. Krall has extensive experience in originating, structuring and executing mezzanine investments, senior bank facilities, high-yield debt securities and private equity investments. In 1996, he joined Gleacher Partners from National Westminster Bank, where he had spent 14 years. From 1991 to 1993, he was General Manager of NatWest's SBIC and 4C7 company. At NatWest, Mr. Krall was involved with leveraged transactions in a wide variety of industries and sizes. Mr. Krall received a BA from Colgate University.

Craig Pisani, 37, Managing Director. Mr. Pisani has extensive experience in originating, structuring and executing mezzanine investments, senior bank facilities, high yield debt securities and private equity investments. Prior to joining Gleacher Partners in 1996, he spent four years at Prudential Investment Corporation. Mr. Pisani received an MBA from New York University and a BA from Lafayette College.

In addition to the Principals, Eric Gleacher and Jeffrey Tepper serve as members of the Investment Committee.

Eric J. Gleacher, 65, Investment Committee. Mr. Gleacher is Chairman of Gleacher Partners, which he founded in 1990. Prior to that, Mr. Gleacher founded the mergers & acquisitions department at Lehman Brothers in 1978 and headed global mergers & acquisitions at Morgan Stanley from 1985 to 1990. Mr. Gleacher is a Trustee of The University of Chicago and New York University. He is Chairman of the Institute for Sports Medicine at the Hospital for Special Surgery in New York and is also Chairman of the Ransome Scholarship Trust for St. Andrews University in St. Andrews, Scotland. Mr. Gleacher received an MBA from The University of Chicago and a BA from Northwestern University and served as a U.S. Marine infantry officer in the 1960s.

Jeffrey H. Tepper, 40, Investment Committee. Mr. Tepper joined Gleacher Partners in 1990 and is a Managing Director and its Chief Operating Officer. Prior to that, he was a member of Morgan Stanley's mergers & acquisitions and merchant banking departments. Mr. Tepper is active in Gleacher's advisory and asset management businesses. Mr. Tepper is President of Gleacher Fund Advisors, a fund-of-hedge funds business with over $460 million of assets under management. Mr. Tepper holds an MBA degree from Columbia Business School and a BS in Economics from The Wharton School of the University of Pennsylvania.

CONCLUSION/RECOMMENDATION

Based upon the successful track record and experience of the principals and the recommendation of PSERS' consultant, Portfolio Advisors, staff recommends that the Board invest an amount equal to 25 percent of the committed capital, but not to exceed $112.5 million plus reasonable normal investment expenses, in Gleacher Mezzanine Fund II, L.P. The final terms and conditions of the investment must be satisfactory to the Investment Office, the Office of Chief Counsel, and the Executive Director.