



PSERS VENTURE CAPITAL INVESTMENT PROGRAM

**Recommendation for Investment in
LLR Equity Partners III, L.P.**

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LLR Equity Partners III, L.P.

INTRODUCTION

LLR Equity Partners III, L.P. is a \$600 million fund being established to continue the investment activities of LLR Partners Inc. Fund III will be LLR Partners' third fund in a series that commenced in 1999. The firm currently manages \$620 million of capital in two funds with vintage years of 1999 and 2004.

LLR Partners' two existing funds, LLR Equity Partners, L.P. and LLR Equity Partners II, L.P. are among the top performing lower middle market growth capital and buyout funds in its peer group. Fund I's portfolio is over 80% realized and is expected to generate a gross IRR in excess of 30% and a gross realization of 3.0 times invested capital, placing Fund I in the top quartile of performance for 1999 vintage private equity funds. Fund II is too early in its term to yield meaningful investment performance results, although the portfolio is performing at or above expectations.

Fund III will make private equity investments of \$10 million to \$75 million in lower middle market growth companies primarily located in the Mid-Atlantic region. This niche is underserved and provides an opportunity for superior investment returns, on a risk adjusted basis. Fund III will also continue to employ the differentiated investment identification process utilized in Funds I and II, leveraging a proprietary regional network and building upon the franchise that has been built since LLR's founding.

The management, strategy and terms of Fund III will generally mirror those of Funds I and II, providing continuity in LLR Partners' investment approach. The investment team is led by an experienced team of six partners, who possess an average of over 20 years of experience in the investment and professional services communities. Furthermore, all six partners have been at LLR since 2000. The Managers will personally make significant capital commitments to Fund III to reflect their confidence in the breadth of attractive investment opportunities available to the fund and the continued success of its investment strategy.

KEY INVESTMENT HIGHLIGHTS

The Fund's strategy presents an attractive investment opportunity for the following reasons:

Superior Investment Performance

LLR Partners seeks to achieve superior risk-adjusted returns with an emphasis on absolute internal rates of return coupled with multiples realized on invested capital.

Fund I is fully invested and over 80% of its portfolio has been realized. Realized investments have generated a gross IRR of 36.3% and 3.1 times invested capital. Including the value of the remaining unrealized investments, Fund I is expected to generate a gross IRR of 31.7% and 3.0 times invested capital, yielding a net IRR of 23.3% and 2.3 times capital called.

Fund II is 70% committed, with investments in 12 companies. Fund II has exited one investment of \$20 million, generating cash of \$67 million (175% realized IRR) and stock of \$23 million, for a total value of \$90.0 million, or 4.5 times invested capital. Fund II's investments have an average age of 20 months and the portfolio is performing at or above expectations.

Unique Investment Objective

LLR Partners emphasizes capital preservation while generating attractive equity returns, frequently utilizing creative investment securities to enhance downside protection. This approach allows LLR Partners to successfully deploy capital in all market cycles.

Attractive Market Opportunity

The lower middle market is an attractive investment segment, particularly in the underserved Mid-Atlantic region.

Lower Middle Market Growth Companies – LLR Partners focuses on equity investments of \$10 million to \$75 million in lower middle market growth companies. The general partners believe that as funds typically focused on this sector have significantly increased in size, the lower middle market has become increasingly underserved, providing the opportunity to generate strong returns.

Mid-Atlantic Focus – The Mid-Atlantic region possesses substantial economic strength, accounting for 12% of the nation's population and 13% of the employment base, and has been the recipient of 14% of U.S. private equity investments since 2002. The Mid-Atlantic region is also a significant net importer of private equity, lacking a base of well-capitalized, sophisticated regional funds focused on mid-sized, later-stage deals. Since 1999, non-resident investment firms supplied 85% of the \$38.6 billion in growth equity and buyout capital invested in the Mid-Atlantic. As a result, when combined with LLR Partners' extensive deal sourcing network, this large and underserved market provides fertile ground for LLR Partners to find and negotiate attractively priced and structured investments.

Differentiated Investment Identification Process

In support of its investment objective, LLR Partners has implemented an investment identification process that enables it to source investments that meet LLR Partners' stringent valuation and risk/reward requirements.

Proprietary Regional Deal Flow – LLR Partners focuses on investment opportunities generated through its extensive Mid-Atlantic referral network that will enable Fund III to focus on investment opportunities outside an investment banking auction processes. This regional network consists of leading deal lawyers and accountants, successful entrepreneurs, owners of private businesses, financial intermediaries and consulting firms, small venture capital firms, high net worth individuals and executive search firms. Through this referral network, the firm has been able to identify transactions that are less competitively shopped, enabling LLR Partners to work closely with owners and management teams to negotiate mutually attractive terms for its investment.

Selective Identification Process – LLR Partners pursues companies with strong, durable business franchises that have attractive risk/reward profiles. LLR Partners aggressively screens investment opportunities seeking companies that possess proven, scalable business models, a defensible competitive advantage and a talented, committed management team. LLR Partners invests in industries and markets with favorable economic fundamentals and long-term growth potential. LLR Partners currently focuses on investments in the Business Services, Information Technology, Healthcare Services, Financial Services and Consumer Services sectors, but will consider investing in other sectors should opportunities meet its investment criteria. Investments are pursued across a balanced combination of late stage growth capital, recapitalizations, buyouts and buy and build transactions.

Disciplined Investment Approach

LLR Partners pursues a disciplined investment approach that incorporates: (i) an extensive investment evaluation process, (ii) structured investment instruments and (iii) proactive investment monitoring and value creation.

Extensive Investment Evaluation Process – In evaluating potential investments, LLR Partners completes an extensive analysis of a company's market position and potential. While

LLR Partners creates an internal team for each due diligence investigation, the firm also engages, as needed, outside accountants, lawyers and industry experts to support this process. During diligence, LLR Partners completes a thorough analysis of a company's products, operations, marketing, management team, industry dynamics, competitive positioning, systems, historical and projected financial results and regulatory, tax and legal matters.

Structured Investment Instruments – The general partners create investment instruments to provide insulation from transaction risks through the use of various protective provisions, including: (i) structural features that protect against transaction-specific risks uncovered during due diligence, (ii) pricing mechanics that provide LLR Partners with sophisticated downside protection provisions, essentially “trading” a portion of the upside for this downside protection and (iii) protective provisions that enable LLR Partners to gain control of the company or restructure the investment if performance hurdles are missed. The general partner utilizes their experience developing and communicating, in simple terms, these complex investment structures gives LLR Partners a significant competitive advantage.

Investment Monitoring and Value Creation – LLR Partners seeks to create significant value in partnership with portfolio company management teams. LLR Partners collaborates with management to develop a detailed business plan designed to achieve targeted performance. LLR Partners is instrumental in helping management: (i) formulate strategy and review operating performance, (ii) create performance incentives and recruit senior management, (iii) access the best strategic relationships and advice from existing or prior portfolio companies or from other value-added industry experts, (iv) formulate and participate in the negotiation and implementation of complex corporate transactions, such as acquisitions, mergers or divestitures, particularly in support of a buy and build growth strategy, (v) raise capital from a wide range of alternative sources and (vi) maximize the ultimate exit strategy and exit value.

Significant Investment by the Managers

The principals of LLR Partners will make significant capital commitments to Fund III, reflecting their confidence in the breadth of attractive investment opportunities available to the Firm and the continuing success of its distinct investment strategy. All incentive compensation to all team members will be tied to the performance of Fund III, and the incentive compensation will be earned based on performance of the portfolio as a whole, rather than that of individual investments. As a result, the Managers believe their financial objectives are aligned with those of the limited partners.

INVESTMENT STRATEGY

LLR Partners pursues an investment objective that emphasizes capital preservation while generating attractive equity returns. This objective allows LLR Partners to successfully deploy capital in all market cycles.

LLR Partners pursues this investment objective by focusing on lower middle market growth companies in the Mid-Atlantic region that possess superior return potential. Within this market segment, LLR Partners employs a disciplined investment approach that incorporates rigorous investment identification, evaluation, monitoring and value creation processes.

Lower Middle Market Growth Companies

LLR Partners has identified an underserved market niche where attractive opportunities are overlooked by other private equity investors. This niche exists among lower middle market companies seeking \$10 million to \$75 million of growth equity and/or financing for organic growth, acquisitions, a buyout or a recapitalization. Investors often overlook this niche because

it falls between the early stage and mature buyout ends of the private equity universe where most institutional investors operate.

Both ends of the market are highly competitive, significantly reducing the potential for generating adequate returns. Early stage investors focus on investment opportunities which may have the ability to generate return multiples of ten times or better, but with a high degree of risk. Early stage investors typically invest no more than \$10 million in any one company. Large buyout investors and mega private equity funds, typically based outside of the Mid-Atlantic region, deploy substantial amounts of capital, typically in excess of \$100 million of equity per investment. These large investors are focused on more mature investments and seek to drive returns by employing financial leverage.

Mid-Atlantic Focus

An imbalance of private equity capital exists in the Mid-Atlantic region, creating investment opportunities for LLR Partners. The Mid-Atlantic region's size, population density and economic scale position it as an attractive investment market. As a significant net importer of private equity, the Mid-Atlantic lacks a base of well capitalized, sophisticated regional funds focused on lower middle market, later-stage investment opportunities.

To date, firms outside of the Mid-Atlantic have filled the region's demand for private equity capital. Since 2002, non-resident investment firms have supplied 85% of the \$38.6 billion growth equity and buyout capital invested in the Mid-Atlantic. Of the 2,759 growth equity and buyout investments funded in the region over the past four years, only 56% had a local firm participate in the syndicate, representing only 15% of the capital invested. In addition, only 8% of total growth equity and buyout capital raised in the U.S. since 2002 has been provided to funds headquartered in the Mid-Atlantic.

Despite the lack of private equity capital in the region, the Mid-Atlantic possesses substantial economic strength, accounting for 12% of the nation's population and 13% of the employment base, and has been the recipient of 14% of U.S. private equity and buyout investments, totaling \$38.6 billion since 2002. Private equity has grown substantially in the Mid-Atlantic region with total investments increasing from \$352 million in 1991 to approximately \$6.6 billion in 2006, after peaking at \$19.4 billion in 2000.

Furthermore, the investment community in the Mid-Atlantic region has historically been focused on early stage investing. As a result, the capital needs of later stage regional companies are being filled by non-resident funds that are not well connected to this region. Many funds that have historically marketed to the region have raised significantly larger funds and are no longer interested in the deal sizes that are the focus of LLR Partners.

Headquartered in Philadelphia, LLR Partners is located in the geographic center of the densely populated Mid-Atlantic region – 35 million people are within a 2-hour drive of Philadelphia, an area that spans from Washington, D.C. to New York City. Philadelphia, itself, is the sixth largest metropolitan area in the country with 5.8 million residents and an employment base of 2.4 million.

Proprietary Regional Deal Flow

Superior investment opportunities are sourced directly, rather than through investment bank-led auctions. The general partner proactively pursues several channels to generate proprietary deal flow including: referral networks, proactive industry targeting and outreach and a variety of other marketing activities.

Referral Networks

The general partners referral networks and reputation for providing value-added advice have led to many proprietary investment opportunities. The general partners have individually and collectively developed an extensive referral network that includes:

- Lower middle market transactional law firms
- Venture capital and private equity firms
- Entrepreneurs and owners of privately held businesses
- Limited partners and portfolio company executives
- Financial intermediaries, consulting firms and executive search firms
- Regional investment banks, accounting firms and commercial banks
- Regional government officials

The referral networks, which extend well beyond the Mid-Atlantic region, have enabled LLR Partners to position itself as the co-investor of choice for many investment groups requiring additional capital. Non-regional funds may seek to bring LLR Partners in as a co-investor as they pursue local investments due to LLR Partners' strong regional presence and experience. Also, smaller, local funds that lack the ability to invest more than \$5 million in a single transaction, or are seeking additional growth capital for an existing portfolio company, may approach LLR Partners to take the lead on a co-investment basis.

Proactive Industry Targeting

LLR Partners targets industries that present attractive growth and return characteristics. LLR Partners continuously performs detailed qualitative and quantitative analyses to first identify and then monitor attractive industry segments and sub-segments. LLR Partners staff complements its analyses with external support and information provided from leading research analysts, investment bankers, industry experts and competitors.

LLR Partners possesses a comprehensive database of leading companies and thought leaders within the industries it targets. LLR Partners proactively contacts promising companies to determine if capital is needed and to position the firm as the capital provider of choice.

Regional Relationship Development

Each senior member of the LLR Partners team is responsible for marketing the firm to selected metropolitan markets within the Mid-Atlantic region. The investment team actively markets LLR Partners through in-person visits and other communications with leading deal sources within each target market (lawyers, bankers, accountants, venture capital firms, deal brokers, etc.). Other activities that support this effort include mailings and emails that announce key activities at LLR Partners, as well as periodic press releases.

Company Characteristics

LLR Partners seeks to invest in companies with strong, durable business franchises that have attractive risk/reward profiles, as demonstrated by possessing many of the following characteristics:

- Talented and committed leadership team with demonstrated performance
- Proven, scalable business model with revenue and earnings growth
- Sustainable competitive advantage
- Significant barriers to entry

- Leading market share or strong position in a defined market niche
- Product or service offering with predictable demand and extended life cycles
- Meaningful value proposition for customers

Investment Types

LLR Partners employs an opportunistic investment approach, committing capital to a broad range of transactions. The Firm's flexibility provides it with the ability to adapt to varying investment, economic and financing environments. Focusing on complex and creative transactions, Funds I and II comprise a diverse portfolio of three types of investments that will continue to be the focus of Fund III – late stage growth capital, recapitalizations, buyouts and buy and build transactions.

Late Stage Growth Capital

LLR Partners provides capital to established, growing companies to accelerate growth, both organically and through add-on acquisitions, and to expand the scope of a company's operations. Targeted growth companies generate a minimum of \$20 million in annual revenues and possess a proven profit model, although they do not necessarily need to have achieved profitability at the enterprise level. Attractive companies provide a product or service that has achieved demonstrable market acceptance, but may need to invest in infrastructure and require significant assistance to sustain superior growth. Growth capital investments also include providing capital to fund an acquisition. In most situations, growth capital investments are too large for early stage venture capital investors and too small for a mega private equity fund.

Buyouts / Recapitalizations

LLR Partners pursues buyout/recapitalization transactions of attractive standalone businesses as well as non-core units of larger corporations. LLR Partners will participate as either a minority or majority partner in these transactions. LLR Partners works with management teams who are dedicated to creating and building value through equity ownership. A recapitalization of a privately held business may be attractive when an owner/operator seeks partial or total liquidity through a sale, or in a generational transition in which a second generation seeks to acquire control or a significant minority ownership from the founder. In a corporate divestiture, a business unit may be run more effectively if structured as an independent entity and managed by a focused, standalone management team.

LLR Partners' strategy towards buyouts/recapitalizations is slightly different than most of its competitors. In order to ensure that LLR Partners' interests are aligned with management, LLR Partners typically does not get involved in transactions where the management team leading the investment post-transaction realizes significant liquidity at the time of LLR Partners' investment or the proceeds received by management at closing are worth materially more than their ongoing equity ownership. Therefore, LLR Partners focuses on those situations where the majority of the proceeds is going to passive owners or is being invested into the company. This approach avoids high debt levels, aligns management's interests with LLR Partners' interests, capitalizes the business for growth and relies upon proven and seasoned managers who are incentivized through increased equity ownership to continue successfully executing a strategy that has been validated.

Buy and Build

"Buy and build" transactions are executed through the acquisition of a platform company, which is then rapidly grown through multiple "tuck-in" acquisitions. LLR Partners identifies a platform company operating in an interesting, but fragmented market around which to aggregate scale. LLR Partners then seeks to exploit cheaper acquisition multiples and drive cost synergies

through the reduction of operating and general and administrative expenses. LLR typically pursues buy and build transactions in which a management team has demonstrated its ability to effectively run the platform company. In several investments, LLR Partners has executed the entire merger and acquisition function on behalf of its portfolio company, which includes researching and cold-calling potential targets, the negotiation of acquisition terms and spearheading the diligence process.

Industry Focus

Consistent with its diversified deal flow and regional focus, LLR Partners is opportunistic and broad in its industry interests. LLR Partners pursues multiple growth industries and constantly evaluates new sectors to determine if its industry focus should be expanded. LLR Partners currently focuses on the following industries where the general partners have significant expertise:

Business Services – includes a broad range of companies that provide various functions or services on an outsourced basis. These services include accounting, benefits administration, document management, staffing, market research and computer services. Funds I and II's business services investments include Community Education Centers, Crothall Services Group, Gestalt and Welocalize.

Financial Services – includes companies that provide outsourced processing of key financial information or specialty lending. LLR Partners focuses on companies that provide specialized lending, insurance and payment and transaction processing. Funds I and II's financial services and transaction processing investments include First Equity Card, Healthcare Finance Group, Heartland Payment Systems and Peachtree Funding.

Consumer Services – includes companies providing products or services to consumers. LLR Partners focuses on companies that provide services through a replicable model, such as education providers, direct marketers and specialty retailers. Funds I and II's consumer services investments include Brightside Academy, Five Below, Franklin Mint and Regency.

Information Technology – includes companies that develop proprietary software or processes that solve complex business problems or organize and process corporate data. Businesses in this sector include companies that provide enterprise-wide software, more focused specialized software applications and information technology consulting services. Funds I and II's information technology investments include CyberShift, Maxwell Systems, Princeton Softech and Prophet21.

Healthcare Services – includes a broad range of companies that provide services to pharmaceutical companies, health plans and healthcare providers. Typical offerings cover outsourcing of administrative services, including sales and marketing, billing, record keeping and management information systems and non-core operations including pharmaceutical distribution, laboratory or diagnostic services. Funds I and II's healthcare services investments include American Renal Associates, excelleRx, InnaPhase and Medmark.

EXIT STRATEGIES

LLR Partners typically holds investments for three to five years, or longer, before seeking liquidity, although that time frame may be altered based on opportunities that arise. As part of its pre-investment due diligence, LLR Partners carefully evaluates likely exit scenarios, including potential strategic buyers, the prospect of an initial public offering, or the possibility of a future refinancing or recapitalization achieving an acceptable return. During the ownership of the

investment, the general partner formally reviews the status of the exit strategy on a quarterly basis. The general partner has demonstrated, both in Funds I and II and in their prior advisory roles to clients, an ability to execute exits in a manner that maximizes returns, independent of the state of the financial markets.

KEY PERSONNEL

The LLR Partners investment team will execute and manage Fund III's investments. The team has extensive experience investing in and advising lower middle market growth companies as well as significant transaction experience in mergers and acquisitions, debt and equity financings and successful exits. The six partners are further supported by a team of professionals at the Principal, Vice President, Associate and Analyst levels.

Mitchell Hollin – Partner. Joined LLR Partners in 2000; 19 years of private equity investment experience. Industry expertise in Information Technology and Financial Services. Began private equity career in 1988 at Patricof and Co. Ventures (Apax Partners) and co-founder Advanta Partners in 1994. M.B.A. in Finance and B.S. in Economics, with honors, Wharton School of the University of Pennsylvania.

Seth Lehr – Partner. Co-founded LLR Partners in 1999; over 20 years of experience advising and/or investing in middle market growth companies. Industry expertise in Consumer and Business Services. Investment banking with Legg Mason, Lehman Brothers and First Boston. M.B.A. in Finance and B.S. in Economics, with honors, Wharton School of the University of Pennsylvania.

Ira Lubert – Partner. Co-founded LLR Partners in 1999; 20 years of private equity investment experience. Industry expertise in Business Services and Information Technology. Involved with seven other investment fund families across various asset classes, also worked at TL Ventures and Safeguard Scientific. B.S. in Human Development, Pennsylvania State University.

Scott Perricelli – Partner. Joined LLR Partners in 2001; 9 years of private equity investment experience. Industry expertise in Healthcare and Business Services. Investment banker at William Blair & Co. and private equity associate at Advanta Partners. M.B.A., Kellogg School of Management at Northwestern University; B.S. in Accounting, Bucknell University.

David Reuter – Partner. Joined LLR Partners in 1999; 8 years of private equity investment experience. Industry expertise in Information Technology, Business and Financial Services. Arthur Andersen with experience in both audit and assurance and strategy/process consulting. B.S. in Business and Economics, with honors, Lehigh University; CPA in Pennsylvania.

Howard Ross – Partner. Co-founded LLR Partners in 1999; over 25 years of experience advising and/or investing in middle market growth companies. Industry expertise in Information Technology and Healthcare Services. Arthur Andersen for 26 years as partner in-charge of Mid Atlantic growth company and family owned business practice. B.S. in Economics, summa cum laude, Wharton School of the University of Pennsylvania; CPA in 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 \$187.5 million plus reasonable normal investment expenses, in LLR Equity Partners III, 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.