COMMONWEALTH OF PENNSYLVANIA
PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM

DATE: February 18, 2008

SUBJECT: Refinancing Debt
Centerline High Yield CMBS Fund III, LLC

TO: PSERS' Finance Committee/Board

FROM: Charles J. Spiller CJS
Director of Private Markets and Real Estate

The Centerline High Yield CMBS Fund III LLC is requesting an immediate protective advance bridge loan from it investors, to be used to deleverage the fund's portfolio. The severe dislocation in the debt markets has resulted in margin calls. The bridge loan will be used to refinance the existing debt, thereby protecting the portfolio from being liquidated in an extremely unfavorable market. PSERS' share of the proposed bridge loan will be in the range of $79.8 to $92.0 million. PSERS' staff and real estate consultant, Courtland Partners, are recommending that PSERS agree to provide its share of the proposed bridge loan.

On September 17, 2007, PSERS' commitment to the fund was established at 25% of the total commitments of the fund, not to exceed $200 million. This fund was formed to acquire and hold for investment, high yield commercial mortgage backed securities ("CMBS") and commercial real estate collateralized debt obligations ("CRE-CDO"). The fund had its initial closing in August 2007 with initial commitments of $432 million. A second closing in September 2007 brought total commitments to $585 million. This level of commitment put PSERS' commitment at $147 million.

Utilizing warehoused investments, new acquisitions, and modest leverage, the fund was fully committed by the end of October 2007. As of January 23, 2008, the fund had called 100% of PSERS' current commitment. The acquisition process was expedited to capitalize on the extraordinary increase in spread yields. This unprecedented market turmoil was a direct result of last summer's subprime dislocation. The fund was able to acquire its investments at spreads that have been increasingly accretive to the fund's initial pro forma spreads. The leverage utilized was repurchase agreements, provided by long-standing providers with whom Centerline has done business since 1999. The original strategy was implemented to withstand as much as a 400 basis point increase in spread yield before margin calls could be exercised. As spreads continued to widen during the last half of 2007, the fund executed an aggressive plan to deleverage its positions, using less repo debt on new acquisitions and repaying over $75 million of existing repo financing. During this same period, the fund had a number of "soft circles" for additional equity commitments that would take the fund up to its target of $800 million. The market turmoil caused these prospective investors to decide not to proceed with their commitments, thereby eliminating funds identified to help deleverage the portfolio. During December 2007 and January 2008, the fund used sale proceeds, remaining investor capital, and a $30 million advance from Centerline Capital Group to reduce debt. Centerline advanced another $2.5 million in February 2008.

The significant losses from subprime mortgage loans reported recently by several large investment banks and commercial banks, who are also the predominant repo providers, have wreaked havoc on the market. Of the fund's three original repo providers, one is no longer in that business. The other two, Morgan Stanley and Bear Stearns, are focused intently on contracting their repo facilities to restore balance sheet capital in the face of further expected losses. Given the volatility of recent cash bond trades, which have varied as much as 650 basis points on investment grade bonds and over 700 basis points on B-piece bonds, the fund's repo lenders have begun to instead rely upon the synthetic CMBX index as a proxy for bond valuations. Historically, the CMBX index was rarely seen as a useful valuation tool. According to this index, the value of the fund's assets has dropped more than 40% since November 2007. At the same time, the fund's repo lenders cut advance rates by between 10% and 20% since August 2007. Consequently, despite its efforts to deleverage, the fund now faces two significant margin calls, initiated in December 2007 and January 2008, totaling $47 million. The repo agreement also gives the lender the right to call the whole loan through the sale of the underlying assets, which it contractually controls, as an alternative to just issuing a margin call for the shortfall.

The assets within the portfolio have a total cost, including leverage, of $916.1 million and a total face value of $1.5 billion. The unleveraged current cash on cash yield is 9.6%. The cash return on the current market value is in excess of 30%. Out of a total of approximately 3,000 loans within the portfolio, there are only two that are with Special Servicing because of problems. One of these is a delinquency. There are another 90 loans on the "watch list." The underlying assets are considered to be of high quality and performing better than would have been expected at the start of the investment period. This is also evidenced by the high cash yield at cost and its relatively low default rate. The severe dislocation in the repo financing and CDO markets, as well as the metrics for bond valuation, are disrupting the fund's ability to execute its buy-and-hold strategy. When looking at the methodology, the lenders are using to reprice the portfolio, it seems irrational based on the underlying credit performance. This is also evidenced by the very high cash return on market. Under normal market volatility, a buy-and-hold investor would have limited concern for the changes in the valuations from quarter to quarter knowing that the unrealized losses would reverse themselves over the life of the fund. However, to the extent that the fund cannot meet its current or future margin calls prior to the placement of the term loan, the fund will have its assets placed into forced liquidation at distressed prices in order to pay down or pay off its repo financing.

In early February 2008, the manager brought the margin call issue to the attention of PSERS. Prior to this and over the next two weeks, all of the LPs in the fund had conversations with the fund manager on this topic. It was indicated to PSERS that all of the investors were "on board" with the concept of having the LPs provide a loan to address the margin calls. When participating in LP-only conference calls, it was apparent that all of the investors were in favor of participating in a financial event that would resolve the problem. They were not all in agreement as to the form or terms. During conversations with all of the investors, it was decided that the investor group would prefer to eliminate all of the debt to avoid similar situation in the future if the market continued to move against the portfolio. Upon further LP-only conversations, it was decided by most, if not all, of the LPs to not only provide enough loan proceeds to remove all of the debt, but to also modify the Limited Partnership Agreement to the benefit of the LPs by back-ending the GP carry. The resulting terms sheet is attached. There are two interest rate scenarios because, at the time of this proposal, there are two LPs that have not fully decided to participate under the proposed terms. In the event that all LPs do not participate, the interest rate would be 200 basis points higher then if all of the LPs participate. There is also an individual LP that has a limit on its dollar participation, thereby causing the remaining participating LPs to have higher prorates shares. There is also an investor that may be required to participate through an equity vehicle that mirrors the structure and terms of the debt vehicle. These items of uncertainty are expected to be resolved over the next week. It is anticipated that the funds will be required from PSERS and the other investors by Friday February 28, 2008, for use on February 29, 2008.

SUMMARY OF TERMS AND CONDITIONS

Set forth below is a summary of the proposed terms of the approximately $317 million loan (the "Loan") to eliminate all outstanding repurchase debt to Centerline High Yield CMBS Fund III (the "Fund") by equity investors of the Fund (collectively referred to as the "Investors"). The Fund is managed by Centerline Capital Group ("Centerline").

SUMMARY OF TERMS AND CONDITIONS

Conditions to Terms:	Centerline will provide Investors information regarding the current value of the portfolio within a reasonable time period as determined by the Investors.
Loan Term:	Two (2) years with an option to extend at Investors' sole discretion for up to two (2) one (1) year periods, so long as any extension is approved by 100% of the investors on a dollar invested basis, excluding Centerline. Prepayment is permissible so long as it is approved by 75% of the Loan investors on a dollar invested basis, excluding Centerline.
Loan Interest Rate:	If all Investors participate in the Loan (either though the commitment of additional capital or through a subscription line loan) and each extension, the annual compounded interest rate shall be 12% with a 9% current amount paid monthly and a 3% accrued annual rate of return. If all Investors participate in the Loan, all cash flow shall be used to: (1) pay off the 9% current rate; (2) pay the 3% accrued rate; (3) pay down the principal balance of the Loan; and (4) after satisfying the Loan, pay the preferred rate of return on the Investors' initial equity contribution. If all Investors do not participate in the Loan (either though the commitment of additional capital or through a subscription line loan)or any extension thereof, the annual compounded interest rate shall be 14% with a 9% current amount paid monthly and a 5% accrued annual rate of return. If all Investors do not participate in the Loan or any extension thereof, all cash flow shall be used to: (1) pay off the 9% current rate; (2) pay the 5% accrued rate; (3) pay down the principal balance of the Loan; and (4) after satisfying the Loan, pay the preferred rate of return on the Investors' initial equity contribution. Centerline's management fee shall be a priority expense of the Fund in either instance above.
Loan Stipulations:	The Fund assets shall not be leveraged in any additional form and shall be secured by the assets of the Fund. Additionally, one investor will provide capital in the form of equity under substantially similar terms as Loan investors.
GP Promote Structure:	The GP will restructure the current waterfall of the Fund so that Investors will receive a return on their capital (including the preferred return) and a return of their capital (before any promote is earned or paid to the GP). The GP catch-up and promote will be retained at the backend of the distributions waterfall, subject to approval by the CIO of one investor.
GP Loan:	The GP loan of approximately $30 million will be reduced to the GP's pro rata share of the Loan provided by Investors.
Investors Legal Counsel:	CalSTRS, on behalf of all Investors, will engage one law firm to advise Investors regarding the Loan, including its structure and related issues.
Costs of Restructuring:	All legal costs associated with the Investors' legal counsel as directed and incurred by the lead investor on behalf of all Investors in the Loan will be paid or reimbursed by the Fund.
Additional Investment by the Fund:	The Fund shall not make any additional investments.

SUMMARY OF TERMS AND CONDITIONS

This term sheet has been prepared as a draft, good faith proposal by Investors. Investors have had numerous discussions related to the financing. While at this point it is unclear if all investors will participate, it is the Investors' belief that a sufficient number of investors will participate to fully retire outstanding repo financing. This term sheet is subject to: (1) the review of Investors' legal counsel and revisions that may be made by legal counsel; (2) the approval of a certain pension fund board;(3) the review of sensitivity analysis and completion of due diligence by certain other investors; and (4) the completion of satisfactory definitive documentation evidencing the Loan.