

Commonwealth of Pennsylvania Public School Employees' Retirement System

DATE: July 18, 2008

SUBJECT: LBC Credit Partners II Recommendation

TO: Members of the Board

FROM: James H. Grossman, Jr., CPA, CFA 
Managing Director of External Public Markets, Risk & Compliance

At the August 13, 2008 Finance Committee meeting, the LBC Credit Partners ("LBC") team will make a presentation regarding the LBC Credit Partners II Fund.

This investment idea was generated out of the Private Market's group and is representative of the convergence of Public and Private Markets, especially in the area of portable alpha.

LBC is an affiliate of Independence Capital (founded by Ira Lubert), which includes Lubert-Adler Real Estate Funds, LLRpartners, Quaker BioVentures, and VERSA Capital Management, Inc. LBC's strategy is to invest in privately-negotiated secured mezzanine loans. LBC's focus is on companies with revenues under \$750 million as this represents an underserved market. The investment team has a strong background in asset-based lending. The size of the loans generated by this team ranges from \$10 million to \$30 million, and the portfolio is expected to be well diversified among sectors and regions in the U.S. and Canada. They originate their deals through numerous sponsors and senior lenders. The loan terms are generally LIBOR (with a floor) plus 650 to 950 basis points so these loans will have little interest rate risk. In addition, they will generate additional fee income of 100 to 300 basis points from closing, amendment, and waiver fees and some of the deals have equity upside participation through warrants and equity participations. The portfolio is expected to use leverage up to 50% of total assets (up to 1:1 debt to equity ratio).

LBC Credit Partners I, a \$400 million fund, has distributed a minimum of 9% annualized each of the eleven quarters since inception. The most recent quarter (2nd quarter 2008) had a distribution of 17% annualized. The current portfolio has 28 loans with a current pay rate of 12%. In addition, this fund collected 150 basis points in up front fees and 75 basis points in other fees. Since October 2005, the LBC team has screened 872 prospects (\$11.6 billion), issued term sheets or proposals for 134 prospects (\$1.8 billion), extended 42 commitments (\$581 million) and funded 28 loans (\$400 million).

Staff recommends an investment of \$375 million in the LBC Credit Partners II Fund. Portfolio Advisors has performed the due diligence on this fund and concurs with staff's recommendation to make an investment in this fund. The total fund size is expected to be \$750 million with a term of 10 years with two one year extensions. The general partner commitment is expected to be at least 5% and the preferred return on funded capital is 9% annualized. We have negotiated a reduced fee of 1.3% (was 1.75%) and the fund has an 80/20 split after the preferred return and return of capital.

Given the nature of the fund (loans with LIBOR plus a spread terms), we are recommending including this investment as part of the portable alpha program in U.S. large cap equities. We will generate the S&P 500 beta using futures as we have done with the other portable alpha strategies.

If you have any questions or comments, please contact me at 717-720-4703.