


Commonwealth of Pennsylvania Public School Employees' Retirement System

DATE: September 7, 2012

SUBJECT: High Yield Debt Recommendations

TO: Members of the Board

FROM: Joseph W. Sheva, CPA
Portfolio Manger 

At the September Finance Committee meeting, staff and Portfolio Advisors will recommend that PSERS commit \$425 million to two U.S.-focused funds (re-ups) and €400 million to two European-focused funds (new relationships). Each Fund invests in the middle-market lending area of the high yield market.

The recommendation will be that the following Funds receive the noted commitments.

U.S.-focused Middle-Market

- \$225 million - Cerberus Levered Loan Opportunities Fund II, L.P.
- \$200 million - LBC Credit Partners III, L.P.

European-focused Middle-Market

- €200 million - ICG Europe Fund V, L.P.
- €200 million - HayFin Special Opportunities Credit Fund L.P.

The investment thesis for investing in the middle-market lending area of the high yield market is that there is a significant need for debt capital providers in the middle-market space as a result of the on-going global financial crisis, which continues to cause a significant contraction in capital available to middle-market companies. This financing need creates opportunities for non-bank lenders and investors to secure attractive risk/reward opportunities. The Cerberus and LBC Funds are focused on U.S. middle-market lending, where the decline in capital provided by non-traditional lenders such as business development companies (BDCs) and credit hedge funds provides the opportunity. The ICG and HayFin Funds will focus on European middle-market lending, which historically has been more bank-centric, where the current appetite for middle-market lending by banks is low. In addition, new CLO (collateralized loan obligations) issuance, historically another large source of capital to European loan markets, appears to be an unlikely source of new debt capital in the future.

All four Fund managers being recommended are institutional quality industry leaders in either U.S. or European middle-market lending, both areas where staff and Portfolio Advisors believe attractive risk/return opportunities currently exist.

Included for your review are Portfolio Advisor's recommendations, PowerPoint presentations prepared by staff for each Fund, and the resolution recommending an investment in each of the Funds.

If you have any questions or comments prior to the meeting, please contact me at 717-720-4632.



September 7, 2012

Board of Trustees
Pennsylvania Public School Employees' Retirement System
5 North 5th Street
Harrisburg, PA 17101

Re: HayFin Special Opportunities Credit Fund, L.P.

Dear Trustees:

Haymarket Financial ("HayFin" or "the Firm") is an independent provider of credit financing to middle market European businesses and an investor in undervalued credit assets. HayFin is headquartered in London with offices in Frankfurt, Madrid and Luxembourg. The Firm was established in 2009 by Towerbrook Capital Partners and HayFin management. The CEO, Tim Flynn, successfully employed these strategies in his previous career as a Partner and Co-Head of Leveraged Finance and Acquisition Finance at Goldman Sachs in London. HayFin is currently raising its first third-party vehicle, the HayFin Special Opportunities Credit Fund, L.P. ("HSOPS" or "the Fund") targeting €500 million. The Fund will invest in European companies, primarily in senior secured credit positions. HSOPS was launched in the second quarter of 2012 and held a first close on September 1st at €204 million with an expected final close towards the end of 2012. HayFin, as the General Partner, will commit a minimum of €100 million (or 20% of the target volume) structured as a co-investment alongside the Fund.

HayFin was established to address the dislocation in the European credit market after the collapse of Lehman Brothers. The crisis revealed the poor financial health of the European banking sector, traditionally the largest corporate loan provider in Europe. As a result, some banks required government support, which has triggered a shift towards a tighter regulatory environment with stricter capital and liquidity requirements (Basel II and III). This situation was exacerbated by the recent European sovereign debt crisis. Currently, stressed bank balance sheets in combination with higher costs of capital due to increased equity requirements make it highly unlikely that European banks can commit a similar volume of capital as they had in the past. Furthermore, collateralized loan obligation managers ("CLOs"), the other large source of capital in the European loan market, are currently facing the end of their re-investment periods. HayFin believes that the market for CLOs will be difficult due to new regulatory equity requirements, resulting in a material increase in funding costs for CLO issuers and a corresponding decline in new issuance.

The growth in European leveraged finance volumes between 2005 and 2007 has resulted in a significant wall of debt maturing in the coming years. It is expected that in the current crisis, many European borrowers will be unable to repay their debt out of earnings. Much of this debt is held by European banks and is maturing in the near term, resulting in the need for refinancing and/or restructuring. In addition, the demand for new debt financing will continue to be generated from merger and acquisition activity, capital expenditures and general corporate purposes. This

imbalance in the supply and demand for capital has created an opportunity to provide capital to companies, which will be forced to identify alternative sources of such capital. It has also created an opportunity to acquire assets from banks and other financial institutions, which may be forced to dispose of them at prices below fair value.

Portfolio Advisors' recommendation is based upon the following analytical factors and is made within the context of PSERS' investment guidelines.

- Detailed due diligence, including interviews with industry peers and private equity professionals.
- Evaluation of the composition of the investment team, how they work together, compensation structure and other factors that help determine whether a group is likely to be able to replicate past successes as currently configured.
- Evaluation of the Fund's proposed investment strategy within the context of the current investment environment.
- The strategy proposed for the Fund is appropriate for the Private Equity Partnership component of the portfolio.

Based on the above, Portfolio Advisors recommends that PSERS commit to up to €200 million of limited partnership interests in HayFin Special Opportunities Credit Fund, L.P. Portfolio Advisors makes this recommendation considering the General Partner's qualifications and PSERS' overall investment guidelines.

This recommendation is given solely for the benefit of PSERS and cannot be relied upon by other investors considering an investment in the Fund, since their needs, objectives and circumstances may not be identical to those of PSERS. The scope of this recommendation is limited to the investment merits of the Fund. Portfolio Advisors does not provide legal or other non-investment-related advice.

Sincerely,

A handwritten signature in blue ink, appearing to be 'J. P. S.', is written over a light blue horizontal line.

Portfolio Advisors, LLC



High Yield Commitment

HayFin Special Opportunities Credit Fund LP

September 7, 2012

See Last Page for Disclaimer

Joe Sheva, Portfolio Manager

HayFin Special Opportunities Credit Fund LP

Market Opportunity

- » Sovereign debt crisis and European banking crisis have created opportunities to both provide capital to companies due to a minimal appetite for new lending by banks as well as purchase assets from banks at prices below fair value
- » Environment compelling for a non-bank lender and investor to secure attractive risk/reward opportunities

Overview

- » Fund size is €500 million with an expected hard cap of €750 million, exclusive of Haymarket Financial's commitment of the greater of €125 million or 25% of total commitments
- » Invest in lending opportunities through two channels: primary lending and secondary markets
- » Fund will primarily invest in European companies

Fund Strategy

- » HayFin will deploy capital through two primary channels:
 - » Primary Lending
 - » focuses on sourcing new, directly originated credit investments primarily to middle-market European companies with enterprise values generally between €100 million and €500 million
 - » generally secured senior or uni-tranche floating-rate loans where traditional bank capital is not readily available
 - » loans that refinance existing corporate capital structures where the incumbent lenders are unwilling or unable to roll their exposure
 - » rescue financing to companies in financial stress or undergoing a turnaround
 - » Secondary Markets
 - » focuses on sourcing existing loans and other credit assets from banks and other financial institutions that are deemed undervalued by HayFin
- » HayFin is targeting a 15% to 20% gross IRR, 11% to 15% net IRR



HayFin Special Opportunities Credit Fund LP

Investment Team

- » Fund will be managed by
 - » Tim Flynn, CEO: former co-head of Goldman Sachs' European Leveraged Finance and Acquisition Finance businesses
 - » Jeff Sockwell, Co-Head: Primary Lending: former Head of the Leveraged Finance Business for Asia and Co-Head of the Private Finance business in Asia for Goldman Sachs
 - » Andrew McCullagh, Co-Head: Primary Lending: former Head of the European Leveraged Finance business at Merrill Lynch
- » HayFin was founded in 2009 and has a team of 34 professionals with an average of 15 years experience with a variety of investment banking backgrounds
- » HayFin is headquartered in London, with principal offices in London, Frankfurt, Madrid, and Luxembourg

GP "Value Add"

- » HayFin has established a large and experienced team of senior, European-focused leveraged finance and credit investors
- » HayFin has proven origination and sourcing capabilities
 - » Generated more than 1,400 financing opportunities that led to 60 investments
 - » 83% of investments, by value, have been sourced on a proprietary basis
- » HayFin has structured their business to have the ability to flexibly deploy capital

Performance

- » Since October 2009 to June 30, 2012, HayFin has invested €1.063 billion in Special Opportunities transactions:
 - » 9.7% current yield (including base rate of 0.86%)
 - » 15.5% gross IRR, expected to generate a gross IRR of 16.7% (12.4%net)



HayFin Special Opportunities Credit Fund LP

History with PSERS

- » This will be PSERS first commitment to HayFin.

Board Issues

- » Placement Agents – Credit Suisse Asset Management Limited
- » PA Political Contributions – none
- » Relationship with Consultant – none
- » Introduction Source: Credit Suisse and Portfolio Advisors

Recommendation

Staff, together with Portfolio Advisors, recommends that the Board invest an amount not to exceed €200 million plus reasonable normal investment expenses

