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.

PORTFOLIO ADVISORS, LLC

September 7, 2012

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

Re: LBC Credit Partners III, L.P.

Dear Trustees:

LBC Credit Management ("LBC" or the "Firm") is raising its third fund, LBC Credit Partners III, L.P. (the "Fund", "Fund III", or "LBC III"). LBC was formed in 2005 by John Brignola, Christopher Calabrese, Nathaniel Cohen, and Ira Lubert. Messrs. Brignola, Calabrese, and Cohen (collectively the "Partners") are responsible for the day-to-day management and operations of the Firm. The Fund is seeking equity commitments of $650 million (with a hard cap set at $1.0 billion). The General Partner will commit at least 2% of total equity commitments to the Fund.

Fund III is being established to continue LBC's strategy of originating, executing, and managing a diversified portfolio of privately negotiated, secured, high-yielding loans to middle market businesses. LBC defines the middle market as companies with revenues between $50 million and $750 million and EBITDA of $10 million to $50 million. A typical borrower will have an enterprise value ("EV") of $120 million and the Firm will not lend to businesses with an EV below $60 million. Typical investments will range in size between $10 million and $50 million. Fund III will seek to provide investors with a high degree of current income (targeted at 8% per annum with quarterly payments) and a targeted net IRR of 15%. Consistent with the prior funds, the Firm will apply leverage to the aggregate investment portfolio of up to 50% of total assets (1:1 debt to equity investment ratio). Fund III intends to originate and manage investments with maturities ranging from three to seven years. The Firm expects the actual tenure of the loan to be shorter than the contractual maturity due to principal reductions in the form of amortization, cash flow sweeps, and early full repayments. In LBC I and II, the weighted average term to maturity of the portfolios are 3.3 years and 4.2 years, respectively.

Fund III will be value oriented by seeking to maximize current return while providing downside protection. Fund III intends to continue LBC's strategy of mitigating risk and minimizing volatility by making investments across a broad range of industry sectors based on comprehensive credit and operational evaluations. Typical investments are expected to be corporate loans possessing a senior lien on all or specific assets or a junior lien on all assets of the borrower. These loans will primarily be unitranche, bifurcated term, second lien and secured mezzanine. Fund III also may invest in traditional revolving and cash flow loans, unsecured mezzanine loans, broadly syndicated corporate loans and, to a lesser extent, equity participations, corporate leases, debtor-in-possession ("DIP") loans, loan pools and bonds that are traded in the primary and secondary market. The loans and other investments held by Fund III generally will be unrated and not actively traded in any secondary market. In pursuing the strategies outlined above, Fund III may utilize leverage, loan sales, hedging techniques and derivative instruments.

The majority of the loans will be structured with floating-rate coupons linked to short-term market base rates (typically LIBOR or the Prime Rate) and include interest rate floors, thereby minimizing risk to interest rate exposure. The components of the investment yield will typically consist of up-front fees (1% to 3%), cash-pay interest (8% to 16%), PIK interest (up to 3%) and ancillary recurring fees including anniversary, servicing and monitoring fees (up to 3%). Opportunistically, structures may also include conversion rights, warrants and other types of equity enhancements which could increase yields on those investments by an additional 2% to 5%. Additionally, as with the prior two funds, LBC will recycle principal realized during the investment period. Specifically, LBC will recycle all principal repaid within 30 months of the funding date of the realized loan.

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 $200 million of limited partnership interests in LBC Credit Partners III, 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,

Portfolio Advisors, LLC

High Yield Commitment

LBC Credit Partners III, L.P.

September 7, 2012

Joe Sheva, Portfolio Manager

See Last Page for disclaimer

LBC Credit Partners III, L.P.

Market Opportunity

» As a result of consolidation, strategy shifts, and other factors impacting capital providers, a significant decline has taken place in lending to middle-market companies, while demand for loans has remained constant and is expected to increase with M&A activity

Overview

» Fund size is $650 million with an expected hard cap of $800 million, inclusive of a 2% minimum General Partner Commitment

» Focus will be on direct lending to U.S. middle-market companies

» Invest in secured debt obligations (including loans, participations in loans, and other debt instruments and obligations) of U.S. middle-market companies

Fund Strategy

» Seek to generate returns primarily through the origination and issuance of senior secured, floating rate debt

» The majority of the loans will be structured with floating-rate coupons linked to short-term market based rates and include interest rate floors

» Typical investments are expected to be corporate loans possessing a senior lien on all or specific assets or a junior lien on all assets

» Earn mid-teens net returns over the life of the Fund

LBC Credit Partners III, L.P.

Investment Team

» LBC maintains a team of 17 investment professionals and 10 support staff

» Average relevant industry experience per senior investment professional is 21 years

GP "Value Add"

» Stable and Experienced Investment Team

» Well defined and consistent strategy

» Strong deal flow and execution capabilities

Performance

as of June 30, 2012

» LBC Credit Partners I, L.P. (2005): 9.5% net

» LBC Credit Partners II, L.P. (2008): 10.8% net

See Last Page for Disclaimer

LBC Credit Partners III, L.P.

History with PSERS

- PSERS has previously committed to the following LBC funds:
  - LBC Credit Partners II, L.P.: $375 mm

Board Issues

- Placement Agents – none
- PA Political Contributions – none
- Relationship with Consultant – none
- Introduction Source: Current Relationship with LBC

Recommendation

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