


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: Cerberus Levered Loan Opportunities Fund II, L.P.

Dear Trustees:

Cerberus Capital Management (“CCM” or “Cerberus”) is seeking to raise up to \$1.5 billion of limited partner commitments for Cerberus Levered Loan Opportunities Fund II, L.P. (the “Fund”). The Fund will invest in opportunities provided through CCM’s lending platform, Cerberus Business Finance, LLC (“CBF”). CBF was formed in 1994 and as of June 30, 2012 had \$3.1 billion of assets under management. Since 2011, Cerberus has raised over \$1.1 billion of commitments, including \$814 million from Cerberus Levered Loan Fund I, L.P. and \$301 million from Cerberus NJ Credit Opportunities Fund, L.P. Cerberus will commit the lesser of 1% of LP commitments or \$10 million to the Fund.

The Fund will seek to generate returns primarily through the origination and issuance of senior secured, floating rate debt to U.S. middle market companies. Cerberus expects that 70% to 80% of the debt will be provided to companies which are being purchased or recapitalized by financial sponsors. The Fund will source new opportunities through the CBF lending platform. CBF’s activities will include the origination, acquisition, management, and servicing of the loans. The Fund will typically provide single tranche secured loans (both asset and cash flow based) for working capital, acquisitions, re-financings, bridge loans, restructurings, exit financings, and debtor-in-possession (DIP) financing. The loans will likely be non-investment grade and have a floating rate supported by a base rate floor. Over the last 18 months, the CBF Lending Platform has closed on over 70 new financings, of which ~90% were sponsor-owned companies and over 80% were first lien. In the loan vehicles from which CBF is currently investing, ~97% of the investments currently have floating rates and 95% have base rate floors. In addition to the primary focus, the Fund will opportunistically make purchases of third party originated debt and loans in the secondary market.

CBF provides comprehensive capital structure solutions for companies with debt needs of \$25 million to \$500 million. CBF will subsequently split the structure into tranches and syndicate as appropriate based on potential partners’ risk appetite. CBF targets a position of \$15 million to \$50 million and seeks to remain in control of the lending syndicate while negotiating the documentation and covenants. CBF will typically be the largest investor within the structure and will hold a senior or junior secured position. In the existing CBF portfolios, 85% of the capital is held in the first lien while the remaining 15% is held in second lien/or junior preferred positions. CBF gains downside protection by ensuring there is strong asset coverage or significant enterprise value in the secured tranches of the capital structure. The unlevered gross return target of 11.5% is provided by the coupon rate (fixed or floating), additional PIK components and fees

(upfront, syndication, amendment and administrative). By driving the process and the syndicate, CBF creates yield enhancement as it bifurcates the structure and sweeps portions of the yield.

The Fund expects to use third party leverage in the range of 1:1 to 2:1x Limited Partner equity commitments. The GP has stated that it expects the average leverage level across the life of the Fund will be 1.25x to 1.5x equity. A debt facility is in place for the investment period of the Funds. The initial facility was secured by Cerberus at a more attractive rate than Fund I.

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 \$225 million of limited partnership interests in Cerberus Levered Loan Opportunities Fund II, 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

Cerberus Levered Loan Opportunities Fund II, L.P.

September 7, 2012

Joe Sheva, Portfolio Manager

See Last Page for Disclaimer

Cerberus Levered Loan Opportunities Fund II

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, together with Cerberus Offshore Levered Loan Opportunities Fund II, is \$1.25 billion with an expected hard cap of \$1.5 billion, inclusive of a \$10 million 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
- » Expects that 70 to 80% of the debt will be provided to companies which are being purchased or recapitalized by financial sponsors
- » Most loans will be originated by Cerberus
- » Earn mid-teens net returns over the life of the Fund



Cerberus Levered Loan Opportunities Fund II

Investment Team

- » Cerberus Capital Management (CCM) has a total staff of more than 400 individuals, including over 125 investment professionals
- » The lending group is referred to as Cerberus Business Finance, LLC (CBF), and has 25 investment professionals and has access to the full CCM back office for legal, reporting, and investor relations needs

GP “Value Add”

- » Is a leading value-oriented private investment firm with \$21.8 billion of assets
- » Has managed numerous funds and accounts that focused on loan origination and loan acquisition since 1994
- » The Funds are able to underwrite complete debt solutions for companies in need of financing
 - > Cerberus has maintained its core lending team and has full capability to directly source, underwrite, agent, syndicate, monitor, and service a large senior secured loan portfolio resulting in superior risk-adjusted returns

Performance

- » Cerberus Levered Loan Opportunities Fund I (May 2011): 20.4% net, annualized since inception as of June 2012
- » Ableco (1997): 11.6% net, annualized since inception as of June 2012
 - > Ableco is the historical lending vehicle that most accurately represents the CBF's ongoing strategy.



Cerberus Levered Loan Opportunities Fund II

History with PSERS

- » PSERS has previously committed to the following Cerberus funds:
 - » Cerberus Institutional Partners, LP – Series 2: \$200 mm
 - » Cerberus Institutional Partners, LP – Series 3: \$100 mm
 - » Cerberus Institutional Partners, LP – Series 4: \$400 mm
 - » Cerberus Levered Loan Opportunities Fund I: \$200 mm

Board Issues

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

Recommendation

Staff, together with Portfolio Advisors, recommends that the Board invest an amount not to exceed \$225 million plus reasonable normal investment expenses

