


Commonwealth of Pennsylvania Public School Employees' Retirement System

DATE: May 22, 2013

SUBJECT: High Yield Debt Recommendation

TO: Members of the Board

FROM: Joseph W. Sheva, CPA 
Portfolio Manger

At the June Finance Committee meeting, staff and Portfolio Advisors will recommend that PSERS commit \$200 million to the Sankaty Middle Market Opportunities Fund, L.P II, a re-up. PSERS is participating in Fund I, which also invested in the middle-market lending area of the high yield market.

The investment thesis for investing in the middle-market lending area of the high yield market is based upon a significant need for debt capital providers in the middle-market space where capital available to middle-market companies has been constrained due to a reduced appetite from banks and hedge funds for junior lending. This financing need creates opportunities for non-bank lenders and investors to secure attractive risk/reward opportunities. Sankaty is targeting low- to mid-teens net returns in Fund II. Sankaty anticipates that Fund II investments will be allocated geographically focused on North America (60-80%) and Europe (20-40%). It is noted that PSERS has made commitments to Cerberus and LBC Funds, focused on U.S. middle-market lending and also made commitments to ICG and HayFin Funds, focused on European middle-market lending.

Sankaty is deemed to be an institutional quality industry leader in both 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 recommendation, a PowerPoint presentation prepared by staff, and the resolution recommending an investment in the Fund.

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



May 22, 2013

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

Re: Sankaty Middle Market Opportunities II, L.P.

Dear Trustees:

Sankaty Advisors, LLC ("Sankaty" or the "Firm") is seeking to raise \$1 billion (\$1.5 billion hard cap) for Sankaty Middle Market Opportunities II, L.P. (the "Fund" or "MMOPs II"). The Fund is Sankaty's second fund dedicated to middle market lending and was formed to invest opportunistically in the following areas: (i) original issue mezzanine and senior debt investments, (ii) secondary purchases of single assets and portfolios, and (iii) rescue financings. The Fund will be managed by Michael Ewald, who is the head of Sankaty's Middle Market Group and has over 17 years of industry experience. Formed in 1998, Sankaty is the credit products investment affiliate of Bain Capital and manages approximately \$18.6 billion in committed capital, including over \$600 million of employee personal investments in the Sankaty funds. Fund II will hold a first close on June 28, 2013 and anticipates holding a final close during September 2013. The General Partner expects to invest approximately \$50 million in the Fund.

Fund II will target investments ranging from \$10 to \$50 million in companies with EBITDA generally in the range of \$10 to \$150 million. MMOPs II's investments will focus on middle market lending opportunities across the capital structure. The strategy will target purchases of subordinated debt, senior and second lien loans, preferred and common stock and other instruments of middle market companies. These opportunities will primarily stem from providing junior capital to traditional mezzanine financings (50-70% of the Fund) with additional flexibility and allocations to pursue special situation opportunities (10-20% of the Fund) and secondary purchases of both existing loan portfolios and single assets, often at a discount to par, from other market participants (10-20% of the Fund). The Firm will seek to close approximately seven investments per year for a total of 20-40 investments over the life of the Fund.

Sankaty believes that the middle market lending opportunity has been and will continue to be attractive for several reasons. From a demand perspective, middle market sponsors possess considerable dry powder and have had continued success in raising additional funds targeting buyouts of companies with between \$10 million and \$150 million of EBITDA. As 60-70% of the purchase prices in these buyout transactions are funded with debt, and because the majority of these businesses are too small to effectively access the public debt market, the demand for private middle market lending is expected to remain strong. On the supply side, while the market will always be subject to competitive ebbs and flows, the recent liquidity crisis in the credit markets has caused banks and other traditional lenders to middle market companies to reduce hold sizes and otherwise scale back their commitments to this



segment. In Europe in particular, bank balance sheets have both constrained lending and created opportunities for secondary purchases. These factors have increased the supply of investment opportunities to those with flexible capital dedicated to the space while at the same time maintained attractive pricing premiums and transaction structures as compared to public debt-like high yield bonds.

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.

The individuals at Portfolio Advisors who were primarily involved in the due diligence process for Sankaty Middle Market Opportunities II, L.P. are:

John Kyles - Managing Director, Connecticut Office

Brian Allen – Vice President , Connecticut Office

Based on the above, Portfolio Advisors recommends that PSERS commit to up to \$200 million of limited partnership interests in Sankaty Middle Market Opportunities 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,

WILLIAM J. INDELICATO
MANAGING DIRECTOR



High Yield Commitment

Sankaty Middle Market Opportunities Fund II, L.P.

June 11, 2013

Joseph W. Sheva, CPA
Portfolio Manager

Sankaty Middle Market Opportunities Fund II, 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

- Targeted fund size is \$1 billion with a \$1.5 billion hard cap
- The fund will invest in a mix of privately placed senior and subordinated debt and equity securities in middle market companies
- Targeting a geographic exposure of predominantly U.S. and Europe
- Semi-annual distributions of interest income plus realized profits

Fund Strategy

- Sankaty uses deep fundamental credit analysis to identify attractive investment opportunities to earn superior risk adjusted returns in credit products and fixed income investments. Sankaty seeks to minimize downside risk.



Sankaty Middle Market Opportunities Fund II, L.P.

Investment Team

- Sankaty has 87 investment professionals which include individuals with backgrounds in private equity investing, high yield investing, commercial lending, and consulting
- The team's scale, experience and local network allows them to source investment opportunities directly and to conduct extensive due diligence internally

GP "Value Add"

- The investment team is organized by industry focus, rather than by asset class. This is a key advantage in the due diligence of middle market opportunities. Sankaty has resident knowledge of the customer, a competitor, or a supplier to a potential portfolio company
- The team also has 15 investment professionals in a London office, which opened in 2005. All but two are native Europeans.
- Sankaty's Middle Market Group has invested \$5 billion in over 100 companies over the past 15 years

Performance

As of December 31, 2012

- Sankaty Middle Market Opportunities I, L.P. (2010): 15.1% net



Sankaty's Middle Market Group

Jonathan Lavine
Chief Investment Officer

Credit Committee
5 Managing Directors

Risk Committee
6 Members

Stuart Davies
Head of Special Situations

Middle Market Group: 16 Dedicated Professionals

Jamie Athanasoulas
Managing Director
(17 years experience)

Michael Ewald
Managing Director, Portfolio Manager
(17 years experience)

Robert Weiss
Managing Director
(20 years experience)

David Brooks
Executive Vice President
(11 years experience)

David Ross
Executive Vice President
(11 years experience)

Carolyn Hastings
Executive Vice President
(10 years experience)

Brad Charchut
Executive Vice President
(17 years experience)

Thomas Kolinski
Senior Vice President
(7 years experience)

Jonathan Leisinger
Senior Vice President
(8 years experience)

Dominic DeBonis
Vice President
(5 years experience)

6 Analysts

5-person
Restructuring
Team

4-person
Portfolio Group

14-person
Europe Team

36-person Industry
Research Team

8-person
Trading Group

7-person Legal &
Compliance Team

47-person
Operations Team

Sankaty's Middle Market Group has the focus of a boutique mezzanine firm as well as the resources of a large global investment firm

Sankaty Middle Market Opportunities Fund II, L.P.

History with PSERS

- PSERS has invested in the following Sankaty Funds: Sankaty Middle Market Opportunities I, Sankaty Advisors LLC (Bank Loans Fund), Sankaty Credit Opportunities Funds IV and V-A.

Board Issues

- Placement Agent(s): None
- Political Contributions in PA: None
- Relationships with Consultant: None
- Introduction Source: Current Relationship with Sankaty

Recommendation

Staff, together with Portfolio Advisors, LLC, recommends that the Board invest \$200 million plus reasonable normal investment expenses in the Sankaty Middle Market Opportunities Fund II, L.P.

NOTICE: This document was presented to the Public School Employees' Retirement Board at the public meeting at which the Board acted on the resolution to which the information relates. The sole purpose for posting the presentation information on this website is to enable the public to have access to documents that were utilized at a public meeting of the Public School Employees' Retirement Board, and no other purpose or use is intended.