


**COMMONWEALTH OF PENNSYLVANIA  
PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM**

DATE: December 12, 2007

SUBJECT: Apollo Real Estate Finance Corporation  
Commitment increase

TO: PSERS' Finance Committee/Board

FROM: Charles J. Spiller   
Director of Private Markets and Real Estate

Based on the information provided by Apollo and Courtland's due diligence, it is staffs' and Courtland's recommendation to increase the commitment to Apollo Real Estate Finance Corporation from \$150 million to \$241.5 million.

Apollo Real Estate Finance Corporation ("AREFIN") was formed to continue and expand the existing lending and debt investment activities of Apollo Real Estate Advisors, L.P., and its real estate affiliates. AREFIN is the vehicle used to originate loans and invest in debt instruments backed by real estate, and to qualify for taxation as a real estate investment trust ("REIT"). Apollo's unique market insight and distinctive approach to sourcing and structuring investments allows AREFIN to create excess risk-adjusted returns for investors while mitigating risks. To date, AREFIN has called approximately 17% of its capital commitments, which total \$621.4 million.

Apollo is of the opinion that the liquidity crisis that the capital markets are experiencing has impacted all debt sectors including commercial real estate debt. With many investors on the sidelines, commercial mortgage debt yields have increased substantially for loan instruments including whole loans, B-notes and mezzanine loans as well as commercial mortgage backed securities. It is their opinion that the change in the credit markets has created increased opportunity for AREFIN as both a buyer and an originator of debt. They have experienced a sharp increase in the number of opportunities being presented with more attractive returns and greater ability to structure to terms that meet their lending criteria. As a result, they have a healthy pipeline of deals with seven transactions representing more than \$180 million of aggregate commitments expected to close by the end of November and many others under review.

The current market environment creates both opportunities and challenges for AREFIN. The opportunities are increased deal flow and higher yields with many competitors on the sidelines. The challenges are managing investment size and fund diversity while trying to gain control positions in large transactions. While loan commitments are relatively large for single asset financing, the ability to commit to \$150 to \$300 million with speed and certainty is required for large portfolio transactions. With the larger loan commitment size comes the negotiating leverage to choose ranking in the capital stack, gain better pricing and terms and, importantly, control decision making in the event of a restructuring where control passes to the investment tranche that AREFIN holds. It is possible to invest lesser amounts in such transactions; however such investments usually involve participating as part of a larger tranche with less bargaining power over pricing and terms with decision making being controlled by a committee of investors. Having the ability to make commitments up to \$300 million and later syndicate down to their target 10% retention level will increase investment opportunities for AREFIN, allowing them to put investors' capital to work more quickly while increasing investment returns.

PSERS has an existing commitment of \$150 million to the Fund. The Fund is requesting a 61% increase in capital commitments from all of its original investors. The new capital commitments are expected to increase the size of the Fund to approximately \$1 billion. It is staff's recommendation that PSERS increase its \$150 million commitment to Apollo Real Estate Corporation by another \$91.5 million, for a combined total commitment of \$241.5 million.