

Manager Recommendation Memo

May 19, 2014

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

Re: Värde Scratch and Dent Fund, L.P.

Dear Trustees:

Aksia LLC, having been duly authorized by the Board of PSERS, has evaluated and herewith recommends a direct allocation to Värde Scratch and Dent Fund, L.P. ("Värde") in line with PSERS Investment Policy Statement, Objectives, and Guidelines.

"Scratch and Dent" loans are commercial real estate loans with high loan-to-values (LTV), low debt service coverage ratios (DSCR) and/or occasional missed payments. Estimates are that over \$100 billion of these loans are held either on the balance sheets of banks or within CMBS structures. Värde is a private equity fund manager with a focus on distressed assets and real estate that has been in business since 1994. After launching eleven private equity funds, this is its first carve out of a single, illiquid asset class; it chose "Scratch and Dent" loans because while they do not meet the return targets of the PE fund (blended portfolio level IRR of 18-21%), they still offer an attractive opportunity (10-15% expected return) given their risk profile. It will focus on loans backed by office, industrial, retail and other miscellaneous properties (car washes, gas stations, auto repair shops) under \$25mn, and in many cases below \$5 million. Apartment and hotel loans are expected to play a limited role in the portfolio.

The manager is launching the Scratch and Dent Fund in early Q3 2014. This fund will leverage the distressed credit and real estate investing experience of Värde with FirstCity Financial's capabilities to source, underwrite, and modify or restructure commercial real estate loans. FirstCity Financial (FCF) is a Waco, TX-based company operating across various businesses within consumer and commercial credit. It is 95% owned by Värde's private equity funds (with the remainder owned by FirstCity executives).

We believe that the Värde and FirstCity partnership is an effective way to capitalize on the opportunity set in performing small balance commercial real estate loans, an underserved market segment. It meets key criteria necessary to execute the strategy effectively, and will be doing so against a positive technical backdrop for commercial real estate pricing.

Aksia's recommendation is based upon the following analytical factors and is made within the context of PSERS' investment guidelines:

- Due diligence of Värde's investment strategy, including a review of the investment opportunity, market dynamics, partner expertise, structure, and primary risks;
 - On-site investment visit of Värde conducted November 12, 2013. Onsite investment visit of FirstCity (Värde's servicer) conducted April 15, 2014.
 - The following is a listing of the relevant points of contact with the manager/servicer since the most recent on-site investment visit in November 2013:

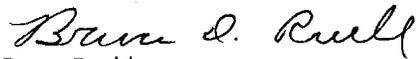
Date	Nature of Contact	Aksia Points of Contact
May 15, 2014	Follow up call with Värde	B. Goldberg
May 05, 2014	Call with Jeff Thuringer & Jim Dunbar	B. Goldberg
April 24, 2014	Meeting with team in London	O. Newton
April 15, 2014	Onsite meeting with FirstCity	B. Goldberg, R. Brei
February 28, 2014	Värde Annual meeting	B. Goldberg
January 30, 2014	Call with Jeff Thuringer	B. Goldberg
December 10, 2013	Call on personnel reorganization	R. Brei

- Due diligence of Värde's operations, including an operations and regulatory review and Form ADV review
 - On-site operational visit conducted on November 13, 2013. Onsite operational visit of FirstCity conducted April 15, 2014
- Evaluation of Värde's strategy within the context of the current investment environment; and
- Appropriateness of Värde as a component of PSERS' portfolio.

This recommendation is given solely for the benefit of PSERS and cannot be relied upon by other investors considering an investment in Värde, 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 Värde. Aksia manager recommendation memos should be reviewed with other Aksia due diligence materials, including the full Opportunity Review and Operational Review. In addition, please consult your tax, legal and/or regulatory advisors before allocating to any private investment fund.

Please feel free to contact us should you have any questions about this recommendation.

Respectfully,



Bruce Ruehl
Partner, Head of Portfolio Advisory, Americas



Patrick Adelsbach
Partner, Head of Event Driven



High Yield Commitment

The Värde Scratch and Dent Fund, L.P.

June 12, 2014

Laurann H Stepp
Portfolio Manager

The Värde Scratch and Dent Fund, L.P.

Market Opportunity

- “Scratch & Dent” (S&D) commercial real estate (CRE) loans are defined as typically less than \$10 million, and having higher loan-to value, lower debt service coverage, and occasional missed payments. The secondary market for these performing type loans is estimated to be over \$100 billion, with more product expected to be created over the next 5 years
- Banks and CMBS special servicers are motivated to sell these loans up to 3 years prior to maturity due to regulatory pressure, lack of workout resources, unwillingness to reserve proper capital levels, or concerns that loans will become non-performing

Overview

- Targeted fund size is \$300 - \$500 million, with a \$500 million hard cap
- The fund will invest in discounted secondary market purchases of existing loans, and originate new high-yield loans, primarily including: whole mortgage loans, bridge loans, mezzanine loans. Additional investments may include tranches of small CMBS bonds, residential first lien modification loans, and second lien performing loans
- Targeting a geographic exposure of predominantly U.S.
- Semi-annual distributions of income, with expected annual yield of 8+%
- Targeting net fund return of 11-14%

Fund Strategy

- The Värde Partners platform has invested over \$25 billion since inception in 1993. Current AUM of approximately \$8.5B, is invested across a wide spectrum of trading and private credit markets, and concentrated on corporate situations, mortgages, real estate and other hard assets. The S&D fund will specifically target an opportunity that they have observed while investing under other strategies. The attractive risk-adjusted return will be pursued while focusing on current/sustainable cash flows and capital preservation. Risk will be managed through establishing a diversified portfolio with an emphasis on downside protection

The Värde Scratch and Dent Fund, L.P.

Investment Team

- Established in 1993, with 2 of 3 founders still fully engaged. Eight Partners own 100% and have worked together for average of 14 years
- Employ 160 total employees, including 50 investment professionals, across three offices in Minneapolis (headquarters), London and Singapore
- Värde and First City will have 20 investment professionals dedicated to S&D to perform underwriting, due diligence, and valuation of assets. First City will also service the majority of the assets

GP “Value – Add”

- In May 2013, Värde acquired First City Financial Corporation, headquartered in Waco, TX. Värde Partners had been working extensively with this firm since the late 1990's and currently jointly underwrite \$4-5 billion of secondary commercial real estate loans annually. First City is considered a leading asset manager and special servicer focused on due diligence, servicing and resolution of performing and non-performing assets
- The sourcing, underwriting and servicing capacity enabled through Värde's dedicated platform with First City presents a distinct market advantage
- The team's reputation, experience and relationships allow them to source investment opportunities directly
- Less capitalized firms would find it difficult to source, service and add value to the small balance CRE loan market. With the Värde and First City systems in place, S&D can take advantage of those platforms to invest more efficiently. Private equity competition in this market is limited due to the higher volume capacities and efficient processes needed to underwrite, price, and service small balance CRE loans

Performance

- This will be the first S&D fund, thus Värde does not have any performance metrics
- The Värde private equity vehicles have historically invested in non performing loans, which are higher risk and require intensive asset management. Since 2009 Värde, and First City, have invested \$875 million in approximately 3,000 individual loans with nearly 2,000 borrowers and expect to achieve a 1.27x MOC and a 17.2% gross IRR

The Värde Scratch and Dent Fund, L.P.

History with PSERS

- This will be PSERS first investment with Värde Partners, Inc

Board Issues

- Placement Agent(s): None
- Political Contributions in PA: None
- Relationships with Consultant: No
- Introduction Source: Aksia

Recommendation

Staff, together with Aksia, LLC, recommend that the Board invest \$150 million plus reasonable normal investment expenses in The Värde Scratch and Dent Fund, 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.