



COMMONWEALTH OF PENNSYLVANIA
PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM

Public Investment Memorandum

Avenue Europe Special Situations Fund III (U.S.), L.P.

High Yield Commitment

James F. Del Gaudio
Senior Investment Professional

September 21, 2015



Recommendation:

Staff, together with Portfolio Advisors, recommends to the Board a commitment of up to \$200 million to Avenue Europe Special Situations Fund III (U.S.), L.P. ("Fund III" or the "Fund"). Avenue Capital Group ("Avenue" or the "Firm"), a New York-headquartered private investment firm, is sponsoring the Fund to make investments primarily in the debt of Western European companies experiencing financial distress.

Firm Overview:

Avenue was founded in 1995 by Marc Lasry (Chairman, Chief Executive Officer and Co-Founder of Avenue) and Sonia Gardner (President, Managing Partner and Co-Founder of Avenue) (collectively, the "Senior Principals"). The Firm's primary focus is investing in distressed debt and other special situations investments in the U.S., Europe and Asia. The Firm has approximately 200 employees (including approximately 65 investment professionals) as of July 31, 2015, and maintains a well-developed infrastructure with extensive Accounting, Operations, Legal, Business Development, Risk Management, Compliance and Information Technology Departments. Avenue manages a variety of investment vehicles focusing on credit opportunities in the U.S., Europe, and Asia with assets under management ("AUM") estimated to be \$13.9 billion as of July 31, 2015. The Fund will be managed by Avenue Europe International Management, L.P. ("Avenue Europe" or the "Investment Manager"), which is controlled by the Firm's Senior Principals.

Investment Strategy:

The Fund will pursue a predominantly Western Europe focused distressed debt strategy, with an emphasis on senior debt positions in fundamentally sound companies which undergo a period of financial distress. The Fund will not pursue a distressed-for-control strategy, but more corporate distressed-for-recovery or distressed-for-restructuring. In addition, as bankruptcy laws and regulations have matured and become more creditor-friendly in non-core Eurozone countries, Avenue Europe may focus on certain special opportunities in such jurisdictions, such as trade claims or healthcare claims. The Investment Manager expects to allocate Fund III as follows:

Strategy	Allocation
Distressed-for-Recovery	20% - 25%
Distressed-for-Restructuring	60% - 65%
Special Opportunities	5% - 10%

While the Fund's investment strategy is industry-agnostic, the Investment Manager prefers companies backed by infrastructure or other tangible assets, as well as those with predictable cash flows. Avenue Europe also favors defensive industries that have high barriers to entry.

Investment Team:

Avenue Europe's investment activities are led by Marc Lasry, Sonia Gardner, Richard Furst and Jon Ford. In total, Avenue Europe has an experienced team of 24 dedicated investment professionals focused on European opportunities with offices in London, Madrid, Milan, Munich and New York. The table below highlights the experience of Avenue Europe's key investment professionals:

Name	Title	Yrs. Experience Avenue / Total	Prior Experience
Marc Lasry	Chairman, CEO & Co-Founder	20 / 31	Amroc, Robert Bass Group
Sonia Gardner	President, Managing Partner & Co-Founder	20 / 29	Amroc, Robert Bass Group
Richard Furst	CIO, Head of Europe Strategy	11 / 27	Moore Capital, BoA, Solomon Brothers
Jon Ford	Senior Portfolio Manager	7 / 17	Deutsche Bank, Close Brothers
Raul Ramirez	Portfolio Manager	9 / 19	Goldentree, Morgan Stanley



In addition to the key investment professionals listed above, Avenue Europe's investment committee is comprised of ten additional members of senior management who bring a mix of investment, risk, legal, compliance, business development and tax expertise.

Investment Instruments:

Investments are expected to focus primarily on individual corporate, distressed debt securities and other special situations investment opportunities of European companies, including non-performing loan pools of corporate and other debt. Avenue will seek to invest primarily in senior-secured debt. However, as market cycles evolve and/or Avenue's investment thesis on a company progresses, the Fund may invest in more junior portions of the capital structure, including equities, depending on the risk/return profiles of an investment.

Investment Structure:

Avenue is offering investors the option to commit through a Euro-denominated vehicle or a U.S. dollar denominated vehicle. We are recommending the U.S. dollar denominated vehicle to the Board. This will serve to minimize PSERS' foreign currency risk as a result of Avenue hedging the Fund's foreign currency exposure.

Market Opportunity:

The convergence of certain European market dynamics will continue to contribute to an attractive and rapidly growing supply of distressed and special situations investment opportunities across the Eurozone, including, but not limited to: (i) anemic economic growth; (ii) over-levered European banks; (iii) increasing bank asset sales; (iv) significant reductions in bank lending; (v) underperforming LBOs leading to numerous corporate restructurings; (vi) growth in European high yield issuance; and (vii) lower underwriting standards.

European banks remain highly levered post-crisis, peripheral Eurozone countries are experiencing historic unemployment levels with rising costs of capital, and small to middle market companies continue to struggle in a difficult economic environment with limited access to capital. Additionally, structural and regulatory changes are forcing banks to accelerate the sale of assets (e.g., impaired loans), resulting in an increased supply of non-economic sellers across Europe.

Investment Highlights:

Experienced & Cohesive Senior Management Team
Avenue Europe's investment activities are led by Marc Lasry, Sonia Gardner, Richard Furst, and Jon Ford, who have 31, 29, 27, and 17 years of relevant experience in the distressed debt market, respectively. Moreover, there are an additional 22 experienced investment professionals that have a broad set of complementary backgrounds, including relevant experience in European distressed debt and other special situations, bankruptcies, turnarounds, private equity, investment banking, trade claims, high-yield investing and post-reorganization equities.
Track Record
Avenue Europe has generated a solid track record since inception. As of March 31, 2015, Avenue Europe Special Situations Fund, a 2008 vintage-year fund, generated an 18.9% IRR (15.9% net) and a 1.68x MOIC (1.49x net). As of the same date, Avenue Europe Special Situations Fund II (Euro), a 2011 vintage-year fund, generated a 14.1% IRR (9.6% net) and a 1.33x MOIC (1.22x net) while the USD vehicle, Avenue Europe Special Situations Fund II (US), generated a 13.2% IRR (8.9% net) and a 1.31x MOIC (1.20x net). Avenue ultimately expects Fund II to generate a net IRR in the range of 11% to 13%.
Low Historical Loss Ratio
As of March 31, 2015, Avenue Europe's two prior investment vehicles generated low realized loss ratios of 4.3% and 5.5%, respectively.



Investment Considerations:

Competition From Other Distressed Debt Investment Managers
While competition does exist in the European distressed debt space, Avenue's platform is differentiated due to their deep team and geographic footprint. Furthermore, Avenue expects the Fund to benefit from limited direct competition. The current market environment has discouraged bank proprietary trading desks from pursuing distressed transactions and there are limited dedicated European distressed investors pursuing a corporate distressed debt strategy.
Public Market Benchmark Returns
While Avenue Europe's historical track record has performed well on an absolute basis, their returns have slightly underperformed the public market equivalent benchmark over recent years. That said, the Investment Manager is generally taking on less risk than the public high yield market given their strategy of investing in senior-secured debt and is further evidenced by their low historic loss ratios. Moreover, publicly traded high yield markets have experienced a multi-year run-up over the past several years against the backdrop of record-low interest rates, creating somewhat inflated benchmark return figures.
Foreign Currency Risk
While there is always risk associated with committing capital across multiple currencies, this risk is somewhat mitigated in this instance given Avenue is offering investors the option to commit through a USD-denominated vehicle that will hedge its foreign currency exposure.

PSERS History & Performance:

Since 2000, PSERS has committed approximately \$1.95 billion to 11 Avenue-managed partnerships. As of March 31, 2015, Avenue generated a 14.3% net IRR and a 1.5x net MOIC for PSERS across their Private Debt/High Yield funds. The table below summarizes PSERS' historical performance with Avenue by partnership:

Fund (\$mm)	Portfolio	Vintage	Commitment	Contributions	Distributions	NAV	Net IRR	MOIC
Avenue Europe Special Situations Fund, L.P.	PD	2008	\$ 214.6	\$ 259.7	\$ 355.8	\$ 5.4	12.2%	1.4x
Avenue Special Situations Fund II, L.P.	PD	2000	125.0	125.4	198.4	0.0	19.2%	1.6x
Avenue Special Situations Fund III, L.P.	PD	2002	205.2	148.9	255.8	0.0	18.5%	1.7x
Avenue Special Situations Fund IV, L.P.	PD	2006	115.0	144.8	188.1	1.9	8.4%	1.3x
Avenue Special Situations Fund V, L.P.	PD	2007	300.0	301.1	394.0	4.6	11.1%	1.3x
Avenue Special Situations Fund VI, L.P.	PD	2010	75.0	76.9	38.2	57.2	7.0%	1.2x
Avenue Asia Special Situations Fund II, L.P.	PD	2001	220.0	220.0	413.3	0.0	21.5%	1.9x
Avenue Asia Special Situations Fund III, L.P.	PD	2003	100.0	76.3	114.4	0.0	8.4%	1.5x
Avenue Asia Special Situations Fund IV, L.P.	PD	2006	300.0	225.1	176.1	97.5	4.5%	1.2x
Avenue Energy Opportunities Fund, L.P.	HY	2014	200.0	100.5	0.0	94.8	NM	0.9x
Sub-Total (Private Debt & High Yield)			\$ 1,854.7	\$ 1,678.7	\$ 2,134.2	\$ 261.6	14.3%	1.5x
Avenue Real Estate Fund (Parallel) L.P.	RE	2006	100.0	94.2	0.0	66.2	-5.3%	0.7x
Grand Total (Avenue Capital Group)			\$ 1,954.7	\$ 1,772.9	\$ 2,134.2	\$ 327.8	12.9%	1.4x



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Portfolio Fit:

A commitment to Fund III will be allocated to the Opportunistic bucket of PSERS' High Yield portfolio. As of June 30, 2015, the High Yield portfolio (based on total exposure) was allocated 46% Opportunistic, 25% Senior Loans, 21% Mezzanine and 8% Real Assets. The Fund's strategy is complementary to PSERS' current European exposure and a commitment to Fund III allows PSERS to maintain its existing relationship with a high-conviction manager.

The table below summarizes PSERS' projected exposure inclusive of a recommended \$200 million commitment to Fund III:

Investment Type	Active Commitments ¹	%	Market Value	%	Unfunded ¹	%	Total Exposure ¹	%
Opportunistic	\$ 3,173.1	42.8%	\$ 1,378.6	44.7%	\$ 1,426.7	52.0%	\$ 2,805.3	48.1%
Senior Loans	2,315.0	31.3%	881.1	28.6%	505.6	18.4%	1,386.7	23.8%
Mezzanine	1,290.4	17.4%	549.0	17.8%	622.1	22.7%	1,171.1	20.1%
Real Assets	628.8	8.5%	277.2	9.0%	190.3	6.9%	467.5	8.0%
Total	\$ 7,407.2	100.0%	\$ 3,085.8	100.0%	\$ 2,744.8	100.0%	\$ 5,830.6	100.0%

(1) Include post Q2'2015 pending/closed commitments.

Liquidity & Leverage Profile:

The Fund is expected to be invested within three-years of its final closing (the "Investment Period"), with the ability to fully recycle proceeds within this period. After the Investment Period, the Fund will have a two-year harvesting period in which to realize investments. The Investment Manager will not employ fund-level leverage.

Finance Committee Disclosure:

Relationship with Portfolio Advisors:	Avenue Special Situations Fund IV: PAPEF III: \$10mm Avenue Special Situations Fund V: PAPEF IV: \$15mm PAPEF V: \$15mm
Placement Agent:	None used for PSERS
PA Political Contributions:	None Disclosed
PA Presence:	No
Conflicts:	None Disclosed
First Time Fund With PSERS:	No
PSERS Internal Alpha Committee Approval:	September 21, 2015

Oversight Responsibility:

Investment Office:	Charles J. Spiller James F. Del Gaudio	Managing Director Senior Investment Professional
External Consultant:	Portfolio Advisors LLC	



September 11, 2015

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

Re: Avenue Europe Special Situations Fund III, L.P.

Dear Trustees:

Avenue Capital Group ("Avenue" or the "Firm") is seeking to raise Avenue Europe Special Situations Fund III, L.P. (the "Fund" or "AESS III"). The Fund will primarily pursue investments in debt, selected equity securities or other obligations of European companies in financial distress. The Fund is targeting €2 billion in commitments (hard cap of €2.01 billion). A first close has been held in June 2015 at €1.1 billion, a next close is expected by the end of September and a final close around the end of the year. With the first close, Avenue has started to invest with a current exposure of 7.3% of the targeted Fund size. The General Partner has committed to invest an amount equal to at least 2% of the aggregate commitments of the limited partners in the Fund.

Avenue pursues a Western Europe focused distressed debt strategy with a strong focus on senior debt positions in fundamentally sound companies that experience a phase of financial distress. Avenue targets corporate distressed-for-recovery and distressed-for-restructuring opportunities. In addition, they focus on certain special opportunities, such as trade claims (Spain) or healthcare claims (Italy). In the corporate distressed-for-recovery strategy, Avenue mostly acquires small debt positions in the bond market with the expectation of a short term market recovery (a large part of the Avenue Fund I portfolio). In distressed-for-restructuring opportunities the debt positions are often loan positions bought directly from banks, which are larger in size and take more time for individual due diligence. In Fund III, Avenue expects to invest roughly 20% - 25% in corporate distressed-for-recovery opportunities, 60% - 65% in distressed-for-restructuring opportunities and the remainder in special opportunities as described above.

Investments are expected to focus primarily on individual corporate, distressed debt securities and other special situations investment opportunities of European companies, including non-performing loan pools of corporate and other debt. Avenue Europe will seek to invest in senior secured debt or other debt that is structurally senior to other portions of the capital structure, as the Firm believes this provides the most attractive risk/reward potential. However, as market cycles evolve and/or the Firm's investment thesis on a company progresses, the Fund may invest in more junior portions of the capital structure, including equities, depending on the risk/return profiles of an investment. The Fund will employ a flexible approach to making and structuring its investments. This approach is expected to allow the Fund to participate at the appropriate time and in the appropriate security type for each investment in order to maximize potential returns while minimizing principal risk. This strategy has allowed Avenue Europe to develop a good level of



knowledge and a broad network of relationships. The Fund III portfolio is expected to contain of 30 to 40 core positions with a focus on mid-cap companies and an average holding period of 12 to 36 months.

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. The on-site due diligence visit was performed on August 14, 2015.
- 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 High Yield Fixed Income component of the portfolio.

The individuals at Portfolio Advisors who were primarily involved in the due diligence process for the Fund are:

Peter Schwanitz – Managing Director, Zurich Office

Nadine Zanger – Senior Associate, Zurich Office

Based on the above, Portfolio Advisors recommends that PSERS commit up to \$200 million in Avenue Europe Special Situations Fund 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,

WILLIAM J. INDELICATO
MANAGING DIRECTOR