



COMMONWEALTH OF PENNSYLVANIA
PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM

Public Investment Memorandum

The Värde Scratch and Dent Fund I-A, L.P.

High Yield Commitment

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Senior Investment Professional

May 16, 2016



Recommendation:

Staff, together with Aksia, LLC, recommends the Board commit an additional \$75 million to Värde via The Värde Scratch and Dent Fund I-A, L.P. (the “Fund” or “Fund I-A”). Värde Partners, Inc. (“Värde” or the “Firm”) is seeking to raise an incremental \$300 million from existing investors of The Värde Scratch and Dent Feeder, L.P. (“Fund I”) to take advantage of a compelling near-term market opportunity involving the acquisition of secured loans backed by U.S. commercial real estate (“CRE”).

Firm Overview:

Värde is a global alternative investment firm focused on credit and value investing strategies. Värde has considerable experience investing in a variety of assets and its activities have encompassed investments in a broad array of segments and jurisdictions. Värde was founded in Minneapolis, Minnesota in 1993 and today manages approximately \$10 billion in assets on behalf of a diverse investor base. Värde is headquartered in Minneapolis, Minnesota and employs over 200 professionals globally. The Firm’s professionals comprise over 20 nationalities and are fluent in more than 30 languages. Värde is managed by a group of senior leaders, including partners: George G. Hicks, Marcia L. Page, Jeremy D. Hedberg, Rick J. Noel, Andrew P. Lenk, Ilfryn C. Carstairs, Ali M. Haroon, Bradley P. Bauer, Timothy J. Mooney, David A. Marple and Giuseppe Naglieri (collectively, the “Principals” or “Partners”).

Värde’s global investment strategies encompass investments across the liquidity spectrum and can be categorized by five investment strategies. The table below summarizes Värde’s AUM by exposure and strategic focus by investment strategy as of December 31, 2015:

Strategy	% Total Exposure ¹	Focus
Corporates & Traded Credit	36.1%	Debt and equity instruments issued by corporate entities as well as government-issued debt.
Residential Mortgages	6.2%	Residential real estate mortgages, including direct investments in portfolio companies that originate and/or service residential mortgages.
Real Estate²	35.7%	Loans to commercial entities that develop or manage real property assets, investments in loans and securities secured by commercial real estate assets and real estate assets or portfolio companies involved in developing property and/or originating commercial real estate loans.
Specialty Finance	17.8%	Assets related to commercial and consumer credits, including credit cards, auto loans and small business loans as well as portfolio companies that originate and/or service those credits.
Transportation, Infrastructure and Energy (“TI&E”)	4.1%	Investments in transportation, infrastructure and energy assets, including loans secured by assets associated with transportation, infrastructure and energy sectors and portfolio companies that operate in those sectors.

(1) Includes investments made by all Värde Funds. Segments are based on Värde’s internal classification system as of the date of this presentation. Investments may have been classified differently in the past. All positions are reflected at fair market value.

(2) Real Estate is inclusive of all investments in The Värde Scratch and Dent Feeder, L.P.

In 2014, as part of Värde’s real estate credit strategy, the Firm raised \$500 million in commitments for Fund I of which PSERS committed \$150 million. Fund I was formed to pursue opportunities in “Scratch and Dent” loans (as defined below in “Market Opportunity”) secured by U.S. commercial real estate and was the Firm’s first dedicated vehicle focused on this niche asset class. Today, Fund I is fully invested and Värde is seeking an incremental \$300 million from existing Fund I investors to bridge the Firm’s near-term pipeline funding gap. Additional capital will allow the Firm to remain active in this dynamic market while avoiding the potential distraction of a broader-based capital raise. That said, it is anticipated that Värde will raise a second “Scratch & Dent” fund in mid-2017.



Market Opportunity:

The original thesis behind the formation of Fund I (2014 vintage) stemmed from the fact that systemic challenges and risks remained in the global economy even though we were six years past the epicenter of the Global Financial Crisis (“GFC”) of 2008. Aggressive lending practices leading up to the GFC were considered to be one of the major causes of the GFC and these practices were prevalent in CRE. In contrast to the residential mortgage markets, the negative consequences of questionable lending practices took longer to surface in the commercial arena. The CRE markets were comparatively more insulated by long term leases that supported occupancy and rental rates as well as less excess inventory. However, as the availability of debt financing evaporated amid continued market distress, the CRE markets experienced an increase in delinquencies and defaults with many borrowers unable to meet debt service obligations or secure refinancing due to depressed asset values and/or inadequate cash flow. In addition to complete defaults, there was a large portion of borrowers that were able to meet some – but not all – of their loan obligations (e.g. occasional missed payments). Värde refers to these types of CRE loans as “Scratch and Dent” loans. Värde defines “Scratch and Dent” (“S&D”) loans as CRE loans with high loan-to-values (“LTV”), low debt service coverage ratios (“DSC”) and/or occasional missed payments. Värde typically focuses on S&D loans that have unpaid principal balances (“UPB”) of less than \$25 million. Värde’s original thesis remains intact and the proposed Fund I-A will provide capital to invest while the Firm prepares for Fund II.

Portfolio Fit:

A commitment to Fund I-A will be allocated to the Real Assets bucket of PSERS’ High Yield portfolio. As of December 31, 2015, the High Yield portfolio (based on total exposure) was allocated 51% Opportunistic, 25% Senior Loans, 14% Mezzanine and 10% Real Assets. An additional commitment to Värde will allow PSERS to continue its relationship with a high-conviction manager that is well positioned to execute on the near-term market opportunity that exists as a result of bank retrenchment in the CRE lending space. As of December 31, 2015, PSERS’ High Yield allocation was 7.02% versus a policy target of 6.0%. Staff is comfortable with the current level of exposure given the risk/return attributes of private credit versus public high yield debt.

The table below summarizes PSERS’ projected exposure inclusive of a recommended \$75 million commitment to the Fund:

Investment Type (\$mm)	Active Commitments ¹	%	Market Value	%	Unfunded ¹	%	Total Exposure ¹	%
Opportunistic	\$ 3,917.3	47.2%	\$ 1,631.2	50.1%	\$ 1,584.2	50.6%	\$ 3,215.4	50.4%
Senior Loans	2,665.0	32.1%	789.0	24.2%	806.9	25.8%	1,595.9	25.0%
Mezzanine	860.3	10.4%	368.4	11.3%	517.0	16.5%	885.4	13.9%
Real Assets	851.2	10.3%	467.6	14.4%	221.2	7.1%	688.8	10.8%
Total	\$ 8,293.8	100.0%	\$ 3,256.2	100.0%	\$ 3,129.4	100.0%	\$ 6,385.5	100.0%

(1) Include post Q4’2015 pending/closed commitments.

Investment Strategy:

Värde launched Fund I in 2014 to leverage the distressed credit and real estate investing experience of Värde combined with their captive servicer’s capabilities to source, underwrite, and modify or restructure CRE loans. Fund I-A will maintain the same strategy and intends to continue to generate attractive returns with asymmetric risk by investing in situations where there is less competition to provide capital. The Fund will continue to employ the Firm’s credit-focused investment philosophy of identifying attractive financial assets at a discount to their “intrinsic value”. The Fund will remain focused on investment opportunities throughout the United States with a concentration in secondary and tertiary markets that have not recovered to the same rate as the major markets. In short, the Fund will purchase high LTV, performing CRE loans at a discount to current collateral value and then service, modify or restructure them with the help of their servicer, Trimont Global Real Estate Advisors, LLC (“Trimont”).



Värde intends to build a diversified portfolio of loans backed by office, industrial, retail and other properties under \$25 million per loan. Apartment and hotel loans are not expected to play a material role in this portfolio.

Investment Instruments:

S&D loans will generally be comprised of whole loans, bridge loans, B-notes and mezzanine loans with UPB of less than \$25 million, which will either be acquired in secondary transactions or newly originated. The Fund may also acquire structured securities that have interests in S&D assets. The table below provides a summary of the principal investment instruments that fall within the Fund's investment mandate:

Instrument	Description
Whole Loans	A whole loan is a loan secured by a first mortgage lien on a commercial property with tenors typically ranging from three to ten years.
Bridge Loans	A bridge loan is a short-term loan secured by a first lien mortgage that is used for the acquisition, construction or rehabilitation of a property and typically refinanced with proceeds of a conventional mortgage loan.
B-Notes	A B-note is a mortgage loan typically (i) secured by a first mortgage on a single large commercial property or group of related properties and (ii) subordinated to an A-note secured by the same first mortgage on the same collateral.
Mezzanine Loans	A mezzanine loan is a loan made to the owner of commercial property that is (i) secured by pledges of the borrower's ownership interest in the property and/or equity interests in the mortgage borrower, (ii) subordinate to first or second mortgage liens on the property and (iii) senior to the borrower's equity interest in the property.
Structured Securities	Structured securities include securities that are collateralized by pools of commercial mortgage loans such as commercial mortgage backed securities (CMBS) or certain CLOs.

Investment Team:

The Värde team comprises over 200 employees including 67 experienced investment professionals who specialize in sourcing, structuring and managing private credit investments. The Fund's day-to-day management, operations and investment decision-making process are led by Senior Managing Director, Brian Schmidt and Managing Directors, Jeffrey Thuringer and Jim Dunbar. Fund oversight is provided by Chief Investment Officer, George Hicks and Executive Chair, Marcia Page. Large transactions, typically greater than \$50 million, are approved by the firm's Investment Committee ("IC"). The Principals, all members of the IC, and senior members of the Fund's investment team, are listed in the table below:

Name	Role	Yrs. Experience Värde / Total	Prior Experience
George Hicks	Founder, CEO & CIO	23 / 37	Cargill Financial
Marcia Page	Founder, Executive Chair	23 / 34	EBF & Associates, Cargill Financial
Brad Bauer	Partner, President	9 / 16	Deephaven, American Express, U.S. Bancorp
Ilfryn Carstairs	Partner, Global Co-Head of Liquids	10 / 15	Deutsche Bank, Pacific Equity Partners
Ali Haroon	Partner, Global Co-Head of Real Estate	11 / 17	Bear Stearns
Jeremy Hedberg	Partner, Global Co-Head of Liquids	19 / 22	Goldner Hawn, Wessels, Arnold
Andy Lenk	Partner, Asset Management	15 / 21	U.S. Bancorp
Tim Mooney	Partner, Global Co-Head of Real Estate	11 / 16	Cadwalader, Wickersham & Taft
Rick Noel	Partner, Global Head of Specialty Finance	17 / 26	Advantus Capital, Cargill Financial
David Marple	Partner, General Counsel	8 / 25	GMAC-ResCap, Orrick, Herrington & Sutcliffe
Giuseppe Naglieri	Partner	7 / 13	Goldman Sachs, JP Morgan
Brian Schmidt	Senior Managing Director, US Real Estate	11 / 16	Piper Jaffray
Jeffrey Thuringer	Managing Director, US Real Estate	12 / 18	U.S. Bancorp, Anchor Bancorp
Jim Dunbar	Managing Director, US Real Estate	6 / 15	Macquarie, Salomon Smith Barney/Citigroup

Värde's investment professionals are further supported by the 200+ employees at Trimont. Trimont, headquartered in Atlanta, Georgia, is a leading provider of real estate financial services, including special



servicing of performing and non-performing CRE and maintains a positive rating with Standard & Poor's Ratings Services. As of December 2015, Trimont provided real estate financial services to over \$95 billion of assets across 143 clients. Värde and Trimont have a combined dedicated due diligence team of over 20 professionals that perform underwriting, due diligence and valuation of assets on a full-time basis.

Investment Highlights:

Breadth & Experience of the Värde Team
Värde's global investment team is comprised of 67 experienced investment professionals who specialize in sourcing, structuring and managing private credit investments. Collectively, the Firm's eleven Principals and additional three senior members of the Fund's investment team have 300+ years of investment experience. This team is further supported by the 15 dedicated professionals at Trimont who perform underwriting, due diligence and valuation of assets on a full-time basis.
Servicing Relationship with Trimont
Värde's proprietary relationship with Trimont provides a distinct competitive advantage in pursuing the S&D loan strategy. Less capitalized firms would find it difficult to source, service and add value to the small balance CRE loan market. With Värde and Trimont's systems in place, the Fund 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.
Deal Sourcing
Since 1993, Värde has developed a wide range of relationships with banks, investment banks, loan sale advisors, CMBS special servicers and real estate investors/developers that provide them a competitive advantage in sourcing transaction deal flow. Additionally, Värde's loan servicer (Trimont) provides a unique lens into the CRE loan market given their deep team of >200 employees and experience servicing >\$95 billion of assets across 143 clients, providing Värde a distinct competitive advantage. Värde and Trimont have a combined dedicated due diligence team of over 20 professionals that perform the underwriting, due diligence and valuation of assets on a full-time basis. This is a "bottoms up" process that includes the underwriting of each loan in the portfolio.

Investment / Risk Considerations:

Competition
Banks make for an unlikely buyer of S&D loans as they are subject to a regulatory regime that makes them better sellers of these assets. While there are a handful of other asset management firms who are active or could potentially be active in the space, in most cases, the potential returns in S&D loans do not meet the return targets of private equity funds that these managers run. Data on small balance loans is difficult to obtain. As such, most widely available data covers loans greater than \$25 million in size. It is for this reason that a real barrier to entry exists – managers which have years of experience in sourcing and relationship building, as well as the technological competency and infrastructure to obtain and analyze historical data should be at an advantage. Having control over a servicer (as Värde does) is also an advantage, as incentives are better aligned.
Liquidity & Leverage Profile
During the Fund's one-year investment period, Värde will have the ability to re-invest distributable proceeds. As a result, any investment proceeds will increase PSERS' undrawn commitments (up to the amount of its initial commitment) and will be available for recall. After the expiration of the investment period, the Fund will have up to four years to harvest its investments; which may be extended by two additional one-year periods at the discretion of the Principals in order to provide for an orderly realization of the Fund's investments and the winding up of the Fund's business. The Fund may lever its assets through various types of financings and through various securitization vehicles. The Fund may also leverage its investment return with derivative instruments. The Principals expect the Fund's overall debt ratio in general to be 65% or less; however, it will not exceed 75% of the fair value of its investments and other assets.



PSERS History & Performance:

PSERS previously committed \$150 million to The Värde Scratch and Dent Feeder, L.P. ("Fund I"). As of December 31, 2015, Fund I generated an 8.8% net IRR and a 1.05x net MOIC. The table below summarizes PSERS' Fund I performance as of December 31, 2015:

<u>Fund (\$mm)</u>	<u>Portfolio</u>	<u>Vintage</u>	<u>Commitment</u>	<u>Contributions</u>	<u>Distributions</u>	<u>NAV</u>	<u>Net IRR</u>	<u>MOIC</u>
Fund I	HY	2014	\$ 150.0	\$ 118.4	\$ 4.1	\$ 119.8	8.8%	1.05x

Finance Committee Disclosure:

Relationship with Aksia, LLC:	Aksia has discretionary clients with an aggregate commitment to Fund I of \$8.0 million. This figure represents all discretionary assets committed to or invested with Värde.
Introduction Source:	Fund Sponsor
Placement Agent:	No
PA Political Contributions:	None Disclosed
PA Presence:	Loans secured by property in Pennsylvania represent approximately 1.0% of the unpaid balance in the Fund I's loan portfolio as of February 29, 2016.
Potential Conflicts:	We are not aware of Värde having any investment conflicts.
First Time Fund With PSERS:	No
PSERS Internal Alpha Committee Approval:	May 6, 2016

Oversight Responsibility:

Investment Office:	Charles J. Spiller James F. Del Gaudio	Deputy CIO, Non-Traditional Investments Senior Investment Professional
External Consultant:	Aksia, LLC	

Manager Recommendation Memo

May 11, 2016

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

Re: Värde Scratch and Dent Fund 1-A, LP

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 1-A, LP in line with PSERS Investment Policy Statement, Objectives, and Guidelines.

Värde Partners, Inc. ("Värde", the "GP" or the "General Partner") is seeking to raise between \$200 million and \$300 million in commitments for the Värde Scratch and Dent Fund I-A ("Fund I-A" or the "Fund"). The Fund's strategy is a continuation of the small balance commercial ("SBC") real estate debt strategy of the Värde Scratch and Dent Fund I ("Fund I") and is a bridge between existing capacity in Fund I and a planned 2016 or 2017 fundraising for a larger Fund II. This fundraising is premised on additional opportunity to acquire sub-performing SBC loans from legacy holders, acquire performing recent vintage SBC loans from stressed sellers and originate SBC bridge loans.

We believe that the Värde and Trimont 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.

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;
 - Värde Private Credit Due Diligence Report published May 2016. Onsite investment visit of Trimont (Värde's servicer) conducted April 13, 2016.
- Due diligence of Värde's operations, including an operations and regulatory review and Form ADV review
 - Värde Private Credit Due Diligence Report published May 2016. Onsite operational visit of Trimont (Värde's servicer) conducted April 13, 2016.
- 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 Private Credit Due Diligence 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, Global Portfolio Strategist



Patrick Adelsbach
Partner, Head of Credit Strategies