



COMMONWEALTH OF PENNSYLVANIA
PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM

Public Investment Memorandum

Falko Regional Aircraft Opportunities Fund II L.P.
Absolute Return Program

Robert E. Little, CPA
Senior Portfolio Manager, Non-Traditional Investment Strategies

February 15, 2019



Recommendation:

Staff, together with Aksia, recommends that PSERS allocate up to \$100 million to the Falko Regional Aircraft Opportunities Fund II L.P. (Fund II). This recommendation is based on our assessment of the investment strategy and our evaluation of Falko Regional Aircraft Limited's (Falko) capabilities.

Firm Overview:

Falko is a regional aircraft operating lessor. Over the last seven years, Falko has invested over \$1.2 billion in over 230 regional aircraft. Falko was founded in July 2011 through the management buy-in of BAE Systems' (BAE) captive aircraft leasing company, BAE Systems Asset Management (BAE AM), by the former management team. The purchase was funded by capital provided by funds managed by affiliates of Fortress Investment Group LLC.

Formed in 1993, BAE AM was responsible for BAE's aircraft leasing, financing, and asset management activities. Jeremy Barnes led the management team at BAE AM from 1993 to 1999. Mr. Barnes and his team were responsible for managing all the financial risks associated with the aircraft portfolio, including both the aircraft assets and related liabilities. During this time, the team developed and implemented the platform needed to manage the existing aircraft exposure and any added aircraft exposure. Through the mid-1990s, the management team completed numerous airline workouts as BAE AM sought to clean up its aircraft portfolio. The management buy-in team left BAE AM, and in 1999 formed Orbis Capital which focused on fundraising and risk transfer transactions in the aerospace sector. BAE AM remained an important client of Orbis Capital. In 2010, BAE AM approached Mr. Barnes with an offer to sell the platform and the remaining aircraft in the portfolio. The transaction was attractive for a number of reasons, the primary reason being that Mr. Barnes and his team had been managing or advising upon the BAE AM regional aircraft portfolio and other regional aircraft assets for close to 20 years and were in a strong position to manage out the aircraft assets. The acquisition comprised an aircraft leasing platform and a portfolio of 142 regional aircraft with remaining contracted lease income in excess of \$210 million at the time of acquisition. The aircraft leasing platform had been built out over a number of years and had a history of successful operations in the market.

The management buy-in team was led by current Falko CEO Jeremy Barnes, who has over 35 years of experience in the aircraft leasing and financing sector. Other members of the management buy-in team comprised the management team responsible for building BAE AM's commercial aircraft financing business throughout the 1990s - Martin Brennan (Chief Financial and Operating Officer), Sarah Dichlian (Chief General Counsel), Mark Hughes (Chief Commercial Officer), and James Greenstreet (Executive Vice President). John Williamson (Senior Vice President, Technical) and Richard Pitt (Senior Vice President, Commercial), who were employed at BAE AM at the time of the management buy-in, joined Falko with the purchase. Together, these seven individuals comprise the senior management team at Falko.

The senior management team manages a team of 44 professionals across the finance, legal, origination, commercial, and technical functions located in the UK and Singapore. In addition, Falko employs two consultants to support origination activity, one based in South America and one based in New Zealand. Each senior management team member has their own functional area for which they have responsibility. Over time, the team has developed a comprehensive aircraft leasing platform which is able to execute on all phases of the investment and asset management lifecycle across the spectrum of regional aircraft assets. Their fully integrated platform provides Falko with a distinct advantage versus most of its competitors as it affords it the ability to efficiently execute highly complex and intricate aircraft transactions which demand a combination of financial, technical, and legal expertise.

Market Opportunity / Investment Strategy:

The regional aircraft sector serves the airline industry with smaller commercial aircraft for traveling shorter distances. A regional aircraft is defined as a single-aisle aircraft with 60 to 150 seats, generally used on



shorter-range flights. Regional aircraft can be split into two sub-categories: regional jets (which are powered by turbofan or 'jet' engines) and turboprops (which are powered by turbine engines which drive the aircraft's propellers). Both types of regional aircraft are widely used in the regional airline sector. The regional aircraft market represents a significant element of the international transportation system with an in-service global fleet of approximately 6,900 aircraft as of 2016 (source: Bombardier Commercial Aircraft Market Forecast, 2017-2016).

The Fund will seek to acquire a geographically diverse portfolio of regional aircraft. Target aircraft will have leases attached or pre-negotiated as part of the purchase. The Fund will seek to recoup a significant portion of its initial investment cost in the form of contracted lease payments and maintenance reserves which significantly derisk the investment over time and mitigate downside risk. Active asset management to maximize residual value and opportunistically capitalize on early exit opportunities presents a meaningful potential to significantly enhance returns.

Falko is targeting \$600 million for its second fund, continuing the investment strategy it has pursued over the past seven years. Falko believes that equity positions in leased regional aircraft assets with medium to long-term operating leases offer a compelling investment opportunity. These operating leases create two main sources of income for the lessor (Falko):

- **Lease Income:** The contractual nature of the monthly lease payment provides Falko with a base case level of income at the inception of the investment. Falko seeks to recoup a significant portion of the asset cost through these contractual payments which derisks the investment over time.
- **Maintenance Reserves:** Leases typically dictate that an aircraft be returned to the lessor at the end of the lease in the same condition as at the start of the lease in terms of the economic life (flying hours used) of its key components. In most cases, the lessee will pay a monthly amount into a maintenance reserve managed by Falko. As maintenance work is completed and approved, the lessee may be reimbursed from this account for the worked performed. This maintenance reserve account provides security for Falko in regard to the aircraft quality and maintenance performance upon the return of the aircraft at the end of the lease. These reserves are a source of security of the lessor and may be a source of revenue at the end of the lease. Should an aircraft be returned to Falko in a more depleted condition than was agreed to in the lease, Falko will also have the right to receive additional monetary end of lease compensation equivalent to the value of the excess economic time used by the lessee on the key components of the aircraft.

Finally, the aircraft investment is protected through other contractual provisions, such as requiring the lessee to insure the aircraft and security deposits which protect Falko in the event of lessee default. Should any default issues arise, leased aircraft assets also have the benefit of a global consensus on moveable assets, ratified through the Cape Town Convention on International Interests in Mobile Equipment. The treaty creates international standards for the registration of contracts of sale, liens, leases, and other legal remedies related to lessee default including the repossession of aircraft equipment.

Portfolio Fit:

The investment in the strategy will be part of the Absolute Return Program.



Investment Team / Key Personnel:

The senior management team consists of Jeremy Barnes and the following individuals, all of whom worked at BAE AM. Information on key personnel is presented below.

Name	Title	Years' Experience Firm / Total	Prior Experience
Jeremy Barnes	Chief Executive Officer	7 (13) / 37	Orbis Capital, XL Capital, BAE AM, Citibank
Martin Brennan	Chief Financial and Operating Officer	7 (13) / 35	Orbis Capital, Marsh, BAE AM, Sunoco
Sarah Dichlian	Chief General Counsel	7 (12) / 32	Orbis Capital, XL Capital, BAE AM, DLA Piper
James Greenstreet	Executive Vice President	7 (11) / 32	Orbis Capital, XL Capital, BAE AM, Arthur Andersen
Mark Hughes	Chief Commercial Officer	7 (9) / 25	Orbis Capital, XL Capital, BAE AM, RBS
John Williamson	Senior Vice President, Technical	7 (42) / 42	BAE AM (originally British Aerospace)
Richard Pitt	Senior Vice President, Commercial	7 (17) / 21	BAE AM

Note: Falko was formed in 2011 through the management buy-in of the BAE Systems Asset Management business. All members of the senior management team listed above have worked at Falko since inception in 2011 (7 years) and formerly worked at BAE AM. The numbers shown in parenthesis in the table above represent the combined years of experience at BAE AM and Falko.

Investment Highlights:

- Limited Competition Within the Regional Aircraft Leasing Market
- High Barriers to Entry
- Demand for Capital to Finance Regional Aircraft
- Limited Sources of Capital to Meet Forecasted Demand
- Access to a Leading Regional Aircraft Platform
- Highly Experienced Origination Team
- Build-to-Order Nature of the Regional Aircraft Market
- Downside Protection in Recessionary Markets

Investment / Risk Considerations:

- Counterparty Credit Risk
- Asset Risk
- Concentration Risk
- Macroeconomic Risk
- Limited Third-Party Fund Management Track Record
- Ownership Structure



Investment Committee Disclosure:

Relationship with Aksia:	None Disclosed
Introduction Source:	Evercore Partners International LLP
Placement Agent:	Yes. In connection with the marketing of Falko Regional Aircraft Opportunities Fund II L.P., Falko engaged Evercore Partners International LLP (Evercore). Evercore will be compensated based on the aggregate commitments to Fund II (including any amounts committed to Fund II by PSERS). The placement agent fees paid to Evercore will not be borne by the Fund II limited partners. Instead, the placement agent fees will be paid by Falko Regional Aircraft Limited.
PA Political Contributions:	None Disclosed
Potential Conflicts:	We are not aware of Falko having any material conflicts.
PSERS History with the Investment Manager:	This investment will be PSERS' first investment with Falko.
PSERS Allocation Implementation Committee Approval:	February 15, 2019

Oversight Responsibility:

Investment Office:	Charles J. Spiller Robert E. Little	Deputy CIO, Non-Traditional Investments Senior Portfolio Manager, Non-Traditional Investments
External Consultant:	Aksia LLC	

Manager Recommendation Memo

February 5, 2019

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

Re: Falko Regional Aircraft Opportunities Fund II L.P.

Dear Trustees:

Aksia LLC, having been duly authorized by the Board of PSERS, has evaluated and hereby recommends a direct allocation to Falko Regional Aircraft Opportunities Fund II L.P. (the "Fund" or "RAOF II") in line with PSERS' Investment Policy Statement, Objectives, and Guidelines. It is further recommended that PSERS invest up to \$100 million in RAOF II.

Falko Regional Aircraft Limited ("Falko"), formed in 2011, is a single-strategy UK-based aircraft leasing platform which focuses exclusively on acquiring and managing portfolios of regional aircraft. Falko is led by its CEO, Jeremy Barnes, who had previously been founder and senior executive of the regional aircraft division of BAE Systems plc ("BAE"), a British multinational defense, security, and aerospace company. During his tenure at BAE, he established a team, the majority of which forms Falko's senior team today, and completed a number of airline workouts in South Africa, U.S., Canada, Australia, U.K. and Colombia.

The Fund will mark the second commingled fund managed by Falko (fund I in the RAOF series was raised in 2015). The investment strategy of the Fund will be broadly consistent with prior activity across the platform and will focus on Falko's core market of regional jet and turboprop aircraft. The Fund will aim to acquire small to mid-sized portfolios (\$2 million to \$30 million value) comprising early to mid-life aircraft (5 – 15 years age) which are already under lease. As a performing lease strategy, returns will be driven by a combination of contracted lease income and asset disposals. Falko is targeting a \$600 million capital raise for the Fund.


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

- Due diligence of the Falko's investment process, including a review of their investment strategy, investment team personnel and structure, and risk management;
 - On-site investment due diligence visit conducted January 16, 2019.
- Due diligence of Falko's operations, including an operations and infrastructure review, regulatory and compliance review, LPA review, Form ADV review, and Financial Statement Review;
 - On-site operational due diligence visit conducted January 16, 2019.
- Evaluation of Falko's strategy within the context of the current investment environment; and
- Appropriateness of RAOF II as a component of the PSERS portfolio.

This recommendation is given solely for the benefit of PSERS and cannot be relied upon by other investors considering an investment in RAOF II, 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 RAOF II. Aksia manager recommendation memos should be reviewed with other Aksia due diligence materials, including the due diligence reports. 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,


Patrick Adelsbach
Partner, Head of Credit Strategies


Simon Fludgate
Partner, Head of Operational Due Diligence