

COMMONWEALTH OF PENNSYLVANIA  
PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM

DATE: March 10, 2011

SUBJECT: Refinancing Debt  
Centerline High Yield CMBS Fund III, LLC

TO: PSERS' Finance Committee/Board

FROM: Charles J. Spiller *CJS/DK*  
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On September 17, 2007, PSERS' committed to the Centerline High Yield CMBS Fund III (Fund III). This fund was formed to acquire and hold for investment, high yield commercial mortgage backed securities ("CMBS") and commercial real estate collateralized debt obligations ("CRE-CDO").

As a result of the collapse of the "sub-prime" market and record CMBS loan delinquency rates, most of the Fund III investors agreed to participate in a loan to Fund III to avoid having assets liquidated as part of margin calls. On February 18, 2008, the Public School Employees Retirement Board approved a bridge loan to Fund III.

The real estate market continued to deteriorate. The CMBS delinquency rates continued to reach record levels. The fund manager, Centerline Capital Group, experienced financial deterioration. As a result, Centerline Capital Group was bought by Island Capital. On December 11, 2009, the Public School Employees Retirement Board approved the change of control and other settlement items relating to the various Centerline funds. In addition, the Fund III Loan maturity date was extended to March 1, 2012.

In September 2010, the new managing entity, C-III Capital Partners, issued an offer to either tender the Fund III loan or convert it to a commitment into a new fund being created. Over the last few months, the delinquencies in the collateral for the Fund III Loan increased dramatically. While the projected cash flow for the loan dropped materially, C-III Capital Partners decided to keep the original tender offer in place. All Fund III cash flow is being used to pay the monthly debt service on the Fund III Loan and no additional proceeds are expected to be recovered from Fund III. The offer from C-III Capital partners is as follows.

## Tender Offer

- 1) C-III Capital Partners would purchase the interest PSERS has in the Fund III Loan and use the proceeds to fund capital calls into their new fund offering (C-III Recovery Fund I).
- 2) The total Fund III Loan base purchase price is set at \$30 million less note payments made subsequent to 9/10/10. PSERS' share of the net purchase price, after cash flow adjustments through March 1, 2011, is \$5,659,912.81.
- 3) In the event that the future realized cash flow from the Fund III Loan collateral is greater than the base purchase price (less note payments received since 9/10/10), PSERS would receive its prorata share of the excess. C-III Capital Partners would incur the loss if the Fund III Loan's future realized cash flow is lower.

Or

- 1) C-III Capital Partners would purchase the interest PSERS has in the Fund III Loan for cash.
- 2) The Total Fund III Loan base purchase price is set at \$30 million less note payments made subsequent to 9/10/10. PSERS' share of the net purchase price, after cash flow adjustments through March 1, 2011, is \$5,659,912.81.
- 3) In the event that the future realized cash flow from the Fund III Loan collateral is greater than the base purchase price (less note payments received since 9/10/10), PSERS would receive its prorata share of the excess. C-III Capital Partners would incur the loss if the Fund III Loan's future realized cash flow is lower.

PSERS staff and the real estate consultant, Courtland Partners, are recommending the acceptance of the cash tender offer for PSERS' share of the Centerline High Yield CMBS Fund III Loan.