# Commonwealth of Pennsylvania
# Public School Employees' Retirement System

**DATE:** September 7, 2012

**SUBJECT:** High Yield Debt Recommendations

**TO:** Members of the Board

**FROM:** Joseph W. Sheva, CPA
Portfolio Manger

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At the September Finance Committee meeting, staff and Portfolio Advisors will recommend that PSERS commit $425 million to two U.S.-focused funds (re-ups) and €400 million to two European-focused funds (new relationships). Each Fund invests in the middle-market lending area of the high yield market.

The recommendation will be that the following Funds receive the noted commitments.

**U.S.-focused Middle-Market**

- $225 million - Cerberus Levered Loan Opportunities Fund II, L.P.
- $200 million - LBC Credit Partners III, L.P.

**European-focused Middle-Market**

- €200 million - ICG Europe Fund V, L.P.
- €200 million - HayFin Special Opportunities Credit Fund L.P.

The investment thesis for investing in the middle-market lending area of the high yield market is that there is a significant need for debt capital providers in the middle-market space as a result of the on-going global financial crisis, which continues to cause a significant contraction in capital available to middle-market companies. This financing need creates opportunities for non-bank lenders and investors to secure attractive risk/reward opportunities. The Cerberus and LBC Funds are focused on U.S. middle-market lending, where the decline in capital provided by non-traditional lenders such as business development companies (BDCs) and credit hedge funds provides the opportunity. The ICG and HayFin Funds will focus on European middle-market lending, which historically has been more bank-centric, where the current appetite for middle-market lending by banks is low. In addition, new CLO (collateralized loan obligations) issuance, historically another large source of capital to European loan markets, appears to be an unlikely source of new debt capital in the future.

All four Fund managers being recommended are institutional quality industry leaders in either U.S. or European middle-market lending, both areas where staff and Portfolio Advisors believe attractive risk/return opportunities currently exist.

Included for your review are Portfolio Advisor's recommendations, PowerPoint presentations prepared by staff for each Fund, and the resolution recommending an investment in each of the Funds.

If you have any questions or comments prior to the meeting, please contact me at 717-720-4632.

PORTFOLIO ADVISORS, LLC

September 7, 2012

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

Re: ICG Europe Fund V, L.P.

Dear Trustees:

Intermediate Capital Group plc ("ICG" or "the Firm") is seeking to raise €2 billion (hard-cap of €2.5 billion) of limited partnership interests for ICG Europe Fund V ("ICG V" or "Fund V"). To date ICG has raised €1.1 billion for the Fund. The Firm is owned by ICG plc, a publicly listed company on the London Stock Exchange since 1994. The plc will invest €500 million in Fund V which will be partially financed with debt. Fund V will focus on structuring mezzanine investments in support of European LBOs, refinancings, and sponsorless mezzanine investment opportunities. The investments will be across the capital structure of portfolio companies in senior secured loans, subordinated debt, preferred and ordinary equity blended to achieve mezzanine-equivalent returns. ICG expects the Fund to continue ICG's flexible investment approach. Alongside senior and junior mezzanine debt, ICG will also seek to participate in equity upside as an important contributor to overall investment returns. ICG's equity investments increased from 2% to 12% to 27%, respectively in ICG Mezzanine Fund 2000, Fund 2003 and Fund 2006. The final close is expected to take place in October, 2012. The General Partner will invest €10 million in Fund V in addition to the investment made by ICG plc.

The Fund will invest in mature, mid-market European companies with enterprise values between €150 million and €1 billion. The average investment size per deal is €60 million to €80 million (maximum investment size is €200 million to €250 million). The average holding period varies from 3 to 5 years. Fund V will seek to invest in companies with leading market positions, led by strong management teams. Access to these companies will result from ICG's strong reputation as a mezzanine investor and the relationships established and maintained by ICG's network of local investment executives. ICG's main geographic focus is on France (30%), the UK (30%), Germany & Benelux (20%), Scandinavia (10%) and Italy & Spain (10%). Based on historical investment patterns, the Firm expects to invest around 20% in junior/subordinated mezzanine, 44% in senior mezzanine, 13% in sponsorless equity, 8% in sponsored equity, 11% in senior debt and 4% in other equity. Target return is a gross IRR of 14% - 20%.

The Fund will not utilize leverage until it has reached an investment level which provides a sufficient underlying assets and yield. It is expected that this will take 2 to 3 years of the investment period of the Fund. If a leverage facility becomes available, LPs will have the option of participating in the facility. The assets of the LPs that do not participate in the leverage facility will be ring-fenced. Any leverage received with respect to the levered partnership will require approval by investors representing over 50% of total commitments and may not exceed 150% of the aggregate commitments of investors that elect to be part of the leveraged partnership.

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.

- 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 Private Equity Partnership component of the portfolio.

Based on the above, Portfolio Advisors recommends that PSERS commit to up to €200 million of limited partnership interests in ICG Europe Fund V, 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,

Portfolio Advisors, LLC

High Yield Commitment

# ICG Europe Fund V

September 7, 2012

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**Joe Sheva, Portfolio Manager**

# ICG Europe Fund V

## Market Opportunity

» Expect to see increasing activity in the European LBO market which has historically driven demand for mezzanine financing

» Maturity of existing loan structures and the expiration of CLO re-investment periods create a shortage of capital due to a retrenching of European bank balance sheets and an expected drop in new CLO issuance

» Environment compelling for a non-bank lender and investor to secure attractive risk/reward opportunities

## Overview

» Fund size is €2 billion with an expected hard cap of €2.5 billion, inclusive of ICG's commitment of €500 million

» Focus will be on structuring mezzanine investments in support of European LBOs, refinancings, and sponsorless mezzanine investment opportunities

» Fund will primarily invest in European companies

## Fund Strategy

» ICG will focus on structuring mezzanine investments in support of:
  - » Mid-market European LBOs
  - » Refinancings
    - » Acquisitions of senior loans from stressed sellers
    - » Capital to strongly performing companies impeded by stressed capital structures as a result of overleveraging
    - » Targeting mid-market European companies
  - » Sponsorless Opportunities
    - » Seeking to invest in strong businesses to support management teams without taking control
    - » Providing financing solutions that incentify and offer long-term support to management
    - » ICG will gain board representation proportionate to its holding in the business
    - » ICG will secure a significant minority equity position

» ICG is targeting a gross IRR of 18% (15% net IRR) and a TVPI of 1.6x

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# ICG Europe Fund V

## Investment Team

- Fund will be managed by
  - Benoit Durteste, Managing Director, Head of European Mezzanine and Fund Manager:  joined ICG in 2002 from Swiss Re where he worked as a managing director in the Structured Finance division in London
  - Rolf Nuijens, Head of Northern Europe Investments and Fund Management:  joined ICG in 1998 from HAL Investments, a private equity firm in The Netherlands
  - Piers Millar, Head of UK Investments and Fund Manager:  joined ICG in 1998
- ICG was founded in 1989 and has a team of 27 professionals dedicated to European mezzanine and 43 investment professionals overall
- Nationalities of team members include British, Dutch, Finnish, French, German, Italian and Spanish
- ICG is headquartered in London, with principal offices in London, Paris, Frankfurt, Amsterdam, Stockholm, and Madrid

## GP “Value Add”

- ICG has an experienced, long-established team that includes 27 professional dedicated to European mezzanine and 146 total staff
- ICG has a strong, long term European track record going back to 1989 during which time they have invested €4.3 billion in 216 deals within their European funds
- ICG has built strong local relationships through its European offices which provides them strong sourcing capabilities – key driver of success in the European market

## Performance

- Since 1989, ICG has invested €4.3 billion in 216 deals within its European Funds with the following performance record:
  - 18% gross IRR achieved on 150 realized investments to date, 14% gross IRR across realized and unrealized portfolio and a net IRR of 12%
  - Gross TVPI is 1.4x and net TVPI is 1.4x (same due to leverage employed)



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# ICG Europe Fund V

## History with PSERS

- » This will be PSERS first commitment to ICG

## Board Issues

- » Placement Agents – Credit Suisse Asset Management Limited
- » PA Political Contributions – none
- » Relationship with Consultant – none
- » Introduction Source: Credit Suisse and Portfolio Advisors

## Recommendation

Staff, together with Portfolio Advisors, recommends that the Board invest an amount not to exceed €200 million plus reasonable normal investment expenses