

# High Yield Commitment



## **Cerberus PSERS Levered Loan Opportunities Fund, L.P.**

June 11, 2015

# Cerberus PSERS Levered Loan Opportunities Fund, L.P.

## Overview

- Cerberus Business Finance, LLC (“CBF”) was established in 1995 as an affiliate of Cerberus Capital Management, L.P. (the “Firm or “Cerberus”) and is the Firm’s U.S. middle market lending platform with \$5.1 billion AUM as of December 31, 2014
- PSERS to invest pro-rata with CBF active loan vehicles through a separate fund-of-one vehicle (the “Fund”)
- Focus will be on direct lending, through controlling origination and issuance of senior secured loans to established U.S. middle-market companies
- Evergreen structure with recycling of principal

## Market Opportunity

- Demand is high for middle market debt capital solutions
  - Overhang of large volume of debt maturities continues to put liquidity and refinancing pressure on companies
  - Private equity sponsors control relatively large sums of uninvested capital commitments which require debt capital to finance transactions
  - Economic recovery underway requires capital to fuel expansion
- Since the 2008 financial crisis, supply is lower for middle market debt capital solutions
  - Increased regulation affecting the ability of many institutional and other private lenders to provide financing on competitive terms
  - Several major institutional lenders have consolidated, dissolved or substantially reduced their lending activities, particularly in the middle-market
  - Limited number of lenders currently capable of providing entire credit facility solutions to middle market businesses

# **Cerberus PSERS Levered Loan Opportunities Fund, L.P.**

## **Investment Strategy**

- Target 11% to 13% net return through leading origination, management and servicing of senior secured, floating rate loans to North American middle market companies
  - Multiple transaction types: refinancings, leveraged buyouts, acquisition financing, restructurings, recapitalizations, working capital, growth capital, bridge loans and DIP loans/exit financings
- Anticipate over 85% of borrowers to be private equity sponsor-owned, with 80% to 90% directly sourced by Cerberus
- Underwrite facilities in the \$200 million to \$300 million range and hold loans in the \$25 to \$100 million size range
- The Fund will utilize third party leverage: Debt to Equity of 1:1x to 2:1x

## **Investment Team**

- Cerberus has a staff of approximately 500 persons, including approximately 150 investment professionals
  - CBF has over 50 professionals (26 dedicated investment professionals) with a full complement of compliance, accounting, and legal personnel
  - Core lending professionals have worked together for 17 years
- CBF is headquartered in New York, with additional offices in Los Angeles and Chicago

## **GP “Value Add”**

- Experienced and cohesive senior management team that has worked together since 1998; with all 26 investment professionals averaging nearly 10 years of experience at the Firm.
- Focus on capital preservation through loan asset coverage and cash flow support. CBF only invests in senior secured loans resulting in a compelling investment loss track record (~1.1% of principal)
- Through control of origination, structure, terms and syndication, CBF has the ability to earn incremental yield premiums

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## Potential Risks/Mitigants

- Risk: **Competition from other non-bank lenders**

- *Mitigant: While competition does exist in the U.S. middle market, CBF's platform is differentiated due to their scale and breadth of resources. CBF's large team and 20-year track record provides substantial value to borrowers through speed of execution and certainty of closure and has resulted in the platform generating repeat business with a majority of the over 200 sponsors. CBF's large capital base is also a key differentiator allowing it to underwrite facilities in the \$200 million to \$300 million range and hold loans in the \$25 to \$100 million size range. CBF is able to provide a full solution to the borrower, while other lenders in the senior secured space are typically only able to provide one portion of the capital structure. Lastly, CBF's ability to utilize Cerberus Operations and Advisory Company ("COAC") differentiates it from competition*

- Risk: **Use of fund-level leverage**

- *Mitigant: Since 1999, CBF has demonstrated its ability to prudently utilize leverage to enhance returns to its investors, and to date has generated a very low principal loss ratio of ~1.1%. Furthermore, CBF actively manages loss risk through: (i) the negotiation of strong covenants, (ii) high interest coverage ratios (>3x), (iii) conservative LTV of 40% to 60%, and (iv) weekly loan monitoring meetings with the CBF team*

# Cerberus PSERS Levered Loan Opportunities Fund, L.P.

## PSERS History & Performance (as of 12/31/2014)

A commitment to Cerberus VI will represent PSERS' seventh commitment to Cerberus

| <u>Fund (\$mm)</u>                                | <u>Portfolio</u> | <u>Vintage</u> | <u>Commitment</u> | <u>Contributions</u> | <u>Distributions</u> | <u>Market Value</u> | <u>Net IRR</u> | <u>MOIC</u> |
|---|------------------|----------------|-------------------|----------------------|----------------------|---------------------|----------------|-------------|
| Cerberus Institutional Partners, L.P. (Series 2)  | Private Debt     | 2001           | \$ 200.0          | \$ 173.1             | \$ 536.6             | \$ 4.2              | 27.1%          | 3.1x        |
| Cerberus Institutional Partners, L.P. (Series 3)  | Private Debt     | 2003           | 100.0             | 81.1                 | 140.7                | 21.3                | 13.2%          | 2.0x        |
| Cerberus Institutional Partners, L.P. (Series 4)  | Private Debt     | 2006           | 400.0             | 369.7                | 289.2                | 281.9               | 8.0%           | 1.5x        |
| Cerberus Institutional Partners V, L.P.           | Private Debt     | 2012           | 200.0             | 191.5                | 19.2                 | 244.3               | 24.3%          | 1.4x        |
| <b>Sub-Total (Institutional Partners)</b>         |                  |                | <b>\$ 900.0</b>   | <b>\$ 815.3</b>      | <b>\$ 984.7</b>      | <b>\$ 551.7</b>     | <b>18.0%</b>   | <b>1.9x</b> |
| Cerberus Levered Loan Opportunities Fund I, L.P.  | High Yield       | 2011           | \$ 200.0          | \$ 164.9             | \$ 138.5             | \$ 57.1             | 8.6%           | 1.2x        |
| Cerberus Levered Loan Opportunities Fund II, L.P. | High Yield       | 2012           | 225.0             | 138.6                | 11.2                 | 161.4               | 13.4%          | 1.3x        |
| <b>Sub-Total (Levered Loan Opportunities)</b>     |                  |                | <b>\$ 425.0</b>   | <b>\$ 303.5</b>      | <b>\$ 149.7</b>      | <b>\$ 218.5</b>     | <b>10.4%</b>   | <b>1.2x</b> |
| <b>Grand Total (Cerberus)</b>                     |                  |                | <b>\$ 1,325.0</b> | <b>\$ 1,118.7</b>    | <b>\$ 1,134.4</b>    | <b>\$ 770.2</b>     | <b>17.5%</b>   | <b>1.7x</b> |

# Cerberus PSERS Levered Loan Opportunities Fund, L.P.

## Board Issues

- **Pennsylvania Presence:** Borrowers with Principal Place of Business (“PPB”) in Pennsylvania

| <u>Borrower (\$mm as of 3/31/15)</u>     | <u>PPB Location</u> | <u>Onshore Fund I</u> | <u>Onshore Fund II</u> | <u>Other CBF Funds</u> | <u>Total</u>    |
|--|---------------------|-----------------------|------------------------|------------------------|-----------------|
| ALG USA Holdings, LLC ("Apple Leisure")  | Newtown Square, PA  | -                     | \$ 16.4                | \$ 39.9                | \$ 56.3         |
| TGG Medical Transitory Inc. ("Therakos") | West Chester, PA    | 15.2                  | 23.1                   | 71.6                   | 109.9           |
| Unitek Global Services, Inc ("Unitek")   | Blue Bell, PA       | -                     | 9.2                    | 13.0                   | 22.2            |
| <b>Total</b>                             |                     | <b>\$ 15.2</b>        | <b>\$ 48.6</b>         | <b>\$ 124.6</b>        | <b>\$ 188.4</b> |

- **Placement Agent:** None
- **PA Political Contributions:** None
- **Relationship with Consultant:**
  - Portfolio Advisors’ Fund of Funds have made the following commitments to Cerberus Institutional Partners Funds: PAPEF II \$6 M – Cerberus Series III; PAPEF III \$5 M – Cerberus Series III; PAPEF IV \$20 M – Cerberus Series IV
  - No commitments to Cerberus Loan Opportunities Funds

## Recommendation

- Staff, together with Portfolio Advisors, recommends that the Board commit an amount not to exceed \$300 million plus reasonable normal investment expenses
  - Initially invest \$225 million with ability to increase over time

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May 20, 2015

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

Re: Cerberus PSERS Levered Loan Opportunities Fund, L.P.

Dear Trustees:

Cerberus Capital Management (“CCM” or “Cerberus”) is seeking to create a Separate Managed Account of up to \$300 million for Cerberus PSERS Levered Loan Opportunities Fund, L.P. (the “Fund” or the “PSERS SMA”). The Fund will invest in opportunities provided through CCM’s lending platform, Cerberus Business Finance, LLC (“CBF,” or the “Platform”). CBF was formed in 1995 and as of December 31, 2014 had \$5.1 billion of assets under management. Within the mandate of the PSERS SMA, Cerberus will continue to employ the same investment strategy as other CBF funds and seek to generate returns primarily through the origination and issuance of senior secured, floating rate debt to U.S. middle market companies. Cerberus expects that 70% to 80% of the debt will be provided to companies which are being purchased or recapitalized by financial sponsors. CBF’s activities will include the origination, acquisition, management, and servicing of the loans. The General Partner of the Fund will commit 1% of the Fund’s total commitments.

CBF will typically provide single tranche secured loans (both asset and cash flow based) for working capital, acquisitions, re-financings, bridge loans, restructurings, exit financings, and debtor-in-possession (DIP) financing. The loans will likely be non-investment grade and have a floating rate supported by a base rate floor. Since the closing of Fund I, the Platform has closed on over 205 new financings, of which ~90% were sponsor-owned companies and over 85% were first lien loans. Of these financings, the unlevered asset yields have been 9%-11%. In the loan vehicles from which CBF is currently investing, 100% of the investments currently have floating rates and 96% have base rate floors. In addition to the primary focus, the PSERS SMA will opportunistically participate in purchases of third party originated debt and loans in the secondary market. Cerberus has a target exposure of 2% per company with a stated limit of 5% per deal. CBF expects to use third party leverage within the PSERS SMA in the range of 1:1 to 2:1x Limited Partner equity commitments. Cerberus believes that the average leverage level across the life of the PSERS SMA will be 1.25x to 1.5x equity. Cerberus has commitments in place for third-party leverage on the PSERS SMA that will go into effect approximately two months after the finalization of the PSERS SMA documents.

The target credit profile of an investment typically includes: (i) established operating history, (ii) at least \$75 million of annual revenues with a preference for businesses at the larger end of the middle market (average revenue of companies in the CBF portfolio since 2011 has been \$325 million), (iii) market leaders with defensible positions, (iv) predictable, stable cash flows, (v) substantial asset or enterprise value relative



to the loan size, (vi) an experienced and properly incentivized management team, and (vii) a well-capitalized and committed financial sponsor or equity owner. The Fund will be broadly diversified across industries and by transactions.

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 May 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:

Kenneth Jarvis – Managing Director, Darien Office  
Mckay Dunn – Senior Associate, Darien Office

Based on the above, Portfolio Advisors recommends that PSERS commit to up to \$300 million in Cerberus PSERS Levered Loan Opportunities Fund, 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