



State of New Jersey

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State Treasurer

March 15, 2013

MEMORANDUM TO: The State Investment Council

FROM: Timothy Walsh
Director

SUBJECT: **Proposed Investment in KPS Special Situations Fund IV, L.P.**

The New Jersey Division of Investment ("Division") is proposing an investment of \$200 million in KPS Special Situations Fund IV, L.P. This memorandum is presented to the State Investment Council (the "Council") pursuant to N.J.A.C. 17:16-69.9.

The Division is recommending this investment based on the following factors:

Opportunity to expand relationship with top quartile manager: The Division committed to KPS Special Situations Fund III, LP (\$25 million), in the spring of 2007. The fund has produced top-quartile performance, with a 1.70x multiple and a 21.7% Net IRR. KPS's previous two funds also have produced top quartile performance. KPS IV is significantly over-subscribed, however, the Division was able to secure a meaningful allocation.

Unique Fee Structure: Limited Partners investing in KPS IV were given the choice between two fee alternatives: 1.75% management fee, 25% carry (the same terms as the previous fund) or 1% management fee, 30% carry. After discussion with several advisors and reviewing several different models, the Division has chosen 1% and 30% for two reasons: (1) From a risk/reward perspective the amount of management fees saved outweighs the potential increased carry paid in even the best return scenarios; (2) Higher carry dollars further incentivize the manager to perform to the best of their ability and not to become as dependent on management fees. It should be noted that KPS believes that most LPs will be choosing the 1%/30% option which in essence means that KPS is losing a substantial amount of money in management fees but further aligning themselves with their LPs.

Experienced and Disciplined Investment Team: The Fund will be managed by the same senior team and will employ the same investment strategy as the Firm's prior funds. The Fund's investment activities will be led by Michael G. Psaros, David P. Shapiro, Raquel V. Palmer and Jay Bernstein, who lead a team of very experienced and talented professionals. There is complete stability and continuity of the KPS senior investment team: Messrs. Psaros and Shapiro, who co-founded the Firm, have worked together as a team for over 21 years, with Ms. Palmer for over 18 years, and with Mr. Bernstein for over 13 years. The KPS Partners have worked together as a team on every KPS investment and through numerous economic and business cycles.

Proven & successful value-add investment strategy: KPS acts as a catalyst for change in portfolio companies. From the creation of the turnaround plan through its execution, KPS plays a very active role with its portfolio companies on a real-time basis, acting as a crucial advisor and adjunct to its management teams. Once a portfolio company has achieved stability and profitability, KPS then works with management to grow the business, both organically and through strategic acquisitions. Finally, KPS plays a critical role in financings, recapitalizations and actively drives the exit process. KPS' focus on fundamentally improving companies have enabled them to increase the aggregate EBITDA of Fund II and Fund III/Fund IIIS portfolio companies by approximately 4.6x and 4.1x, respectively.

Unique approach to Portfolio Company Employee Relationships: KPS has worked constructively with most of the major industrial and service unions in the United States and Canada, and increasingly in Western Europe. KPS expects that many of their investments will involve meaningful participation from a company's employees in the restructuring and turnaround process. Central to this approach is the creation of participatory, communicative and empowered corporate cultures that encourage employee input and involvement in all levels of decision-making. The approach has resulted in the successful turnaround of numerous companies.

A report of the Investment Policy Committee ("IPC") summarizing the details of the proposed investment is attached.

Division Staff and its private equity consultant, Strategic Investment Solutions, undertook extensive due diligence on the proposed investment in accordance with the Division's Alternative Investment Due Diligence Procedures.

As part of its due diligence process, staff determined that the fund has not engaged a third-party solicitor (a "placement agent") in connection with New Jersey's potential investment.

We will work with representatives of the Division of Law and outside counsel to review and negotiate specific terms of the legal documents to govern the investment. In addition, the proposed investment must comply with the Council's regulation governing political contributions (N.J.A.C. 17:16-4).

Please note that the investment is authorized pursuant to Articles 69 and 90 of the Council's regulations. The KPS Special Situations Fund IV, L.P. will be considered a buy-out investment, as defined under N.J.A.C. 17:16-90.1.

A formal written due diligence report for the proposed investment was sent to each member of the IPC and a meeting of the Committee was held on March 12, 2013. In addition to the formal written due diligence report, all other information obtained by the Division on the investment was made available to the IPC.

We look forward to discussing the proposed investment at the Council's March 21, 2013 meeting.

Attachments

Fund Name: KPS Special Situations Fund IV, LP **March 21, 2013**

Contact Info: Emily Nolan, 485 Lexington Avenue, 31st Floor, New York, NY 10017

Fund Details:		<p>Key Investment Professionals:</p> <p>Michael G. Psaros, (Founder and Managing Partner) Mr. Psaros is a founder and Managing Partner of KPS and a member of its Investment Committee. His career spans 23 years with a focus on special situations investing and advising on turnaround, restructuring and bankruptcy transactions. Previously, Mr. Psaros was an investment banker with Bear, Stearns & Co., Inc.</p> <p>David P. Shapiro, (Founder and Managing Partner) Mr. Shapiro a founder and Managing Partner of KPS Capital Partners, LP and a member of its Investment Committee. He has 27 years experience and previously was an investment banker with Drexel Burnham Lambert and Dean Witter Reynolds.</p> <p>Raquel V. Palmer, (Partner) Prior to joining KPS in 1997 and Keilin & Co. in 1994, Ms. Palmer was an investment banker in the Paper and Forest products group with Kidder, Peabody & Co. and has 18 years experience.</p> <p>Jay Bernstein, (Partner) Prior to joining KPS in 1999, Mr. Bernstein was previously an investment banker in the M&A Group at Schrodgers and has 15 years experience.</p>
Firm AUM (\$bil.):	\$2.5 bil	
Strategy:	Private Equity Distressed Buyout	
Year Founded:	1997	
Headquarters:	New York, NY	
GP Commitment:	2%	

Investment Summary	Existing and Prior Funds															
<p>The Fund is being established to seek significant capital appreciation by making controlling equity investments in companies across a diverse range of manufacturing industries experiencing a period of transition or challenged by the need to effect immediate and significant change. KPS believes that superior investment returns are achieved primarily by turning around the operations of non-core, underperforming or distressed assets or businesses and not through financial engineering. The Fund will target 15-20 investments that require on average \$200 to \$250 million and up to \$450 million of capital in order to take control of and subsequently operate a company. The Fund expects to invest primarily in companies domiciled or headquartered in North America or Europe, but which may have operations located throughout the world. The Fund will be managed by the same senior team and will employ the same investment strategy as the Firm's prior funds. KPS has worked constructively with most of the major industrial and service unions in the United States and Canada.</p>	<table border="1"> <thead> <tr> <th><u>Funds</u></th> <th><u>Strategy</u></th> <th><u>Returns</u></th> </tr> </thead> <tbody> <tr> <td>Fund I (1998)</td> <td>Distressed Buyout</td> <td>14.30% Net IRR, 1.90x Gross Multiple of Max Capital Invested</td> </tr> <tr> <td>Fund II (2002)</td> <td>Distressed Buyout</td> <td>56.40% Net IRR, 4.20x Gross Multiple of Max Capital Invested</td> </tr> <tr> <td>Fund III (2007)</td> <td>Distressed Buyout</td> <td>21.70% Net IRR, 1.70x Gross Multiple of Max Capital Invested</td> </tr> <tr> <td>Fund IIIS (2009)</td> <td>Distressed Buyout</td> <td>11.6% Net IRR, 1.30x Gross Multiple of Max Capital Invested</td> </tr> </tbody> </table>	<u>Funds</u>	<u>Strategy</u>	<u>Returns</u>	Fund I (1998)	Distressed Buyout	14.30% Net IRR, 1.90x Gross Multiple of Max Capital Invested	Fund II (2002)	Distressed Buyout	56.40% Net IRR, 4.20x Gross Multiple of Max Capital Invested	Fund III (2007)	Distressed Buyout	21.70% Net IRR, 1.70x Gross Multiple of Max Capital Invested	Fund IIIS (2009)	Distressed Buyout	11.6% Net IRR, 1.30x Gross Multiple of Max Capital Invested
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Vehicle Information:

Inception:	2013	Auditor:	Ernst & Young, LLP
Fund Size (\$mil.):	\$3.0 billion	Legal Counsel:	Paul, Weiss, Rifkind, Wharton & Garrison LLP
Management Fee:	1.00%		
Carry:	30%		
Hurdle Rate:	8%		
Additional Expenses:	100% monitoring fee offset (50% of net transaction fees)		

NJ AIP Program

Recommended Allocation (\$mil):	\$200,000,000.00	LP Advisory Board Membership:	Yes
% of Fund:	6.70%	Consultant Recommendation:	Yes
		Placement Agent:	None
		Compliance w/ Division Placement Agent Policy:	N/A
		Compliance w/ SIC Political Contribution Reg:	Yes

*This review memorandum was prepared in accordance with the State Investment Council rules governing the Alternatives Investment Program and the policies and procedures related thereto.