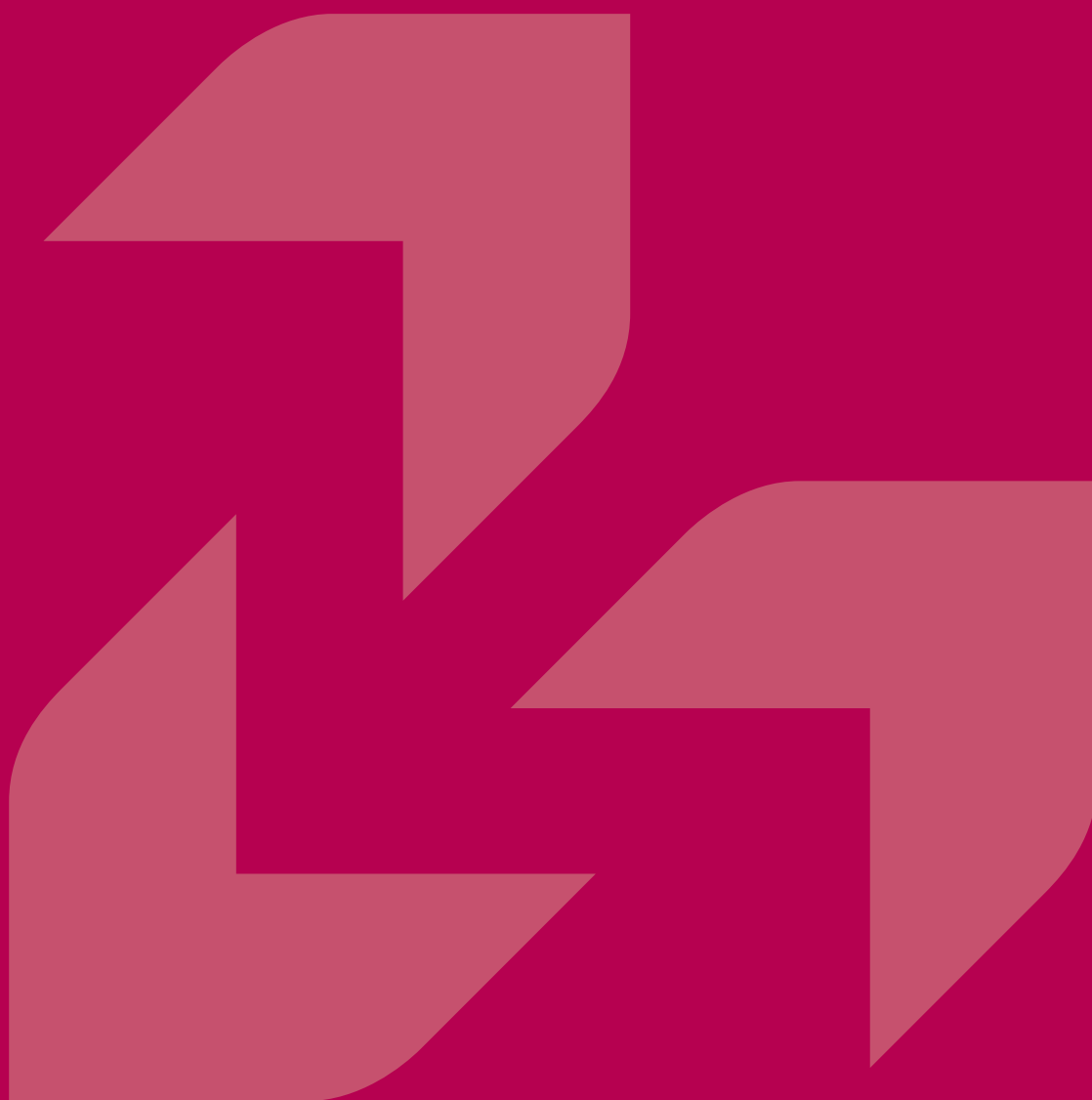


AUSTRALIAN

RESEARCH

PROPERTY INVESTMENT RESEARCH



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Note: This report is based on the Abacus Diversified Income Fund II PDS, dated **24 December 2009**, together with other information provided by Abacus Funds Management Ltd as at January/February 2010. The rating assigned to this report is on the "Offer".

Unlisted Property – Retail Offer

Abacus Diversified Income Fund II

An income and capital property investment supported by ADIF II and underwritten by Abacus Property Group
Offer Overview



Product Summary

Abacus Diversified Income Fund II (*ADIF II* or the *Fund*) is offering existing and new investors to participate in an income and capital property investment (the *Offer*) with underwritten returns. The underwriter is Abacus Property Group (*ABP*), an ASX-listed A-REIT with a market capitalisation of approximately A\$690M. The Responsible Entity (*RE* or *Manager*) is Abacus Funds Management Limited (*AFML*), a wholly owned subsidiary of ABP.

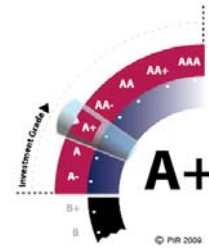
The offer is priced at A\$0.75 per unit, which represents a substantial premium to the Fund's PIR-adjusted net asset value (*NAV*) of A\$0.51 per unit. Of the A\$0.75 required, A\$0.51 is backed by underlying property assets, with the remaining A\$0.24 representing the ABP underwriting risk. Of the A\$0.24, A\$0.13 represents ABP debt, which is lower ranking than unitholders' equity and could be viewed as value in addition to the asset-backed A\$0.51 (A\$0.64). The underlying NAV (A\$0.51) is the required starting point to enable the Fund to deliver what it is designed to do with minimal (ideally zero) support from ABP, that is, return new investors their original A\$0.75. Furthermore, investors have the potential to benefit from capital growth at maturity, although this is dependent on prevailing asset values at that point in time. New investors will receive a fully underwritten (by ABP) distribution yield of 8% in FY10 and thereafter distributions will grow in line with CPI until maturity.

ABP has a significant equity interest in the Fund, which is currently held up in an interim funding facility. The Offer allows ABP to extract cash to reinvest in the business at the head-stock level. Moreover, it enables ABP to increase the value of its exposure by crystallising future underwriting risk value today in return for providing underwriting benefits to the Fund over its term. PIR views the Fund strategy as structurally sound. However, the Fund is expected to encounter headwinds in the interim with respect to property income risk, interest coverage risk and loan-to-valuation ratio (*LVR*) management risk. PIR has stress-tested these risks and believes that ABP's current capital position is sound enough to provide funding to the Fund, if required. Ultimately, investors must be comfortable with the notion that ABP's capital position will be prudently managed over the life of the Fund. This would include a material ongoing liquidity buffer, should ADIF II require it.

Major Considerations

-  This is not a typical equity investment. Investors should be of the understanding that the income profile of the Fund is bond-like in nature with equity-like capital upside characteristics. However, PIR views the likelihood of capital upside to be minimal. Therefore, this product should be viewed more as a fixed-interest security.
-  In PIR's view, the underwritten distribution returns (yield) exhibit an acceptable risk/return trade-off, considering the underwriter has unrated debt.

Investment Rating



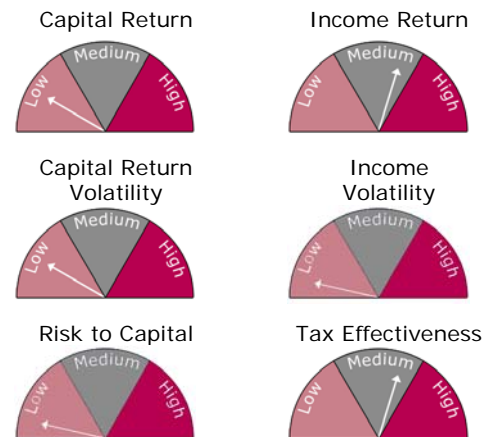
Refer to Appendix for a description of our rating

Offer Details

Offer Opened	24 December 2009
Offer Closes	n/a
Maturity	30 June 2016
Min. Investment ¹ (existing/new investor)	A\$5,000
Liquidity ²	Illiquid
Distributions	Quarterly
Initial NTA ³	A\$0.51

- ¹ Can invest in multiples of A\$1,000 above the minimum investment of A\$5,000.
- ² Investors should view this investment as illiquid over the life of the Fund. Special hardship cases will be acknowledged. Please refer to Section 2.9 in the PDS.
- ³ Initial NAV in the PDS is A\$0.47; however, PIR-adjusted NAV nets out the carrying value of derivatives on the balance sheet.

Risk/Return Profile



Fees (paid to advisors), incl. GST, %

Capital raising fees paid to advisors will be payable by ABP, not the Fund.

The investment opinion in this report is current as at the date of publication. Investors and advisers should be aware that over time the circumstances of the issuer and/or product may change which may affect our investment opinion.

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SWOT Summary

Strengths

- Competitive underwritten income return of 8% per annum, growing in line with inflation until Fund maturity.
- Underwritten return of capital.
- PIR's stress-testing indicates underwriter's cash funding headroom is deep to support distributions over the life of the Fund.
- ABP has structured its loans to the Fund such that if the underlying NAV is not sufficient to return capital, lower-ranking ABP debt has the capacity to mitigate the likelihood of a significant cash call on the underwriter.
- Generous concessions on fees charged to the Fund.
- Strength of the underwriter's current balance sheet position, currently geared at near sector lows of 23%.

Weaknesses

- Reliant on ABP to prudently manage sufficient liquidity buffer, should ADIF II require it. This reliance will be over the life of the Fund, 6.5 years.
- The way the product is structured, part of new investors' capital upside will be used to subsidise existing investors' return of capital, therefore, eroding new investors' capital upside potential.
- The Fund supporting distributions is expected to be cashflow negative over the first three years, before becoming cashflow positive in later years.

Opportunities

- Potential for capital upside. In particular, the first 10% of excess capital to be realised ranks ahead of ABP's deferred management fee.

Threats

- Close proximity to financial covenants. This could require the underwriter's support early in the Fund term, thus affecting underlying NAV. This could put more pressure on a potential NAV shortfall at Fund maturity.
- Upcoming refinancing required on one of the major debt facilities. Proximity to covenants could dictate the severity of terms on a facility rollover, adversely affecting the Fund's ability to perform.
- Timing of upcoming refinancing for the Fund coincides with the refinancing of ABP's major debt facility.
- Underlying asset class is higher-risk than institutional-grade property, from both an income and a capital perspective. However, it is an asset class that ABP specialises in and is in line with ABP's core competency.
- ABP's balance sheet and liquidity could be impacted if it experiences impairments in its high risk exposures, and therefore its capacity as underwriter to the Fund.

Key Qualitative Criteria

Management

Track record	★★★★☆
Investment process and philosophy	★★★★☆
Corporate Governance	★★★★☆

Product

Structure	★★★★☆
Fees	★★★★☆
Exit mechanism	★★☆☆☆
Leverage/ Capital structure	★★★★☆

Portfolio

Property Grade/ Asset quality	★★☆☆☆
Property diversification	★★★★☆
Tenancy profile	★★☆☆☆
Weighted average lease expiry profile	★★★★☆

Investment Profile

Number of properties	25
Property locations	Australia wide
Property sector	Diversified
Gearing (including the Abacus Loan Facility)	60%
Gearing (excluding the Abacus Loan Facility)	52%

Financial Forecasts*

IRR ¹ (pre-tax,%) ¹	9.2%
IRR ² (post-tax,%) ²	6.6%
Min. Investment period	6.5 years
Tax advantage ³	60%
Yield on new units	8.0% + CPI
Yield on Fund Term (2.7% CAGR)	9.2%

¹ Assumes distributions are paid quarterly over a 6.5-year term. No capital upside incorporated.

² Assumes a tax rate of 45%.

³ Average forecast tax deferred over the Fund term.

Issue Price Backing

Price of Issue per unit	A\$0.75
Asset Backing (PIR Adjusted)	A\$0.51
Value of ALF to ADIF II investors	A\$0.13
ABP underwriting risk	A\$0.11
Total	A\$0.75

2. Product Summary

Executive Summary

Investment Objective

The Fund is designed to attract new investors with an underwritten income return of 8.0%, growing annually thereafter at a rate that is indexed each year with inflation (CPI growth). Upon Fund maturity in June 2016 (6.5-year term), Abacus Property Group (ABP) will underwrite the return of new investors' original capital with the potential for capital upside.

New investors are being asked to purchase units at A\$0.75 each, which represents a substantial premium to the Fund's PIR-adjusted NAV of A\$0.51 per unit.

Of the A\$0.75 required, A\$0.51 is backed by underlying property assets, with the remaining A\$0.24 representing ABP underwriting risk. Of the A\$0.24, A\$0.13 represents ABP debt, which is lower ranking than unitholders' equity and could be viewed as value in addition to the asset-backed A\$0.51 (A\$0.64). For table representation, please see *Issue Price Backing* on Page 4.

The underlying NAV (A\$0.51) is the required starting point to enable the Fund to deliver what it is designed to do with minimal (ideally zero) support from ABP, that is, return new investors their original A\$0.75.

Fund Structure

The Fund is structured such that the underwriter's net contribution at Fund maturity is zero. However, should the Fund underperform relative to its forecasts for any reason, it is ABP's capital that is at risk. This is not to say investors have no risk to capital, but before investors are faced with the prospect of capital (or income) loss, ABP would likely have to be deemed insolvent.

This is a key distinction that separates this product from a traditional property equity investment. Therefore, the way in which investors are required to provide capital and receive indexed fixed income returns, with capital returned upon maturity, is bond-like in nature. That said, units in ADIF II rank behind senior debt (bank lenders) and income, and capital risk is laid off to the underwriter. Like traditional equity, unitholders participate in capital upside.

PIR therefore considers the product best described as an underwritten equity investment with inflation-linked yield. Investment in this product should be considered somewhere in between debt and equity, or more commonly referred to as a hybrid investment.

Legal Structure

Wrapper:	Unit trust
Responsible Entity:	Abacus Funds Management Ltd
Custodian:	Perpetual Trustees
Offer Document:	The PDS in use notice, dated 24 December 2009, has been lodged with the Australian Securities and Investment Commission (ASIC).

Investment Exit Provisions

We note that the Manager has suspended the withdrawal facility for the foreseeable future. An investment in this fund should be considered illiquid and new investors must expect to stay fully invested for the life of the Fund. There is a new limited liquidity facility where ABP will acquire units in case of investor hardship at ABP's absolute discretion. For more information, please see Section 9.7 of the PDS.

Background of the Fund

ADIF II was launched in July 2007 with a portfolio of 19 property assets and an allocation to indirect property investments (listed and unlisted). ABP originally held all interests in the Fund via an equity bridge, called the Abacus Working Capital Facility (AWCF), with the intention of selling down all or most of the units to repay the AWCF. The facility sold down around A\$36M worth of units to external equity investors, leaving approximately A\$90M worth of unsold equity.

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Between June 2009 and December 2009, ADIF II underwent a structural change in which a combination of asset acquisitions and disposals took place. These transactions were to improve key metrics required to gain refinancing of one of the two major debt facilities in the Fund. Most notably, ABP has written down the value of its interim funding through AWCF by A\$15.9M, which is non-recoverable. This, combined with recent property transactions, has helped boost NAV to a level that has allowed Abacus to restructure ADIF II into its current form.

The Fund now holds 25 property assets and has liquidated the majority of its indirect assets. Furthermore, ADIF II, under the new PDS, now offers an underwritten income and capital component.

Gross assets of the Fund are approximately A\$190M with a weighted average cap rate of around 9.0%. Independent revaluations have taken place on around 34% of the portfolio as at June 2009, with 59% being revalued in October 2009. The remaining 7% of indirect assets were valued in December 2009. The portfolio is currently 95% occupied and exhibits a weighted average lease expiry (*WALE*) profile, by income, of four years.

Unitholder Structure

Each unitholder's interest in the Fund will be by way of one of the following three classes of unlisted units:

- Class A (existing units): Class A units are those that were issued under the original PDS in July 2007. Class A units offer an underwritten 8.5% per annum income return until 30 June 2011 and thereafter on the basis of free cashflow of the Fund. A full return of capital of A\$1.00 will be offered on 30 September 2013. We note it is at ABP's discretion whether Class A unitholders receive cash or ABP scrip at that time. Class A units are *not* being offered as part of this PDS. However, Class A unitholders are able to convert their holdings into Class B units;
- Class B (converted Class A units): Class B units will be entitled to an underwritten distribution of 8.5% per annum until 30 June 2011 and thereafter 8% + CPI until Fund maturity at 30 June 2016. Unitholders will receive the minimum of their full originally invested A\$1.00 at this time. There also exists the potential for capital upside; and
- Class C (new units issued under this offering): Class C units will be issued at A\$0.75 per unit and will return an underwritten yield of 8% per annum, increasing annually in line with CPI increases over the term of the Fund. At Fund maturity, Class C unitholders will, at a minimum, receive the underwritten A\$0.75 per unit originally invested. There is the potential for further capital upside, although this is contingent on asset values at maturity. We discuss this in more detail later in the report.

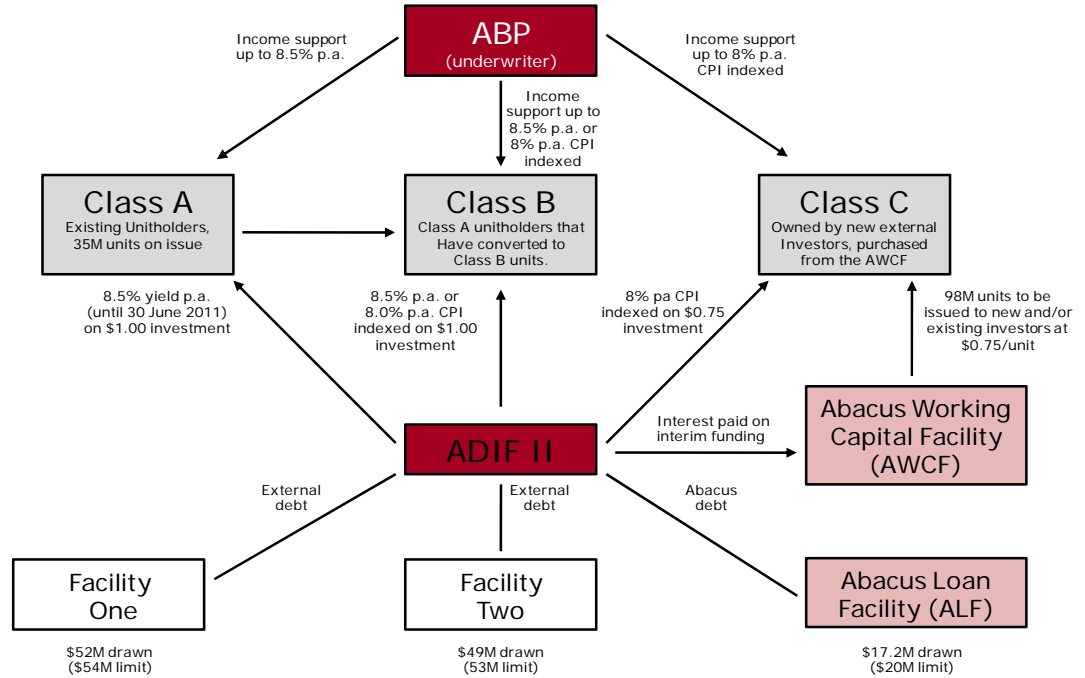
Both class B and C unitholders will have discretion over the method of payment they wish for any underwritten capital shortfall. This could be cash, ABP scrip or a combination of both.

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Capital Structure

We summarise the capital structure in Figure 1 below.

Figure 1. Capital Structure



Source: PIR

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Fees

The RE, the Manager, the Custodian and other parties are entitled to fees for services provided to the Fund. These fees are included in our financial forecasts. Although fee structures vary by product, trust and fund, we categorise fees into groups, making it easier to draw comparisons across products.

Equity raising cost	Any capital raising fees paid to financial planners or brokers will be payable from ABP, not the Fund.
Ongoing management fees	The Manager is entitled to a base management fee of 0.70% of the gross asset value of the Fund, but will defer the payment of this fee until the end of the Fund term. Therefore, the Manager is not entitled to start recouping its deferred fee until unitholders have received 110% of their original capital investment (NAV of A\$0.90). For the Manager to recoup its entire fee, PIR forecasts a required NAV of A\$0.98.
Performance fee	The Manager has agreed to waive its entitlement to a performance fee under any circumstances.
Other fees	<p>General expenses for the ongoing costs of running the Fund are estimated to be 0.37% per annum of the gross assets of the Fund. This includes custodian costs, but does not include the base management fee, which is deferred until Fund maturity.</p> <p>An asset acquisition fee of 2% of the acquisition value of an asset purchased, paid within three business days of completion of the acquisition. PIR notes that acquisition fees that are normally applicable have been waived for the acquisitions made between FY09 balance date and December 2009.</p> <p>ABP will charge for property management, leasing and development services provided to the Fund. PIR has determined fees charged for these services are in line with market (Section 5.3.1 in PDS).</p> <p>Fees waived include establishment fee, contribution fee, withdrawal fee (other than sell spread) and termination fee.</p> <p>Please refer to Section 5 in the PDS for a more detailed description of the fee structure.</p>

Tax

Disclaimer	Tax consequences depend on individual circumstances. Investors must seek their own taxation advice. The following comments show PIR's expectation of tax for ordinary Australian taxpayers, but cannot be considered tax advice.
CGT	Capital gains tax (CGT) is likely to apply upon sale of the units in the Fund. Individual investors will likely be eligible for the 50% CGT discount upon sale of Fund units, if held for more than 12 months.
Distributions	Distributions will be treated as income in the year received. The Manager expects distributions to 30 June 2011 will be 100% tax deferred. It is expected the tax-deferred rate will then deplete for the remaining term of the Fund, for a total average level of 60%.

Risks

Counterparty risk	The offer is underwritten by Abacus Property Group. ABP has a contractual obligation to support the Fund by any means it has at its disposal. The only way it would not be able to perform this would be insolvency.
Investor recourse	No investor recourse exists in the Fund's structure.
Events of default	The Fund is currently close to LVR covenants and, to a lesser extent, interest coverage ratio (ICR) covenants. Events of default may require funding support from ABP. Therefore, default risk could be considered counterparty risk. Risks that could trigger covenant breaches would be risk to property income and property devaluation risks.
Worst-case scenario	<p>In our view, a worst-case scenario would be a non-refinancing of a major facility due on 2 December 2010. This would require either a capital injection from ABP (around \$50M) or asset sales, or a combination of both.</p> <p>For a more detailed list of the key risks, refer to the <i>Risks</i> section (Section 8) of the PDS.</p>

3. Investment Analytics

Underlying Unitholder Value

The value of each class of security is determined by the NAV of the Fund. A change in the Fund NAV will depend predominantly on independent valuations of the underlying property assets.

For the Fund to return all capital to unitholders without any capital support from the underwriter (ABP), the Fund's NAV will have to increase from a current PIR-adjusted level of A\$0.51 per unit to A\$0.82 per unit by Fund maturity in June 2016. The unit price of A\$0.82 represents the weighted-average NAV required to return all outstanding capital to investors (both existing and new). That is, A\$1.00 to existing and A\$0.75 to new investors.

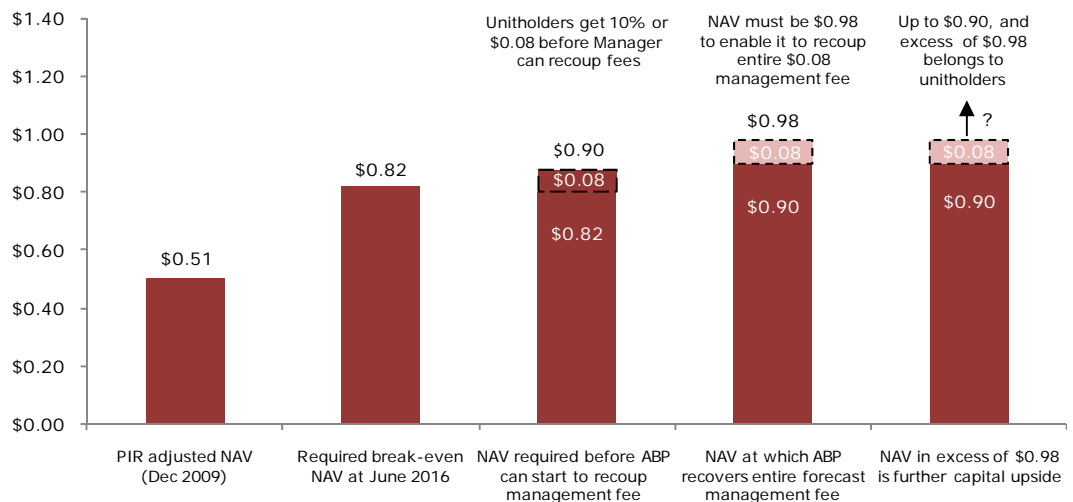
PIR notes, however, that new investors under the offer are effectively subsidising part of existing unitholders' return of capital at the expense of their own capital growth. At an underlying NAV of A\$0.75, new unitholders have recouped their original investment. However, to enable existing unitholders to receive their original A\$1.00 back, underlying NAV needs to reach A\$0.82, thus new unitholders have foregone the first A\$0.07 of capital upside.

For full details of NAV sensitivity, please see *NAV* and *Cash Call Sensitivity* below.

Capital Upside

As part of this offer, ABP is deferring its base management fee to be paid only if the unit price at maturity is in excess of 110% of the break-even NAV of A\$0.82. Therefore, any gains between A\$0.82 and A\$0.90 are paid to unitholders. The deferred management fee represents approximately A\$0.08 per unit, and, therefore, any capital gain in excess of around A\$0.98 per unit also belongs to unitholders. PIR notes the capital upside structure in Figure 2 below applies to class A and class B unitholders. For Class A unitholders (other than units held by ABP), capital upside would only exist if at 30 June 2013, the NTA value was in excess of \$1.00.

Figure 2. Capital Upside Breakdown



Source: PIR

Abacus' Exposure to ADIF II

ABP has a significant exposure to ADIF II. In addition to the A\$73.5M it is owed through AWCF, which it wishes to sell down, it also holds around 20% of existing units on issue (worth A\$7.2M). We note that whatever proportion of existing unitholders (or Class A unitholders) converts to Class B units, ABP will convert the same proportion of its Class A unit holdings.

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Abacus Loan Facility (ALF): Further exposure exists through this facility that was created to fund the transactions that took place between June 2009 and December 2009. The facility is currently drawn to approximately A\$17M, with a facility limit of up to A\$20M. Interest on the facility is charged at 10% per annum and is expected to be capitalised until Fund maturity. The facility expires on 30 June 2018.

The loan is only repayable if

- Investors achieve a full return of capital on liquidation or sale of the Fund, without any assistance from ABP or
- Unitholders elect to replace the RE (Manager) or wind up the Fund.

If at Fund maturity the NAV of the Fund is less than A\$0.82, the outstanding principal amount due on the facility will be forgiven by ABP to the extent that NAV remains below A\$0.82. The ALF principal at Fund maturity will be at least A\$17M (A\$0.13). Therefore, if NAV at Fund maturity was as low as A\$0.69, then ABP would have to forgive the entire principal amount outstanding on the ALF to boost the NAV back up to A\$0.82 per unit. As such, PIR believes ALF has the lowest ranking in the Fund's proposed capital structure.

Abacus Working Capital Facility (AWCF): ABP's interim funding to ADIF II through AWCF stands at A\$73.5M, or 98M units at A\$0.75 per unit. Until all units are sold down to repay the funding, AWCF is entitled to receive interest payments at the lower of

- The distribution rate that applies to Class C units or
- A rate equivalent to the bank bill swap bid rate (*BBSY*) plus a margin of 7%.

The facility has a limit of A\$100M and expires on 30 June 2018.

The facility will also be used to fulfill capital expenditure requirements for the life of the Fund. Assuming all units are sold down within the first 12 months of this offer (by 30 December 2010), it is anticipated AWCF will be drawn to around A\$8.8M (for capex) at Fund maturity.

If there is a shortfall in required distributions to external unitholders, any interest payments on AWCF will be deferred to the extent that ABP meets its obligations to external investors. If however ABP successfully sells 100% of units, then any shortfall in distributable income required will have to be sourced from ABP in cash.

Alignment of Interest with Manager

ABP's incentive to underwrite the Fund

ABP has a vested interest in ADIF II, delivering on its stated objectives as a substantial investor in the Fund and in its capacity as the RE. Moreover, as ABP is the underwriter, its management needs to focus on prudent capital and asset management at the Fund level to minimise cash top-ups to support investor returns.

This is also about preserving the value of ABP's economic interest in AWCF. If the Fund was not restructured to offer units at A\$0.75, which is a ~60% premium to NAV, ABP's holdings would be worth considerably less. There would be little interest in the investor market to purchase units without the underwriting agreement, and to sell them, they would have to be offered at a discount to NAV. PIR estimates units in the Fund without the restructure would be worth around A\$0.51 per unit. Therefore, by taking on underwriting risk, ABP is able to increase the value of its holdings and the attractiveness of the Offer.

ABP has already written off A\$15.9M (from Abacus Funds Management division of ABP) resulting from its exposure to ADIF II. Therefore, given income and capital from this offer is underwritten, there lies a significant incentive to mitigate further potential loss through solid management of the Fund.

Equally important is the need for ABP to free up capital tied up in ADIF II to reinvest at the head-stock level. In particular, we are at the stage in the asset cycle (cap rate) where accretive acquisition and redevelopment potential is crucial to drive earnings growth for ABP. Freeing up capital from ADIF II will be a meaningful contributor to capital reinvestment for ABP, going forward.

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Cash top-up required from ABP to support distribution payments

ABP's dollar-value exposure to the Fund does not change throughout the life of the Fund. This is because whatever units are sold to repay AWCF, it will always carry capital underwriting risk to the same value. Therefore, PIR views ABP's capital at risk from AWCF to be A\$73.5M, irrespective of whether AWCF is repaid or not from units sold.

In PIR's view, the worst-case scenario for the Fund in a cashflow sense is if the entire AWCF is repaid through the issue of new units. This is because ABP will not have the option to defer interest payments on AWCF. In addition, lower property income from the Fund's assets may cause a funding shortfall for paying distributions that may be required to be topped up by ABP. However, if the Offer is fully subscribed, ABP will have recovered cash proceeds of A\$73.5M, which strengthens its own balance sheet if it is required to meet underwriting commitments.

We have, however, constructed a property income sensitivity that illustrates the cash requirements (distribution shortfall) from ABP for varying income growth scenarios until maturity.

As Figure 3 shows, even if the Fund experienced a 1.1% decline in property income over its term, it would still result in a fairly smooth cash call on ABP. As the figure shows, the maximum top-up amount in any given year that may be required from ABP is less than A\$3.5M.

Assuming 98M units are sold to repay the AWCF (thereby raising A\$73.5M), we believe ABP would have adequate sources of funding to meet any distribution shortfall.

PIR also notes that it has relied on the rent growth and leasing assumptions used by independent valuers to determine the value of the Fund's assets.

For more information on ABP's balance sheet capacity, please see Section 4, *Leverage*.

Figure 3. Property Income to "Ongoing Cash Drag" Sensitivity (A\$M)

Market rent Growth CAGR	Cash required each year							Total income surplus/ deficit (A\$M)
	FY10	FY11	FY12	FY13	FY14	FY15	FY16	
8.4%	-3.3	-1.8	0.2	3.1	5.6	7.6	9.8	21.1
5.6%	-3.3	-2.1	-0.6	1.6	3.3	4.4	5.6	8.9
4.6%	-3.3	-2.2	-1.0	0.9	2.4	3.1	3.9	3.8
3.7%	-3.3	-2.3	-1.2	0.6	1.9	2.5	3.1	1.3
2.7%	-3.3	-2.4	-1.4	0.1	1.2	1.6	1.9	-2.3
1.8%	-3.3	-2.5	-1.7	-0.3	0.6	0.7	0.8	-5.8
-1.1%	-3.3	-2.8	-2.5	-1.7	-1.4	-1.8	-2.3	-15.8

Source: PIR

Debt forgiveness to boost NAV is key to a workable starting NAV

Since ADIF II's reported FY09 result, there have been a number of balance sheet movements that explain the current NAV of A\$0.47 per unit or PIR's adjusted NAV of A\$0.51 (excluding the interest rate swap carrying value, which nets out to \$0 value at maturity).

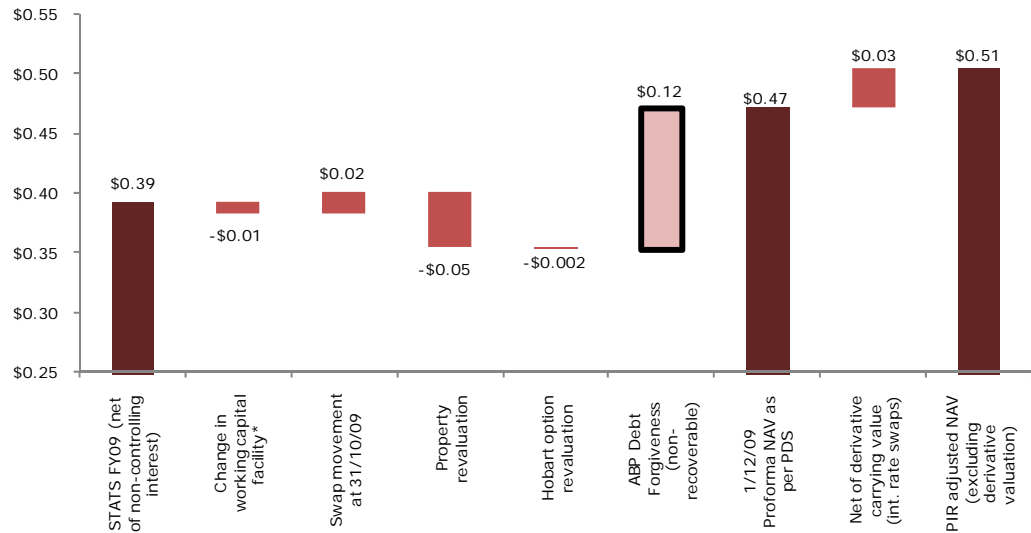
The main contributor to the net increase in NAV is the amount of debt forgiveness ABP has granted to the Fund. On PIR's adjusted NAV of A\$0.51 per unit, the debt forgiveness represents A\$0.12 (24%) per unit. We believe this to be a significant commitment by ABP, representing its serious intentions to ensure the Fund strategy is robust. Furthermore, it is our understanding that a write-down of this magnitude was required to enable a capital return over a reasonable time-frame for investors.

PIR reiterates this amount cannot be recovered under any circumstances and was featured in ABP's FY09 result as an asset impairment of A\$11M. ABP's 1H10 result revealed the remaining \$4.9M ADIF II writedown (\$15.9M in total).

Property devaluations (-A\$0.05 per unit) have eroded the benefits of debt forgiveness somewhat. However, other balance sheet movements have resulted in a net increase in NAV from A\$0.39 to A\$0.47 (A\$0.51 PIR adjusted).

For a breakdown of the components within the change in AWCF (-\$0.01 per unit or -\$0.96M), please refer to the PDS Section 6.4, notes to balance sheet, note 9. This includes the indirect disposals and property acquisitions undertaken by the Fund.

Figure 4. Debt Forgiveness in Perspective



Source: PIR

NAV and Cash Call Sensitivity at Fund Maturity

As the underlying assets in the Fund theoretically grow over time (via income growth), there are a few key drivers that will determine the final NAV upon Fund maturity—most notably, the terminal cap rate and the growth in market rents. The deferred management fee also creates a unique capital return profile.

Since the issue of the PDS (24 December 2009), ADIF II has successfully assumed 100% control of the Abacus Hobart Growth Trust (*AHGT* or the *Trust*). The Fund previously held a 79% interest in the Trust, and as at 4 February, minority unitholders voted in favour of ADIF II buying out their interest in the Trust. In acquiring the minority unitholders' interest, ADIF II's deferred tax position will be reduced significantly. The net result of the transaction will be an increase in the Fund's NAV by A\$0.03 per unit.

PIR has undertaken NAV sensitivity analysis using the terminal cap rate and income growth profile over the life of the Fund as variables. Additionally, where NAVs have been in excess of A\$0.90 (110% of A\$0.82 capital return break-even), we have netted out deferred management fees payable to ABP. We have also incorporated the NAV accretion resulting from the AHGT acquisition.

Finally, we have analysed the expected cash call on ABP resulting from a NAV shortfall at Fund maturity. We have incorporated the buffer provided by the Abacus Loan Facility (ALF), which is forecast to be around A\$17M principal (A\$0.13 per unit). As mentioned in Section 3, the loan is repayable only if investors achieve a full return of capital on liquidation or sale of the Fund, without any assistance from ABP.

We expect ALF to have a capitalised interest component of around A\$0.13 per unit at Fund maturity. PIR has included this amount as an additional source of funding should the NAV shortfall be in excess of the principal loan buffer. The key distinction is the capitalised component ranks higher than the principal amount. Therefore, if ABP were deemed insolvent at Fund maturity, the Fund would retain the benefit of the principal amount outstanding whilst the capitalised interest would belong to ABP creditors. Our inclusion of this amount accounts as a source of funding only and assumes ABP will be operating as a going concern at Fund maturity.

Figure 5 shows that for considerable cash calls to be required from ABP at maturity, cap rates would need to expand considerably from current levels and/or long-term market rents would need to be materially below current market forecasts. We note that market practice amongst valuers for market rent forecasts is around a 3.5%-4.0% CAGR.

We therefore consider an appropriate conservative NAV outcome would be around 9.0% cap rate and a modest income growth of 2.7%-3.7% until maturity. Although underlying NAV is below the break-even NAV benchmark of A\$0.82, no cash will be required from ABP as losses will be absorbed by the ALF buffer.

PIR views the likelihood of the Fund generating capital growth to be highly dependent on its ability to source and execute value-add opportunities, as well as the overall cap rate environment at Fund maturity. Given the grade of the underlying assets, we view non-asset specific cap rate compression to be limited to a "once in a cycle" probability. As such, capital upside prospects for unitholders should be viewed as *opportunistic*.

Figure 5. NAV and Cash Call Sensitivity

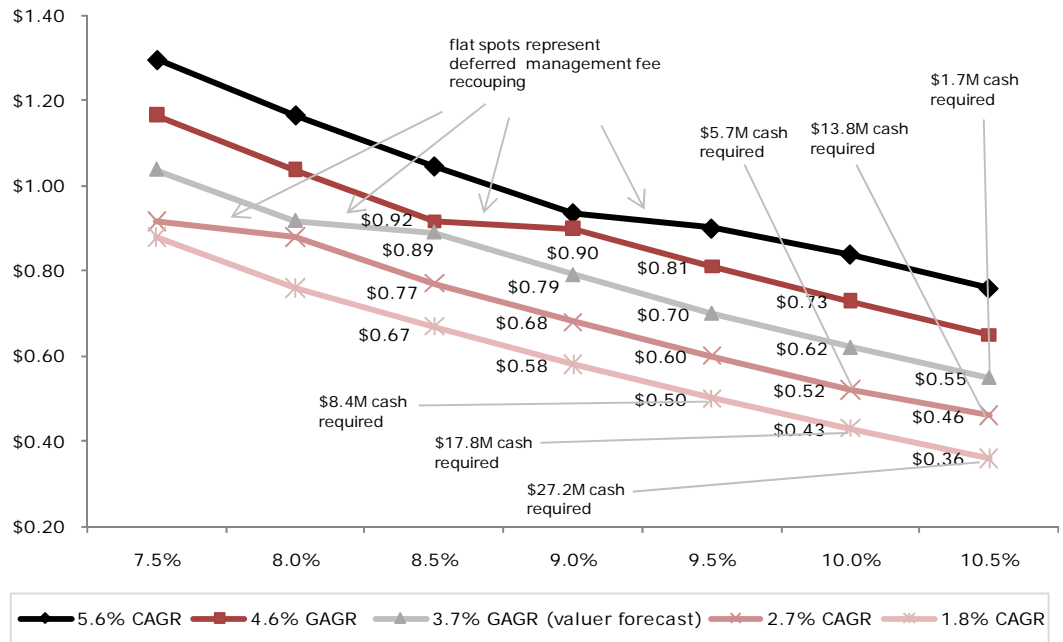
Change from current Cap Rate	-1.50%	-1.00%	-0.50%	0.00%	0.50%	1.00%	1.50%
Cap Rate	7.50%	8.00%	8.50%	9.00%	9.50%	10.00%	10.50%
5.6% CAGR (+200bps)							
NAV after mgnt fee	\$1.30	\$1.17	\$1.05	\$0.94	\$0.90	\$0.84	\$0.76
Capital return	\$1.30	\$1.17	\$1.05	\$0.94	\$0.90	\$0.84	\$0.82
Actual cash call in excess of ALF total buffer (\$M)	-	-	-	-	-	-	-
4.6% CAGR (+100bps)							
NAV after mgnt fee	\$1.25	\$1.12	\$1.00	\$0.90	\$0.81	\$0.73	\$0.65
Capital return	\$1.17	\$1.04	\$0.92	\$0.90	\$0.82	\$0.82	\$0.82
Actual cash call in excess of ALF total buffer (\$M)	-	-	-	-	-	-	-
3.7% CAGR (= valuer forecast)							
NAV after mgnt fee	\$1.12	\$1.00	\$0.89	\$0.79	\$0.70	\$0.62	\$0.55
Capital return	\$1.04	\$0.92	\$0.89	\$0.82	\$0.82	\$0.82	\$0.82
Actual cash call in excess of ALF total buffer (\$M)	-	-	-	-	-	-	1.71
2.7% CAGR (-100bps)							
NAV after mgnt fee	\$1.00	\$0.88	\$0.77	\$0.68	\$0.60	\$0.52	\$0.46
Capital return	\$0.92	\$0.88	\$0.82	\$0.82	\$0.82	\$0.82	\$0.82
Actual cash call in excess of ALF total buffer (\$M)	-	-	-	-	-	5.73	13.76
1.8% CAGR (-200bps)							
NAV after mgnt fee	\$0.88	\$0.76	\$0.67	\$0.58	\$0.50	\$0.43	\$0.36
Capital return	\$0.88	\$0.82	\$0.82	\$0.82	\$0.82	\$0.82	\$0.82
Actual cash call in excess of ALF total buffer (\$M)	-	-	-	-	8.41	17.78	27.16

Source: PIR

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Figure 6 shows the sensitivities in a graphical presentation. This gives investors a better idea of how the deferred management fee erodes upside potential.

Figure 6. Potential Cash Calls On Extreme Scenarios



Source: PIR

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4. Leverage

The Fund has two facilities as summarised below.

Figure 7. Debt Facility Summary

	Facility Limit (A\$M)	Drawn Amount (A\$M)	ICR (FY09)	ICR Covenant	Pro Forma LVR	LVR Covenant	Expiry Date
Facility 1	54.0	51.9	1.8	1.5	52.4%	57.5%	Aug-12
Facility 2	52.8	49.3	1.9	1.5	63.5%	65.0%	Dec-10
Total/Avg	106.8	101.2	1.7	1.5			

Source: ABP/PIR

ICR

Both facilities exhibit quite thin ICRs and suggest little headroom is available relative to LVR covenants. For more information on specific covenant details, please see Section 2.5 in the PDS under "Facility Covenants".

Going forward, the Fund expects to significantly improve the headroom on both facilities. The Fund expects significant income accretion when it exercises options to purchase two properties, one in August 2010 and the other in 2013. The two properties are part of the Fund's ownership of AGHT. The options allow the Fund to purchase the properties for A\$1 each, resulting from AGHT having already paid consideration for the options in prior years.

Margins/Interest Rate Swaps

The extra income from the new properties more than offsets the effects of higher interest margin when Facility 2 expires. The current weighted-average interest margin cost on Facility 2 is approximately 71bps, and management has forecast a margin of 286bps when the facility rollover is due.

The average swapped (hedged) base interest rate of the Fund is 6.54%. The swap book is staggered with a WALE of 2.61 years.

Options to Deal with Potential LVR Breaches

Facility 1 was recently renegotiated and, in line with current bank lender practices, LVRs are being required to progressively step down (PDS, Section 2.5, "Facility Covenants"). We expect a similar LVR step-down requirement to be imposed when Facility 2 is due for rollover.

Forecasting an average bank LVR requirement of 50% for the entire portfolio as of FY11, the portfolio cap rate would need to firm by 25bps down to 8.75% for compliance. Holding cap rates constant, one or two asset sales (equating to \$10M) would reduce the LVR by around 2.5%, which would satisfy PIR's forecast LVR requirements.

The significance of this example is to show the ease with which the Fund would be able to dispose of assets. The assets are not institutional-grade and are tailor-made for the private investor market. Furthermore, even if private investors were not willing buyers, ABP would be required to recapitalise the Fund, most likely through buying assets from the Fund. At approximately A\$5M-A\$10M per asset, this would not be a strain on ABP's balance sheet. Finally, an independent valuation is required for any related party transaction to ensure deals are conducted at an arm's length.

Debt Refinancing Risks

In our view, worst-case scenario would be the non-refinancing of Facility 2 in December 2010. This would require either a capital injection from ABP (around \$50M) or asset sales, or a combination of both.

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ABP's Balance Sheet Capacity

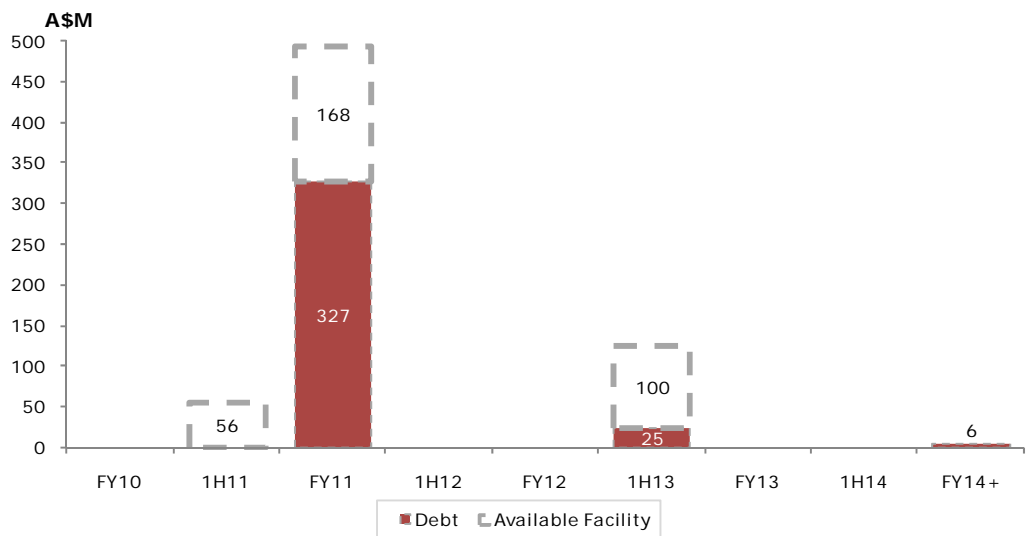
ABP's major facility expires in FY11 and represents over 70% ABP's sources of debt funding (see Figure 8 below). PIR notes that this is shortly after the expiry of the Fund's Facility 2. If ABP was to experience difficulty in refinancing its debt, this would pose a serious threat to its capacity as the underwriter to the Fund. We have therefore reviewed ABP's current balance sheet position and risks going forward.

ABP's gearing stands at around 23% (covenant gearing of 28% vs limit of 45%). In its 1H10 result, ABP announced \$10.9M of property asset impairments. However, there exists a significant amount of ABP capital (~\$330M) tied up in risky exposures (interim funding to funds and mortgage loans). Therefore any potential impairments would impact ABP's balance sheet.

However, the extent of further impairments that could arise is unclear. Nonetheless, we believe ABP's current balance sheet position and size as sufficient to absorb further expected writedowns. We therefore ascribe a low probability for ABP to experience any major refinancing risk.

Perhaps the more important issue is liquidity which includes cash balance and any undrawn debt facilities. ABP currently has liquidity of \$140M. Taking into consideration the undrawn portions of existing debt facilities (see Figure 8 below), we view ABP's sources of funding to be adequate. Even if lenders reduced the amount of funding available to ABP, it would only be required to fund around \$3M per year to the Fund.

Figure 8. ABP 1H10 Debt Maturity Profile



Source: ABP

5. Property Portfolio

Executive Summary

The ADIF II property portfolio consists of 25 diversified commercial properties. The assets are not institutional-grade. However, managing sub-grade assets is at the core of ABP's management expertise.

This class of asset is generally much more labour-intensive, as lease durations are typically quite short (circa four years). This generally exposes a fund with these assets to higher vacancy risks and, potentially, significant downtimes as well. However, the value-add potential for these type of assets is generally much greater than that with institutional-grade property. Furthermore, typical players in this market are private investors who do not necessarily have access to tenant relationships to the extent that ABP does.

PIR has a neutral view on the portfolio as a whole, as investing in these type of assets really comes down to risk appetite. Investors should understand that this type of asset is generally higher-risk than institutional grade assets, compensated by higher yields and potentially strong capital growth as markets recover.

When taking into consideration the capital position of the Fund, PIR would ordinarily have quite a cautious view, given proximity to covenants etc. However, the underwriting of the Fund by ABP, in our view, demonstrates a high level of conviction on the Manager's behalf. This gives PIR further comfort that the assets are indeed workable and have the capacity to support the objectives of the Fund.

PIR has reviewed the Fund's book values, having taken into account general market conditions impacting the portfolio. We note that the independent valuations across the portfolio are between three and six months old at the time of writing this report, during which time PIR would expect further value losses to have occurred. However, no valuation updates are required until June 2010. At present, it appears the cap rate cycle will have troughed by the time June 2010 is upon us. The main concern to value resides in the income risk.

Lease Expiry Profile

The portfolio has a WALE of four years and an occupancy rate of 95%. Whilst the WALE is considered not ideal for a typical unlisted property Fund, we consider it to be quite strong considering the grade of assets. The WALE has also been boosted by the addition of the Campbellfield and Port Macquarie properties, which has provided some headroom on the WALE covenant imposed by Facility 1.

Figure 9 shows that over the whole term of the Fund, there are no more than 16% of expiries falling in any one year. For this type of portfolio, we see this as manageable. Furthermore, the relatively equal weighting of assets across the portfolio prevents lumpy expiries mid Fund term.

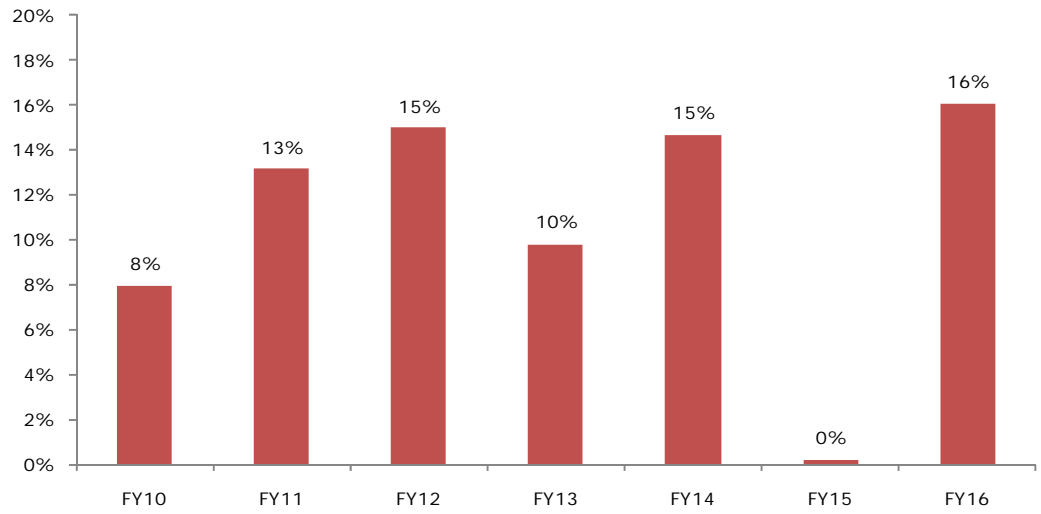
PIR has reviewed management's market rent, downtime, lease renewal and incentive assumptions across the portfolio. We have concluded that they are generally conservative in relation to independent valuers' assumptions.

For further asset-by-asset detail, please refer to Section 3 in the PDS.

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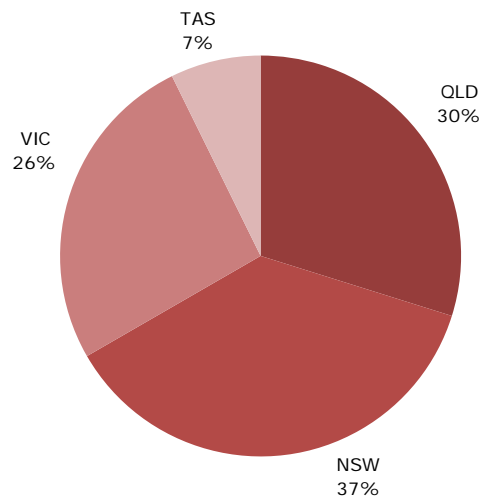
Figure 9. Lease Expiry by Financial Year



Source: PIR/ABP

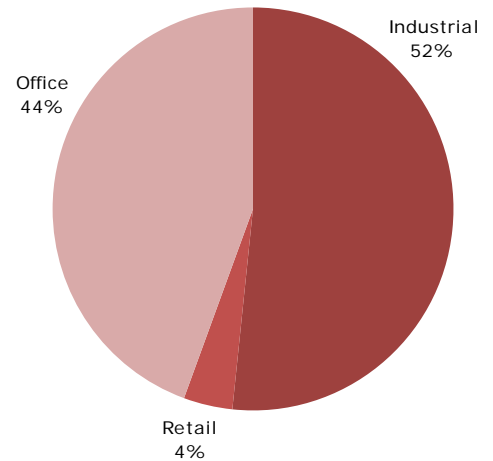
Geographical and Sector Exposure

Figure 10. Weighting by Geography



Source: PIR/ABP

Figure 11. Weighting by Sector



Source: PIR/ABP

Figure 12. Property Portfolio Summary

Sector	Location	State	Property	Lettable area (sqm)	Book value (\$M)	Capitalisation Rate (%)
Industrial	Sydney	NSW	13 Boundary Road, Northmead	5,678	8.0	9.75%
Industrial	Sydney	NSW	2-6 George Young St, Regents Park	7,827	9.4	8.75%
Industrial	Sydney	NSW	70 Gibbes St, Chatswood	4,225	7.4	9.00%
Industrial	Sydney	NSW	4 Bruncker St, Chullora	6,100	8.0	9.50%
Industrial	Gold Coast	QLD	26 Production Av, Molendinar	6,696	7.8	8.75%
Industrial	Gold Coast	QLD	8-12 Mercantile Court, Molendinar	6,823	8.2	9.00%
Industrial	Melbourne	VIC	1-5 Lake Drive, Dingley	16,153	13.4	8.75%
Industrial	Melbourne	VIC	63-73 Woodlands Dr, Braeside	7,087	6.1	9.25%
Industrial	Melbourne	VIC	75-83 Woodlands Dr, Braeside	2,495	2.1	8.75%
Industrial	Melbourne	VIC	418-424 South Gippsland Hwy, Dandenong South	5,345	4.5	9.00%
Industrial	Melbourne	VIC	138-140 Williams Road, Dandenong South	785	0.8	8.50%
Industrial	Melbourne	VIC	571 Mount Road, Derrimut	8,357	6.6	9.25%
Industrial	Melbourne	VIC	144-168 National Boulevard, Campbellfield	16,635	16.3	8.75%
Sub-Total				94,206	98.4	9.01%
Office	Sydney	NSW	22-28 Edgeworth David Av, Hornsby	3,573	11.1	9.00%
Office	Sydney	NSW	75 Railway St, Rockdale	1,547	3.6	8.50%
Office	Sydney	NSW	81 Railway St, Rockdale	2,690	4.6	9.00%
Office	Port Macquarie	NSW	27 Grant St	3,631	10.6	9.75%
Office	Sunshine Coast	QLD	12 Innovation Parkway, Kawana	3,111	8.2	8.50%
Office	Gold Coast	QLD	121 Scarborough St, Southport	3,199	11.3	8.50%
Office	Gold Coast	QLD	12 Short St, Southport	2,883	9.0	9.75%
Office	Brisbane	QLD	Building A, 5-6 Grevillea St, Brisbane Airport	1,492	5.3	8.50%
Office	Townsville	QLD	313-315 Ross River Road, Aitkenvale	2,350	7.2	8.50%
Office	Hobart	TAS	99 Bathurst St	7,244	6.5	9.50%
Office	Hobart	TAS	79-85 Melville St	7,558	6.6	10.50%
Sub-Total				39,278	83.9	9.12%
Retail	Sydney	NSW	Lot 6, 2 Endeavour St, Chatswood	1,952	7.5	8.00%
Total				135,436	189.8	9.02%

Source: PIR

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6. Investment Comparison

Investment comparison is ultimately an assessment of relative risk and return. PIR views the potential for capital upside in ADIF II to be minimal. As such, we view the expected inflation-adjusted yield should be compared with other fixed-interest products.

In assessing the competitiveness of the underwritten yield, we have undertaken a comparison of the risks and returns available from alternative fixed-interest investments. However, we note that the structure, liquidity and risks of these investment alternatives are different from those of ADIF II units and these are only intended as a general comparison for investors.

PIR's forecast yield over the Fund's term is 9.2% per annum, assuming a CPI CAGR of 2.7%. We believe this is the most appropriate return to compare with other fixed-interest securities.

Deposits with Financial Institutions

The Fund can be compared in nature to fixed-term deposits with banks or other deposit-taking institutions, in that investors should view the investment as having a certain time horizon. However, it is important to note that the risk associated with the Fund is significantly different from the risk associated with a bank deposit. The Australian banks are rated organisations, with the four major banks being among the most highly rated banks in the world at "AA". Additionally, the banks and certain other deposit-taking institutions currently have their deposits guaranteed by the Australian government.

Term deposits are typically not offered for a term in excess of five years. As such, rates in Figure 13 below are over a five-year term. PIR notes the term of ADIF II is 6.5 years. The current yield curve is upward sloping and if term deposits were offered at 6.5 years, they would show a slight premium to the rates in Figure 13 below.

Figure 13. Comparative Five-year Interest Rates as at 9 February 2010

Institution	Median %	Maximum %
Banks	6.35	7.28
Credit Unions	6.12	7.01

Source: PIR/Canstar Cannex

Australian Corporate Debt

We can also compare the Fund yield to standard corporate debt, although again, we need to allow for risk differentials. Figure 14 below shows the current interest rates for corporate debt of varying maturities at different entity rating levels. We note long-dated corporate debt (more comparable to ADIF II term) is not as common as shorter dated corporate debt and there is a lack of data available. Furthermore, ABP debt is unrated, which requires a return premium in comparison to rated debt.

Ordinarily, BBB debt would be the most appropriate benchmark in estimating a reasonable required return premium for unrated debt. In comparison to AAA-rated debt, ADIF II is offering a ~300bps yield premium. In our view, this represents an acceptable risk/return trade-off.

Figure 14. Australian Corporate Debt Rates as at February 2010

Entity Rating	Rate (%), Swap Spread(bpts) Maturity 4yrs	Rate (%), Swap Spread(bpts) Maturity 5yrs	Rate (%), Swap Spread(bpts) Maturity 7yrs
AAA	5.696 (28.1)	5.892 (30.6)	6.094 (26.4)
AA	6.359 (94.3)	6.499 (91.4)	6.654 (82.4)
A	7.112 (198)	7.564 (197.9)	N/A
BBB	7.726 (231.1)	N/A	N/A
ADIF II (unrated)			9.2

Source: Reuters

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7. Management

Corporate Structure

AFML, the RE of the Fund, is a wholly owned subsidiary of S&P/ASX 200-listed Abacus Property Group (ASX code: ABP). ABP was established in 1996 as a specialist property funds manager and currently has a market capitalisation of around A\$690M (as at 1 February 2010) and has approximately A\$2B worth of assets under management.

Since the group's inception, ABP has established more than 35 investment funds and has raised over A\$1.1B through a series of capital raisings.

Board of Directors

The Board of AFML comprises two executive directors and five independent directors, all of whom (with the exception of two) have been with the Abacus group since its listing on the ASX. The key executive is Dr. Frank Wolf who assumed the Managing Director's role in ABP on the retirement of co-founder David Bastian in October 2006. PIR considers that the board is well qualified and experienced to supervise the Fund.

Management

The core strengths of ADIF II lay in the broad experience and expertise of the management team in the acquisition and management of direct property. The Fund has access to the ABP property team, enabling it to draw on a pool of property expertise across Australia.

The investment management team (directed by Mr. Tom Hardwick) is responsible for the management of the Fund. PIR views the management team as having suitable skills and experience for managing a property funds management business. ABP, as a group, has expertise in the structuring, pricing and management of structured investments.

The direct and indirect property acquisition team is under the direction of Dr. Frank Wolf.

The direct property management is undertaken by Abacus Property Services (APS), which may outsource the day-to-day management of some properties to external agents.

Risk Management

Related Party Transactions

The Fund may transact with other funds managed by AFML or members of ABP. The AFML board has a majority of independent directors, which is responsible for approving related party transactions. All related party transactions must be at arm's length or the financial benefit is approved by scheme members. The chief operating officer is also involved in ensuring this policy is met.

Compliance Committee

Procedures for the management of the Fund are set out in the Compliance Plan lodged with the ASIC and overseen by the Compliance Committee, comprising one independent member (chairman) and two executives. PIR has viewed the Compliance Plan and believes it is consistent with good corporate governance.

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8. Past Performance

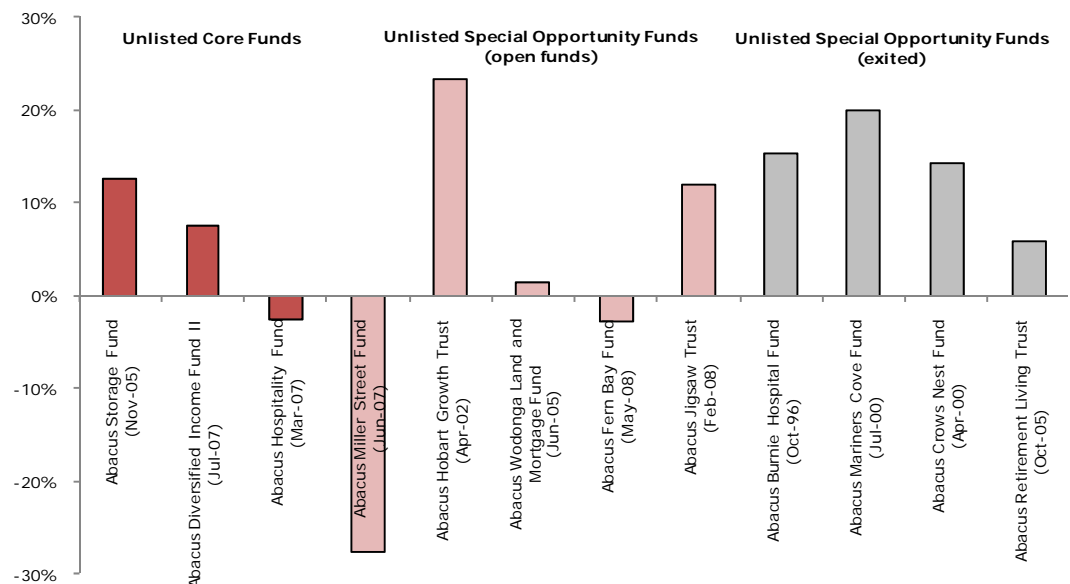
Figure 15 below shows the returns for different ABP funds. The performance is broken into three fund risk/return categories:

- Unlisted core funds (including ADIF II);
- Unlisted special opportunity funds (open funds); and
- Unlisted special opportunity funds (exited).

The total returns in Figure 15 are calculated as the average income return as at 31 December 2009 added to a capital return that is based on unit values as at June 2009 with an exit assumption at December 2009.

Total returns show varying degrees of outcomes, especially in the unlisted special opportunity funds, which, by nature, are much higher risk than core funds. Unlisted core funds' total returns appear mediocre in an absolute sense; however, PIR views the Abacus Storage Fund's performance to be superior to that of peers. Funds like ADIF II and Abacus Hospitality Fund were launched at the very peak of the property cycle. Given we are currently experiencing the trough of the market, negative total returns are expected.

Figure 15. Past Performance



Note: dates in brackets refer to inception date
Source: PIR/ABP

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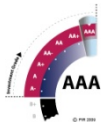
Appendix – Ratings Process

PIR has developed a framework for rating investment product offerings in Australia. Our review process gives consideration to a broad number of qualitative and quantitative factors. Essentially, the evaluation process includes the following key factors: product management and underlying portfolio construction; investment management, product structure, risk management, experience and performance; fees, risks and likely outcomes.

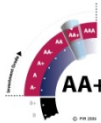
The Ratings

Financial Advisers and investors should note that for all ratings categories, the product may not suit the risk/return profiles of all investors.

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AAA: This is the highest rating provided by PIR, indicating this is a best of breed product that has exceeded the requirements of our review process across a number of key evaluation parameters and scored exceptionally in a number of categories. The product provides a highly attractive risk/return trade-off. The Fund is likely to effectively manage endogenous and, to the extent that it can, exogenous risk factors with industry best practice.



AA+: Indicates that PIR believes this is a superior grade product that has exceeded the requirements of our review process across a number of key evaluation parameters and scored exceptionally in a number of categories.



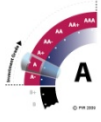
AA: Indicates that PIR believes this is an above-average grade product that has exceeded the minimum requirements of our review process across a number of key evaluation parameters. In addition, the product rates highly on one or two attributes in our key criteria. It has an above-average risk/return trade-off and should be able to consistently generate above-average risk adjusted returns in line with stated investment objectives. The Fund should be in a position to effectively manage endogenous and, to the extent that it can, exogenous risk factors. This should result in returns being reflective of the expected level of up-side and down-side risk.



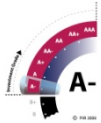
AA-: Indicates that PIR believes this is an above-average grade product that has exceeded the minimum requirements of our review process across a number of key evaluation parameters. It has an above-average risk/return trade-off and should be able to consistently generate above-average risk adjusted returns in line with stated investment objectives.



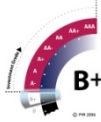
A+: PIR believes this is a suitable product that has met the aggregate requirements of our review process across a number of key evaluation criteria. The product provides some unique diversification opportunities, but may not stand apart from its peers. It has an acceptable risk/return trade-off and should generate risk adjusted returns in line with stated investment objectives.



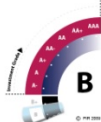
A: PIR believes this is a suitable product that has met the aggregate requirements of our review process across a number of key evaluation criteria but may not stand apart from its peers. There are certain assumptions, the outcome of which is sometime in the future and, therefore, less predictable. The product has an acceptable risk/return trade-off and is potentially able to generate risk-adjusted returns in line with stated investment objectives.



A-: PIR believes this is a suitable product that has met the aggregate requirements of our review process across a number of key evaluation criteria. There are certain assumptions, the outcome of which is sometime in the future and, therefore, uncertain. However, it has an acceptable risk/return trade-off. The product has an acceptable risk/return trade-off and is potentially able to generate risk-adjusted returns in-line with stated investment objectives.



B+: PIR believes this is a product that has a number of positive attributes; however, there are a number of risks that make investing in this product a speculative proposal. While PIR does not rule out investing in this product, investors should be very aware of, and be comfortable with, the specific risks. The product may provide unique diversification opportunities. However, concerns over one or more features mean that it may not be suitable for most investors.



B: PIR believes that despite the product's merits and attributes, it has failed to meet the minimum aggregate requirements of our review process across a number of key evaluation parameters. While this is a product below the minimum rating to be considered Investment Grade, this does not mean the product is without merit. Funds in this category are considered to contain high risks which are not reflected by the projected return. Performance volatility, particularly on the down-side, is likely.

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