ATCHISON

CONSULTANTS

360 Capital Industrial Fund

August 2012

Investment proposition for ASX listing

1 Introduction

The 360 Capital Industrial Fund is an unlisted property trust established in 2002. The fund is managed by 360 Capital Property Group Ltd, a property investment and funds manager formed in 2006. As at 31 December 2011, the Group managed 11 investment vehicles holding assets valued at more than $820 million on behalf of over 9,000 investors.

In December 2010, 360 Capital Property Group purchased Becton Investment Management Limited. As part of this acquisition, the Group acquired the management rights to the 360 Capital Industrial Fund. The fund has a diversified portfolio of 24 properties.

The fund is not a liquid investment. The manager of the fund is required to offer an opportunity for investors to redeem their investment by December 2012.

Mechanisms for the provision of liquidity in an unlisted property fund are available.

Attributes and sources of liquidity have been identified. Analysis of the provision and pricing of liquidity in an unlisted property fund has been undertaken. Pricing of liquidity has been estimated reflecting the discount associated with an investment in an illiquid property fund. The characteristics of an A-REIT are defined. An analysis of the prospects of listing the fund on the ASX has been undertaken.

2 Liquidity

Liquidity is the ease of buying and selling an investment within a reasonable timeframe without affecting the price of the investment. High liquidity is characterised by frequent trading activity.

2.1 Attributes of liquidity in property

Ownership of property provides investors with an interest in the income and expenses and affords prospects of capital appreciation through improvements in the net rental income generated and falls in capitalisation rates. Among the attributes of liquidity are:

- Depth, which includes the market impact of a transaction. It describes the ability to sell or buy securities without materially influencing the quoted price. It can be measured, through metrics such as order ratio, trading volume of transactions or the flow ratio;

- Breadth being the size of bid-ask spreads which is also referred to as tightness. It describes the ability to buy and sell an asset/security at about the same price at the same time. Tightness shows in the clearest way the cost associated with transacting as it reflects the size of bid-ask spreads;

- Timeliness and ease of execution of trades. This includes ease of selling a current investment holding.

2.2 Pricing Liquidity

Investors pay lower prices and demand higher returns from less liquid assets than from otherwise similar more liquid assets. The effect of illiquidity on value can be estimated as follows:

- Value of the asset can be computed as if it were liquid, and then discounted;

- Higher discount rate used for illiquid assets than liquid assets

Empirical evidence supports the notion that liquidity is valued by investors and can be determined and quantified through turnover, size and transaction costs. An analytical model that estimates the value of liquidity or the cost of illiquidity through discount rate has been developed. It considers:

- difference in the discount/premium to fair value between investments of differing turnover;

- difference in the bid/offer spread between investments of differing sizes;

- difference in transaction costs;

- difference in current pricing volatility, using value at risk

2.2.1 Turnover

A listed investment through the public clearing market may turnover more than 100% of market value in a year. An unlisted investment will not turnover during the life of the investment which may be many years other than in exceptional circumstances.

The value of liquidity can be measured in the relationship of turnover to liquidity using the premium/discount to fair value in listed markets. The measure of the value of liquidity, or the cost of illiquidity, can be estimated from the difference between investments of high turnover and investments with low turnover.

2.2.2 Size

The size of an investment can have varying effects when looked at from the perspective of direct property or from securities in an entity holding property assets.
Direct property is not liquid and is generally of high value per unit, requiring significant capital resources. Thereby the number of investors is relatively limited.

The larger the asset size the more illiquid direct property becomes with a reducing number of prospective investors in the market. The example of residential property where the value is small versus a city office tower, which is high value illustrates this with the former being relatively highly liquid

The acquisition of securities in the listed property market is immediate through an exchange. Within the listed property market, the larger the size the greater the liquidity as entities with larger market capitalisation are included in market indices.

2.2.3 Transaction Costs

Transaction costs of direct property can be substantial when compared with the listed property sector. Investments through unlisted property trusts, private holdings and syndicates have little or no liquidity throughout the term of investment with transaction costs being high.

Higher transaction costs for direct property equates with the cost of illiquidity. This can be seen in a reduction in the price of the investment and may be reflected in the difference in yield between listed and unlisted investments in the same underlying assets. Transaction costs include government charges, stamp duties, legal charges, due diligence costs, agency fees and accounting fees. Transaction costs of securities are relatively minimal.

2.2.4 Current pricing volatility

Liquidity varies over time, resulting in volatility in prices.

The present value of the difference in current pricing volatility between investments of liquid and illiquid property market utilising value at risk can be used in estimating the price for liquidity.

The pricing premium that liquidity brings is equal to cost of illiquidity and is represented by the sum of:

Table 1 – Cost of liquidity at 30th June 2012

	Range	
	%	**%**
Price discount for turnover	1.1	3.3
Price discount from size	0.2	0.9
Price discount for transaction costs	2.5	
Price discount for volatility	5.9	
Total Cost of Liquidity	**9.7**	**12.3**

Source: Atchison Consultants

As presented in Table 1, the cost of illiquidity ranges between 9.7% and 12.3%, representing the additional discount rate associated with investments in unlisted property.

2.3 Sources of liquidity

Mechanisms are available to provide liquidity in a portfolio of property investments.

2.3.1 Asset sales

Property assets may be sold. Assets which are the most appropriate for sale in the prevailing market conditions are identified. Any debt owing on a property is subtracted from the net realisation price after costs to yield the residual equity on an investment property held in the portfolio. The residual equity can be used to fund liquidity.

2.3.2 Fund investment inflows

A source of liquidity is new equity contributions from investors. This inward investment can be used to fund redemption requests from outgoing investors.

2.3.3 Rental cash flow

Net rental income provides free cash flow provided it is not committed for payment of interest on debt, new property fund investment, capital or operating expenditure on the portfolio or for the payment of distributions.

2.3.4 Distribution re-investment

A distribution re-investment plan permits distributions to be retained by the fund. Investors are allocated new units to the equivalent value of the distribution. This assists in the retention of free cash flow within a portfolio. The degree of participation in the in re-investment plan determines the extent to which liquidity can be financed by this mechanism.

2.3.5 Cash

Cash and cash equivalents can be used to fund liquidity.

2.3.6 Borrowings

Borrowing can be used to fund liquidity by increasing gearing against the value of assets in the fund and using the cash to redeem investments.

2.3.7 Listed property securities

Investments in listed property securities are highly liquid. Any such holdings can be traded on a market exchange to realise invested equity.

2.3.8 Manager Buy Back Offers

An offer by the manager to purchase units from unit holders may be made. Offers may be made at the prevailing unit withdrawal price or at a discount reflecting the cost of liquidity.

2.3.9 Secondary market

There is potential for a party to facilitate a transaction in existing units between current and/or new unit holders. This would be a sale and purchase transaction between a unit holder and another party. The parties would determine the price between themselves.

2.3.10 Securities market listing

The manager may seek to list the units in the fund on a publicly quoted securities exchange such as the Australian Securities Exchange (ASX). This facilitates trading of securities at a price set in the market.

2.3.11 Sale of portfolio in one line

The manager may seek to sell the entire portfolio of assets. The net proceeds of this liquidation after all liabilities and transaction costs would be distributed to unit holders.

2.4 Manager activities

Three asset sales have been transacted in the fund since December 2011 for total gross proceeds of $19.1 million. This reduced the loan to value ratio (LVR) on the overall portfolio to its current level of 63.8%. A further five properties are under heads of agreement to be sold. The expected proceeds from these sales is $43.8 million with anticipated sale dates between August and October 2012. This would reduce the LVR to 59.0%. The sale process has been commenced on a further three property assets with target sale proceeds of $30.2 million and target sales dates in December 2012. This would reduce the portfolio LVR to 54.7%. These sales would maintain compliance with the LVR covenants imposed in the recently renegotiated three year debt facility. A refinance covenant from the lender requires the LVR to be below 50% by March 2014. Additional equity would be required to meet the fund’s LVR covenant by March 2014. The proceeds from these asset sales have been used to reduce debt and not to fund liquidity.

In June 2012, an institutional placement raised $27 million of redeemable unsecured convertible notes. The notes were offered at a 23% discount to NTA with a 12% coupon. This equity was combined with additional debt to acquire a number of property assets. Raising additional equity would occur at a material discount to prevailing NTA.

In raising sufficient equity to redeem all existing equity, 360 Capital RE Limited, the manager, would need to exceed the total equity capital raising recorded in the Australian unlisted property trust industry in the year to June 2012.

The fund entered into a debt facility with a major Australian bank totalling $260 million. The facility comprised two tranches expiring in November 2012 ($20 million) and December 2015 ($240 million). The bank would not contemplate increasing the debt facility.

The fund retains cash for operational purposes. Cash represents 0.5% of the total assets of the fund. This is insufficient to facilitate liquidity or to make offers to buy back units from unit holders.

The fund does not hold investments in listed property securities or other similar liquid investments. This is not a source of liquidity for the fund.

3 Attributes of an A-REIT

An Australian Real Estate Investment Trust (A-REIT) is an entity which owns real estate investment assets. Holders of securities in an A-REIT have a proportional ownership in the underlying assets. An A-REIT is listed on a securities exchange which enables trading of securities at prices set by the market in accordance with supply, demand and sentiment. The principal such exchange in Australia is the Australian Securities Exchange (ASX).

Rental is paid by the occupants of improved investment property owned by an A-REIT. This rent is structured in accordance with a lease. That rent along with other income is distributed to unit holders. The proportion of that distribution to the price of the security is called the yield.

A-REITs are professionally managed for a fee by an external party by appointment or by an internal manager in a related corporate structure. In an internal structure, management fees remain within the operation. The manager will make decisions about the assets and leases.

It is common for A-REITs to have their property-owning trust permanently attached to a company which carries on property management, development, construction or other business activities. These A-REITs are known as stapled A-REITs.

The Trust component of an A-REIT is obliged to pay income to investors as distributions. These distributions are not taxed at the Trust level. The Trust is tax transparent leaving the investor to pay tax on gross income. Any dividends paid by the corporate component of an A-REIT are paid from after-tax profits and are distributed with franking credits.

4 Analysis of listing on the ASX

The strategy set out by 360 Capital to resolve the liquidity requirement in December is to seek unit holder approval to amend the fund’s constitution in such a way as to enable the listing of the fund on the Australian Securities Exchange.

4.1 Liquidity

A listing of the units in the fund on the ASX would provide an ongoing liquidity mechanism enabling security holders to exit their investment. The trade would be executed at a price determined by the market. This price is not predictable and can introduce price volatility as a consequence of issues associated with the fund or by contagion effects from other broader issues not specific to the fund.

A listing on the ASX will enable the equitable redemption of an investment at a price set by the market without impact on other investors. The provision of equity by asset sales will take time to organise due diligence material, conduct the marketing and negotiation processes followed by settlement. Sale prices may or may not reflect book value for each asset sold. This may impact unit holders variously.

4.2 Fees

The Responsible Entity (RE) is currently entitled to a number of accrued fees totaling $7.1 million. These fees comprise initial fees in respect of acquisition of the fund properties of $2.4 million, and exit fees of $4.7 million. These fees are separate to ongoing management fees incurred in the ordinary course of managing the fund. The RE has committed to waiving the $7.1 million fees should the resolution to list the fund on the ASX be passed.

4.3 Distributions

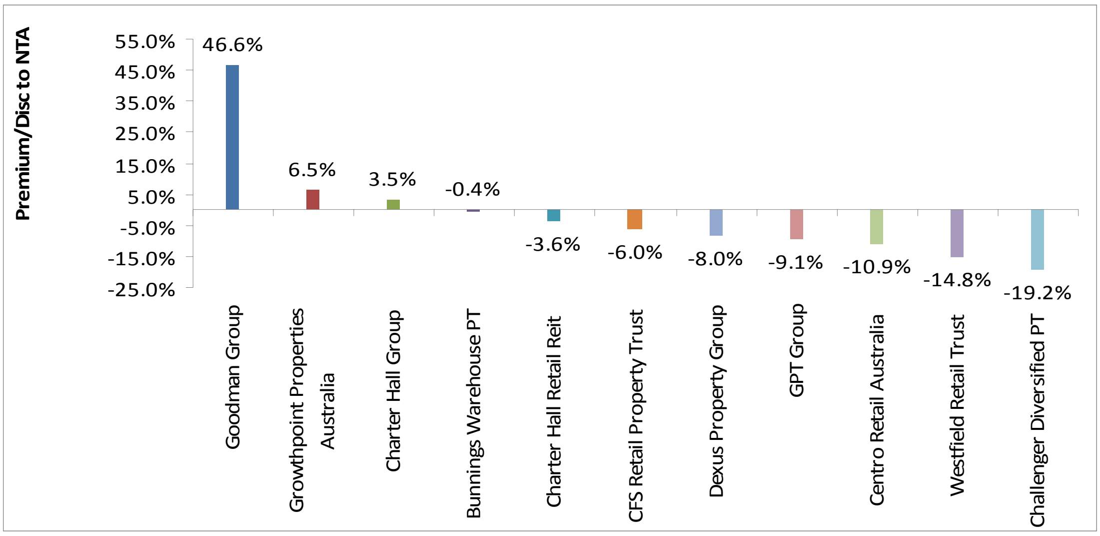
The manager has committed to the continuation of distributions of $0.045 per annum to unit holders under the listed option. This equates to a distribution yield of 8.9% at a NTA of $0.505 including the conversion of the $27 million of notes issued in June 2012. The manager has stated that distributions will be discontinued if the fund is not listed in accordance with the provisions of the debt facility.

4.4 Pricing analysis

The assessment of a prospective initial trading price is presented below. The assessments are based on comparison to other A-REITs of NTA premium/discounts and distribution yields.

Chart 1 shows the current premium/discount NTA comparison across a number of A-REITs. The current sector average discount is approximately 3% excluding the impact of the Westfield Group which trades at a significant premium to NTA. Goodman Group is currently the only A-REIT with an exclusive focus on industrial property.

Chart 1 – NTA comparison for A-REITs



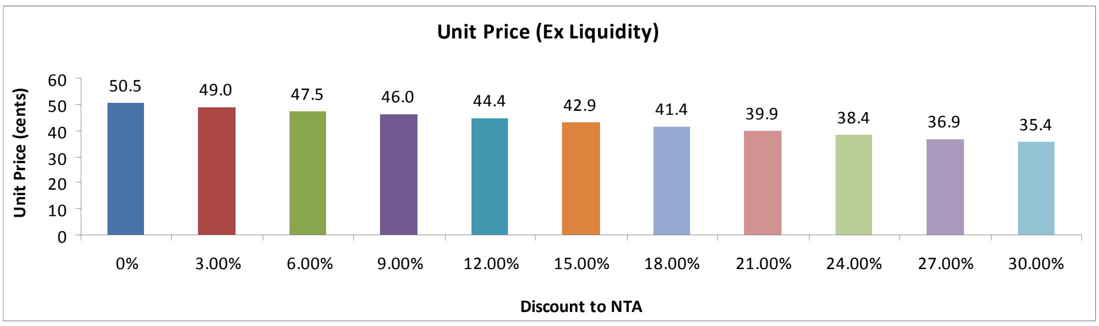
Source: Iress, JP Morgan

Chart 2 shows the prospective unit price of the 360 Capital Industrial Fund using various discounts to NTA. With the current NTA at $0.505, a 3% discount would translate to a trading price of $0.49. However, it is considered that the fund will trade at a larger discount to the broader market average for a number of reasons:

- pricing pressure from investors seeking an exit as the first liquidity event for ten years. This was seen in the recent example of Centro Retail Australia. An analysis is provided in section 4.5 below.
- while sector gearing averages 30%, the current portfolio has a gearing level of 63.8%. This higher level of gearing introduces elevated risk as a consequence of higher debt repayments to earnings and refinance risk;
- the portfolio is B-grade;

A discount to NTA of 20% would translate to a trading price of $0.40.

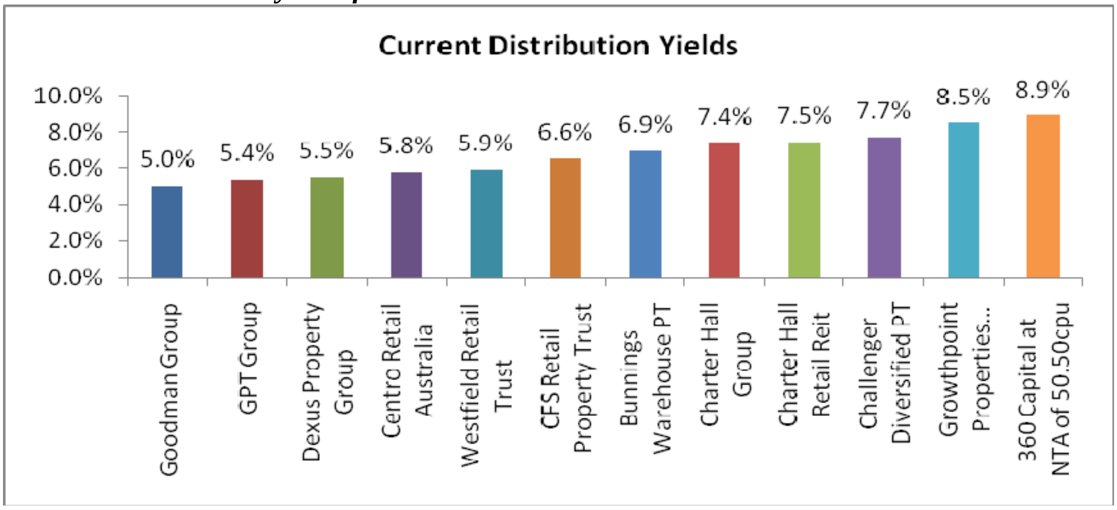
Chart 2: Prospective unit price based on various discounts to NTA



Source: Atchison Consultants

The current distribution yield from the fund is 8.9% based on the NTA of $0.505. The fund is expected to maintain this level of distribution on listing on the ASX. The A-REIT sector average distribution yield excluding Westfield Group is 6.3%.Chart 3 shows distribution yields from current A-REITs.

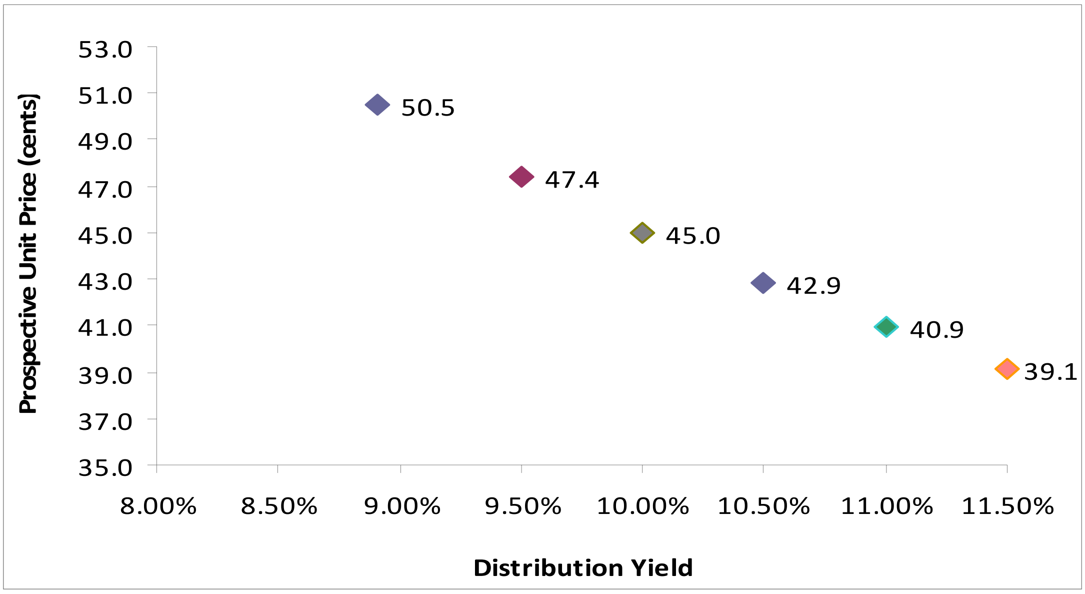
Chart 3 – Distribution yields from current A-REITs



Source: Iress, Atchison Consultants

Prospective trading prices for the fund are presented in Chart 4. A higher yield will be required by purchasers of units as compensation for the risks associated with an investment in the fund as outlined above. This implies a lower trading price. Chart 4 shows the range of outcomes from various distribution yields required from investors.

Chart 4 – Prospective unit price based on 4.5c distribution per unit on $0.505 NTA



Source: Atchison Consultants

A series of higher distribution yields have been tested, given the size and the level of gearing within the fund. It is expected that the Fund could trade between $0.39 on a distribution yield of 11.5% and $0.505 without any discount.

4.5 Centro Retail Australia

The Centro Retail Australia, which is listed on the ASX is comprised of a number of funds formerly managed by Centro, most of which of which were not liquid.

Source: Iress, Atchison Consultants

Centro Retail Australia was listed on the ASX on 5th December 2011. There had been no liquidity in the funds in the four years prior to the listing. Unit holders exiting the fund prompted the price to trade at a steep discount of 24.1% to NTA in the first week of trading. Centro Retail Australia has been trading upwards towards NTA since listing.

A similar scenario is anticipated for 360 Capital Industrial Fund. An initial sale of holdings by exiting investors which exceeds demand will prompt the fund's shares to trade at a discount to NTA.

Trading toward NTA over time will be governed by the reduction in fund gearing which is significantly higher than the A-REIT sector average. Other factors which will determine the price will include share market sentiment, capacity of management, quality of the portfolio and capital management initiatives.

5 Conclusion

Listing the fund facilitates the opportunity to realise an investment at a price determined by the market. It is equitable for all investors. Those who elect to sell their units will determine whether the price is suitable. Those who elect to remain in the fund would expect a gradual improvement in price.

The only feasible alternative liquidity solution is the sale of assets. The proceeds would be used to pay down debt prior to any liquidity being offered to investors. Sales of assets in volume would almost certainly result in lower prices than book value. This would detract value from all unit holders, including those who do not seek a liquidity event.

The securities will initially trade at a discount to NTA on listing reflecting the likely volume of selling.

Listing of the 360 Capital Industrial Fund would provide liquidity on an equitable basis for all investors.

STATEMENT OF ANALYST INTEREST AND CERTIFICATION, WARNING AND DISCLOSURE

Atchison Consultants' Financial Services Guide has been provided to 360 Capital Group Ltd. Retail investors may obtain this directly from Atchison Consultants using the contact details below. The Financial Services Guide is designed to assist retail investors in their use of any financial product advice in this Report.

Analyst Interest and Certification:

The Analyst(s) may hold an investment in this product and this holding may change over the duration of this rating. Atchison Consultants does not consider such holdings to be sufficiently material to comprise the report. The Analyst(s) certifies that with respect to content covered in this report: (1) all of the views expressed accurately reflect his or her personal views about product; and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by that research analyst in the research report.

Warning (General Advice Only):

This report is prepared for 360 Capital Property Group Limited. The report contains advice of a general nature and does not have regard to the particular circumstances or needs of any specific person who may read it. Investors should assess either personally or with the assistance of a licensed financial adviser whether the Atchison Consultants advice is appropriate to their situation before making an investment decision. The information contained in the report is believed to be reliable, but its completeness and accuracy is not guaranteed. Opinions expressed may change without notice. Atchison Consultants does not accept any liability, whether direct or indirect arising from the use of information contained in this report. No part of this report is to be construed as a solicitation to buy or sell any investment. Atchison Consultants does not accept any responsibility to inform you of any matter that subsequently comes to its notice, which may affect any of the information contained in this report. The performance of the investment in this report is not a representation as to future performance or likely return.

Disclosure (Commissioned Research):

Atchison Consultants has received a fixed fee, established prior to commencement of work, plus travel expenses from 360 Capital Group Limited for the preparation of this report. Atchison Consultants applies a strict and rigorous process for the production of research reports and has no direct or indirect interest in the success or otherwise of this investment.