

15 June 2010

Important and comprehensive fund report to investors

Orchard Childcare Property Fund

Orchard Capital Investments Limited (Orchard) as Responsible Entity for the Orchard Childcare Property Fund (OCPF or Fund) is pleased to provide this comprehensive update to investors following the completion of lease assignments on 30 May 2010 for 115 child care centres to Goodstart Childcare Limited (Goodstart).

Executive summary

Over the last two years Orchard has been dealing with the impact of the global financial crisis (GFC) and the collapse of the Fund's major tenant ABC Learning Centres Limited (ABC).

During the last 18 months Orchard has transitioned 164 of the Fund's 201 child care centres to new operators on leases that provide for similar rents but with improved lease terms. New leases now include extended initial terms to 15 years, provisions for rent reviews based on at least consumer price index (CPI) increases and access to trading and financial data of the tenants. In addition, the Fund now holds security in the form of bank guarantees and in some instances corporate and personal guarantees in respect of these 164 centres.

Following completion of the assignment of leases to Goodstart, NAB has issued a Positive Receivership Notice on the 11 June 2010 which confirms the expiry date of the Fund's current debt facility as 30 June 2012. This Notice also effectively allows the Fund to resume quarterly income distributions to investors commencing with the distribution for the year ended 30 June 2010.

The Fund is now in a strong financial position with low debt, secure cash flow and acceptable banking arrangements.

Background

As the GFC gathered momentum during 2008 the Orchard Childcare Property Fund along with other property funds experienced a tightening of credit, increased funding costs and falling property values. In managing the Fund, Orchard took steps in August 2008 to close the Fund to all new applications and withdrawals and in October 2008 Orchard advised that it was also necessary to change the distribution frequency from a quarterly to an annual cycle to conserve funds and use the money towards debt repayment.

The Fund's situation was worsened when, on 6 November 2008, ABC appointed voluntary administrators. On that same day, ABC's banking syndicate appointed McGrath Nicol as Receivers and Managers of the ABC business and assets.

At the time ABC was the Fund's major tenant leasing 94% of the Fund's child care centres.

McGrath Nicol conducted a business review of ABC and on 10 December 2008 announced that 55 centres would be closed. This announcement impacted negatively on the Fund with eight of its centres being closed down immediately; a further seven centres owned by the Fund were closed down in early 2009. These centres are referred to as Closed Centres in this report.

Another portfolio of 241 centres (including 35 owned by the Fund) were transferred to the control of a court appointed receiver and continued to operate with federal government funding; this group of centres is referred to in this report as government supported or ABC2 centres.

The remaining 720 ABC centres (including 115 owned by the Fund) continued to trade under the control of McGrath Nicol; in this report, these centres are referred to as Continuing or ABC1 centres.

Orchard engaged Vin Harink, formerly Chief Executive Officer of Austock Property Management Ltd (the responsible entity for the Australian Education Trust), to assist with the Fund's management and specifically to work with McGrath Nicol to achieve the best outcome possible for the Fund.

Over the last 18 months Orchard has been working to transition ABC operating centres to new tenants and to re-lease vacant centres on terms acceptable to the Fund.

Outcomes

A number of positive outcomes have been achieved by Orchard for the Fund in respect of the various groups of centres. These outcomes are summarised below.

Closed Centres

During 2009 the Orchard Childcare Property Fund entered into long term leasing arrangements with four existing operators in respect of 11 of the 15 child care centres closed by McGrath Nicol. These new lease arrangements involved 15 year initial terms with commencing rents at the same levels as those being paid by ABC and a combination of bank guarantees and personal guarantees as security. Some short term incentives were provided to assist the new operators in reopening these centres. Of the remaining four centres, one has been contracted for sale while the remaining three are in the process of being re-leased or sold.

Government Supported or ABC2 Centres

In May 2009, after working closely with the court appointed receiver and manager, the Fund entered into leasing arrangements with two experienced operators for the 35 childcare centres which were included in this portfolio. These new leases were for an initial 15 year term with two options for further terms of five years each, CPI driven rent reviews, market review provisions, strengthened assignment clauses, provision of operating and financial data for the centres and a combination of bank guarantees and personal guarantees as security.

Continuing or ABC1 Centres

Following a federal court hearing in August 2009, McGrath Nicol announced that they would proceed with the sale of the remaining ABC business and hoped to have a purchaser agreement signed by the end of December 2009. On 22 December 2009, McGrath Nicol signed a conditional business sale agreement with Goodstart Childcare Limited. The agreement was conditional upon the consent of the landlords to the assignment of the leases and the issuing of necessary licences by the respective state government departments.

Since the execution of the business sale agreement in December 2009, Orchard has been working with McGrath Nicol and Goodstart Childcare Limited on the terms and conditions of the lease assignments. Given the nature and complexity of the ABC receivership, this lengthy process was necessary to ensure all of the Fund's centres previously leased to ABC were transitioned to Goodstart with minimal disruption to the families with children at the centres whilst protecting the interests of OCPF investors.

Orchard approved the assignment of all 115 leases from ABC to Goodstart, following consent from the Fund's financier National Australia Bank. The lease assignment process was completed on 30 May 2010.

In addition, three child care centres were leased to third parties but managed by ABC under licence arrangements as part of ABC's corporate child care arrangements. On behalf of the Fund, Orchard has agreed with these third party tenants to surrender the existing leases and enter into replacement leases directly with Goodstart.

Goodstart Childcare Limited

Like most not-for-profit organisations, Goodstart is a company limited by guarantee as opposed to a company limited by shares. It therefore does not have shareholders but each of the charities that is a member has a maximum liability of \$100 due upon the winding up of the company. Goodstart's members comprise the following:

- **Mission Australia (Mission)**

The Mission is a national non-denominational Christian community services organisation which operates more than 450 services in every state and in 2008 assisted more than 330,000 people. Its programs and services aim to eradicate homelessness, strengthen families and empower youth with a particular focus on unemployed people. Its 2008/2009 annual report reflects annual operating revenue of \$300 million while it had net assets at 30 June 2009 of \$61 million. Its experience in child care includes operating 29 existing early learning centres.

- **The Brotherhood of St Laurence (BSL)**

BSL is an Anglican organisation established during the great depression in the 1930s and works in and around Melbourne. It provides services including job training and placement programs, care for the elderly and people with disabilities, early childhood development programs and support services for newly arrived refugees and migrants. At 30 June 2009 BSL had assets of \$85 million.

- **The Benevolent Society (TBS)**

TBS is Australia's oldest charity established in 1813 working with individuals and communities to ensure people are safe, healthy, included and valued. At 30 June 2009 TBS had assets of over \$90 million and over 750 staff and volunteers throughout Australia.

- **Social Ventures Australia Limited (SVA)**

SVA was established in 2002 by TBS, The Smith Family, WorkVentures and AMP Foundation. It works with innovative not-for-profit organisations to increase their growth and impact to drive transformational social change. It focuses on three areas – supporting a portfolio of not-for-profit organisations, consulting to the broader not-for-profit sector and developing social sector partnerships.

Goodstart has been exempted from payroll tax and income tax; it has been granted concessional FBT benefits and potential relief from stamp duty, all of which provides Goodstart with significant financial benefits.

At Orchard's request, Goodstart has provided detailed business plans, financial data and other information to support its request for the assignment of the former ABC leases. Goodstart's initial funding for the acquisition and working capital has been sourced from members in the form of subordinated notes (\$7.5 million with a 15% annual return), from a large group of philanthropists in the form of unsecured social capital notes (\$22.5 million with a 12% annual return), from the Commonwealth Government in the form of a \$15 million secured second ranking loan together with secured acquisition finance, working capital and other facilities provided by National Australia Bank.

Based on the business plan, financial forecasts and other data provided, Orchard believes that Goodstart will be a good long term tenant of the 118 child care centres leased from the Fund.

Assignment of leases

The key aspects of the assignment of the leases over the 115 centres, includes the following:

- Initial lease term has been extended from 10 to 15 years;
- Annual rent review: the existing sliding fixed annual rent increases have been replaced with an annual CPI increase with a minimum increase of 2.5% and a maximum of 6%;
- Market rent reviews have been introduced with market reviews occurring at years 10, 15 and 20;
- Bank guarantees: given the nature and structure of Goodstart, corporate and personal guarantees were not available. However, Goodstart has provided the Fund with an \$8.4 million pooled bank guarantee, which is equivalent to six months' rent, outgoings, and goods and services tax (GST); and
- Operating and financial information: under the terms of the leases, Goodstart is required to provide Orchard with quarterly trading and operating data in respect of each of the centres leased from the Fund. Goodstart must also provide Orchard with annual and half yearly financial statements.

In addition arrangements were entered into in respect of seven nominated centres enabling the Fund and Goodstart to work together to improve the performance level of these centres over the next two years. These arrangements also provide for a process to deal with these centres in the event that this performance level is not achieved.

As a condition to providing the Fund's consent to the assignment of the leases, McGrath Nicol has also reimbursed the Fund for pre-receivership outgoings in respect of the 115 centres and has paid the Fund's substantial costs associated directly with the assignment of these leases.

Set out below is a summary of the key terms of the leases entered into by Goodstart:

| | |
|---------------------------|--|
| Commencement date | As per current leases |
| Lease term | 15 years from the commencement date |
| Options | 2 x 5 years with 5 years' notice of exercise of the option |
| Rents | As per existing lease |
| Annual rent review | CPI increases on anniversary with 2.5% minimum and maximum of 6%. In Victoria the leases will have a CPI only increase without the minimum and maximum applying. |
| Market rent review | Market review of rent at year 10 and commencement of each further term with minimum of the previous rent and a maximum increase of 7.5%. In Victoria the leases will be subject to a market review without a minimum and maximum applying. |
| Lease incentives | None |
| Outgoings | Triple net including structural repairs. Redecoration required once in each 5 year period. |
| Use of premises | Licensed child care centre |
| Child care licence | Tenant to maintain licence and cannot vary without the Fund's consent |
| Assignment | Fund's consent required to assign, sublet or management arrangements |
| Lessee reporting | Tenant to provide operating reports quarterly and financials each half year |
| Rent security | Participate in a pooled bank guarantee equivalent to six months' rent, outgoings and GST |

This lease summary applies to all the former ABC centres now leased to Goodstart and is consistent with the leases for all other former ABC centres entered into over the last 18 months.

Property portfolio

Following the completion of the lease assignment to Goodstart the Fund's property portfolio as at May 2010 is summarised in the table below.

| Property portfolio | Number of properties | Current property valuation (\$m) | Current annual rent (\$) |
|---|----------------------|----------------------------------|--------------------------|
| Operating child care centres | | | |
| Goodstart Childcare Limited | 118 | 145.6 | 13,624 |
| ABC Developmental Learning Centres (NZ) Ltd | 25 | 10.8 | 1,133 |
| Kids in Care Pty Ltd | 25 | 29.9 | 2,959 |
| NurtureOne | 9 | 8.3 | 828 |
| Preschool Services Australia | 8 | 8.3 | 813 |
| Other tenants | 11 | 13.9 | 1,314 |
| Total operating centres | <u>196</u> | <u>216.7</u> | <u>20,671</u> |
| Vacant centres | | | |
| For lease or sale | 2 | 2.1 | |
| For sale | 2 | 0.7 | |
| Contracted for sale | 1 | 1.3 | |
| Total vacant centres | <u>5</u> | <u>4.1</u> | |
| Sub-total child care centres | <u>201</u> | <u>220.8</u> | |
| Other property | | | |
| For lease | 1 | 3.6 | |
| Development land | 7 | 3.5 | |
| Sub-total other property | <u>8</u> | <u>7.1</u> | |
| Total | <u>209</u> | <u>227.8</u> | |

Source: Orchard property valuation reconciliation and other records

With the completion of the lease assignment to Goodstart, the only remaining connection that the Fund has with the former ABC group is through 25 child care centres in New Zealand leased to ABC Developmental Learning Centres (NZ) Ltd (ABCNZ), which is not in administration or receivership. However, McGrath Nicol as the receivers and managers of the ultimate parent entity in ABC is seeking to sell the New Zealand business comprising 127 centres. ABCNZ continues to pay its rent and meet its lease obligations. Orchard is working with McGrath Nicol and potential purchasers to transition these centres to new tenants.

The amendments to the lease terms for centres leased to Goodstart have resulted in the weighted average lease expiry (WALE) profile for the entire portfolio increasing to 11.0 years with 97.5% of centres leased and paying rent.

Orchard also continues to work towards the sale or lease of vacant centres and the sale of land that it does not intend to develop into new child care centres.

Debt facility

The Fund's debt continues to be reduced through the sale of excess development land and vacant child care centres. As at 31 May 2010 the amount of debt was \$112.15 million.

The Fund's debt facility agreement with National Australia Bank (NAB) was executed on 23 December 2009 and the facility was extended to 30 June 2012 subject to the following:

- The Fund making a monthly payment of \$500,000 into a holding account that will be returned to the Fund upon a satisfactory resolution of the ABC receivership;
- A review event occurring if there is not a satisfactory outcome to the ABC receivership, with the debt maturity date being brought forward to 31 December 2010; and
- Revaluation of the remainder of the portfolio to be completed within six months of the outcome of the ABC sale process and every two years thereafter.

Following the assignment of the ABC leases to Goodstart, NAB has issued a Positive Receivership Notice dated the 11 June 2010 satisfying the review event referred to above. As a result NAB has released back to the Fund \$2 million it was holding as additional security. The receipt of this notice also confirms that the expiry date of the debt facility is 30 June 2012.

Distributions

In October 2008 the distribution frequency was changed from quarterly to annual. The Fund made an income distribution payment of 3.25 cents per unit for the year ended 30 June 2009.

Following the completion of the lease assignment to Goodstart and the return of funds held by NAB, the Fund will pay a distribution to unitholders for the year to 30 June 2010. We expect to be in a position to announce the amount of such a distribution before 30 June 2010.

We also expect that the Fund will recommence quarterly distributions in the 2011 financial year with the first payment being made in October 2010 for the September 2010 quarter.

Outlook

The completion of the assignment of the former ABC leases to Goodstart is a major milestone for the Orchard Childcare Property Fund. Having worked its way through the impact of the GFC and the collapse of the Fund's major tenant that leased 94% of the Fund's property portfolio, Orchard will now be looking to resume quarterly income distribution payments and will be exploring and considering options for the Fund to provide liquidity to investors.

Please contact Orchard Investor Services on 1800 008 494 or speak with your financial adviser for further information.

Orchard Capital Investments Limited ABN 23 077 235 879 AFSL No. 233190

Responsible Entity of the Orchard Childcare Property Fund ARSN 106 891 641