Adviser Edge

Arafura Pearl Project 2010

INDEPENDENT ASSESSMENT

This report has been prepared for financial advisers only

Scope

Adviser Edge independent assessments are conducted by Barik Pty Ltd trading as Adviser Edge Investment Research (Adviser Edge) which has developed a key industry sector review process that follows a methodology developed specifically for this asset class.

Key Principles

The underlying principles of the assessment process are to:
– identify the long term commercial potential of the project;
– evaluate project management's capabilities, previous performance in the specific industry and the stability of the organisation;
– evaluate identified markets (domestic and international –existence, stability and growth potential);
– benchmark key performance assumptions and variables against industry and other MIS projects;
– weigh up the relevant risks of the project against projected returns;
– assess project structure and ownership;
– compare and substantiate project fees and expenses;
– determine if the project is structured in such a way as to protect investor's interests; and
– allow an opinion to be formed regarding the investment quality of the project.

Site Assessment

Adviser Edge conducts a detailed site inspection of the project, meets with all levels of project management and inspects the project's infrastructure and market accessibility.

The site assessment considers the following areas:
– suitability of the project site for the purpose intended;
– performance of previous project stages located within close proximity to the proposed site;
– management skills, qualifications, capabilities and experience; and
– associated project risks and their management.

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Report Date

17 November 2009.

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Investment Summary

The Arafura Pearl Project 2010 provides investors with the opportunity to become involved in the Australian South Sea pearl industry. Pearls will be produced at Elizabeth Bay, north-west of Nhulunbuy in the Northern Territory, a proven region for cultured South Sea pearl production due to its tropical climate and favourable marine environment.

Established in the Broome region of Western Australia in the late nineteenth century, and later revived in the early 1950s, the cultured pearl industry now reaches across the northern Australian tropics. It is Australia's second most valuable aquaculture export, and was valued at approximately $264 million in FY2007-08, a drop from $314 million since FY2006-07. (Department of Foreign Affairs and Trade) This drop in exports can be attributed to the fall in international demand for luxury commodity goods due to the global financial crisis. Despite South Sea pearls representing less than 1% of global production by volume, they represent 37% by value, and Australia accounts for nearly 30% of world production by value. (Atlas 2009)

Arafura Pearls Holdings Ltd (Arafura) is the Responsible Entity (RE) and Project manager for this offer, which represents the sixth Managed Investment Scheme (MIS) offer since FY2004-05. Arafura was established as a partnership in 1998 specifically for the purpose of developing and operating a commercial pearl farm at Elizabeth Bay. Arafura listed on the Australian Securities Exchange in December 2006 (ASX: APB) and is the largest pearl farmer in the Northern Territory.

Up to 2,350 units (Project Interests) are to be provided by Arafura under this offer. The application fee is $6,950 (excluding GST) per Project Interest with a minimum application of two Project Interests per Grower, with investors subsequently liable for deferred management, sales and marketing fees. In addition, investors will be liable for a performance incentive fee should final project returns exceed 16% p.a. on a pre-tax basis, or a fixed Management Fee shortfall if certain sales proceed targets are not met. The investment term is approximately six-and-a-half years.

Environmental factors such as site water quality, storm activity, and pests and disease have the potential to affect the health of oysters and the number, size and quality of pearls produced. Helping to mitigate this risk is the availability of insurance against damage arising from disease, storm activity, environmental pollution, cyclone event or other natural disaster. In addition, the supply and demand for pearls may change over time as a result of changes in consumer preferences and changes in the supply of pearls in the global market. The Australian South Sea pearls industry mitigates this risk by producing higher quality pearls that, in the past, have not attracted as large a discount when compared to lower quality pearls. This has been achieved, in part, through the implementation of quota regulation that restricts the supply of Australian South Sea pearls. However, a risk to this is the potential for international producers to narrow any differences in quality.

The Project has obtained a product ruling from the Australian Taxation Office which provides a ruling on the taxation consequences of an investment in the Project. Early Growers that invest by 31 December 2009 may be eligible for an additional deduction under the Small Business and General Business Tax Break introduced in December 2008 and extended in the May 2009 Budget to 31 December 2009. This additional tax break effectively reduces the after-tax effective cost of an investment in the Project, and thereby increasing the potential for higher after-tax returns for eligible investors.

The potential investment returns from the Project will be affected by a number of performance parameters, with returns expected to be most sensitive to variations in shell sizes and exchange rates. Based on the analysis of the various parameters that contribute to investment returns, Adviser Edge has estimated an indicative pre-tax IRR range of between -1.3% and 18.8%, with the potential for higher after-tax IRR ranges for Early Growers. Accordingly, the risk/reward profile for Early Growers is comparatively more attractive when compared to Late Growers. Using Adviser Edge's investment ratings model, the Arafura Pearl Project 2010 has received a 4-star investment rating.

★★★★☆

Adviser Edge Rating

Low Medium High

Recommended Client Risk Tolerance[1]

Project Details	
Project name	Arafura Pearl Project 2010
Product	Australian cultured South Sea Pearls
Responsible Entity	Arafura Pearls Holdings Limited (Arafura)
Operations Manager	Arafura Pearls Holdings Limited (Arafura)

Investment Details	
Investment term	Approximately six-and-a-half years
Unit size	Project Interest comprised of 405 graded spat and 13 oyster panels
Application fee (ex GST)	$6,950 per Project Interest
Ongoing fee structure	Deferred (except insurance)
Minimum investment	Two Project Interests
Close date for Early Growers 2010	31 December 2009
Close date for Late Growers 2010	15 June 2010
Investor finance	10-month Terms Payment Facility
ATO Product Ruling	PR 2009/55

Investor Returns		
Potential investment returns	**Pre-Tax**	**Post-Tax**[1]
Early Growers (Small business entities)	-1.3%–18.8%	6.6%–28.9%
Early Growers (Other)	-1.3%–18.8%	-0.3%–20.3%
Late Growers	-1.3%–18.8%	-1.3%–18.8%

[1] Post-tax calculations are based on a number of conditions, which are described in the product ruling. Please refer to the Investment Analysis section for further information.

Key Points:

Strengths of the Project

- Arafura is an experienced manager of South Sea pearl farms, managing both investor-owned and company-owned shells for over nine years
- The Project has the potential to achieve high returns, provided that yield, quality and price targets are reached
- The quality of the pearls harvested by Arafura and inspected by Adviser Edge has been excellent
- Australian production is quota controlled, which assists in ensuring that quality standards are maintained. This helps to maintain Australia's reputation as a high quality pearl producer
- Investors that invest prior to 31 December 2009 may be eligible for the Small Business & General Business Tax Break

Weaknesses of the Project

- The market for South Sea pearls is inherently volatile, with the global financial crisis significantly affecting the world pearl market
- Pearl farming is inherently risky, being subject to a number of risks including weather and disease. These risks may affect both mortality and quality. However, Arafura has implemented a number of strategies to minimise the impact of these risks, including insurance
- The Australian pearl farming industry is comprised of a small number of private enterprises, which makes it difficult to obtain independent empirical data on the price, yield and quality assumptions
- The highly specialised nature of pearl farming and use of Arafura's extensive infrastructure means that investors are highly reliant on Arafura to manage the Project for the full term. Accordingly, the Project is highly reliant on the solvency of Arafura, which is partially dependent on external sources of funding as it ramps up to full production

Other considerations

- The investment is considered to be illiquid, with no liquid secondary market currently established
- Returns from the Project will be significantly dependent on exchange rates at the time of sale. However, as a non-perishable commodity, it is expected that there will be some flexibility with managing the exchange rate risk

Investor Suitability

As a general note, investment in agribusiness should represent a balance between the various potential risks and the forecast returns. This project is potentially suitable for investors with a risk-tolerant profile and medium-term investment horizon, and as part of a diversified portfolio.

Investment Specifications	
Target subscription	2,350 Project Interests
Location	Elizabeth Bay, Northern Territory
Unit size	405 graded spat plus 13 panels
Minimum application	Two Project Interests
Project asset ownership	Ownership of oysters panels and oysters
Liquidity	Illiquid – no established secondary market
Insurance	Compulsory
Investor finance provider	Not provided

Arafura is giving investors the opportunity to participate in the Australian pearling industry through the offer of 2,350 units (Project Interests) in the Arafura Pearl Project 2010, with provision for oversubscriptions subject to quota restrictions.

The Project pearl farm is located on a marine leasehold covering in excess of 500km^2 at Elizabeth Bay, near Nhulunbuy off the north-west coast of the Northern Territory. This lease was established in 1998 with the Northern Land Council (NLC). The lease expires on 3 September 2018, with a 10-year renewal option.

Investors are required to purchase a minimum of two Project Interests, each initially comprised of 405 selected spat (settled pearl oyster larvae). Arafura has provided a guarantee that it will replace any spat necessary to ensure that 18 months after the project commencement there are at least 177 pearl oysters available per Project Interest. This guarantee has been calculated to accommodate the selection and seeding of 159 pearl oysters. After accounting for post-operative oyster mortalities and seed rejections, Arafura intends to make available 100 healthy seeded oysters to meet quota limits. Oyster mortality rates will depend on seasonal conditions and management practices. Accordingly, the key risks to the Project in achieving its initial seeding targets are located around the expected rejection rates and mortality of oysters after 18 months. This mitigates the difficulty associated with estimating the number of spat required to grow out 177 pearl oysters. Although the guarantee is for 177 oysters, Arafura has advised that it will rear additional oysters to ensure that the full quota of shells is seeded on the investors' behalf. After Project year four Arafura will conduct the first harvest and a second seeding of those oysters that produced a pearl in the first operation. The investors' agriculture exposure after the shells are successfully seeded is mitigated by the availability of insurance.

Investors in the Project will have counter-party risk to Arafura, in relation to the 18-month guarantee but also for the performance of its obligations under the Management

Key Points:

- All ongoing fees (except insurance) are deferred until harvest
- The Project term is approximately six-and-a-half years
- Arafura has incentive to maximise returns through management and marketing fees linked to proceeds
- The technical and specialised nature of pearl farming means the Project is significantly reliant on Arafura

Agreement and Constitution, although there is some mitigation of this through the beneficial ownership of the panels and oysters by investors.

The Project's structure and reliance on Arafura to provide management services and access to plant and equipment means investors are significantly reliant on the continued solvency of Arafura. Accordingly, the financial position of Arafura over the Project term will be important for overall investor returns.

Project structure and agreements

When investors are accepted into the Project, they will be bound by a number of legal agreements that outline the rights and responsibilities of each party involved in the investment scheme. These agreements are outlined in the Project's Product Disclosure Statement (PDS). It is recommended that each potential investor and their adviser read and understand the Project agreements to ensure that the Project is suitable for the investor's needs.

Fee Schedule

The fees outlined in the following tables relate to an investment made on or before 15 June 2010.

Initial cost to the investor

Schedule of initial fees (ex. GST)*	
Payment Type	Cost per Project Interest
Application Fee	$6,950

Ongoing cost to the investor

Schedule of ongoing fees (ex. GST) (per Project Interest)	
Fee	Cost
Deferred Management Fee	30% of gross pearl sales proceeds[1]
Sales and Marketing Fee	10% of gross pearl sales proceeds[1]
Deferred Management Fee Shortfall	Up to a maximum of $5,900[2]
Bonus	10% of the amount that exceeds the benchmark[3]
Insurance	Up to 1.5% of agreed value per annum

[1] Gross pearl sales proceeds means the proceeds received through the sale of polished and/or further improved pearls.

[2] This fee is only payable in the event that the sales and marketing fee and the deferred marketing fee do not exceed specified amounts. The actual amount payable will depend on the amount of the shortfall, the number of years remaining on the Project term, and the number of oysters lost if the Management Agreement is terminated or there are significant losses to grower oysters.

[3] The benchmark is the amount of harvest proceeds, less all applicable costs and expenses, that must be paid on final harvest to provide an investor with a before-tax internal rate of return of 16%.

Initial Management Fee

The Initial Management Fee for the Project has increased by approximately 10% to $6,950 plus GST. This fee is charged for rights to access and grow-out spat, the identification of panels, and other preparatory services required to establish the investors' oysters. Adviser Edge believes that profits earned by Arafura from the Initial Management Fee will need to be used to meet ongoing cash flow requirements over the Project term, given the deferred nature of the ongoing management fee. Accordingly, Arafura will need to manage its cash flow from these and other sources to meet its obligations to investors.

Ongoing Management Fee

Ongoing fees are deferred and include a Management Fee and a Sales and Marketing Fee. Fees are calculated as a proportion of gross pearl sales proceeds and deducted prior to any distribution being made to investors. If the sum of deferred fees is less than the prescribed shortfall amount of $5,900 (excluding GST) per Project Interest at the conclusion of the Project, investors will be invoiced for the difference. This fee structure provides significant alignment of interests of Arafura with investors. This is considered important for the Project because of the potential to create significant value-add to the harvested pearls through matching, grading and marketing. Accordingly, as there are no cost recovery provisions in the Management Agreement, the deferred fees provide Arafura with a mechanism to meet the cost of providing these services, while also providing an incentive to maximise harvest proceeds.

Bonus

Arafura is also entitled to a performance incentive fee equal to 10% of any amount by which each Project Interest exceeds a pre-tax IRR of 16% p.a. at the completion of the Project term.

Shell insurance

Under the terms of the Management Agreement, Arafura is required to use all reasonable endeavours to arrange insurance of Project oysters on behalf of investors. Arafura has indicated that it has obtained quotes to insure mature shells against the risk of damage arising from disease, storm activity, environmental pollution, cyclone events, disease or other natural disasters.

Adviser Edge believes that the use of insurance to protect against insurable production risks should be part of a comprehensive risk management strategy whenever economically feasible. Arafura has recently taken measures to insure its entire shell inventory under the aforementioned policy to mitigate the risks of extreme climatic events and a range of other events. This policy also applies to Project shells and is seen to provide considerable benefit to the offer.

Where insurance cover is maintained, Arafura has agreed to share some of the estimated cost of insurance premiums under the policy. This annual cost will be limited to 1.5% of the agreed value of seeded shells prescribed under the policy, and acts to reduce the financial impact of the cover on investment returns.

Fee Analysis

With any MIS project, the application fee is generally dictated by the actual development cost incurred in establishing and managing the Project, other administration costs such as corporate overheads, marketing and PDS development expenses, and the profit margin taken by the Project manager.

The total application fee for the Project has increased by approximately 10% on the previous year. Due to the limited availability of third party information on pearl farming, it is difficult to assess the reasonableness of the fees payable. Arafura has provided a financial model that estimates the costs and expenses associated with managing the Project, which indicates that the increase in the Initial Management Fee is approximately twice the size of the estimated cost increases. This suggests a slight shift in the apportionment of risk and reward to Arafura from the investor.

Another perspective to analysing the fee increase, from the point of view of investors that acquire a Project Interest by 31 December 2009, is to review the apportionment of the taxation benefit of the Small Business and General Business Tax Break. For investors that are entitled to an additional 50% deduction, this equates to an after-tax benefit of $1,390 per Interest. When considered from this perspective, the additional cost is equivalent to approximately 50% of the additional tax benefit.

While the fee increase appears to be higher than the increase in the cost of providing the initial management services, Adviser Edge considers the fees charged to investors to be a reasonable apportionment for those investors that are entitled to the Small Business and General Business Tax Break.

Risk apportionment

Risk apportionment refers to the level of risk the Project Manager/RE shares with investors as a consequence of the Project fee structure. When ongoing Project fees are deferred and linked to harvest proceeds, the level of risk sharing between investors and the Project manager is more evenly aligned.

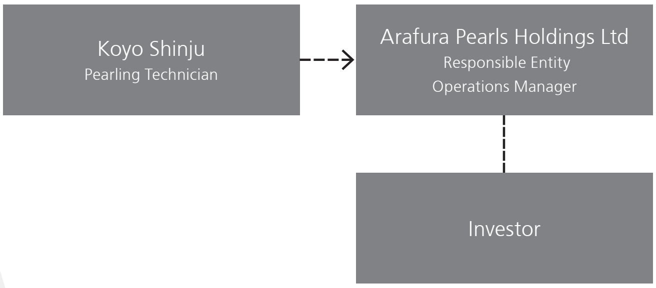
The fee structure provides incentives for Arafura to achieve the best outcomes for the Project through the deferred management fee and the sales and marketing fee.

Additional Information

The Project has been issued a product ruling PR 2009/55, which provides certainty in relation to the taxation consequences of investing in the Project. This product ruling also contains important information regarding the eligibility of investors to certain deductions.

Adviser Edge does not conduct detailed analysis on the implications of the Project's Product Ruling, and it is advised that investors seek appropriate professional advice in relation to the full financial and taxation implications of their investment as it applies to their situation.

Key Counterparties



Arafura Pearls Holdings Limited (Responsible Entity/Operations Manager)

Arafura Pearls Holdings Ltd (Arafura) was established as a partnership in 1998 specifically for the purpose of developing and operating a commercial pearl farming operation north-west of Nhulunbuy on the Gove Peninsula in the Northern Territory. Arafura is listed on the Australian Securities Exchange (ASX Code: APB).

The main farming operations operate on over 500km^2 of maritime leasehold in Elizabeth Bay, Northern Territory. Elizabeth Bay is located 48km north-west of Nhulunbuy, Northern Territory. A key component of Arafura's business is an integrated pearl oyster hatchery established in 2001. The company has offices in Darwin for senior operational management, and a corporate head office in Perth, Western Australia.

Arafura has expanded its pearl production capacity in recent years, having increased its initial quota holding of 40,000 shells to 235,000 shells in 2008. Of this quota holding, 140,000 shells are owned by Arafura in its own right. In addition, Arafura manages a joint venture pearling operation in Beagle Bay, Western Australia. This site has been producing pearls since the early 1980s and holds a 15,000 shell quota.

Board of Directors – Arafura Pearls Holdings Limited

Director	Credentials	Industry	Director
Mark Ceglinski (Non-Executive Chairman)	★	★	★
Andrew Hewitt (Chief Executive Officer)	★	★	★
Christopher Cleveland (Executive Director)	★		★
Jeffrey Mews (Non-Executive Director)	★	★	★

Board of Directors

Adviser Edge believes that the directors of Arafura possess the appropriate experience and credentials ordinarily required to manage a listed MIS company.

Key Points:

- Arafura has substantial experience and resources in the Australian pearl industry
- Arafura is reliant on achieving its MIS sales targets and raising equity in capital markets. While Arafura has demonstrated its capacity to achieve these objectives in the past, there is a risk that these objectives may not be met in the future
- Koyo Shinju's personnel are considered to be highly experienced pearl technicians. The skill of the individual technicians will have a significant bearing on overall Project performance. The addition of Phil Thomas to the team should further improve Arafura's seeding and harvesting capabilities.

Corporate governance and compliance

Adviser Edge has reviewed the corporate governance documents supplied by Arafura, including the corporate governance statement, board charter, and corporate code of conduct. Adviser Edge is satisfied that Arafura has adopted appropriate corporate and financial management procedures for a company of its size and nature. However, to improve investor protection, Adviser Edge would have preferred a separation of roles between the Responsible Entity and the Project manager.

Financial performance

Key financial data – As at 30 June

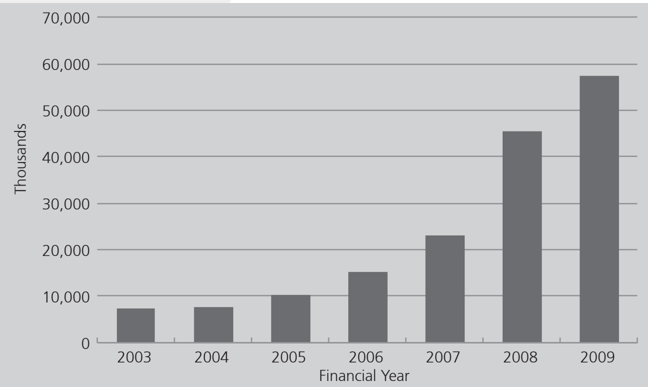
Financial Profitability	2009	2008
Revenue ($'000)	8,110	6,514
Net profit ($'000)	3,126	10,960
Profit margin (%)	38.55%	168.2%
ROCE (%)	8.6%	27.5%
ROE (%)	5.7%	23.6%
Market Measures		
EPS (basic/cents)	2.0	9.0
P/E Ratio	2.3	1.0
NTA per Share ($ per share)	0.21	0.31
Financial Liquidity/Solvency		
Net working Capital ($'000)	5,791.6	438.6
Current Ratio	1.40	1.07
Quick Ratio	0.48	0.41
Net debt to equity ratio	0.19	0.04
Interest Cover	6.6	40.8

Source: Arafura Financial Report 2009.

There was little change in Arafura's financial performance in FY2008-09, with higher MIS project management fees more than offsetting lower pearl sales revenue. However, Arafura's financial position was challenged because of its reliance on external funding sources to meet current operating expenditure, which was significantly restricted due to the global financial crisis. With this in mind, Arafura appears to have performed reasonably well in the circumstances, achieving MIS sales of $5.4 million, an equity raise of $5.6 million and a convertible note offering of $0.5 million in FY2008-09.

Although Arafura experienced an improvement in revenue, up from $6.5 million to $8.1 million, profitability declined to $3.1 million as the company was not able to continue the growth in valuation of its pearl and shell inventories as depicted in the following graph. The performance growth in inventory and biological asset valuation in FY2007-08 is representative of a change in accounting practice, including the discounted cash flows expected to be generated from the second and third seeding of the shells. As such, the one-off gains earned in FY2008-09 are unlikely to be repeated again.

Arafura Pearl Holdings: Inventory and biological assets



Source: Arafura annual reports 2004–2009.

In addition, it is important to note that Arafura's auditors have provided a qualified opinion in relation to the 2009 financial report, particularly the valuation of Arafura's inventory and biological asset valuation, where the auditor expressed an opinion that lower assumptions should be used in light of market conditions as at 30 June 2009.

DJ Carmichael, which is recommending a proposed convertible note issue (discussed below), has indicated that, even using the more conservative valuation adopted by the auditors, there is sufficient security to warrant a recommendation to subscribe to the convertible note.

Adviser Edge believes that Arafura's cash flow funding will be tight, that and strong cash flow management by Arafura will be required. The challenge for Arafura is to convert its substantial biological assets into reliable revenue in the near-term and to demonstrate its ability to fund operations internally, without external funding. The annual report has indicated that certain covenants associated with Arafura's secured bank overdraft were breached, although Adviser Edge was advised that these breaches were technical and did not result in any financial impact to Arafura.

To this end, Arafura has harvested 80,000 pearls, of which 90% are Arafura-owned. With a wholesale value expected to be approximately $12 million, depending on price and exchange rate, it appears that Arafura does have some capacity to internally generate cash flow. This sum appears to be sufficient to meet Arafura's FY2010 operating cost obligations. Accordingly, the ability of Arafura to deliver on both the sale of both harvested pearls and MIS sales in the near future is crucial to improving the access and cost to debt and equity funding. In addition, Arafura is seeking to raise an additional $5 million through a convertible note offering to sophisticated investors, which should strengthen Arafura's short-term cash position.

As discussed in the Structure and Fees section of the report, the Project is significantly reliant on the continued solvency of Arafura to meet Project objectives. That being said, Arafura can be differentiated from some of the more recent MIS project failures by the size of the MIS projects when compared to Arafura's interest bearing liabilities. Adviser Edge has been advised that these liabilities have been reduced by over $1 million since 30 June 2009. This provides the Project greater scope to achieve a reasonable outcome for investors, which provides them scope to recapitalise the MIS projects and manage them to maturity. That said, financial circumstances can change over time and there are no assurances that a recapitalisation proposal will be successful, or even possible.

Arafura is continuing with its strategy to reduce its reliance on MIS sales over the medium-term. The ability to achieve this strategy will become more apparent when Arafura successfully markets the 2009 pearl harvest and the impact of these sales is filtered through to its balance sheet. Nonetheless, in the short-term Arafura continues to be reliant on other funding sources to meet its operational cash flow needs.

Investors should note that, as a listed company, Arafura has a number of avenues to secure short-term funding. Arafura has demonstrated its willingness and ability to access these in the past, although they may not necessarily be available in the future.

MIS Capital Raising History – Arafura		
Project Name	Financial Year	Capital Raised ($ million)
Arafura Pearl Farms 2005	2005	0.9
Arafura Pearl Project 2006	2006	4.6
Arafura Pearl Project 2007	2007	9.8
Arafura Pearl Project 2008	2008	4.5
Arafura Pearl Project 2009	2009	5.4
TOTAL		**$25.2**

Operational Management

Arafura will be responsible for the propagation of pearl oysters and their management and harvest over the Project term. Arafura has developed the necessary infrastructure and relationships for a modern pearl production and marketing operation. The company operates a regional office in Darwin that serves as an administrative base for senior operations management, while the head office in Perth fulfils Arafura's corporate requirements.

Assets relevant to operations include a fleet of service vessels and a permanent land base at Elizabeth Bay, which also incorporates a pearl hatchery operation. Arafura also has ongoing research and development programs in areas such as the genetic tracking of hatchery broodstock and aspects of the grow-out process. These programs are aimed at improving both the quality and productivity of its operations.

Key Operational Personnel			
Key Personnel	Credentials	Industry	MIS
Captain Chris Cleveland – Executive Director and Pearling Advisor	★		★
Philip Thomas – General Manager Operations	★		★
Tim Jones – Manager Sales and Distribution	★		★
Juan Carlos Gutierrez Serrano – Hatchery Manager	★		★

Adviser Edge believes that Arafura's operational management personnel are suitably qualified and experienced to meet Project objectives.

Executive Director Captain Chris Cleveland joined Arafura in 2005 and provides valuable management oversight to Arafura's operations. Chris periodically conducts site visits and reports directly to the board. Chris has extensive pearling industry experience, having formerly held the position of General Manager of Operations for Australia's two largest South Sea pearl producers, Paspaley and MG Kailis. Chris also serves as a member nominee on the Northern Territory Pearling Industry Advisory Committee, and represents Arafura on industry matters.

Philip Thomas joined Arafura in April 2009, providing Arafura with general pearl management expertise, together with skills as a pearling technician. Prior to joining Arafura, Phillip held many roles in the pearling industry including, manager, diver, and pearl technician for a number of pearling companies including MG Kailis, Broome Pearls, Maxima Pearl Company and Arrow Pearl Company. Philip's experience and expertise should be invaluable in taking Arafura to the next level of performance, particularly improving Arafura's management of pearl seeding and harvesting.

Tim Jones joined Arafura in October 2008 in the capacity of Manager – Sales and Distribution. Prior to joining Arafura, Tim was the Sales and Distribution Manager for MG Kailis, one of the world's largest pearl jewellery brands. Tim also has previous experience in the jewellery business with the sales and marketing arm of DeBeers, one of the largest diamond trading companies in the world. Tim has an honours degree in Archaeology from University College, London.

Juan Carlos Gutierrez Serrano is the Elizabeth Bay hatchery manager. Juan is a qualified marine biologist with a Masters degree in Aquaculture from Deakin University. Juan has had over five years' experience in hatchery operations prior to joining Arafura in 2006, and has capably managed the growth in Arafura's hatchery production, which is required to service its rapidly expanding operations.

Key Counterparties

Key Counterparties		
Company	Role	Location
Koyo Shinju	Pearling Technician	Wagu, Japan

Arafura formally engaged the experienced Japanese firm Koyo Shinju in 2006 to perform the specialised oyster seeding and harvest operations for a 10-year period. Koyo Shinju is an integrated Japanese pearling firm with capabilities ranging from technical consulting to the management of its own pearl farming, grading and marketing operations. Based in Wagu in the Japanese province of Shima, the company employs approximately 50 to 60 staff and has been involved with Australian South Sea Pearl production for over 40 years.

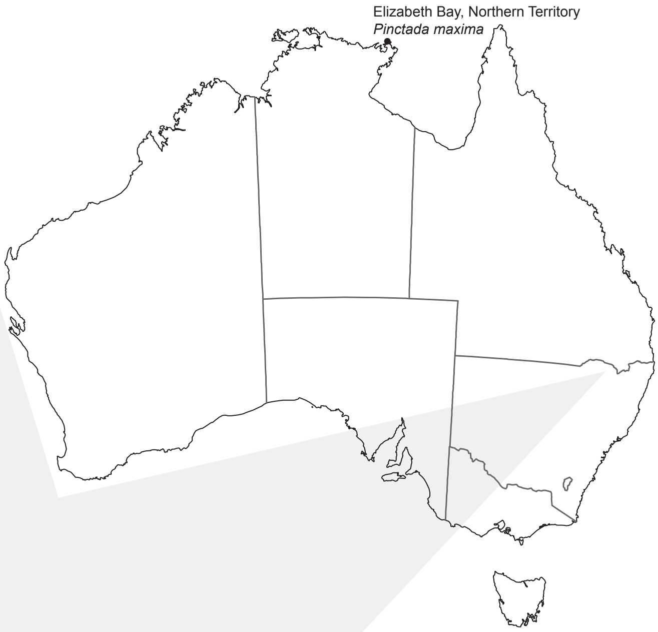
Koyo Shinju's employees are considered to be highly experienced and are suitable pearl technicians for the Project. It is also pleasing to see Arafura's adoption of management strategies that match seeded pearls with individual pearl technicians. This process helps to ensure that mortality rates and the size of implanted nuclei are not compromised in the interests of efficiency.

Independent Expert

Independent Expert		
Focus	Company	Responsible Person
Pearl production	Serena Sanders	Serenidae Pty Ltd

Arafura has engaged Serena Sanders of Serenidae Pty Ltd to provide an assessment of Arafura's production practices and productivity estimates. Serena has over 20 years of involvement in the pearl industry in senior management and external consulting roles, and holds a Bachelor of Science (Marine Biology/Zoology) degree with honours.

The independent expert is considered suitably qualified to undertake her assigned reporting role under the offer. However, Adviser Edge would have preferred that a more thorough examination of the Project assumptions was taken in her expert report.



Key Points:

- Adviser Edge's last site inspection of Arafura's operations was carried out in November 2009
- Koyo Shinju conducts the seeding and harvesting operations
- The location of the Project is ideally suited to pearl farming, although cyclones remain a risk to the Project
- Arafura has made significant investment into infrastructure and equipment at its operations

Adviser Edge conducted a site inspection at Elizabeth Bay on 6 November 2009. Accompanying Adviser Edge on the site inspection was Arafura's Commercial Manager, Dan Hewitt, General Manager Phil Thomas and Hatchery Manager Juan Carlos Gutierrez Serrano. During the site visit, Adviser Edge was able to appreciate the size and scale of Arafura's pearling operations and gained an insight into its operational capabilities. It was evident that Arafura has continued to make significant advances in its pearling operations, with substantial investment in plant and equipment, human resources, and research and development.

Region

The Nhulunbuy region is located in Arnhem Land, which is under the stewardship of its traditional Aboriginal owners. The development of economic activities such as mining and aquaculture in the area is tightly regulated by the Northern Land Council (NLC), which was established in 1973 to represent the interests of the traditional Aboriginal landowners. (NLC 2003) The process of obtaining permission for a commercial enterprise in the region is complicated, requiring approval by the NLC and also consent from the Minister for Aboriginal and Torres Strait Island Affairs for terms exceeding ten years.

Also located at Nhulunbuy is Rio Tinto's multi-billion dollar bauxite operation near Gove. As the primary source of employment and income in the region, the operation has a positive effect on the local economy and maintains a high level of infrastructure in the region. Rio Tinto and its predecessor Alcan's both have a strong environmental record at the site, including ISO 14001 accreditation. This suggests that the risk that Rio Tinto may pose to Arafura's operations is low. That said, the operation does generate a high volume of shipping activity that poses a potential risk of marine contamination from the ballast water of ships, which originates from all over the world.

Climate

At approximately 12° latitude, the Nhulunbuy region experiences tropical weather patterns. Climate data from the Australian Bureau of Meteorology's (BOM) nearest observation point to Nhulunbuy (Gove) was assessed to evaluate regional climatic conditions. Average annual rainfall for the region is 1,480mm, with December to April experiencing heavy rainfall, accounting for approximately 86% of average annual rainfall. Average temperature data for the region reflects relatively stable maximum and minimum temperatures, with the 30-year annual minimum and maximum averaging 22.5°C and 30.7°C, respectively (BOM 2009). This climate is recognised as being well suited to the production of cultured pearls.

Nhulunbuy's location also makes it susceptible to tropical cyclones, which can occur in northern Australia from November through to April. Since records began in 1948, 12 cyclones have been reported in the Nhulunbuy region. These have occurred every four to seven years, with the exception of a 15-year hiatus between December 1981 and March 2003.

While the area surrounding Nhulunbuy has remained relatively free from tropical cyclone activity over recent decades, Tropical Cyclone Ingrid in March 2005 and Tropical Cyclone Monica in April 2006 caused widespread damage across northern Australia. Cyclone Monica largely avoided Elizabeth Bay, although Cyclone Ingrid seriously affected Arafura's operations, resulting in significant asset damage and loss of stock. The environmental conditions are vital for the achievement of optimum pearl quality.

In addition to employing various management practices and systems to mitigate the risk of storm activity, Arafura has obtained quotes to insure mature shell against the risk of significant damage caused by disease, storm activity and environmental damage.

Site selection
Arafura's Elizabeth Bay operation is situated on the north-east tip of the Northern Territory, approximately 48km north of Nhulunbuy. The Elizabeth Bay site was identified for pearl production in the mid 1990s by pre-eminent marine biologist and *Pinctada maxima* expert, Dr Robert Rose. In the late 1990s, Arafura conducted ecological and environmental surveys on the site, which indicated that tidal flow, water exchange and plankton levels were suitable for South Sea pearl production.

Following the positive findings of these surveys, the company successfully negotiated a lease agreement with the Arnhem Land Aboriginal Land Trust and the NLC in 1998, extending rights to over 500km^2 in and around Elizabeth Bay for the sole purpose of pearl production. This area consists of an archipelago of islands in which Arafura places the long-lines in and around the islands' bays. The lease term is 20 years expiring on 3 September 2018, with a 10-year renewal option.

While Arafura has assumed control of a secondary site in Beagle Bay, WA, all Project shell associated with the offer will be produced out of Arafura's Elizabeth Bay operations.

Species
Pinctada maxima, commonly known as the silver or gold lip pearl oyster, will be used as the host pearl oyster variety. This species, which produces the South Sea Pearl, occurs naturally in Western Australia and the Northern Territory, and has been farmed in these regions for over four decades.

Hatchery-bred *Pinctada maxima* shells will be used for the Project, sourced from Arafura's own hatchery operations located at Elizabeth Bay. Arafura's hatchery, established in 1999, has produced commercial spat since 2001 with sufficient capacity to meet the needs of Arafura's quota holding. Arafura has made significant progress in hatchery production, producing approximately 750,000 spat. During the site visit, Adviser Edge had the opportunity to inspect the hatchery and gained an overview of the hatchery process, which appeared to be well run with appropriate safeguards in place.

Spat are collected in collector bags when the oysters are spawning, which is expected during the full moon. The spat are left in the collector bags for 120 days before the spat are selected based on growth and other characteristics.

Cultured pearl production
The oyster shell production process from hatchery rearing to seeding usually takes between 18 to 24 months. Hatchery rearing involves the culture of larvae and newly settled small juveniles (spat) inside a controlled environment. Feeding in this environment is undertaken in a strictly controlled manner. Bacteria-free tested micro-algae obtained from the CSIRO's hatchery in Tasmania is used to produce feed for the spat in the hatchery, which are also subject to UV light treatment and high-pressure heating. As the spat grow to become oysters, a filtering system is used to select the faster growing spat for on-growth. Following an on-shore nursery phase lasting two to three weeks, spat are placed in an ocean nursery for a period of 10 to 12 weeks before undergoing selection and grading according to potential viability.

Juvenile oysters must experience a grow-out phase, which occurs in the ocean and can last up to 15 months. During this period, Arafura will place oysters into 15-pocket netted panels and attached to long lines suspended by buoys that are anchored to the sea floor. Faster growing shells are placed directly into 8-pocket panels, which group the better performing oysters together for improved grow-out management and reduced double handling. Each line is approximately 100m long and holds 100 panels, spaced at 1m between panels and submerged approximately 2m below the ocean surface. The oysters should measure 40mm to 50mm at the time of the transfer from the collectors to the panels.

The pearl cultivation process begins with the seeding of the virgin shell. Technicians from the Japanese company Koyo Shinju will perform the delicate seeding operation on Project oysters. The technician makes a small incision in the gonad of the oyster in which they graft a nucleus and a piece of mantle tissue from another oyster. Post operation, the shells are placed in panels and rested in sites on the ocean floor for a period of around two weeks, with divers turning the panels every two days. Following the resting period, each panel (typically holding six seeded shells) is placed back onto the long lines.

Seeded shells are cleaned every three to six weeks, and where appropriate a representative sample may be x-rayed to determine whether the nuclei have been retained. The first pearl harvest takes place 18 to 24 months after seeding. Shells that are determined to be in adequate health following the first harvest are re-seeded with a larger nucleus. At the time of the site visit, Arafura staff members were transferring the oysters from the 15-pocket panels to 8-pocket panels for further grow-out. These panels were tagged to identify the panels to the relevant investor and seeding technician.

Project infrastructure
Land-based infrastructure at the Elizabeth Bay base appeared to be well resourced. This included the hatchery and laboratory, office and workshop facilities, staff quarters, mess hall and recreation hall. An additional power generator has been added to the site, with the site now running two generators, with a third generator available as a backup. During FY2008-09, a new septic system was installed on site and additional accommodation was added to provide for the additional workforce required to maintain operations for Arafura's full quota.

Arafura has a well-maintained fleet of boats at its disposal, including a 32m mothership, several cleaning boats, dive boats and work boats. Capital investment in supporting infrastructure has increased in line with general maintenance requirements and expansion plans. Arafura maintains a large fleet of five cleaning boats, a mid-sized mothership, the ***Norwest Pearl***, and a larger mothership, ***Aracat***, which Arafura acquired in FY2008-08. This larger mothership reduces downtime, as staff can remain on the boat during pearling operations. In addition, together with the *Norwest Pearl* providing supplementary accommodation, the ***Aracat*** has sufficient accommodation to manage the ten-person seeding team needed to meet Arafura's seeding requirements in FY2010. Arafura intends to take delivery of a further two cleaning boats after the wet season in 2010.

During the site visit, Adviser Edge took the opportunity to inspect Arafura's infrastructure, including its land-based operations and the recently acquired ***Aracat***. With oyster shells spread around the islands in and around Elizabeth Bay, Arafura maintains a reasonably large sized workforce, varying between 45 and 65 staff members, depending on the season. Crew rotations are four weeks on and two weeks off for new staff, which is lengthened to six weeks on and one week off for longer term staff.

Adviser Edge was impressed by the facilities that have been developed at Elizabeth Bay, given the remote location. This operations base appears to be both efficient and cost-effective, with adequate capability to meet the Project needs.

Operational capabilities

Arafura is currently undertaking four separate research and development programs (R&D), which it has funded in conjunction with rebates available through the Australian government agency AusIndustry. These programs are focused on varying stages of the production cycle, with subjects including grow-out practices, genetic tracking of brood stock and post-operative care. The company has also entered into an R&D joint venture seeking to gain a detailed understanding of how the oyster genetically controls bio-fabrication. It is hoped that this information can be used to identify pearl oysters that are a source of high quality donor mantle tissue, which can then be applied in Arafura's hatchery program.

Maintaining an environment free of pollution is key to maximising the productivity of a pearl farm, as polluted water can detrimentally affect oyster health as well as pearl size and quality. Arafura has implemented an Environmental Management Plan, which identifies potential environmental impacts associated with its pearl farming operations and outlines management practices and procedures designed to minimise their effects. Given the sensitive nature of the project site, this represents a critical risk-management strategy.

Pearl oysters are also susceptible to a range of diseases, with the health of the shell continually monitored throughout the cleaning cycle. In addition to this, the Aquatic Pest Management Unit (APMU) operated by the Northern Territory Fisheries department continually monitors marine pests. Arafura and the APMU had not identified any uncontrolled marine pests in the Nhulunbuy area at the time of writing.

Harvesting

Japanese pearl oyster technicians Koyo Shinju has been engaged to undertake the Project's harvesting operations. These will be carried out between June and August each year. Arafura's general manager, in consultation with Koyo Shinju, will determine the most appropriate time to commence the pearl harvest. Koyo Shinju is well qualified to undertake this role within the project, and Arafura strengthened this important counterparty relationship in 2006 via the negotiation of a 10-year agreement for Koyo Shinju to provide technical services to Arafura.

The addition of Phil Thomas should greatly benefit Arafura's harvesting operations. Phil's knowledge as a pearling technician will prove to be invaluable in managing the pearling technicians.

Market Overview	
Product type	Australian South Sea pearls
Primary use	Jewellery
Key target market	Domestic and export
Major competitors	Paspaley Pearls and other South Sea pearl producers

Marketing Strategy

The Project pearls are expected to undergo polishing and sorting to improve marketability. After loose pearl valuation, a portion of the Project pearls are expected to be set aside for value adding opportunities, such as matching and stranding of pearls, which can carry a premium to loose, single pearl lots.

Tim Jones is the Manager of Sales and Distribution at Arafura and has substantial experience in the sales and marketing of loose pearls, pearl jewellery and uncut diamonds, having previously worked for MG Kailis Group and DeBeers.

Arafura intends to market the pearls using a combination of internal marketing and the use of external sales. The pearls are expected to be marketed locally and overseas in the major South Sea pearl markets of Japan, Hong Kong, Europe and the United States.

Arafura expects that value adding and a flexible sales and distribution strategy will result in higher prices for investors in the Project than relying on a single independent third party agent. Arafura has advised that it will be compensated for the value adding and sales and marketing activities undertaken on behalf of investors by the Sales and Marketing Fee under the Project agreements. Accordingly, the cost of Arafura internalising the marketing of the pearls will not add to the costs paid by investors.

Adviser Edge considers the marketing strategy adopted by Arafura to be sound. By establishing internal marketing capabilities, Arafura is well placed to maximise grower returns.

Market overview

Japan is the largest importer of both natural and cultured pearls, importing just over 32% of total world imports in 2006, valued at an estimated US$380 million. Other major importers include Hong Kong (26%), the United States (26%) and Australia (11%). The largest destinations for Australian produced pearls, in order of export value, are Hong Kong, Japan and the United States.

Hong Kong is the world's largest exporter of pearls, and was responsible for over 34% of world exports in 2006, valued at an estimated US$405 million. Hong Kong is followed by Japan (23%), Australia (21%) and China (12%). (UN Comtrade 2008) Hong Kong is predominantly a re-exporter of value-added pearls, whereas Japan, Australia and China are both producers and exporters. The largest exporter of unimproved cultured pearls is French Polynesia, exporting over $110 million of product in 2006.

The Australian pearl industry exports are valued at approximately $314 million. (Department of Foreign Affairs and Trade, 2008) This accounts for approximately 93% of all non-edible fisheries products. (ABARE 2008) Japan, the United States, Hong Kong, France and Switzerland rank as Australia's major markets, with the majority of trade conducted in Japanese Yen. Consequently, Australian pearl receipts vary with the value of the Australian Dollar/Japanese Yen exchange rate.

South Sea pearl production is also common throughout South East Asia, with large industries now established in Indonesia and the Philippines. While neither of these countries possesses the same reputation for quality that the Australian industry has fostered over many decades, they have had a significant impact on world supply. In recent years the market for Australian South Sea pearls has experienced a downturn, due largely to mounting global inventories arising from the export of hatchery and farming technologies to developing countries. A steady appreciation in the Australian Dollar in recent years, as well as the broader global financial crisis, has also affected the Australian South Sea pearl market.

Key Points:

- Arafura has established internal sales and marketing capabilities
- Australia is recognised as a high quality producer of South Sea pearls
- The major destinations for Australian South Sea pearls are Hong Kong, Japan and the United States

Market outlook

The cultured pearl industry initially began to flourish in Japan in the early twentieth century with rapidly growing Akoya pearl production, which peaked at approximately 230 tonnes in 1966. (Müller, 2009) Since then, the Akoya pearl industry experienced a dramatic decline to around 12 tonnes to 15 tonnes per annum as a result of increased competition from South Sea, Tahitian and freshwater pearls, pollution in Japan which affected quality and mortality, and increased cost of production in Japan.

Similar to Akoya pearls' early experience, global South Sea pearl production has increased dramatically, with an estimated 2.4 tonnes produced in 1998 growing to 12.5 tonnes in 2009. (Müller, 2009) However, as a result of a fall in pearl prices total value declined from an estimated $220 million in 1998 to $172 million in 2009. Recognising the challenges facing the industry is critical for the Australian South Sea pearl industry to maintain and improve the market.

Assisting in these challenges is the fact that the supply of Australian South Sea pearls is restricted by production quota licences issued by the Western Australia and Northern Territory governments. In addition to this, the RE and the Paspaley Group now control approximately 80% of Australia's total quota, either directly or indirectly. This structure gives some stability to the supply side of the market, as production can be controlled to a large extent, and assists in maintaining Australia's reputation as a quality pearl producer. Maintaining a quality advantage is considered critical in reducing the Australian South Sea pearl market's exposure to other South Sea pearl producers. Currently, it is estimated that Australia accounts for approximately 40% of South Sea pearl production by weight and 60% by value. (Müller, 2009)

The global financial crisis that started in late 2007 represents a risk to consumer demand in many key markets for Australian South Sea pearls. The Australian export pearl industry was valued at approximately $264 million in FY2007-08, a drop from $314 million since FY 2006-07. (ABARE 2008) Commentary from a number of pearl producers in Australia confirms that the market was particularly affected by the global financial crisis. While the fear of a severe downturn in the global economy appears to be subsiding, it is not yet clear whether there will be a sustained recovery in the medium-term.

The following section provides a discussion of the key project parameters that directly affect the performance of the investment.

Pearl Yield and Quality

Project Year	Arafura
First harvest mortality rate^ (% of seeded shells)	24%
Second harvest mortality rate^ (% of seeded shells	12%
Saleable shells (% of harvest)	80%
First harvest average size (momme/piece)	0.72
Second harvest average size (momme/piece)	1.20

Source: Arafura, 2009.

^ Mortality rate refers to the number of shells unsuccessfully harvested from confirmed seeded shells.

Yield

Arafura has advised that the lower mortality rate, increased proportion of harvestable shell, higher average pearl weight, and higher proportion of marketable pearls assumed in the second harvest is projected due to the larger oyster size and proven compatibility of the oysters with cultured pearl production. The yields from the first harvest will depend on a number of factors including oyster mortality rates, the percentage of oysters that reject nuclei, percentage of oysters that yield a saleable pearl and the average size of the pearls. The yields from the second harvest will depend on the same variables as the first harvest, although this will also be affected by the number of oysters that are able to be seeded again after the first operation.

The quality of farm management will have a strong bearing on yield outcomes over the Project term, influenced by factors such as the average size of shell seeded following the grow-out stage, the size of the nuclei inserted into the shells, the timeliness of shell cleaning operations, and the proficiency of seeding and harvesting operations. These factors will have a bearing on mortality rates, the size of pearls and nacre growth. Theft is also a risk for such a highly valued product, although the isolation of the farm and regular governmental surveillance of the region for illegal boats should help to mitigate the risk.

The experience that Arafura has gained since establishing the Elizabeth Bay farm in 1998 is expected to provide a strong foundation for future operations. Continued improvement in production practices, assisted by the agreement forged with highly experienced pearling technicians Koyo Shinju, various research and development initiatives, and the further accumulation of site-specific knowledge, has the potential to provide some upside to historical performance levels. Arafura has indicated that it believes these assumptions are conservative given its knowledge of the industry.

Key Points:

- Given variability of exchange rates and quality, it is difficult to accurately estimate pearl prices that may be received
- Arafura is intending to value-add to the pearls to provide investors with prices that exceed the prevailing farm gate prices
- Yield and quality will largely be determined by the size of the shells grown and the skill of the seeding technicians
- The 2009 harvest confirms Arafura's ability to achieve its pearl size targets. Limited information has been provided regarding mortality and nuclei rejection rates

The independent expert has noted that she believes that the production assumptions appear to be within a feasible range for Australian pearl farms operating hatchery shells and using qualified, experienced technicians and good farm husbandry practices. While the operations appeared to be well run and senior management are considered to be very capable, investors should note that Arafura has yet to provide empirical information that demonstrates the ability of the Elizabeth Bay site to achieve the mortality and rejection rates that are assumed in the Project.

In addition to management-related factors, environmental factors such as site water quality (including temperature, nutrient content, tidal activity, and pest and disease loads etc.) and storm activity have the potential to affect the health of oysters and the size and quality of pearls produced.

The category five Cyclone Monica in April 2006 did not result in any damage to the pearl farm or the land-based infrastructure, although Cyclone Ingrid in March 2005 did result in the loss of 30% of stock and significant damage to vessels and buildings. However, these events are considered to be exceptional, as there had not been a tropical cyclone greater than category two in the preceding 40 years.

Arafura has attempted to minimise the potential impact of weather-related events through the provision of shell insurance, where economically feasible, as well as the maintenance of a formal Cyclone Contingency Plan. This plan includes the selection of sheltered sites within the lease and the implementation of a system that enables oyster panels to be lowered to a greater depth in the event of extreme weather conditions. All buildings and land-based infrastructure have been constructed to cyclone proof standards in accordance with local building codes.

The isolated nature of the site, combined with Arafura's Environmental Management Plan, is intended to mitigate the potential for water pollution to threaten project viability. The extensive lease area controlled by Arafura allows for production to be spread into isolated management blocks, which will assist in controlling the spread of disease and pollutants. This will also provide benefits in the selection of sheltered locations for long-lines.

Risks to Project shells from disease are covered by the shell insurance policy. Arafura also maintains an active Disease Management Plan to mitigate the risks of disease, and the condition of the shells is actively monitored during cleaning rotations as well as by the Aquatic Pest Management Unit (APMU), run by the Northern Territory Fisheries department. At the time of writing, Arafura indicated that neither the APMU nor Arafura has identified any unmanageable marine pests in the Nhulunbuy area.

Quality

A typical Australian South Sea pearl harvest will produce a range of pearls of various qualities. Pearl quality is a function of its lustre, complexion, size, shape and colour. The South Sea pearl is typically larger than most other varieties, averaging approximately 13mm in diameter. (WA Department of Fisheries 2006) While there is no direct link between oyster age and pearl quality, larger pearls are generally produced by larger, more mature oysters. Arafura advises that shells selected for repeated operations generally produce better quality pearls, as they have been intentionally selected according to their health and the quality of their previous production. In addition, the potential for matching uniform strings of pearls are increased with the use of more consistent hatchery-produced spat.

Australian South Sea pearls are distinct from the Tahitian Black pearl, and are most commonly coloured white, silver, yellow or gold. Spherical shapes are most valuable, although less uniform shapes known as drop, button, oval, and baroque can also attract high prices. The size (diameter and weight) and lustre of a pearl often have the greatest influence on its value, with lustre determined by the uniformity of the nacre layering around the nucleus.

The suitability of the Project site, the quality of work received from the seeding and harvesting technicians, and the standard of farm management practices are likely to significantly affect the quality of pearls produced from the Project. Australian South Sea pearls are internationally regarded as being of the highest quality, and Arafura expects the quality of pearls produced by this Project to at least meet industry standards.

An important variable in determining overall returns is average pearl quality and size achieved. Although unable to appreciate the variance in quality of a full harvest, which will ultimately determine the average pearl price, Adviser Edge did inspect a sample of Arafura's 2008 harvest, which appeared to be of excellent quality. A number of examples of different sizes and shapes, including perfect rounds, teardrops and baroque shapes were observed. Arafura has provided Adviser Edge with an estimate for the expected proportion of each pearl grade, which has assisted in determining average pearl prices.

Pearl sizes are determined by nacre growth achieved over the growing period and the size of the nuclei used to seed the shell, which in turn is dependent on shell size at seeding and the expertise of the operating technician. Arafura has estimated average pearl size to be 0.72 momme per piece for the first harvest. The 2008 harvest has demonstrated Arafura's ability to meet its harvest target, with average pearl size reported to be 0.71 momme. Although in a different region, average pearl size at Arafura's joint venture pearl farm in Beagle Bay achieved an average size of 0.96 momme. A larger average pearl size should be expected for the second harvest as it is expected the oysters will be larger and can be seeded with larger nuclei.

The independent expert has commented that analysis of Arafura's 2009 harvest is consistent with the variability expected from technicians, husbandry methods and site locations.

Past performance

The 2010 Project will be the sixth MIS project issued by Arafura pearls. As a consequence, Arafura does not have any harvest data pertaining to an MIS project. However, Arafura has provided Adviser Edge with harvest results from its earlier trial harvests and its larger 2009 harvest, of which a small proportion relates to the 2005 Project. Adviser Edge has not been provided with Arafura's mortality and nuclei rejection rates from previous harvests.

The harvest data has demonstrated the potential for pearl farming in Elizabeth Bay. While average pearl sizes for the earlier trial harvests were smaller than the estimates for the 2010 Project, the 2009 harvest indicated the ability of Arafura in achieving the size targets sought, with an average saleable size similar to Arafura's 2010 Project assumptions. The proportion of saleable product was slightly lower than Arafura's assumptions.

Improved results should be expected for investors in the 2006 and 2007 Projects. The grower report has indicated that the average shell size to be seeded for the 2006 Project has increased by around 10%, to between 110mm and 120mm when compared to the 2005 Project. This will enable the seeding of a nucleus of 2.4bu, compared to an average nucleus size of 2.2bu in the 2005 project. Assuming average nacre growth over the two-year growing period, the average size of pearls should increase from between 10mm and 11mm to between 11 and 12mm.

Pearl Price

Project Parameter	Arafura Estimate
Pearl price (JPY/momme)	18,000
Exchange Rate (AUD/JPY)	75

Source: Arafura, 2009.

Pearl prices achieved by Australian producers depend on a number of variables, most notably average pearl size and quality, global South Sea pearl production, economic growth and consumption trends in key markets, and the AUD/JPY exchange rate. In recent years Australian South Sea pearl prices have suffered from mounting global supplies of internationally produced South Sea pearls and a steadily appreciating Australian dollar. However, due to the larger pearl shells that are native to Australia, the environmental factors and the domestic quota system, the quality of Australian South Sea pearls is considered superior to pearls produced in South East Asia.

In addition to prevailing market fundamentals, prices expressed in Japanese Yen per momme naturally vary according to the size, shape and colour of the pearl. Arafura has provided an average price estimate of ¥18,000 /momme in Project year zero (FY2010), increasing at an estimated rate of 3.0% p.a. Adviser Edge has reviewed Arafura's quality, size and price assumptions, which appear to be broadly in line with the expected price range for the first harvest. However, an analysis of potential prices for the second harvest suggests that prices estimated by Arafura for the second harvest may be conservative, due to the expected increase in size at the second harvest.

It should be noted that over the past year there has been a decline in pearl prices worldwide as a result of the economic uncertainty caused by the global financial crisis. In this regard, Arafura's auditors considered it prudent to reduce Arafura's pearl price assumption used in the valuation of its biological assets to ¥15,000/momme to reflect current conditions.

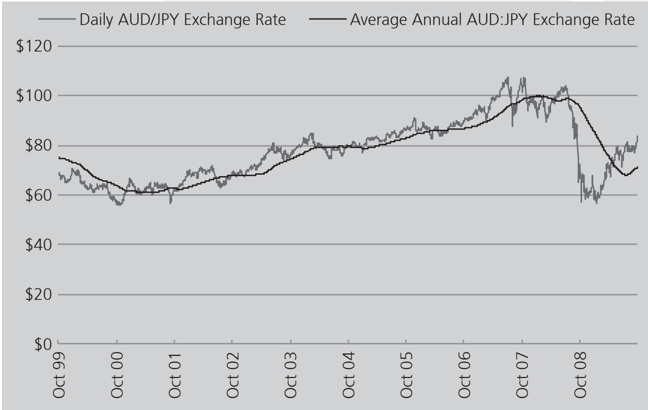
However, it is important to note that the potential returns from an investment in the Project are not affected by prices currently being achieved today, but rather the prices that are expected to be achieved at the time of harvest. Accordingly, when assessing potential returns, Adviser Edge takes into account the state of the market and the potential for mean reversion over the longer-term. This means that the assessed potential returns are less affected by short-term price fluctuations.

While Arafura's average pearl price estimate of ¥18,000 appears to be achievable, with regard to the fact that there is limited empirical information substantiating Arafura's average price assumption, Adviser Edge believes that it is prudent to adopt a more conservative price approach.

Gross pearl sales proceeds received by investors will be dependent upon the prevailing AUD/JPY exchange rate, as the majority of global trade in South Sea pearls is conducted in Japanese Yen.

Estimating future exchange rates is notoriously difficult, as they are affected by a number of factors that are difficult to predict, including local and domestic inflation rates, interest rates and global economic activity. As a consequence, when assessing the potential returns from the Project, Adviser Edge has used a wide range of assumptions. This has had a large impact on overall returns. The following graph illustrates the AUD/JPY exchange rate for the ten years to 16 October 2009, with an average over the period of 77.8.

AUD/JPY Exchange rate



Over the course of the decade, the Australian dollar has experienced a steady appreciation in value, particularly relative to the US dollar and the Japanese Yen. The key drivers of this trend have been the appreciation in global commodity prices that comprise over half of Australia's export trade, and an interest rate differential with many foreign economies that encourages foreign investment into comparatively higher yielding Australian assets. The Japanese 'carry trade' has had a particular impact on foreign exchange rates in recent history.

As a consequence of declining interest rates and a reversal of the Japanese 'carry trade' there is potential for the AUD/JPY exchange rate to remain low, especially if global economic recovery takes longer than anticipated and commodity prices remain subdued. However, in recent months equity markets around the world have experienced an aggressive recovery from their March 2009 lows. This has also seen a near-50% appreciation of the Australian dollar against the Japanese Yen, as the likelihood of rising interest rates in Australia has seen the potential for the 'carry trade' to reappear.

Exchange rates are notoriously volatile, and economic forecasting is an inexact science due to the matrix of global economic scenarios that may prevail over the forecast period.

This section provides an analysis of the potential investment returns for the Project. Please note that this analysis is based on estimated performance assumptions, which may change over the Project term. Investors need to be aware of the way in which these assumptions may influence investment returns, and should seek additional professional advice to determine whether or not this investment is suitable for their own risk and return objectives.

Adviser Edge Returns Modelling[1]

	Pre-Tax	Post-Tax[2]		
		Early Growers (Small Business)	Early Growers (Other)	Late Growers
Adviser Edge Base Case	10.0%	19.2%	11.4%	10.0%
IRR Range[1]	-1.3%–18.8%	6.6%–28.9%	-0.3%–20.3%	-1.3%–18.8%
Mean	0.69%	9.11%	1.96%	0.69%
Median Return	8.60%	17.7%	10.0%	8.60%
Percentage of results that are break even or better	77.2%	86.0%	79.6%	77.2%
Percentage of results with an IRR of 10% or better	45.2%	73.4%	50.2%	45.2%

[1] The IRR range represents the range of results that occur within the 20th and 80th percentile in the simulated model. The range is based on Adviser Edge modelling of potential outcomes for the Project using Monte Carlo simulations, which are subject to a number of limitations. These are discussed further below. Accordingly, the range is provided as a guide only. Investors should seek additional professional advice regarding the impact of changes in key variables on Project returns given their individual financial circumstances. The analysis does not consider investor finance arrangements.

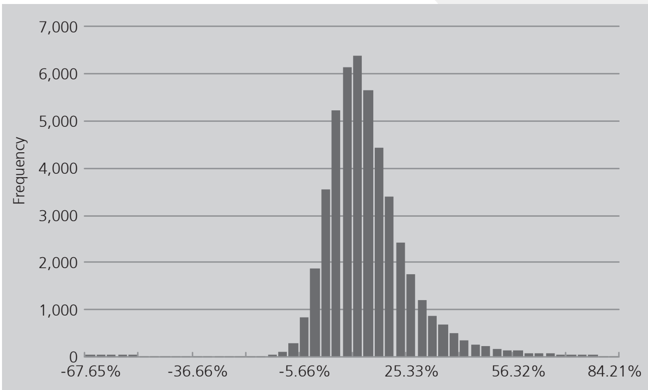
[2] The analysis assumes a 46.5% marginal tax rate for investors over the life of the Project, that investors are registered for GST, and that all GST is rebated in the year paid. Investors that invest before 31 December 2009 may be eligible for an extra 10% or 50% tax deduction on the cost of the grower's panels under the Small Business and General Business Tax Break initiatives. For the purpose of analysis in this section, Adviser Edge has assumed an investor is eligible for a 50% tax deduction.

Scenario Testing

In reviewing the Project, Adviser Edge has undertaken scenario testing of potential returns from the Project using Monte Carlo simulations, using variations to key assumptions relating to price, yield, quality, and the potential for the MIS manager to default or a disaster event to occur and the relative impact of these events on returns. Investors should be aware of the limitations associated with scenario testing. The model used incorporates a number of subjective assessments made by Adviser Edge, which may not be empirically verifiable and does not include all the variables that affect returns. Accordingly, the predictive capability of financial modelling is limited. Nonetheless, Adviser Edge believes that the use of such modelling practices provides an improved insight on the risk/return profile of a particular investment, when compared with static investment modelling techniques.

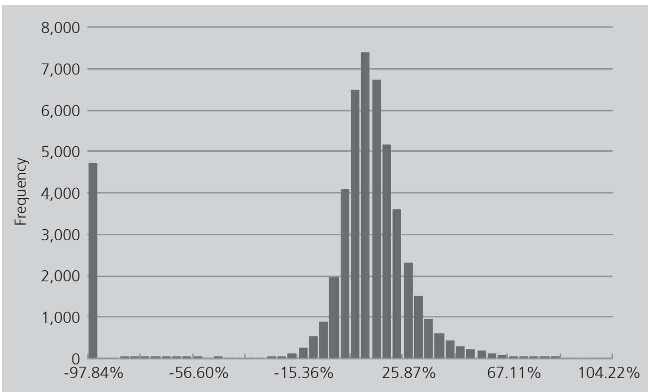
Returns modelling undertaken by Adviser Edge suggests that the median internal rate of return from an investment in the Project is a reasonable internal rate of return of 10.0% on a pre-tax basis, with higher post-tax internal rates of return based on an investors' individual circumstances. Ignoring the risk of Manager insolvency, mean returns were only slightly below median returns for a Small Business Early Grower (8.3% and 17.4% on a pre-tax and post-tax basis respectively). However, after implying a subjective risk of insolvency on modelled returns and the consequent impact of such an event, mean returns are reported to be significantly lower than median returns for all investors. This result reflects the skewed nature of modelled returns. The following graph illustrates the distribution of returns that resulted from Adviser Edge's analysis.

Investor Returns (excluding the impact of insolvency)[1]



[1] Post-tax returns for an eligible small business investor that invests prior to 31 December 2009.

Investor Returns (including the impact of insolvency)[1]



[1] Post-tax returns for an eligible small business investor that invests prior to 31 December 2009.

This analysis therefore demonstrates the importance of the Project manager's solvency in achieving expected returns. Should the Project manager be able to complete the management services over the Project term, fairly strong returns from investment, on balance, may be achieved from an investment in the Project.

Key Investment Analysis Performance Assumptions

The estimated project returns provided by Adviser Edge have been calculated using various performance assumptions. The key assumptions adopted by Adviser Edge in its base case assumptions are presented in the following table. These assumptions have been determined from information provided in the PDS, directly by Arafura, from the independent expert's report, and independent research performed by Adviser Edge. The following table also includes the performance assumptions adopted by Arafura, as discussed in the Performance Parameters section of this report.

Performance Assumptions	Arafura	Adviser Edge
Shell and nucleus vomit rates (First harvest)	36%	36%
Shell and nucleus vomit rates (Second harvest)	35%	50%
Post-seeding mortality	24%	24%
Momme per shell (First harvest)	0.72	0.72
Momme per shell (Second harvest)	1.20	1.10
Saleable proportion (First harvest)	80%	75%
Saleable proportion (Second harvest)	80%	80%
Price estimate (First harvest) (AUD)	18,000	18,000
Price estimate (Second harvest) (¥)	18,000	22,000
Current AUD/JPY Exchange Rate	75	80
Price indexation/currency depreciation	3.00%	2.90%

Pearl yield
In relation to the Project's first harvest, Adviser Edge has adopted Arafura's estimates in relation to mortality and nucleus rejection rates, although slightly lower assumptions were used in relation to the proportion of shells that will produce a saleable pearl to reflect lower performance results achieved from Arafura's most recent harvest. Although Arafura achieved a saleable shell proportion of 75.5% of total momme, this figure included a proportion of undersized pearls, which are expected to account for a non-material amount of sale proceeds. Taking into account expected performance improvements since those harvested pearls were first grown, Adviser Edge has used a saleable proportion of 75% for the first harvest and 80% for the second harvest, on the assumption that Arafura will continue to improve its productivity over the Project term.

As Arafura has guaranteed the number of shells at 18 months of age, Adviser Edge has not applied any volatility to the pre-seeding mortality and rejection rates for the first operation. However, moderately high volatility was used for post-seeding survival and saleable rates. Adviser Edge has applied relatively higher volatility assumptions to second harvest assumptions, as data is more limited for these harvests. In addition, lower than expected shell rejection and vomit rates (as a percentage of harvested shells) were used for the second harvest, to reflect the impact of more selective shell seeding (i.e. not seeding shells that do not produce saleable shell and or which display mortality during the harvest process.

The independent expert has stated that the assumptions used are within the collective range for Australian pearl farms producing hatchery shells and using qualified and experienced technicians and good farm husbandry practices. Nonetheless, it is difficult for Adviser Edge to verify Arafura's assumptions in relation to mortality and rejection due to the lack of publicly available independent information. This has been reflected in Adviser Edge's investment modelling assumptions.

Pearl quality
Pearl quality is an important factor in determining overall returns from an investment in the Project. In assessing returns, this factor was assessed in relation to average pearl prices and average pearl size, which is affected by quality of the pearls produced. Adviser Edge has adopted Arafura's assumptions for pearl sizes, which reflects the nuclei sizes that Arafura has been able to achieve in its recent harvests. A larger pearl size can be expected for the second harvest as shell sizes are typically larger at seeding, which allows for larger nuclei to be inserted. Provided that Arafura is able to insert the larger sized nuclei for the second harvest and average pearl diameter exceeds 15mm, Adviser Edge considers the larger pearl sizes to be reasonable.

As a result of limited sale price information, the impact of quality on pearl prices is reflected in the relatively large volatility applied to the assumed pearl prices in the model.

Arafura has demonstrated its ability to grow and harvest pearls to the quality being demonstrated in pearl harvests inspected by Adviser Edge. However, in the absence of sales data, Adviser Edge has applied relatively large volatility assumptions in its investment model.

Pearl price

Predicting average pearl prices is inherently difficult, due to volatility in markets and the AUD/JPY exchange rate. Arafura has provided Adviser Edge with its assumptions regarding farm gate prices for polished pearls of different sizes and grades.[1] In assessing returns, Adviser Edge has reviewed pricing and grading assumptions, historical average prices and exchange rates, prices achieved by competitors and the potential variations in sizes and grades that may be achieved. Due to limited past performance information and the average prices achieved by competitors, albeit for lower quality pearls, Adviser Edge has adopted a more conservative price approach than is used by Arafura, and which is subject to relatively higher volatility.

In reviewing returns, Adviser Edge's slightly lower price assumptions for pearl prices at the first harvest has been offset by slightly higher price assumptions for the second harvest. Adviser Edge expects that second harvest pearls will be larger and more valuable than first harvest pearls. Arafura has indicated that it may value-add to the pearls through pairing and stranding, which partially offsets Adviser Edge's concerns regarding limited sales information.

Estimating future Australian dollar to Japanese Yen Exchange Rates is notoriously difficult. To provide an unbiased assessment of future exchange rates, Adviser Edge has used an AUD/JPY exchange rate of 85 and depreciated the Australian Dollar in accordance with an estimated divergence in inflation rates in Australia and Japan of 2.9%. Accordingly, the exchange rate used for each harvest is 69 and 65 for the first and second harvests respectively.

Adviser Edge has adopted slightly different prices than those estimated by Arafura, although these assumptions do not result in materially different overall returns. However, investors should note that the actual prices achieved by the Project will be heavily dependent on overall harvest quality and the exchange rate at the time of sale. These factors can significantly affect overall returns, both positively and negatively. To mitigate price and exchange rate risk, Adviser Edge expects that Arafura will be flexible in determining the appropriate time to sell the pearls grown as part of the Project.

Other assumptions

Two other important assumptions were applied to Adviser Edge's investment modelling relating to the potential insolvency of the Responsible Entity and its expected impact, and the potential for a cyclone event to cause Project failure. In assessing the potential impact of these events, Adviser Edge has assumed that investors will recover the insured value of the shells should one of these events arise during the Project term.

In assessing the likelihood of an insolvency event, Adviser Edge has taken into account Arafura's balance sheet, its ability to generate and certainty with respect to future cash flow, and access to capital. While the future outlook for Arafura appears to be promising, the relative reliance of the company on MIS capital raisings and its present cash flow position resulted in Adviser Edge applying a relatively higher default rate in its investment modelling.

To reflect the potential for the Project to be recapitalised, Adviser Edge applied both the potential for Project Interests to be sold at salvage value or be recapitalised by investors, should a default event occur. However, this assumption is subject to investors' Project Interests not being defeated by third party interests (i.e. secured creditor) or there being a severe lack of capital at the time of administration, which would prevent preservation of the shell value until the sales process can be completed.

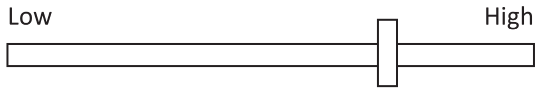
It is difficult to estimate the probability and impact of these assumptions with regards to investment returns due to the limited information available to verify the underlying assumptions. However, Adviser Edge believes that by including its judgment on the potential impact of these events, investment returns modelling will be more reliable when compared to less sophisticated assessments.

Sensitivities

The Project's ability for the Project to achieve these assumptions is a function of both the inherent volatility of the underlying activity but also assumption risk, which is the accuracy of the initial estimate. Accordingly, the volatility used in Adviser Edge's modelling depends on the quality of the data supporting the assumptions, and an assessment of the expected volatility of the underlying activity.

[1] Arafura will polish the pearls on behalf of investors.

Yield

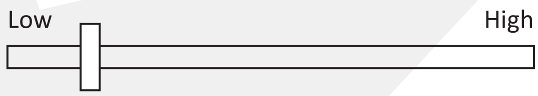


Yield risk was primarily affected by the underlying expected volatility of growth rates and mortality rates of the oysters. Seasonal conditions and the quality of management will have a significant bearing on whether the Project achieves budgeted yields. However, Arafura's past performance has indicated that it is capable of delivering the required oyster sizes and pearls after the first seeding.

Quality & Price

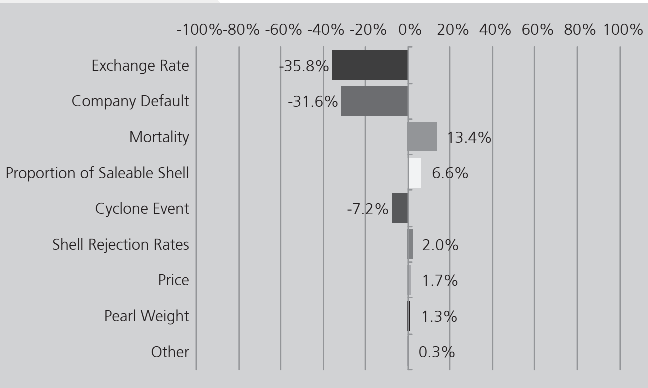
Quality and price risk is affected by the same issues affecting yield risk, as well as the inherent volatility in global pearl prices and exchange rates. In addition, the limited information available to verify the price and implied quality assumptions means that there is uncertainty regarding the assumptions used. Accordingly, fairly large volatility assumptions are used in assessing returns.

Cost



With costs to investors in the Project defined as a proportion of harvest proceeds or the Management Fee shortfall, the risk of achieving the cost outcomes budgeted is substantially mitigated. That said, cost assumptions are affected by Arafura's ability to provide the management services over the Project term. Should Arafura not be able to provide these services, investors may be required to recapitalise the Project and/or seek an alternate manager.

IRR sensitivity



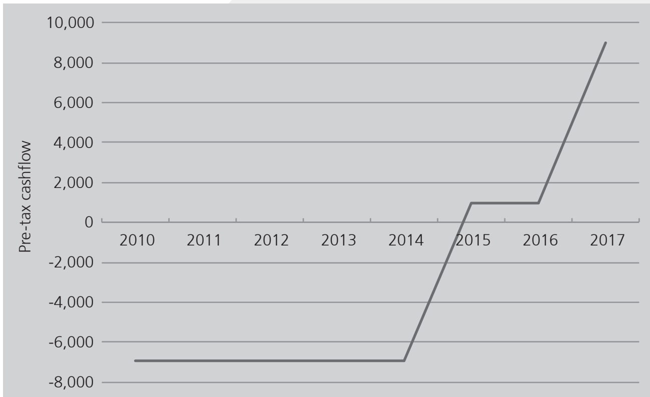
The table above is the resulting sensitivity of investment returns to the various assumptions used in Adviser Edge's financial model. This table indicates that exchange rate volatility at each harvest accounts for 35.8% of the variance in modelled returns, followed by company default and mortality. Accordingly, further investigation and research into the potential outcomes for these factors may assist investors in becoming more confident in the Project's potential returns.

Pre-Tax Cash Flow per Project Interest

The Arafura Pearl Project 2010 aims to generate investor returns through the cultivation, establishment and sale of South Sea pearls. The Project has a term of approximately six-and-a-half years. Returns are expected to be generated from the sale of pearls from the first harvest, which is expected in the first half of Project year five (FY2015), and the sale of the pearls from the second harvest, which is expected in the first half of Project year seven (FY2017).

An indicative pre-tax cumulative cash flow for Project is presented below. These cash flows have been calculated using the performance assumptions adopted by Adviser Edge.

Cumulative pre-tax cash flow



Post-Tax Potential

The post-tax returns earned by an investor will depend on the investor's marginal tax rate when harvest returns are received. The post-tax IRR range provided by Adviser Edge assumes that the investor maintains the same marginal tax rate of 46.5% over investment term.

Investors that invest prior to 31 December 2009 may also be eligible for an additional tax deduction for certain eligible assets.

Paragraph 35 of the Product Ruling provides that growers that are small business entities will be entitled to an additional deduction at a rate of 50% of the cost of the grower panels. All other growers are entitled to an additional deduction at a rate of 10%. The cost of the grower panels is approximately 86% of the Application Fee.

In addition to this, it is also possible that an investor's tax status will change over the life of the Project. A change in tax status may result from a change in circumstance for the investor, or a change in tax policy administered by the Australian government. It is important that investors are aware of how these may affect the post-tax performance of the Project.

Adviser Edge recommends that investors consult with qualified specialists who understand how changes to an investor's tax status may affect investment returns.

Investors in the Arafura Pearl Project 2010 will be subject to risks associated with medium-term aquaculture investments. All potential investors should carefully consider the risks outlined in the Project PDS, and the specific risks outlined in the Adviser Edge research report.

Management and structure and fees risks

MIS management encompasses not only the operational capabilities of the project counterparties, but also the corporate abilities of Arafura to monitor operation performance, ensure that the shells are not overstocked, and to meet the regulatory and statutory responsibilities required of it as Project RE.

For all MIS projects there is a risk that if the financial position or performance of management deteriorates, asset condition, project outcomes and/or regulatory outcomes may be temporarily or permanently compromised.

Ongoing management fees are deferred and taken as a percentage of sale proceeds. The fee structure means that investors have some protection from unexpected increases to management costs over the Project term. The prescribed deferred fee shortfall amount is structured to provide Arafura with some protection against a harvest proceeds shortfall. That said, Arafura's ability to control production costs and maintain adequate operating cash flow will be a critical determinant of the quality of operational management supplied to the Project, as well as Project outcomes.

While the relatively large up-front fee provides investors with a tax-effective investment structure, the structure does mean that the Project is subject to higher risks earlier in the Project term when investor-owned assets are in their early stages of growth and are less marketable. This risk reflects the experience of investors in the Timbercorp and Great Southern MIS projects. In addition, investors should be aware that, as a highly specialised aquacultural activity, in the event of an insolvency event there may be limited purchasers for investors' oyster assets. Investors will be reliant on Arafura's ability to maintain sufficient cash reserves to meet short-term funding, and to organise a suitable recapitalisation of the Project in order to maximise the value of Project Interests.

Site and aquacultural risks

Investors should to be aware of the risks associated with the site and management of the Project. Key areas of risk identified by Adviser Edge are:

Climate and weather

There is the risk that weather conditions can adversely affect the performance of the Project through destruction of Project assets and/or impact to water quality. In particular, there is a risk that cyclone activity may cause significant asset damage and loss of stock. Arafura has adopted various management activities and insurance to cover mature shell to mitigate these risks.

Disease

Biosecurity is important in aquacultural production systems, including pearl farming. For example, disease outbreaks in Akoya shells in Japan have dramatically curtailed the country's production, especially in larger, higher value pearls. Australia's strict quarantine laws and quota system have been implemented to mitigate this risk. Arafura has a Disease Management Plan in place (expert report).

Technician expertise

The Project is substantially dependent on the skills and expertise of seeding technicians to meet seeding rejection rates and pearl sizes. Arafura uses qualified and experienced technicians from Koyo Shinju to undertake all seeding operations, and has maintained a relationship with this firm over a number of years.

Infrastructure

Infrastructure risks include the factors associated with boats, longlines and other infrastructure. Over time, Arafura has developed substantial infrastructure required to manage the pearl farms, which should ensure that Project outcomes are met.

Performance risks

Yield and quality

Activities that deal with pearl farming are exposed to similar risks as those inherent in other aquacultural production systems. These risk can affect shell mortality, average shell size and nacre growth. Investors should be aware that even conservative yield estimates are prone to failing due to adverse growing conditions. However, these threats can be mitigated by good quality management to prevent overstocking, appropriate shell cleaning regimes, and the appropriate selection of broodstock.

Information risk

There is a risk that the productivity assumptions used are too optimistic or that the productivity potential of a selected property may be overestimated.

Price

Investor returns will be directly affected by pearl prices at the time of sale. While prices are generally dictated by the dynamics of supply and demand, changes in certain macro-economic factors can also have an impact. Such factors include exchange rates, interest rates, and inflation. Investors need to be aware that these factors can both positively and negatively affect investor returns.

Market risks

As with any MIS project, there is a risk that the market for the Project resources will encounter a significant downturn at the time of harvest. This may be due to factors such as competition, regulation and/or market preferences. The effect of reduced demand may affect prices, which could potentially reduce investors' returns. However, it should be noted that as a non-perishable item, pearl sales can be delayed until economic conditions improve.

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