



## LOAN PORTFOLIO AND SECURITISATION ASSETS

### What are these assets?

Babcock & Brown Structured Finance Fund Limited (“BBSFF”) invests in loans which are secured against various asset classes. It does this in two ways:

**Loan Portfolio Assets:** BBSFF buys loans that have already been advanced from the original lender, for example, loans secured against real estate, shop inventory, or intellectual property, etc. After the purchase, BBSFF is a secured lender. Typically, these loans are small value, secured loans within a target asset class and there are a number of borrowers.

**Securitisation Assets:** BBSFF buys the high yield bonds which are secured by multiple obligor (or multi-borrower) loans. Such bonds are created where a third party has undertaken a restructure of the loans to create various layers of risk and reward from a reasonably generic loan portfolio, that is, a securitisation. Securitisation is a standard financing tool used by banks and companies to ensure that they have optimal funding for their assets. It is a form of secured lending. A collateralised loan obligation (“CLO”) is a securitisation backed by leveraged loans. Leveraged loans are loans made to corporations and are typically secured with a first or second lien claim on the assets of the firm and are generally prepayable at any time.

Assets that can be securitised include:

- Residential mortgages
- Commercial mortgages
- Student loans
- Credit cards
- Auto loans
- Music royalties
- Trade receivables
- Aircraft
- Corporate loans
- Corporate debt
- Asset backed securities
- Lease Receivables.

### What is Securitisation?

Securitisation is the creation and issuance of debt securities whose principal and interest payments are derived from the cash flows of the underlying pool of assets.

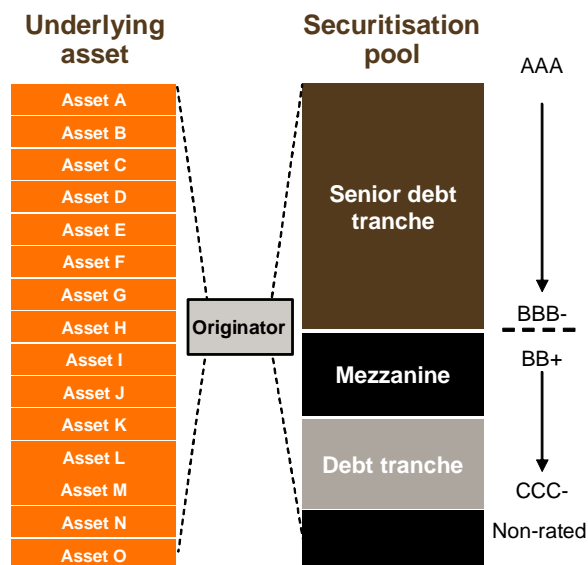
For instance, a lender may have provided \$10 million nominal value of housing loans to home owners, and it will receive regular cash flows over the next 25 years from these loans. If the lender sells the rights to the cash flows from the loans to someone else, it could transform that income stream into a lump sum today (in effect, *receiving today the present value of a future cash flow*).

In this case, a suitably large number of secured loans and/or receivables can be grouped to form a securitisation pool. A securitisation pool will look for diversity amongst the borrowers and assets to ensure, to the extent possible, that a default on one loan does not result in defaults in more than one or all loans. This pool of assets is then sold to a bankruptcy-remote vehicle (also known as “special purpose vehicle” or “SPV”).

To fund the purchase of the loans, the SPV issues tradable “debt securities”. These debt securities usually have different risk profiles and hence, different returns (for example, difference in returns for tranches rated AAA or BB+). The higher the rating, the lower the return. Any losses arising from the underlying loans would typically be borne first by the lowest or unrated tranche before they progress up to the higher rated debt securities. Accordingly, the lower or unrated tranches receive a higher return.

Typically, transactions are structured so that even the equity or unrated tranche has a measure of protection on its principal and an anticipated return from losses on underlying loans. The amount of protection will vary from transaction to transaction.

### The Securitisation Process



### What is a Collateralised Debt Obligation?

A collateralised debt obligation (“CDO”) is a fixed income product that is a securitisation of other bonds, loans and financial instruments. The collateral, in this case, is thus a portfolio of debt securities, loans or similar obligations.

### Why does BBSFF invest in Loan Portfolio and Securitisation Assets?

#### Strong Stable Cash Flows:

Loan Portfolio and Securitisation Assets (“LPSA”) have the potential to produce strong stable cash flows. At its initial public offering, BBSFF indicated that its expected cash

return from the assets, based on its modelling assumptions over its portfolio of LPSA, was 13.6%. As at end of first quarter 2007, all assets within BBSFF's LPSA Class have performed in accordance, or better than expectations. Therefore, an investment in this asset class should allow BBSFF to deliver strong semi-annual dividends to Shareholders

***Potential for Total Shareholder Return to be greater than currently anticipated yield:***

*Loan Portfolios:* The BBSFF strategy is to restructure the loans which it purchases to increase the return to BBSFF. It can do this by leveraging the loans (in much the same way as banks leverage their loans by taking deposits from customers or borrowing in the capital markets) or creating bonds secured by the loans which it issues to the capital markets - with BBSFF holding the high yield bonds which are issued (that is, securitisation).

*Securitisation Assets:* The BBSFF strategy is to work with the premier securitisation originators and servicers, in particular target asset classes, and to price the BBSFF participation in the bond such that there is upside for BBSFF if the bond performs in line with historical data. Additionally, as BBSFF will buy at the inception of the securitisation, there is the potential to create value for BBSFF by selling the bonds after a couple of years, but well before maturity, where the value of the bond may have increased because the security has in fact performed well.

**What are the risks to BBSFF from its investment in Loan Portfolio and Securitisation Assets?**

All investments have risks. Returns such as those outlined cannot be achieved without risks. Without limitation, BBSFF could lose money on its investments if:

- the borrower of the loans which secure the bonds (that BBSFF owns) defaults and the realisation value of the security does not payout the loan;
- where the underlying loans mature and the proceeds cannot be reinvested in assets which provide BBSFF with its expected return (that is, reinvestment risk);
- where BBSFF has made assumptions regarding certain events which impact the financial outcome to BBSFF (for example, prepayments on loans which can produce additional income which flows through the bond to BBSFF) and those assumptions prove to be too aggressive.

To mitigate these risks, BBSFF has introduced, amongst other matters, the following risk mitigators:

- BBSFF seeks to use, what it regards as conservative assumptions in evaluating transactions;
- Diversity in assets – to protect against correlation risks within assets and across the sector;
- Working with premier originators and servicers in the industry whose historical track record shows capabilities to assess and manage risk;
- Day 1 and ongoing due diligence.

## Who are the other participants in the Loan Portfolio and Securitisation Asset market?

Parties such as General Electric, General Motors and Ford Credit along with many major banks and investment banks, have embraced securitisation as part of the solution to their funding needs.

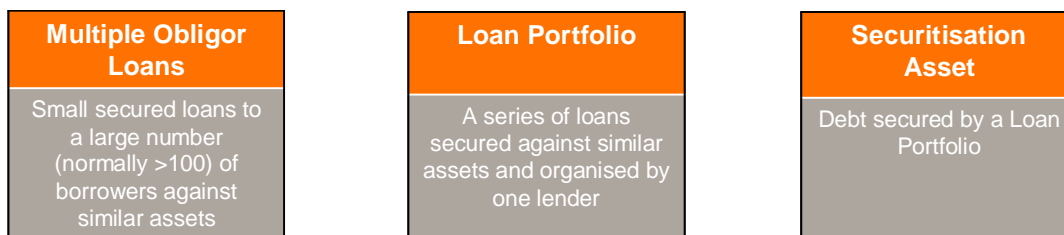
A number of international CDO managers have set up operations in Singapore, with the view to manage Asian-based CDOs. This has been generally encouraged by the Monetary Authority of Singapore ("MAS").

According to the MAS<sup>1</sup>, over the last three years, Singapore managers originated more investment CDOs than any other country in Asia ex-Japan, with an estimated S\$6 billion of CDOs in 2006.

## How does BBSFF make money from Loan Portfolio & Securitisation Assets?

The assets in the LPSA Class have varying characteristics but the primary sources of income include interest income and certain penalty payments which can be paid by borrowers e.g. prepayment fees. BBSFF can receive a higher than anticipated return when:

- it sells an asset to a third party which it may look to do so once a loan has been performing well for a number of years;
- the financial assumptions made by BBSFF prove to be more conservative than actually occurs;
- where reinvestment occurs in a loan pool and such reinvestment occurs at a higher interest rate than assumed.



## How does BBSFF source and manage such assets?

BBSFF capitalises on Babcock & Brown Group's longstanding capabilities in structured finance and works closely with the Group's global Structured Finance and Operating Leasing teams. Babcock & Brown Group, parent company to the Manager of BBSFF, has been an adviser in structured finance, including leases, debt placement for large leases, hedging and securitisation, for almost 30 years.

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<sup>1</sup> Speech by Ms. Tay Bee Bee, Director, Monetary Authority of Singapore, Derivative FitchGlobal Structured Credit Conference, 14 May 2007

As the Manager of BBSFF, Babcock & Brown Structured Finance Management Pty Ltd regularly monitors the performance of all assets owned by BBSFF. Such monitoring includes stress testing the assets, meeting with loan originators and parties that service (or enforce and monitor) individual underlying loans, reviewing general economic data and reviewing data to determine the value of the asset to BBSFF so as to ensure that distributions of cash economic income are made, but that BBSFF's capital is preserved.

**What underlying assets have BBSFF's LPSA investments been made in?**

As at 30 June 2007, BBSFF's LPSA are invested in the following assets:

**Securitisation assets**

Ancora - Pepper Securitisation No. 2 Investment	Australia residential property
Ancora - Pepper Securitisation No. 3 Investment	Australia residential property
Ancora - Seiza Warehouse Note Investment	Australia residential & commercial property
Ancora – Seiza Augustus Series 2007-1 Trust	Australia residential & commercial property
Mortgages plc Securitisation Investment	UK residential property
Avoca VI CLO Investment	Euro collateralised loan obligations
Avoca VII CLO Investment	Euro collateralised loan obligations

**Loan portfolios**

Paradox Capital LLC – Subordinated Loan	Intellectual property loans
Ancora - Provident Inventory Finance	Inventory funding

BBSFF's portfolio currently does not include any sub-prime loans relating to the United States property mortgage market.

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