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DOMINION FINANCE GROUP LTD (In Receivership) – 'DFG' or 'the company'

As you know from our earlier reports of 19 September and 3 October, we are the receivers for DFG. We were appointed by the Trustee, Perpetual Trust, and our primary responsibility is to you, the secured investors and to the Trustee which appointed us.

This letter, our fourth report to investors:

- provides you with our current estimate of the likely return to debentureholders over time;
- explains how we arrived at this estimate;
- outlines some of the reasons causing the expected losses to debentureholders; and
- provides an update on the conduct of the receivership.

Estimated return to debentureholders

Our objective has been to provide investors with an estimated outcome that is as reliable as possible subject to the uncertainties inherent in the property market on which the majority of the company's loan securities rely.

At the time of our appointment most loan files did not have a reliable current, independent assessment of recovery value available. Generally the valuations on file were borrower commissioned valuations from when the loan was originally approved, but a number of these did not appear to be reliable. The absence of updated valuations was surprising given that most loans had been impaired or in default for a substantial period prior to our appointment. There was therefore no reliable basis for determining the recovery prospects from defaulted loans available at the time of our appointment.

We therefore selected valuers experienced in the relevant property types and locations and briefed them to assess values for most of the property securities supporting company loans to provide the information on which to base our estimate. Those specialists reviewed DFG's loans as at the time of our appointment.

Based on this review we expect to distribute between 10 cents in the dollar and 25 cents in the dollar to debentureholders over time subject to the qualifications that follow in this letter. We do not expect there to be any funds available for payment to DFG's unsecured creditors.

In this report we describe how we have calculated the estimate based on current valuations, set out a number of important qualifications in order to provide you with an understanding of how the estimate could change over time and explain some of the factors leading to the losses the company incurred.

Basis of estimated return

The estimate is a calculation based on a review of DFG's loans and underlying securities by experienced property and finance specialists. The receivers have withheld sale action to date pending receipt of this specialist advice except where sales were committed to prior to receivership. It is now our intention to begin to realise assets in an orderly way – securing the best return possible for investors in all of the circumstances. However, we may continue to defer the sale of particular properties where circumstances allow, and where a better return would be achieved by doing that.

The reason that the estimate of experienced specialists is low is partly due to the property market downturn but much more significantly due to the lending decisions made by DFG.

Approximately 42% of DFG loans by value are secured over apartment developments either in progress or completed. A further 15% are secured over developed sections outside main centres and 10% over undeveloped land.

The DFG loan book was exposed to severe risk of loss because a very high proportion of loans remaining at 9 September 2008 was:

- secured by second mortgage or lower ranking security (80% by number and value);
- for property development;
- for assets that were not paying interest from cash 'holding income' generated from the properties (80% by number);
- in default (78% by value and 82% by number).

Most had at least three if not four of these characteristics which precludes a good outcome. The type of properties and lack of holding income generated can also make the underlying securities unattractive to buyers at a time when property sales and prices have been decreasing and when finance is restricted. DFG's ability to hold properties until the market improves is significantly restricted by:

- the rights of first mortgagees to sell in order to repay their debt; and
- ongoing interest due to the first mortgagee increasing the debt secured in priority to DFG. The average interest rate applying to prior secured first mortgages is approximately 13%. If a first mortgagee was prepared to wait, say, two years for the market to improve, DFG would need to be confident that value would improve by 26% on average over this period in order to break even with a sale at current values.

The effect of the high proportion of second mortgage lending has been to amplify the effect of the movements in property prices on DFG's loan losses:

- If a first mortgage lender advances, say, 70% of the purchase price and the second mortgage lender advances the balance, a reduction of 20% in the value of the property will cause a loss of two thirds of the second mortgage security value;
- Most agreements between first and second mortgagees allow first mortgagees to add 2 years' interest, and costs of enforcement, to their priority amount. This means that ongoing interest, often at penalty rates, is added to the amount owed to the first mortgagee and reduces the amount available for DFG. We have noted that this reduces DFG's ability to hold property in order to benefit from a future improvement in the market;
- When a property is being developed, a first mortgagee often requires the ability to add development cost overruns to the amount deducted from proceeds available to the second mortgagee. This means that the second mortgagee bears the full effect of development cost increases until its security is exhausted; and
- If a first mortgagee believes it can achieve repayment of nearly all of a debt in default with an immediate 'bulk' sale, it will often do so, even if an alternative approach might have produced a better return for the second mortgagee. While the first mortgagee has a duty of care to the second mortgagee this doesn't extend to going beyond a well managed forced sale process.

With most loans on second mortgage security, and with some of DFG's largest loans experiencing in some cases multi-million dollar development cost overruns, DFG was exposed to significant risk of loss if property prices decreased. Cost overruns on development properties of approximately $15m have been determined since receivership with the potential for more to follow.

As is usual in property market corrections, development properties and properties not generating cash 'holding income' have been severely affected. Nearly all of DFG's loans remaining at our appointment were either for development properties, or for properties without sufficient cash 'holding income' to cover the interest on the loan, or both.

Other Issues

Security sharing agreements and related party transactions

In a small number of cases where DFG did have first mortgage security it entered into agreements purporting to provide for payment of the first realisation proceeds from these to other financiers raising cash in the period from December 2007 to May 2008. These agreements, if valid, could make DFG's claim against the assets securing the loan equivalent to that of a second mortgagee. The legal effect of those agreements, whether or not they constitute security interests and the priorities of such claims as a matter of law, is to be determined and may be the subject of applications for Court directions. The agreements contain confidentiality clauses preventing disclosure of terms. We have assumed that these disputed proceeds will not be received by DFG for the purposes of our "Low" realisation estimate but have assumed that they will be received for the purposes of our "High" realisation estimate.

DFG received money from, and paid money to, related parties in the period up to the suspension of debentureholder repayments. We are investigating these transactions but cannot provide details as this could prejudice DFG's position in respect to these.

Loan renewals

At the time of our appointment 78% by value and 82% by number of DFG's loans were in default. In many cases they would have been in default a lot earlier if DFG had required the loans to be repaid according to the terms agreed with the borrowers when the loans were first drawn down. Instead, a number of the borrowers remaining when we were appointed had been granted significant, and sometimes multiple, extensions. In many cases interest was charged to these borrowers and added to the amount due. This significantly affected reported profit and, because interest was added to the loan balance, increased the loan assets reported as available to support amounts owing to investors. In some cases money was lent to new borrowing entities with a significant proportion of the money lent being applied to debts owed by other (related) borrowers in default.

Loans are frequently renewed by lenders for good customers. However if poor borrowers have their loans renewed without good reason, remedial action which might have limited losses will be delayed. It can also create significant difficulties in accurate reporting of problem loans and loan loss provisions.

Loan management

Our work in evaluating DFG's loans and realising securities has been considerably complicated by difficulties in obtaining appropriate information from the loan files. In many cases files do not have financial accounts for borrowing companies or updated valuations (independent of the valuations on which the original loan approval was based). For the loans remaining at the date of appointment of receivers, there were very few updated valuation appraisals (independent of the original valuer) of property securities obtained, even when it was apparent that the borrower would not be able to repay the debt on the terms originally agreed.

Timing of Distributions

A number of factors will influence the timing of realising property securities including:

- Whether our review determines that further work is required to optimise the net realisation. It may be determined that further physical work on the property could benefit the net realisation or that the property needs to be traded for a time to achieve results that might enhance value;
- Whether the market for a particular property is so depressed that it may be better to defer a sale process until it improves. For example, this may apply to some types and locations of bare land;
- The level of prior secured debt and the interest rate applying to this (refer above); and
- Costs associated with holding a property.

Some other recoveries may involve legal action, and those recoveries could take two or more years to complete.

We cannot therefore provide a timetable of expected distributions. However we expect to have made the majority of distributions within 24 months of our appointment (that is before September 2010).

Some investors have queried the effect of interest earned but unpaid on their principal balances as at the date of appointment of receivers (9 September 2008). The provisions of the Trust Deed and Debenture Stock terms of issue regarding the proper calculation of secured debt for distribution purposes will be applied to the distributions to be made. While interest is not likely to be paid, making sure that the amount of interest due but not paid prior to receivership is correctly taken into account in calculating the total amount you are owed will enable your share of total distributions to be properly determined.

Update on Conduct of the Receivership

As noted, we obtained a detailed review of DFG's loans by property and finance specialists. To date we have not realised securities other than completing sales that had been committed to prior to the receivership.

We are now proceeding to realise securities with the benefit of the information obtained from this review. We have appointed property specialists to advise further on realisation strategy in specific cases. This particularly applies where DFG has a first mortgage security for a significant exposure. Where DFG holds a second mortgage security our ability to influence the first mortgagee's handling of the security is not strong in a number of cases.

Qualifications and Important Notice

The information required to complete this report was provided by the employees of the company and obtained from company records. Accounting values are based on book values from the financial statements and accounting records prepared by company personnel. Loan realisation estimates have been based on the work of property and finance specialists.

We take no responsibility for any incorrect information contained in this report that has been supplied by the company, its officers or other persons. This report is confidential to the Trustee and debentureholders and is not to be reproduced or used for any other purpose without our prior written consent in each case. We do not accept any liability whatsoever to any party from any use of, or reliance on, this report.

Any realisation estimates, time taken to complete realisations and related costs were all subject to uncertainty at the time that the estimates were prepared. We express no opinion on the likelihood of any estimates being achieved. Financial projections are based on assumptions and estimates of future events which cannot be estimated with any certainty. Actual results are likely to be different from estimates and the variations could be material since anticipated events frequently do not occur as expected. In accordance with standard practice neither Deloitte, the receivers, nor any member or employee of Deloitte, undertakes responsibility arising in any way whatsoever to any person in respect of realisation estimates, the related commentary on options available to the receivership, or any other report content including any errors or omissions herein arising through negligence or otherwise however caused.

Communication and Further Updates

We have previously provided details of the receivership website developed at the time of our appointment (*www.deloitte.com/nz/dominion*). We have filed the receivers' first statutory report on-line at the Companies Office and that report can be viewed free at the Companies' Office website *www.companies.govt.nz.*

We will continue to update the Trustee who is overseeing us, and will post further updates and matters of relevance to investors on the receivership website as appropriate.

In the meantime:

- For further information please visit the website *www.deloitte.com/nz/dominion* ; and
- If you have questions please use the email facility on the website or call the investor information phone number: 09-306-4343.

Yours faithfully
Dominion Finance Group Limited (In Receivership)

Rod Pardington

R G Pardington
Receiver and Manager