Fundamental Research Corp.

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Investment Analysis for Intelligent Investors

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Capital Direct I Income Trust – An Income Trust of Home Equity Loans

Sector/Industry: Real Estate Mortgages

www.incometrustone.com

Issuer	Capital Direct I Income Trust
Offering	No minimum offering Maximum offering: $125 million
Securities Offered	Trust units
Unit Price	$10
Minimum Subscription	$5,000
Expected Time Horizon	Continuous offering until the Maximum Offering is achieved. Full redemption only availabel after 5 full years. The Trust terminates by June 23, 2031 or upon the Manager's decision to terminate.
Fees	*Management fee, 2.0% per annum based on the net asset value

FRC Rating	
Base-Case Return (IRR)	6.9% p.a.
Risk	3 (Average)
Rating	**2 - (Very Good)**

*see back of report for rating definitions

Investment Highlights

- The trust invests in first, second and third home equity loans originated to near-prime borrowers.
- Trust units are eligible for quarterly distributions of 80% of the net income and net realized capital gains of the trust.
- The trust's mortgage portfolio is geographically concentrated in major urban areas within British Columbia, Alberta, and Ontario.
- The primary source of the trust's mortgages, Capital Direct Lending Corp., has originated $570 million in mortgage loans since 1997.
- Mortgage interest rates reset annually, and therefore, reinvestment risk is minimal.
- All mortgages within the portfolio are secured by real property with an average loan-to-value of 59.1%.
- A $5 million line of credit is available to ensure redemption needs are met.
- Fees for this offering are comparatively much lower than the typical fees charged by exempt market offerings.
- Investor's returns have ranged between 8% - 11% p.a. in the last four years.

Risks

- Investors are not guaranteed minimum distributions, or return of capital.
- Mortgage default rates could adversely interrupt investors' income stream (the trust has not had any material loan losses since inception).
- The units are non-transferable, partially redeemable before 5 years and fully redeemable only after 5 years.
- A drop in home prices will result in higher loan-to-value and higher default risk for Capital Direct as the value of collateral decreases.
- The manager has a high incentive to acquire mortgages with high interest income, yet mortgages with higher interest rates usually imply more default risk (note that management owns of the 7.6% trust units; so their interest is aligned with investors).
- Like any portfolio manager, the trust's manager has the incentive to keep expanding the portfolio due to the 2% management fee.

Background and Terms of the Offering

Capital Direct I Income Trust is an open-ended investment trust. The offering is a continuous offering with a gross maximum offering of up to $125 million. The net proceeds will be invested in a diversified portfolio of loans including both first and second mortgages on Real Property. The trust's home equity loans are all located in Canada; British Columbia, Alberta and Ontario. The trust units will be entitled to quarterly cash distributions from the profits of the income trust and are eligible for redemption semi-annually.

A Home Equity Loan (HEL) is a loan extended to a homeowner that uses his/her home as collateral. The homeowner may use the loan at his or her discretion. Interest is charged on a predetermined variable rate, which is usually based on prevailing prime rates. **However, the first claim on the home goes to the primary lender, and the HEL lender can only claim the home after the primary lender.**

In the event of default on a HEL, the lender can foreclose the property and potentially recover the principal after the more senior claims have been satisfied. The HEL lender can do so even if the borrower did not default on the primary lenders.

Purpose

The purpose of this report is to evaluate the risk/reward benefits of the Capital Direct I Income Trust units.

Company Details

The trust was created on June 23, 2006, and its principal place of business is Vancouver, BC. The manager of the trust is Capital Direct Management Ltd., a subsidiary of Capital Direct Lending Corp. (Capital Direct, a private company). The mortgage investments for the trust will be sourced through the company's mortgage broker.

The mortgage broker (broker) is Capital Direct Lending Corp. which was incorporated in 1997. The broker was founded to be a near-prime mortgage lender, aimed at providing mortgage lending to individuals with unique needs who do not conform to the strict lending guidelines of chartered banks and other traditional lenders. The mortgage broker began its business in British Columbia, later expanding to Alberta and Ontario. The broker has established branches in four major cities in these provinces including, Vancouver, Calgary, Edmonton and Toronto.

During the period from 1997 to 2012, the broker has originated and placed approximately $570 million of residential mortgages. The broker acquires 75% of its clients directly through advertisements, and 25% from referrals by other brokers and banks. The broker currently has a pool of about 700 HELs. Currently, the broker services approximately $96 million in mortgages for itself, the trust, as well as other private/institutional investors and financial institutions. The servicing and administering of mortgages includes collection of payments, distribution to investors, monitoring and arrears management. *(Source: Broker)*

Over the years, the broker has developed a proprietary information management system (IMS). The IMS keeps track of all the stages of the approval process allowing for a stream-lined approval process while reducing human errors. The IMS also manages payment schedules, arrears management, and stores all client related information. The broker will serve two important roles for the trust - originate and service/administer the mortgage investments (discussed below).

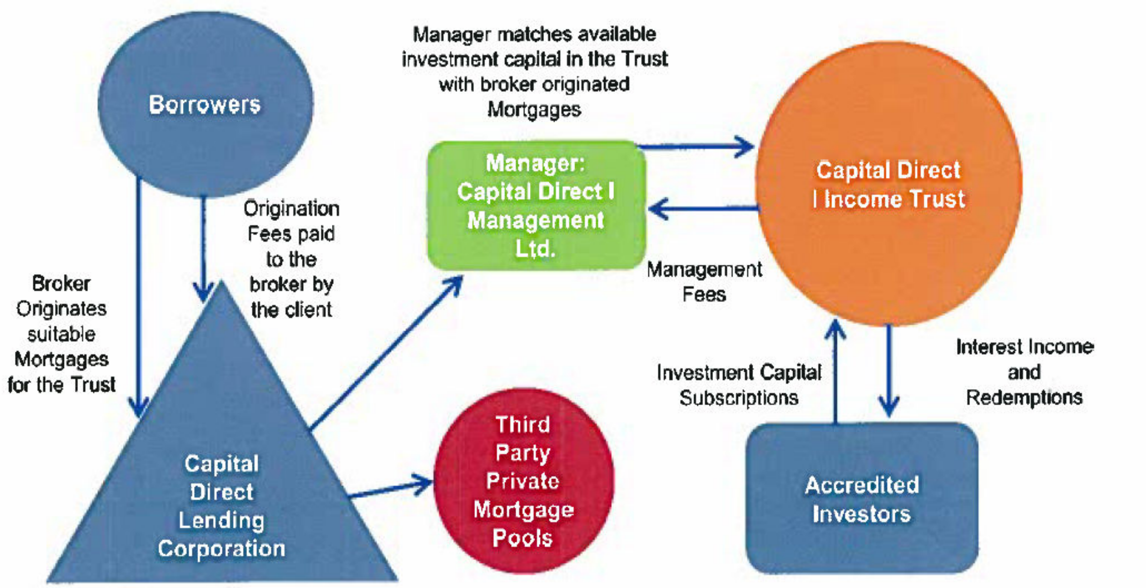
Capital Direct I Income Trust is a mortgage pass-through (MPT) security or a pool of Alternative-A (Alt-A) HELs. Cash flows from these mortgages are passed through to investors as investment income/return. Capital Direct's structure in comparison to public home mortgage companies is shown in the following chart.

	Capital Direct	Public Home Mortgage Companies
Distribution	Quarterly distribution of 80% of its net income to unitholders in cash.	Typically, about 30% to 70% of net income is distributed quarterly.
Volatility	Only bad debt loss can cause NAV to change.	Both bad debt loss and stock market sentiments can cause changes to the share price.
Liquidity	The units are non-transferable, partially redeemable before 5 years and fully redeemable only after 5 years.	Highly liquid as shares trade on a stock exchange
ROE	The trust has achieved ROE higher than public home mortgage companies (Further discussed in the financial section of the report)	

Source: Fundamental Research Corp.

The mortgage broker is the primary source for the mortgage investments of the trust. We believe this is an advantage for Capital Direct as the trust can choose from the current pool size of 700 HEL. Management owns 7.6% of the trust units – indicating that their interests are aligned with investors and, therefore, are likely to only pick suitable/appropriate mortgages for this trust.

The following chart summarizes the relationship of the trust and the broker.



Sources: Capital Direct

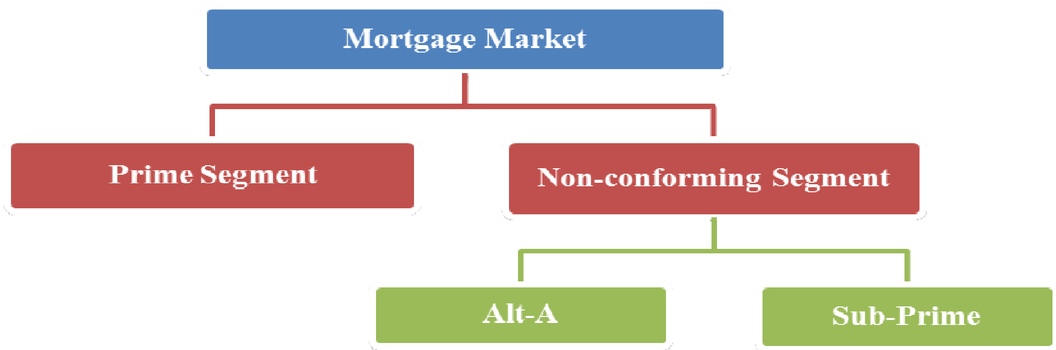
Mortgage Lending Markets

We will now examine the mortgage lending markets in North America.

Mortgage lending markets can be divided into two main segments**: 1. Prime Segment and 2. Non-conforming Segment.**

The prime segment composes of mortgage borrowers with an established credit history, strong asset to liability ratio and a proven and stable income stream.

The non-conforming segments include borrowers who do not meet the requirements above, and this segment can be further broken down into: **1. Alternative-A (Alt-A) or near-prime and 2. Sub-Prime**, as the graph below shows.

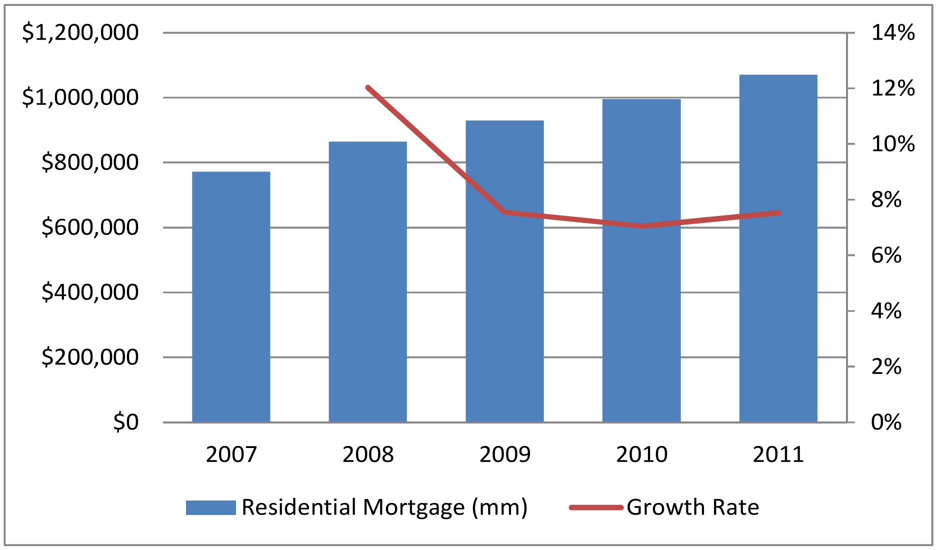


Source: Fundamental Research Corp.

Typically, Alt-A borrowers are self-employed individuals or individuals with slightly higher risk profiles compared to prime borrowers.

Capital Direct focuses on investing in the Alt-A segment of the mortgage market. Alt-A differs from sub-prime borrowers as the sub-prime segment includes borrowers with bad credit history, high debt to asset ratios and high debt servicing ratios.

The following chart shows the Canadian residential mortgage market size from 2007 to 2011.



Sources: Fundamental Research Corp.

During 2007 to 2011, the residential mortgage market grew from $0.77 trillion to more than $1 trillion. **From our research, the Alt-A and sub-prime segments amounted to approximately 5% to 7% of the total mortgage market in Canada. This implies an approximate $50 to $70 billion industry for the Alt-A and subprime segments in 2011**. The size of the Alt-A segment indicates significant market potential for Capital Direct's portfolio ($14 million) to grow and prudently select appropriate investment opportunities.

<u>Recent Changes in the Mortgage Regulations in Canada</u>

There have been several changes in mortgage rules in Canada over the past six years that have contributed to the fluctuation in housing prices, supply and demand.

The timeline below shows the recent changes made to mortgage rules in Canada.

Prior to 2005: Maximum allowable amortization for a mortgage was 25 years.

2005 – 2008: The federal government introduced a maximum amortization of 40 years with 0% down payment (i.e. Loan-To-Value, LTV of 100%). We believe this has been a major catalyst in the house price increases seen over the period as individuals are able to arrange lower monthly payments, which made a house more affordable.

October 2008: The maximum amortization was reduced to 35 years and minimum down payment was increased to 5% (i.e. LTV 95%). Government began to slowly tighten the restrictions on mortgages in an effort to avoid a real estate bubble as was seen in the U.S.

April 2010: Minimum down payment increased to 20% (80% LTV) for non-owner occupied properties (investment/speculative properties).

April 2011*:* Amortization was further reduced to a maximum of 30 years. The removal of Canada Mortgage Housing Corporation Insurance from HELs resulted in banks tightening their lending practices. **As a result of the removal, the big six banks tightened their lending of HELs, and many homeowners shifted to brokers like Capital Direct Lending.**

Current Portfolio

As of March 31, 2012, the trust's portfolio size was about $14 million with 165 properties across British Columbia, Alberta, and Ontario, with an average duration of 18.43 months (ranging from 13 to 21 months). The table below outlines the trust portfolio's current distribution, values and loan-to-value (LTV) for each province. 53% of the portfolio is from BC. According to management, all of the 165 properties are within a 90 km radius of the metropolitan areas – properties close to metropolitan areas, we believe, are less vulnerable to economic downturns.

Province	Loans	Loan Principal	LTV	Average Time Left (Months)
AB	48	$ 4,326,347	59.50%	13.35
BC	89	$ 7,400,288	58.07%	21.01
ON	28	$ 2,355,869	68.39%	19.68
Total	165	$ 14,082,504	59.64%	18.43

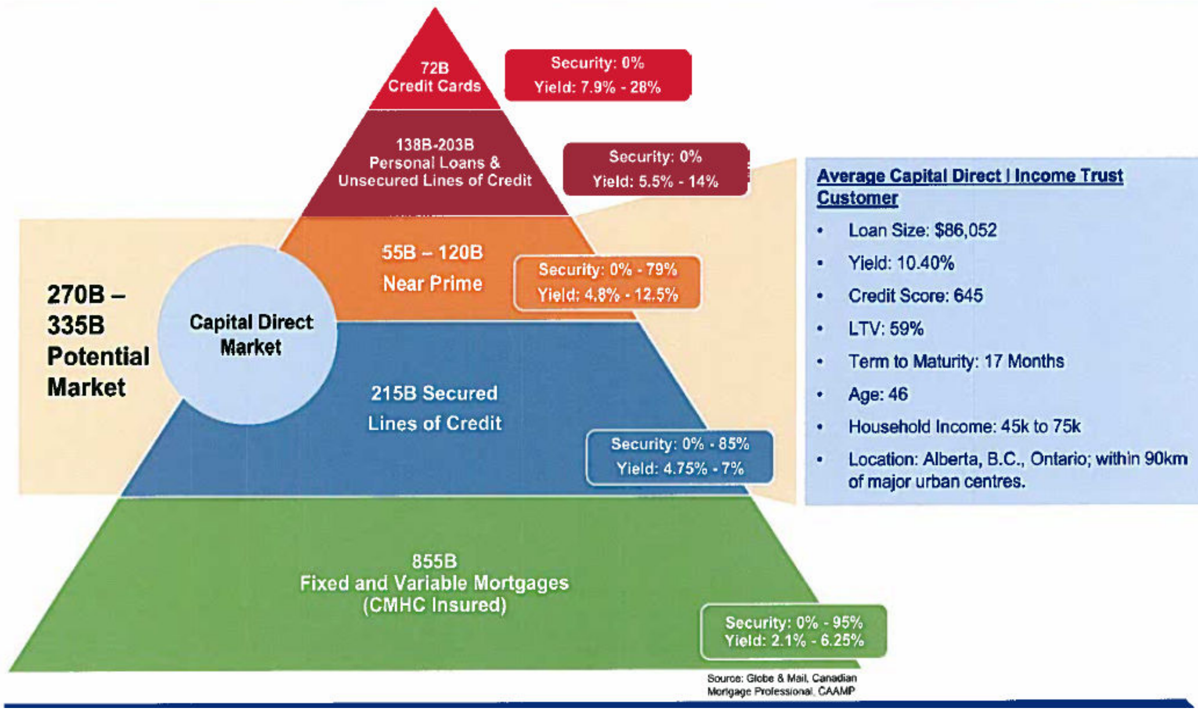
Sources: Capital Direct

The following chart shows Capital Direct's claim on its HELs.

Sources: Capital Direct

As shown in the chart, 29% of Capital Direct's HELs were lent to homeowners that already fully owned their own houses, 60% of the HELs were to homeowners that are still servicing another mortgage with a primary lender, and 11% were lent to homeowners already servicing two mortgages - to the primary lender and to a secondary lender. **We believe the 11% third security portion is highly risky because Capital Direct only has a third claim on the collateral.**

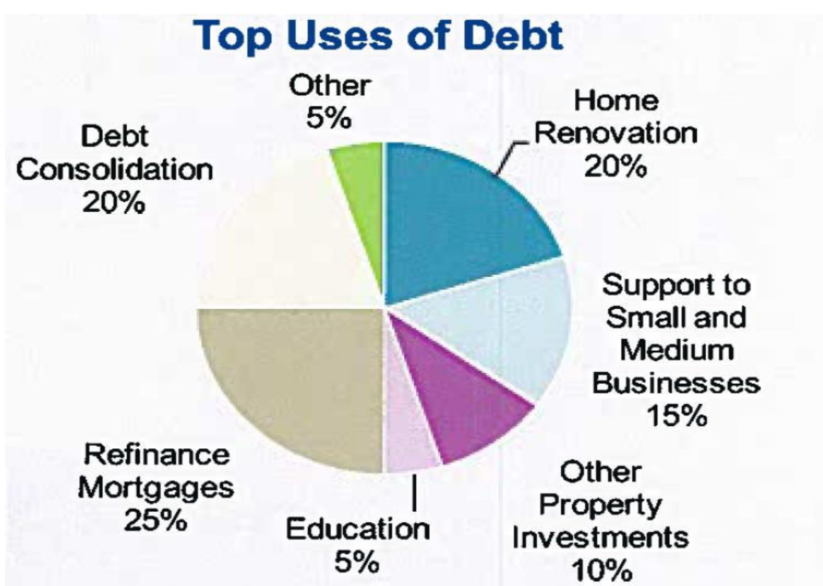
The following chart gives a snapshot of a typical Capital Direct borrower's profile.



Sources: Capital Direct

As shown in the above chart, the average interest rate on Capital Direct' mortgage portfolio was 10.40% as of March 31, 2012. **The interest rate on the HELs reset annually based on the variable prime rate, and this practice helps Capital Direct to mitigate risk exposure to interest rate volatility.**

As mentioned earlier, the homeowner may use the loan at his or her discretion. The following chart shows the breakdown of how the borrowers use the trust's mortgages.



The following chart shows Capital Direct's portfolio from 2008 to Q1- 2012.

Mortgage Table			2008		2009		2010		2011		Q1-2012	
Loan to Value		Average	#	Value	#	Value	#	Value	#	Value	#	Value
0.00%	4.99%	2.50%	0		0		0		0		0	
5.00%	9.99%	7.50%	0		1	$ 21,741	0		0		0	
10.00%	14.99%	12.50%	1	$87,577	1	$ 26,579	3	$101,636	2	$92,166	2	$ 91,693
15.00%	19.99%	17.50%	1	$218,111	2	$ 289,583	2	$289,151	3	$121,456	3	$ 121,263
20.00%	24.99%	22.50%	2	$156,297	2	$ 83,239	2	$56,873	3	$410,334	3	$ 409,337
25.00%	29.99%	27.50%	1	$25,047	3	$ 421,688	2	$115,595	3	$138,885	3	$ 138,004
30.00%	34.99%	32.50%	2	$76,701	4	$ 408,562	5	$422,184	9	$667,258	8	$ 573,920
35.00%	39.99%	37.50%	3	$253,719	3	$ 255,185	3	$290,927	6	$332,890	7	$ 427,603
40.00%	44.99%	42.50%	1	$14,472	3	$ 205,754	6	$311,190	8	$469,659	8	$ 521,329
45.00%	49.99%	47.50%	1	$25,718	4	$ 528,047	9	$886,870	12	$1,085,580	13	$1,103,522
50.00%	54.99%	52.50%	2	$161,241	4	$ 322,047	6	$653,052	7	$680,788	6	$ 435,595
55.00%	59.99%	57.50%	5	$1,100,891	5	$ 810,530	8	$999,593	15	$1,462,230	14	$1,566,033
60.00%	64.99%	62.50%	3	$226,772	2	$ 334,153	11	$1,777,388	16	$2,279,817	19	$2,133,150
65.00%	69.99%	67.50%	1	$22,953	7	$ 799,605	16	$1,396,089	21	$2,166,848	22	$2,895,426
70.00%	74.99%	72.50%	5	$525,152	5	$ 557,343	9	$540,942	26	$1,749,811	31	$2,070,568
75.00%	79.99%	77.50%	7	$374,875	6	$ 305,505	12	$706,349	23	$1,285,373	26	$1,537,356
80.00%	84.99%	82.50%	1	$102,402	2	$ 101,012	0		0		0	
85.00%	89.99%	87.50%	0		0		0		0		0	
90.00%	94.99%	92.50%	0		0		0		0		0	
95.00%	99.99%	97.50%	0		0		0		0		0	
			36	$3,371,928	54	$5,470,573	94	$8,547,839	154	$12,943,095	165	$14,024,799
Provision for Loan Losses				-$ 16,604		-$30,756		-$46,136		-$76,112		-$ 81,521
Deferred Mortgage Discount Income				$ -		-$31,793		-$21,890		-$29,256		-$ 31,753
				$3,355,324		$5,408,024		$8,479,813		$12,837,727		$13,911,525
Weighted LTV			55.16%		52.37%		56.36%		58.49%		59.64%	

Sources: Fundamental Research Corp.

We are pleased to see that Capital Direct has maintained its weighted LTV in the 55% to 60% range while growing its portfolio from $3 million in 2008 to $14 million by Q1-2012. **As the second and third mortgages have higher risk exposure to the volatility of collateral values, we believe it is crucial for Capital Direct to maintain its LTV at 50% to 60%.**

Investment Criteria

The trust intends to continue to invest in mortgages located in British Columbia, Alberta and Ontario. Pending an investment in mortgages, funds may be invested in "Authorized interim investments" which are qualified investments for a trust that are governed by the Canada Revenue Agency for registered accounts. Authorized interim investments may include, and not limited to; shares, bonds, debentures, notes, income trust units, marketable securities and cash. **Management has indicated that they currently have no investments in authorized interim investments.**

The investment criteria for the selection of mortgage investments in the trust is summarized below (Source, OM):

- The trust may invest in first, second or third mortgage of a real property.
- The mortgages will primarily be on residential property situated within Canada. Once the Trust's assets reach $10 million (already achieved), no more than 5% of the Trust's assets will be invested in mortgages on the same property.
- The trust will not directly invest in real property, however, it may hold property acquired as a result of foreclosure.
- The trust will not make loans to, nor invest in securities issued by the manager or its affiliates. The trust will not make loans to any of the directors or officers of the manager or their associates or members of the board of governors.
- The trust may only invest in "qualified investments", as defined in the tax act for a

trust governed by a deferred plan.
- The trust may co-invest with a third party(ies) in a mortgage.
- The trust may invest in mortgages with any length of term.
- When not invested in mortgages, the trust's funds are to be placed in authorized interim investments (described above).
- The trust may only borrow funds in order to acquire or invest in specific mortgage investments or mortgage portfolios. The maximum amount the trust is able to borrow is the greater of $1.0 million and 40% of the book value of the trust mortgage portfolio and at an interest less than the interest rate charged or yield earned by the trust's overall mortgage portfolio.
- The trust may participate in mortgages on a syndication basis, subject to the approval by the credit committee of the investment amount and the proposed syndication partners.

Management has indicated the Lending Committee selects 4 to 8 mortgage deals from a pool of 60 – 80 deals on a monthly basis, and the general guideline is to choose the ones with the highest credit worthiness.

Structure of the Offering

The fund is structured as an Income Trust. The trust units are eligible for inclusion in registered accounts such as LIF, RRSP, TFSA, RESP, etc. The trust will be managed by the manager, Capital Direct Management Ltd. **The manager will be entitled to a share of the profits as well as a management fee.**

Details of the profit sharing are below:

- 80% of the aggregate of net income and net realized capital gains will be paid to the unitholders on a quarterly basis (Q1 distribution: April 15, Q2: July 15, Q3: October 15, Q4 March 31)

- The remaining 20% of the aggregate of net income and net realized capital gains will be paid to the manager.

There is no market or exchange that the trust units trade on and there is none planned to form. The units are non-transferable; **however, they are eligible for redemption twice a year (June 30 and December 31) for all or any of a unit holder's units in increments of not less than $5,000.** The unit holders must provide 30 days written notice of their intentions, and if redeeming within the first 5 years, the following redemption schedule applies:

- If notice of redemption is given prior to the first anniversary of acquisition of such units, **redemption will be 95% of the net asset value per unit on the redemption date. The redemption amount will increase by 1% each year until on or after the fifth anniversary at which time redemptions will be equal to 100% of the net asset value of the units on the redemption date.**

The following is a list of the fees associated with the units:

- **2.0% annual management fee.** The management fee is paid monthly at a annual rate of 2% of the previous year's net asset value. This fee is in line with exempt market management fees.

- There are **no sales commission fees**, any sales commissions paid will be the responsibility of the manager. Sales commission fees in exempt markets are typically 10% on every unit sold. Charging no commission allows more of the investors' capital to be put to work. The manager may intend to engage exempt market dealers to sell trust units in the future, and the dealers are likely to charge a commission; however, according to management, the manager needs unitholders' approval prior to implementing sales commissions, and we believe, the ability to vote on this is beneficiary to the unitholders. Our discussions with management indicated that they may issue another unit class if and when the trust decides to charge sales commissions, and this would avoid any adverse impact on existing unitholders.

- **The manager will pay for the costs of the offering (legal, accounting, audit and agent's costs).** In most exempt market deals, this is paid for using investors' capital.

- Other fees such as expenses related to unit holder's meetings, brokerage, trustee fee, etc. are payable through the trust's assets and is typical in exempt market offerings.

Overall, we believe, the fees for this offering are comparatively lower than the typical fees charged by exempt market offerings.

Factors Affecting Capital Direct I Income Trust

We have summarized several factors below that would affect Capital Direct's return and performance.

1. Household Values and Recovery Rates

Capital Direct's HELs are all backed by real property located within British Columbia, Alberta and Ontario**. The trust's mortgage portfolio has an average LTV of 60% (maximum of 80% and minimum of 10.00%).** The borrowers' equity (100% minus LTV), is a cushion that prevents or reduces losses in the event the borrower is unable to meet the mortgage payments. The lender is able to foreclose on the property and sell the house to recover the outstanding mortgage. However, it is important for readers to keep in mind that 60% of Capital Direct's HELs are second mortgages, and have claim on the property only after the primary lender recovers its residential mortgage value. 11% of Capital Direct's HELs are third mortgages meaning that Capital Direct can claim the property only after the first and second lenders recover their mortgage values. **Therefore, we believe 29% of Capital Direct's HELs have a 40% downside cushion, 60% of the HELs have a downside cushion less than 40%, and 11% of the HELs have a downside cushion significantly lower than 40%.**

Therefore, any sharp decline in housing prices in Canada can adversely affect Capital

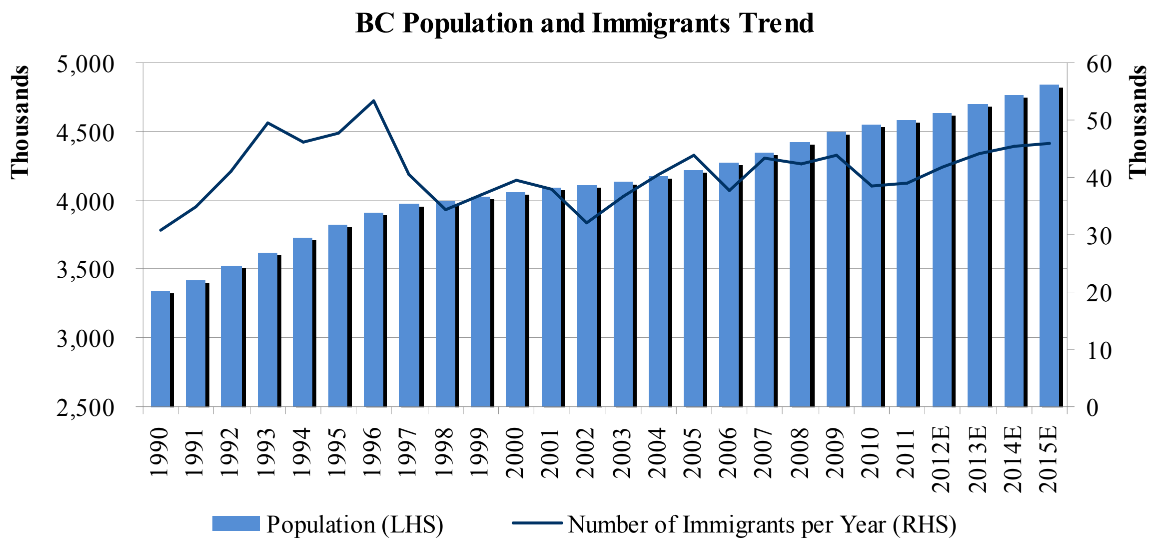
Direct's ability to recovery its mortgage loans.

We will further examine the variables affecting the housing markets in each province.

British Columbia

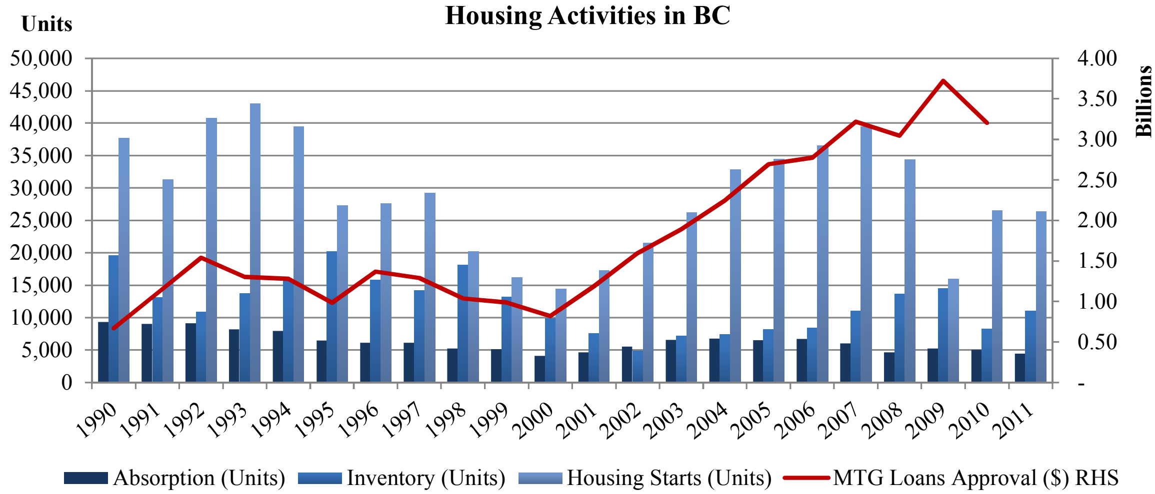
British Columbia's GDP grew at 3.2%, and 2.2%, in 2010, and 2011. The consensus GDP forecast for 2012, and 2013, are 2.0%, and 2.5%. GDP growth has been positive every year from 1997 to 2010, ranging from 0.5% to 4.7%, except for 2009, when GDP contracted at -2.2%. The strong growth in GDP either has exceeded or was in line with the overall Canadian GDP (source, Stats Canada).

One of the main drivers for housing demand is population growth; the higher the population, the more housing units are required. From 1990 to 2011, BC's population has grown at an average rate of 1.62% per year, **from 3.2 million to 4.5 million people. New immigrants to the province from other countries (excluding inter provincial migration) account for about 65% of the growth**. The graph below shows the population and immigration trends and forecast in BC (source, Statistics Canada, BC Stats).



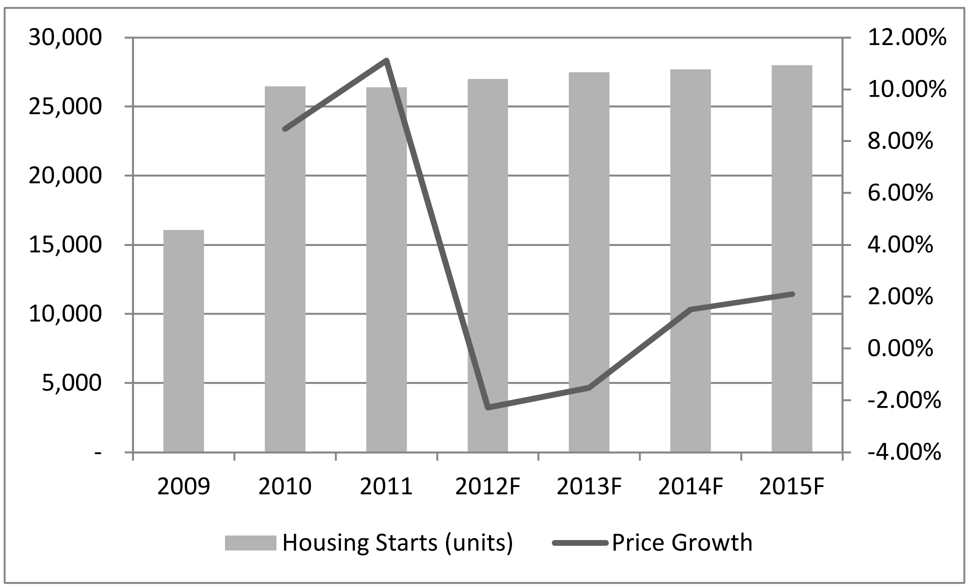
Source: Statistics Canada, BC Stats & Fundamental Research Corp.

The increase in population has directly contributed to the increase in overall real estate activity in BC. **Total housing starts from 1990 to 2011 were ~639,000 units, averaging 29,000 units per year**, and the inventory decreased from 19,500 units to 11,000 units during the same period. As the chart below shows, BC's housing activity remained very strong during the period from 2000 to 2009, and housing sales remained around 5,000 units per year.



Source: Statistics Canada, BC Stats & Fundamental Research Corp.

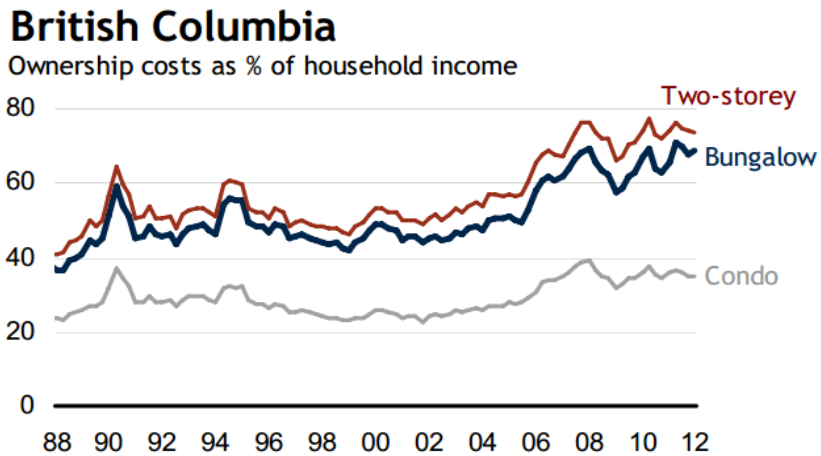
However, the consensus estimate is that BC will face moderating housing market activity in the next few years as a result of the rise in housing starts in recent years (shown below).



Sources: Fundamental Research Corp., RBC Economics & CMHC

Our research indicates that BC home prices (especially Vancouver) are over-valued by roughly 11% based on metrics including price to income, price to rent and affordability.

The following chart shows that the costs to own a home in BC have grown significantly since 2000, and it is our opinion that weaker affordability will put downward pressure on homebuyer demand over the next few years.



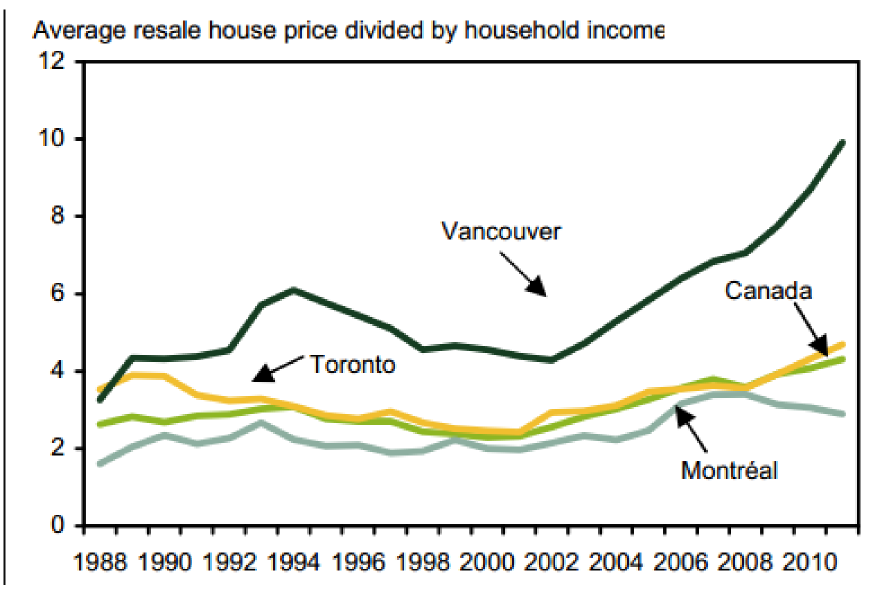
Sources: RBC Economics

The following chart shows the home price to income and home affordability measure in Vancouver. Home affordability is the portion of home ownership costs to a household's pre-tax income.

Vancouver, BC	2009	2010	2011F	2012F	2013F
Price to Income Ratio	7.90x	8.70x	9.90x	9.20x	9.30x
Home Affordability	46.30%	50.10%	54.60%	49.57%	50.10%

Sources: Fundamental Research, TD Economics & RBC Economics

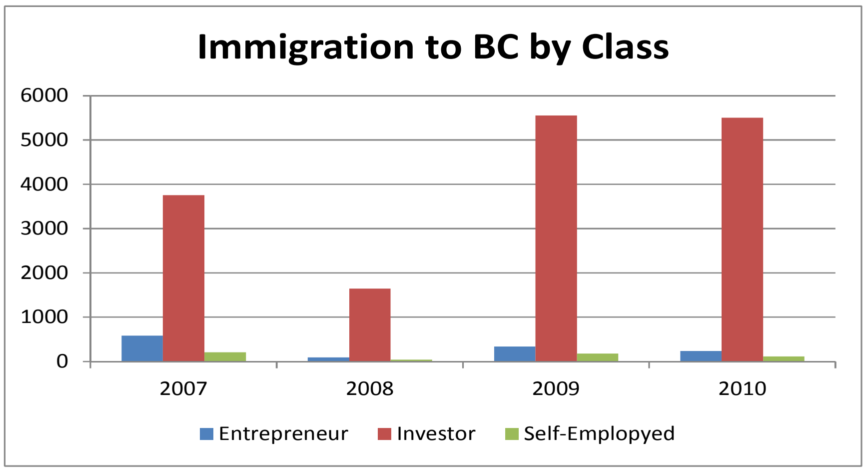
Based on the above reason, we expect home prices in Vancouver to decline in the next couple of years. The following chart further shows that Vancouver home prices have peaked and might be due for a correction.



Sources: TD Economics

The broker provides loans to near-prime mortgage borrowers. We believe that entrepreneurs, investors and self-employed immigrants can be primarily categorized as near-prime mortgage borrowers. **These near-prime borrowers are less likely to be able to take out mortgages with the big six banks because they do not have a proven track record of stable income.**

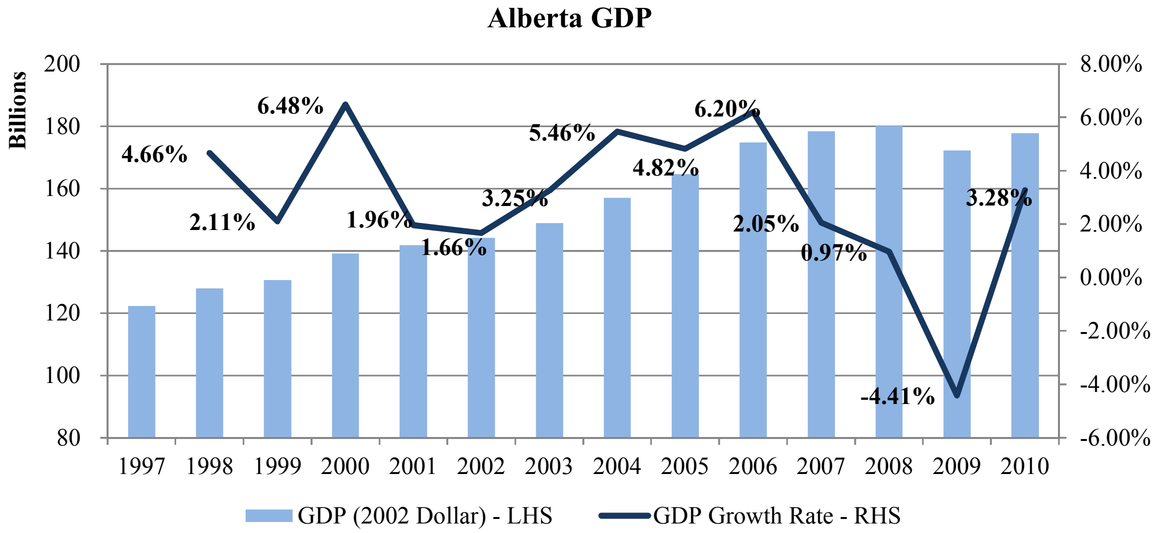
The following chart shows annual immigration to BC by class, and we believe these three classes are potential clients of the broker. It is our opinion that immigrant investors are ideal clients for the broker as they have no proven track record of income but a net worth of at least $1.60 million. As suggested by the following chart, **there are 5,000 investors immigrating to BC every year since 2009, and this should bring more quality HELs for the broker.**



Source: BC Government

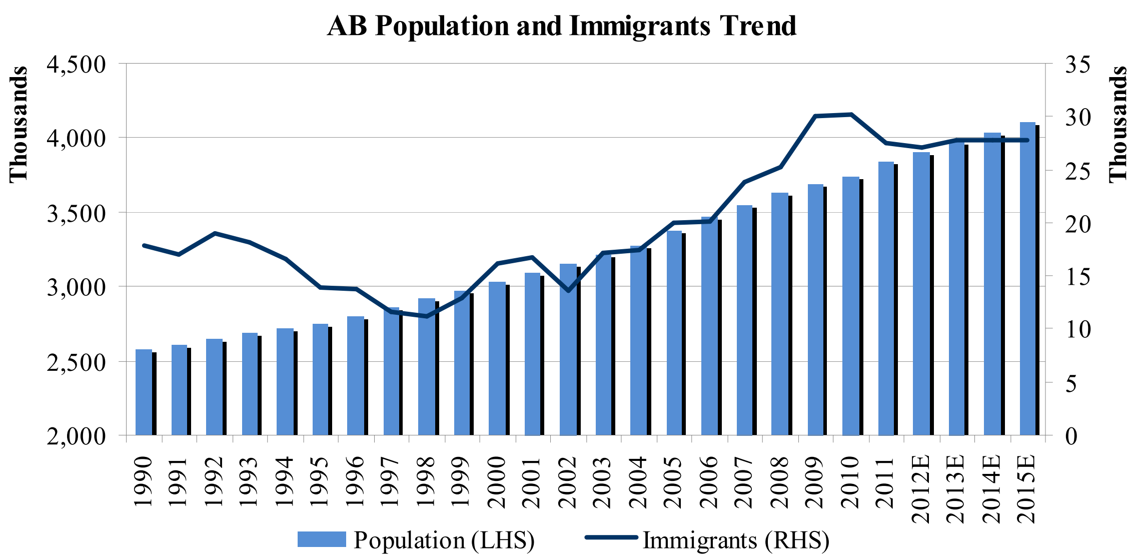
Alberta

Alberta's economy has benefited from its strong oil & gas activities over the past decade with an average annual growth rate in GDP of 3.11% from 1997 to 2011. The consensus GDP growth rate in Alberta for 2012, and 2013, is estimated at 3.80% p.a. In 2010, Alberta's GDP ($178 billion) accounted for 13.42% of Canadian GDP.



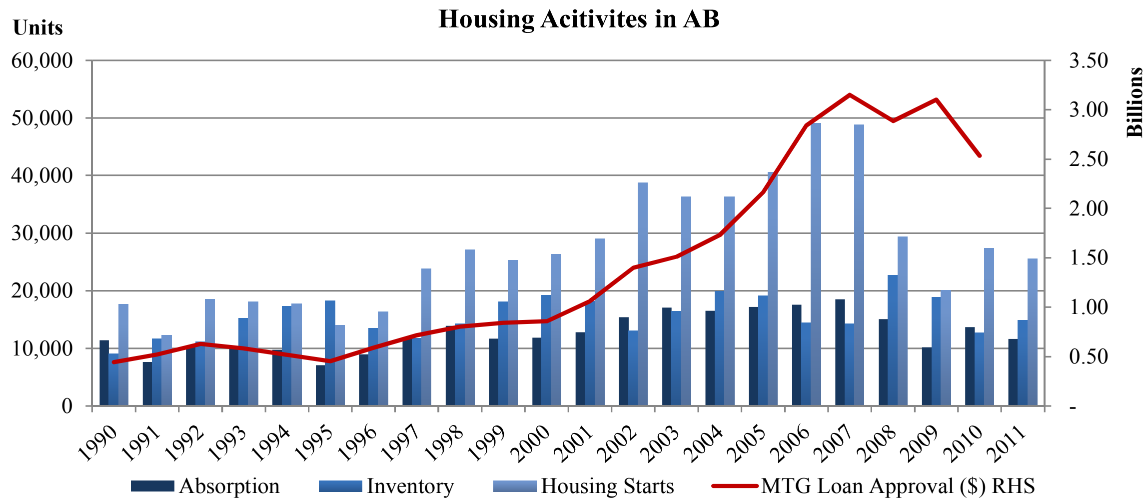
Source: Statistics Canada & Fundamental Research Corp.

AB's population has been growing at an average of 1.90% per year from 2.52 million people in 1990, to 3.74 million in 2011. Unlike BC, the main driver of population growth in Alberta has been inter-provincial migration instead of international immigration. International immigration only accounted for 31.28% of the change in population.



Source: Statistics Canada & Fundamental Research Corp.

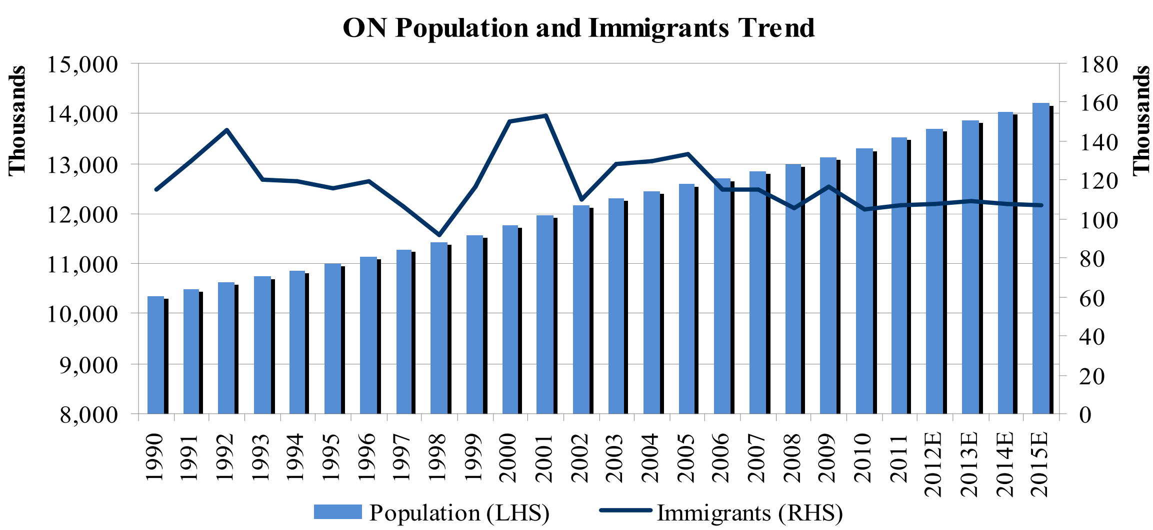
Alberta's housing activities have increased from the lows experienced in the global financial crisis in 2008 – 2009. Housing inventories have decreased from 22,600 units in 2008, to 14,900 units in 2011, while housing starts have picked up from 20,000 units in 2009, to 25,500 units in 2011 (27.5% YoY increase). Housing starts are still well below the levels seen in early 2000's. **These figures together point toward a recovery in Alberta's housing markets.**



Source: Statistics Canada, BC Stats & Fundamental Research Corp.

Ontario

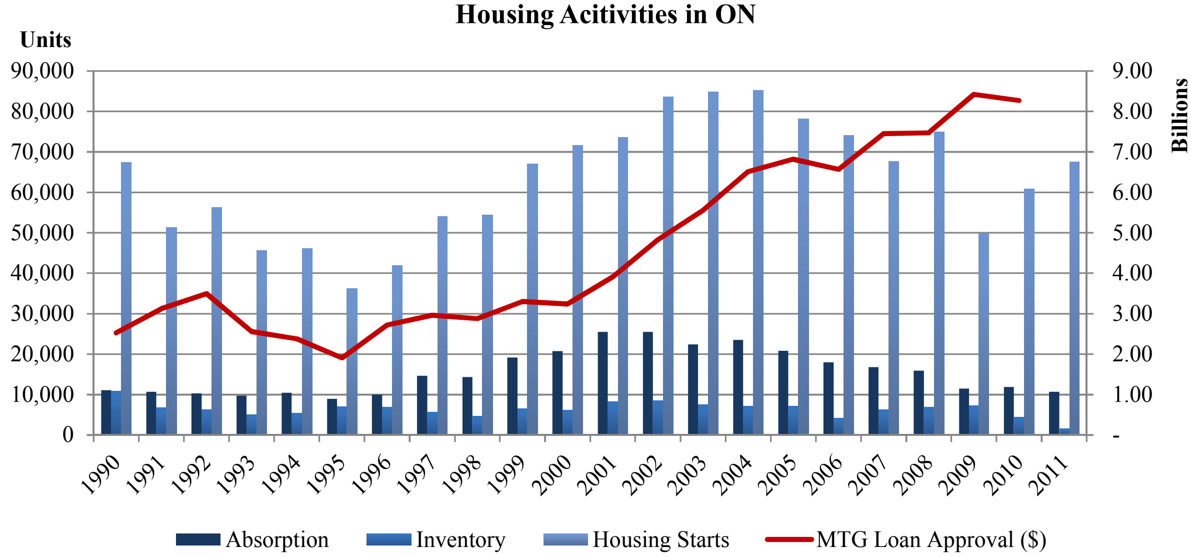
The province of Ontario is the largest contributor to Canadian GDP. In 2010, Ontario's GDP accounted for 36.75% of Canada's total GDP with an average annual growth rate of 2.53% from 1997 to 2010. The consensus GDP growth for 2012, and 2013, are estimated at 1.70% and 2.20%, respectively. The strong economic activity has attracted many immigrants to the region who further contribute to the strong growth in GDP. Immigrants from outside Canada accounted for 81.7% of the total population increase over the past 20 years, and during this time, the total population increased by 3.1 million people.



Source: Statistics Canada & Fundamental Research Corp.

Below is a graph of Ontario's housing market activity. **One thing to note from the graph is that housing inventory is at its lowest level (1,573 units) in 20 years** (note that loan approval value and housing start figures are for the entire province while absorption and inventory figures are for major metropolitan areas). **We see the low inventory levels and**

relatively low housing starts from 2009 to 2011 as an indication of a healthy real estate market in the coming years.



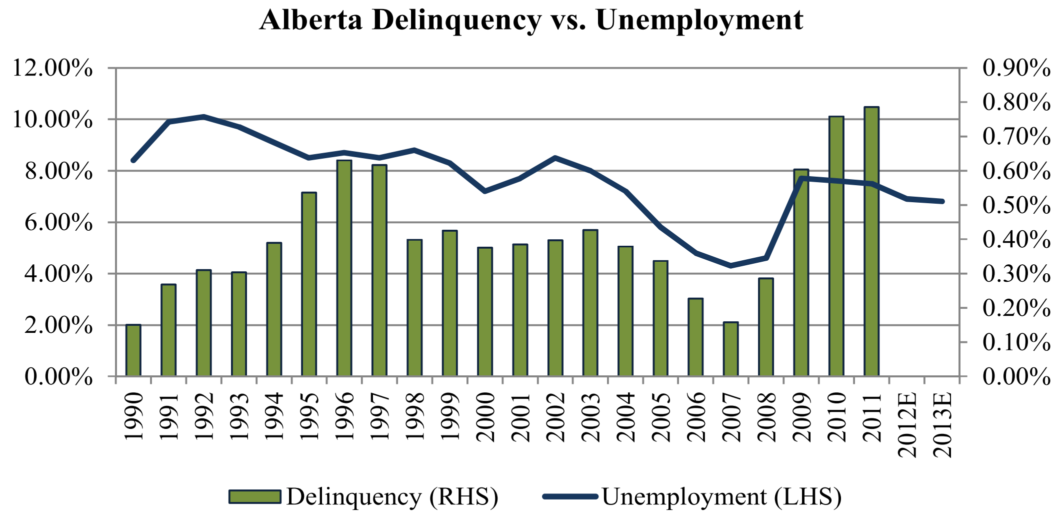
Source: Statistics Canada & Fundamental Research Corp.

Overall, we see a strong inflow of immigrants and steady inter-provincial migration, especially to the urban centers across the three provinces, as a strong driver for the housing markets. The GDP and population growth forecasts are a good indication of increased demand while the relatively low housing starts and inventory levels indicate low supply.

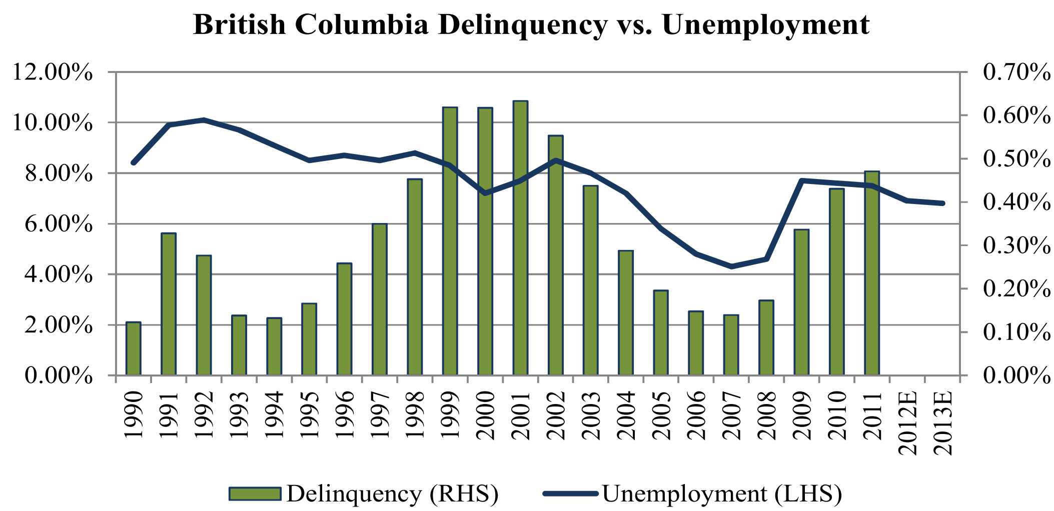
Overall, our research indicates a drop (10-15%) in housing prices in BC but continued increase in Alberta and Ontario, especially the metropolitan areas.

Employment

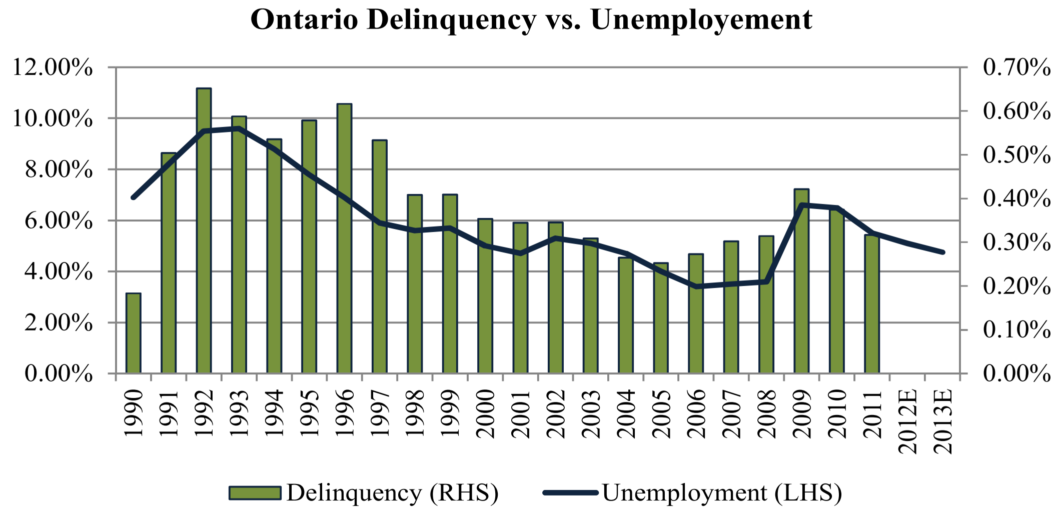
As can been seen in the graphs below, mortgage delinquency is highly related to the unemployment rate across all three provinces over the past 15 years. There are three key take-aways from the graphs below.



Source: Canadian Bankers Association, Statistics Canada and Fundamental Research Corp.



Source: Canadian Bankers Association, Statistics Canada and Fundamental Research Corp.



Source: Canadian Bankers Association, Statistics Canada and Fundamental Research Corp.

Firstly, delinquencies and unemployment are highly correlated, and the correlation between the two variables has been increasing since 1995. The current 10 year correlation between delinquency and unemployment is 0.77 (ON), 0.87 (AB) and 0.87 (BC). As the table below shows, the correlation has remained relatively strong for Ontario for the past 21 years. For Alberta and British Columbia, the correlation has increased significantly over the years. We believe the strong correlation makes economic sense as employment income is the main source of cash flows for many families. A decrease in income cash flow increases the likelihood of delaying payments.

10 Year Correlation - Delinquency & Unemployment

	ON	AB	BC
1990 - 2000	0.84	(0.32)	(0.50)
1991 - 2001	0.90	(0.35)	(0.68)
1992 - 2002	0.90	(0.25)	(0.71)
1993 - 2003	0.86	(0.07)	(0.76)
1994 - 2004	0.83	0.36	(0.46)
1995 - 2005	0.83	0.78	0.16
1996 - 2006	0.80	0.90	0.54
1997 - 2007	0.61	0.88	0.76
1998 - 2008	0.04	0.89	0.84
1999 - 2009	0.40	0.94	0.84
2000 - 2010	0.63	0.94	0.82
2001 - 2011	0.77	0.87	0.87

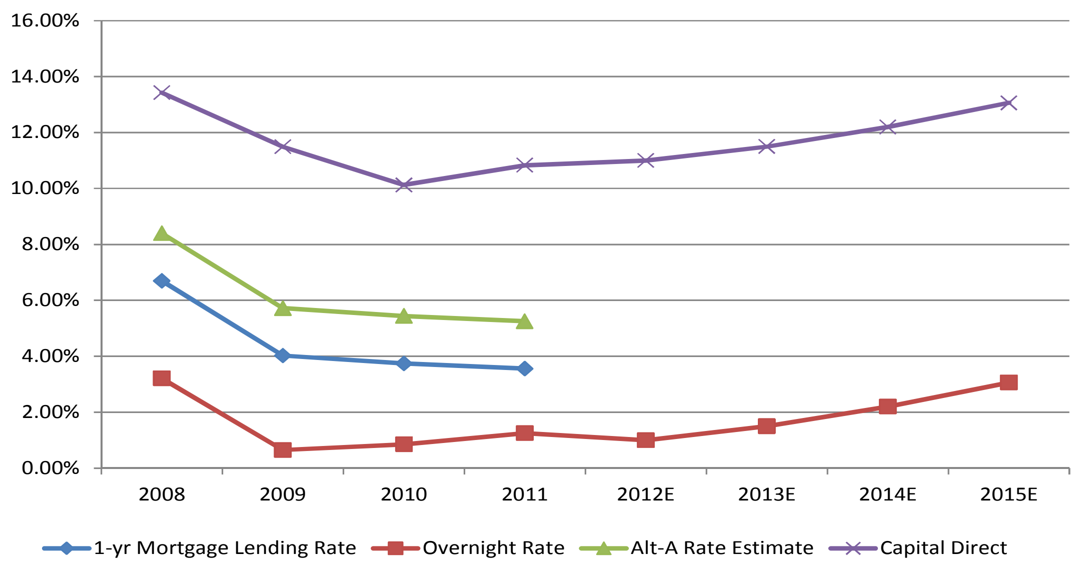
Source: Fundamental Research Corp.

We are expecting unemployment rates to decrease in all three provinces in 2012, and 2013, based on the economic recovery, and based on the increase in the consumer confidence index to the current level of 106.9 from 85 in 2007. As a result, we expect delinquencies to decrease.

Secondly**, even though delinquency is highly related to unemployment,** in 2011, the year with the highest delinquency rate over the past 21 years, delinquency was only 0.80% of the entire mortgage lending market.

Interest Rates

The following chart shows both the historical and expected overnight rate, benchmark 1-yr lending rate, Alt-A lending rate and Capital Direct's HEL rate.



Sources: Fundamental Research Corp., TD Economics and RBC Economics

As shown in the above chart, the historical Alt-A interest rate closely tracked the movement of the 1-yr lending rate benchmark, which in turn was closely related to the overnight rate. In the past, **Capital Direct's HEL yields have been at approximately a 10% premium (past four year average) over the overnight rate**, and we expect this credit spread to be maintained going forward.

As Capital Direct's HEL interest rate is closely correlated to the overnight rate, we believe changes in future overnight rate will impact Capital Direct's revenues. Our research indicates that the Bank of Canada is likely to adopt a stimulative monetary policy for the next five years to ensure economic growth, and we believe the overnight rate will increase gradually in the next five years. (consensus estimate for 2015 is 3.06%; up from the current 1.0% p.a.).

Management Team

The directors and senior officers of the Manager and the Mortgage Broker have extensive experience in real estate and mortgages. Due to their success, the Mortgage Broker has evolved from a pure Vancouver-based company, into an inter-provincial organization. Brief bios as provided by the Manager are provided below

Richard F.M. Nichols
Mortgage Broker: Mr. Nichols is Founding Partner and President of the Mortgage Broker from 1997 to present.

Mr. Nichols oversaw the company's expansion into new markets including Calgary, Edmonton, and other Central Canadian cities, and later developed a subsidiary into three Atlantic Provinces. He has obtained his Bachelors of Business Administration from the University of Prince Edward Island studying finance and capital budgeting. In 1993, Mr. Nichols graduated with honors from the Masters of Business Administration program at the University of British Columbia. While completing his Masters degree, Mr. Nichols studied international marketing at the Haute Etude Commerciale in Paris, France. Mr. Nichols is an Accredited Mortgage Professional certified by the Canadian Institute of Mortgage Brokers and Lenders and the Canadian Association of Accredited Mortgage Professionals. He is an active Member of Mortgage Brokers Association of Ontario and other provincial and national mortgage-brokering professional and trade organizations. He is also a long standing member of the Vancouver Board of Trade. In the Spring of 2010, Mr. Nichols was elected to the Chorus CKNW Orphan's Fund board of directors.

The Manager: Mr. Nichols is Managing Director and Director of the Manager from 2005 to the present.

Derek R. Tripp
Mortgage Broker: Mr. Tripp is Founding Partner and Vice President of the Mortgage Broker from 1997 to present.

Mr. Tripp brings over 20 years of financial experience to the company. He has underwritten over $300 million in mortgages and specializes in builder's mortgages. Mr. Tripp has been instrumental in expanding the Mortgage Broker into new provinces throughout Canada. Mr. Tripp studied Urban Land Economics in Real Estate at the University of British Columbia. He is an Accredited Mortgage Professional certified by the Canadian Institute of Mortgage Brokers and Lenders and the Canadian Association of Accredited Mortgage Professionals. He is a licensed mortgage broker in BC and Alberta and a licensed mortgage agent in Ontario. He is a member of the Alberta Mortgage Brokers Association, Independent Mortgage Brokers Association of Ontario and other provincial and national mortgage-brokering professional and trade organizations.

The Manager: Mr. Tripp is Managing Director and Director of the Manager from 2005 to the present.

Tim Wittig
Mortgage Broker: Partner, Vice President and Director of the Mortgage Broker from 2010 to the present.

The Manager: Vice President and Director of the Manager from 2010 to the present.

Mr. Wittig brings 20 years of business experience to the company. He studied History and

Political Science (Joint Honors) at both University of Waterloo and University of British Columbia before answering his entrepreneurial call. In 1987, Mr. Wittig and a partner founded Shaftebury Brewing Company in Vancouver. Mr. Wittig was instrumental in establishing Shaftebury as one of the most successful craft breweries in the Pacific Northwest. Mr. Wittig's entrepreneurial spirit was recognized when he was twice nominated for Ernest & Young's Entrepreneurial of The Year Award and when he was recipient of Business In Vancouver's prestigious Forty Under 40 Award. He has been an investor in private mortgages for the past 12 years and is a licensed mortgage broker. He is an active member of various professional organizations including the Canadian Association of Accredited Mortgage Professionals, the Mortgage Brokers Association of British Columbia and the Independent Mortgage Brokers Association of Ontario.

David Rally
Mortgage Broker: Vice President, Legal Affairs, of the Mortgage Broker from 1997 to the present.

Mr. Rally is a lawyer and has been associate counsel at Beck, Robinson & Company since 1989. In his work as a lawyer, Mr. Rally deals extensively in real estate law, including bank mortgages, private financing and commercial leasing as well as in realizations and insurance law. He has acted as counsel before all levels of court in British Columbia and is a member of good standing of the Bars of British Columbia and Upper Canada (Ontario). Mr. Rally served as an advisor in establishing in-house paralegal services for a well-known real estate service provider and is also licensed as a mortgage broker in Ontario. Mr. Rally studied in the Economics (Honors) program at the University of British Columbia and obtained LL.B. from the University of British Columbia in 1988.

Paul Wylie
Independent member of the Board of Governors.

Mr. Wylie's experience includes over 17 years with two leading financial institutions within North America. Most recently Mr. Wylie worked as a Senior Vice-President and Branch Manager with the financial institutions. Throughout his banking career, he has held numerous management roles in various divisions including: private banking, credit, sales and service and wealth management. Mr. Wylie was educated at the University of Toronto, Wharton Business School and the Canadian Securities Institute. He has gained a number of designations including a Bachelors of Arts, Certified Investment Management Analyst, Financial Management Advisor and has completed the Partners, Directors and Senior Officer's Course. Mr. Wylie has also served on the executive board of his local Big Brothers & Sisters chapter and the community board of Energy International Thermonuclear Research Canada.

Board of Governors

The board of governors consists of five individuals, namely, Richard Nichols, Derek Tripp, David B. Rally, Paul Wylie and Tim Wittig. The board's mandate is to identify and establish procedures for resolving situations where there exists a conflict or potential conflict between the interests of the manager and mortgage broker, and the interests of the trust and unitholders. Some of the roles of the board include, approving every material contract, review portfolio performance, appoint auditors, etc. To assist the board in certain of its duties, the board has appointed a credit and audit committee as detailed further below.

We believe that the board of a company should include independent or unrelated directors who are free of any relationships or business that could materially interfere with the director's ability to act in the best interest of the company. **Although there is only one independent director on the company's board, the non-independent directors combined, own 7.6% of the outstanding units (as of 31 March, 2012). In addition, the trust units purchased by these directors were at a price of $10 per unit (the same price as the current offering). We believe the board's ownership helps align the interests of the board with the interests of the unitholders.**

Credit Committee

The credit committee consists of two individuals. The credit committee is mandated to review the mortgage portfolio on a quarterly basis to ensure compliance with the investment objectives of the trust. The members of the credit committee are Tim Wittig and David Rally.

Audit Committee

The audit committee consists of two individuals. The audit committee is mandated to meet with the auditors, review and recommend approval of the financial statements to the board. The members of the audit committee are David Rally and Paul Wylie (independent).

Exit Strategy

The Trust will continue until the earlier of 25 years from the original data of Declaration of the Trust or the date on which it is otherwise terminated by the manager. The manager may terminate and dissolve the Trust by giving to the Trustee, and each then unit holder, written notice of its intention to terminate the Trust at least 90 days before the termination. However, the manager also has the option to extend the trust if all unit holders elect to do so.

Financials

The trust's financials are audited by Johnsen Archer LLP. Johnsen Archer LLP is a Chartered Accountant firm with over 25 years of experience.

The trust's revenues come from the interest generated from the acquired mortgages. The total assets under management (AUM) increased from $1.70 million at the end of 2007, to $14 million at the end of March 2012. Revenues grew (as a result of this expansion) from $59,318 in 2007, to $1.15 million in 2011; a CAGR of 110%. Net income grew from $21,201 in 2007, to $0.80 million in 2011; a CAGR of 147%. The following table shows a summary of the trust's performance along with our forecasts.

	2007	2008	2009	2010	2011	2012E	2013E	2014E	2015E	2016E
Revenue	$62,226	$369,646	$537,756	$775,260	$1,227,250	$1,672,366	$2,171,131	$2,619,376	$3,134,654	$3,457,767
Net Income	$21,201	$231,023	$376,799	$552,615	$795,149	$1,108,396	$1,423,718	$1,750,986	$2,139,783	$2,355,650
Net Margin	34%	62%	70%	71%	65%	66%	66%	67%	68%	68%

Source: Fundamental Research Corp

Interest income as a percentage of total mortgage investments (or AUM) has ranged between 10.1% and 13.4% in the past four years *(calculated as interest income in a particular year divided by the average of the AUM at the end of that year and the previous year)*, and averaged 11.5% p.a.

As shown in the table above, the trust has high net margins (ranged between 68% and 79% in the last four years) because the company has nominal operating costs. The net income margin for the 'Real Estate Investment Trusts' sector is 34%. Operating costs include:

- Management fee - 2% of the previous year's NAV
- Audit + bank charges + legal + trustee fees averaged about 10% of revenues in the past four years.
- Interest on a line of credit arrangement with Canadian Western Bank - the interest rate is the lower of 4% or prime plus 1.65%.
- Every year, the trust maintains a provision for loan losses (non-cash expenses) – which have averaged 0.29% of the AUM - *(calculated as loan losses in a particular year divided by the average of the AUM at the end of that year and the previous year).* The trust's NAV per unit should always stay at $10 as 100% of the net income is distributed to investors and management. NAV will drop only if there are real loan losses. **As the trust's NAV has stayed at $10 per unit (since 2008), as indicated by the audited financial statements, we estimate the company has not had any material actual loan losses since 2008 – which is very impressive.**
- The trust pays out all of its net income, so only unit holders pay tax.

The company reported net income of $0.80 million ($0.74 per unit) in FY2011, up from $0.02 million ($0.07 per unit) in FY2007. **At the current unit price of $10, FY2011 net income (net of management distributions) reflects a P/E of 15.4x. The average P/E of the 'Real Estate Investment Trusts' sector is currently at 16.7x.**

We made the following assumptions for our revenue and net income forecasts through 2016 (5 year projections):

- The trust raises $5 million in FY2012 and $3 million a year from 2013-2016.
- Lending rate of 11% in 2012, 11.5% in 2013, 12.2% in 2014, 13.1% in 2015 and 13.1% in 2016 (based on our estimates presented earlier in this report).
- Assumed an annual redemption rate of 3.1% of the total equity (which was the average in the past four years); redemptions will be paid through the available balance on the line of credit and cash on hand (50:50 mix).
- **The trust has not had any material loan losses in the past; for conservatism, we have assumed a loan loss rate of 0.80% of the AUM.** *(As mentioned earlier in this report, in 2011, the year with the highest delinquency rate over the past 21 years, delinquency was 0.80% of the entire mortgage lending market.)*

We expect revenues of $1.67 million in FY2012, and $2.17 million in FY2013. Our net income forecasts for FY2012, and FY2013, are $1.11 million ($0.74 per unit) and $1.42 million ($0.80 per unit), respectively.

Income Statement	2007	2008	2009	2010	2011	2012E	2013E	2014E	2015E	2016E
Revenue										
Interest Income	$59,318	$337,521	$501,656	$702,948	$1,154,458	$1,672,366	$2,171,131	$2,619,376	$3,134,654	$3,457,767
Other Income	2,908	32,125	36,100	72,312	72,792	-	-	-	-	-
	$62,226	**$369,646**	**$537,756**	**$775,260**	**$1,227,250**	**$1,672,366**	**$2,171,131**	**$2,619,376**	**$3,134,654**	**$3,457,767**
G&A Cost										
Audit Fees	2,240	10,000	22,000	40,000	67,275	70,365	91,350	110,210	131,890	145,485
Bank Charges	826	4,316	1,975	8,048	27,923	20,656	26,816	32,353	38,717	42,708
Interest on Loan Payable	27,739	70,983	51,773	31,063	84,727	87,323	93,968	103,507	114,613	127,235
Legal Fees		8,532	5,892	18,681	64,287	36,965	47,990	57,897	69,287	76,429
Management Fees	2,257	24,539	54,797	97,621	145,619	214,185	305,486	353,135	398,800	442,538
Provision for Loan Losses	7,963	8,641	14,152	15,380	29,976	102,702	140,551	161,519	182,006	202,025
Trustee Fees		11,612	10,368	11,852	12,294	31,775	41,251	49,768	59,558	65,697
	41,025	**138,623**	**160,957**	**222,645**	**432,101**	**563,970**	**747,413**	**868,390**	**994,870**	**1,102,117**
Net Income	**$21,201**	**$231,023**	**$376,799**	**$552,615**	**$795,149**	**$1,108,396**	**$1,423,718**	**$1,750,986**	**$2,139,783**	**$2,355,650**

The trust's NAV has stayed at $10 per unit since 2008. Based on our very conservative loan loss estimate of 0.80% p.a., our models estimate that the NAV will gradually drop to $9.68 per unit by 2016. The NAV drops to $9.88 per unit if actual loan losses are at the historical average provision for loss rate of 0.29%.

Distributions

The following table shows the trust's free cash flows since 2007. Distributions to unit holders were always made from FCF and not from new equity – which is a positive sign.

Although the profit sharing between investors and management is 80%:20%, management handed out 90% of the net profits to investors in FY2009, FY2010 and FY2011 – we believe, this was to increase the investment's attractiveness. Going forward, there is no guarantee that investors will receive 90%, therefore, our models are based on a 80% distribution.

We estimate that investors, on average, have the potential to receive 6.8% - 8.1% p.a. over the next five years (based on a 80% distribution rate). **Assuming an actual loan loss of 0.80% p.a., the overall internal rate of return (IRR) for the 5-year period, we estimate, is 6.9% p.a. The IRR increases to 7.6% p.a. if the loan loss is 0.29% p.a, and to 8.1% p.a. if there is no loan loss.**

Distribution	2007	2008	2009	2010	2011	2012E	2013E	2014E	2015E	2016E
Free Cash Flows	$140,859	$213,049	$383,470	$572,302	$791,420	$652,971	$1,138,975	$1,400,789	$1,711,827	$1,884,520
Distribution (2007/2008 - 80%; 2009+ - 90% of NI)	$16,961	$192,478	$339,112	$497,354	$715,634	$886,716	$1,138,975	$1,400,789	$1,711,827	$1,884,520
Distribution per Unit	0.06	0.66	0.87	0.82	0.80	0.68	0.68	0.73	0.80	0.79
Distribution (% of NAV)	2.5%	10.7%	8.7%	8.2%	8.0%	6.8%	6.9%	7.5%	8.1%	8.1%

Management's Distribution / Fees	2007	2008	2009	2010	2011	2012E	2013E	2014E	2015E	2016E
Distribution to Management	-	$38,545	$37,687	$55,261	$79,515	$221,679	$284,744	$350,197	$427,957	$471,130
Management Fees	$2,257	$24,539	$54,797	$97,621	$145,619	$214,185	$305,486	$353,135	$398,800	$442,538

Source : Fundamental Research Corp

Due to the management fees (shown in the table below), management has a strong incentive to keep expanding the portfolio. Investors, however, do not have any significant additional benefit from expansion.

About 45% - 55% of the annual distributions have been reinvested by investors in the last four years – which is extremely encouraging for new investors as the high reinvestment rate indicates the attractiveness of this investment opportunity.

	2008	2009	2010	2011
Distributions	$192,478	$339,112	$497,354	$715,634
Reinvested	$105,133	$151,708	$232,843	$330,497
Reinvested (as a % of Distributions)	55%	45%	47%	46%

According to management, only five investors have redeemed out of the trust (two full and three partial) – there are currently 122 investors.

Balance Sheet

The trust holds little cash on its balance sheet as most of the free cash flows are distributed to investors. This, we believe, is a reasonable strategy as the trust has nominal operating costs.

Profitability Analysis	2007	2008	2009	2010	2011	2012E	2013E	2014E	2015E	2016E	Industry
Cash	$75,327	$698,744	$215,007	$121,264	$288,331	$54,586	$54,586	$54,586	$54,586	$54,586	
Working Capital	-$36,368	$600,583	$86,640	-$66,671	$54,586	$54,586	$54,586	$54,586	$54,586	$54,586	
Debt/Capital	60%	25%	11%	14%	17%	13%	13%	13%	13%	13%	48%
LT Debt/Capital	-	-	-	-	-	-	-	-	-	-	38%
ROE	3%	13%	10%	9%	9%	9%	9%	9%	10%	10%	7%
ROA	1%	8%	8%	8%	7%	7%	8%	8%	9%	9%	5%
ROIC	1%	8%	8%	8%	7%	7%	8%	8%	9%	9%	5%
EBIT/Interest Expense	1.76	4.25	8.28	18.79	10.38	13.69	16.15	17.92	19.67	19.51	

Source : Fundamental Research Corp

The trust has a $5 million line of credit with Canadian Western Bank. As of March 31, 2012, $1.92 million was withdrawn. The debt to capital ratio was 17% at the end of FY2011. The interest coverage ratio of the trust is fairly strong, and it is good to see that operating profits generated by the trust can easily cover its annual debt obligation. **As the interest rate on the line of credit is the lower of 4% or prime plus 1.65%, which is lower than yields generated from the mortgages, we believe taking on debt (at acceptable levels) to acquire mortgages (or meet redemptions) will improve trust holder's return.**

The return on equity and return on capital, as shown in the table above, have been higher than the industry average ratios.

Sensitivity Analysis

The following section shows the sensitivity of the expected returns to two key variables – yield and loan loss rate.

1. **Sensitivity to loan losses –** As shown in the table below, the average return changes from 6.8% to 8.2% p.a. as the annual loan loss rates change from 1.6% to 0% of the AUM.

	2012E	2013E	2014E	2015E	2016E	Average
0.00%	7.46%	7.60%	8.13%	8.82%	8.81%	8.16%
0.20%	7.30%	7.43%	7.96%	8.65%	8.64%	8.00%
0.40%	7.14%	7.26%	7.79%	8.48%	8.47%	7.83%
0.60%	6.98%	7.09%	7.62%	8.31%	8.30%	7.66%
0.80%	6.83%	6.92%	7.45%	8.14%	8.13%	7.49%
1.00%	6.67%	6.75%	7.28%	7.97%	7.96%	7.32%
1.20%	6.51%	6.57%	7.11%	7.80%	7.79%	7.16%
1.40%	6.35%	6.40%	6.94%	7.63%	7.62%	6.99%
1.60%	6.19%	6.23%	6.77%	7.45%	7.45%	6.82%

2. **Sensitivity to mortgage rates (assuming an actual loan loss of 0.80% p.a.)–** The average yield we used in our 2012-2016 forecasts is 12.2% p.a. The following table shows the sensitivity of our IRR estimates to yield.

Avg. Yield	IRR
7.2%	2.7%
8.2%	3.6%
9.2%	4.4%
10.2%	5.3%
11.2%	6.1%
12.2%	6.9%
13.2%	7.8%
14.2%	8.6%
15.2%	9.5%
16.2%	10.3%
17.2%	11.2%

Risk

Investors are exposed to the following risks:

- Unit holders' principal is not guaranteed as the NAV per unit could decrease from current levels (as a result of loan losses). Unit holders are also not guaranteed minimum distributions as quarterly distributions are solely dependent on the net income of every quarter.
- The units are not transferable, which increases liquidity risk to the unitholders, and the units can only be retracted at full NAV after five years. A penalty would be applied to the NAV if unitholders redeem in the first five years of subscription.
- The net income distribution between investors and the manager has been 90%:10% in the past few years; however, there is no guarantee that this trend will continue going forward.
- 60% of Capital Direct's HELs are second mortgage that have only secondary claim to property after the primary lenders. 11% of Capital Direct's HELs are third mortgages which carry significant risk as two lenders have more senior claims than Capital Direct on the property.
- A drop in housing prices will result in higher LTV and higher default risk for Capital Direct as the value of its collateral decreases.
- Interest volatility would impact Capital Direct's revenues as its HEL's interest rate resets annually based on the overnight rate.
- The manager is paid 20% of the net income quarterly. This is an incentive for the management to acquire mortgages with high interest rates; however, mortgages with higher interest rates carry higher default risk.

Conclusion

Overall, based on our review of the offering, structure, management team and cash flow projections, we assign a Stability Rating of 2 - (on a scale of 1 to 7) on the units issued by Capital Direct I Income Trust.

FRC Rating	
Base-Case Return (IRR)	6.9% p.a.
Risk	3 (Average)
Rating	**2 - (Very Good)**

Fundamental Research Corp. Rating Scale:

Rating – 1: Excellent Return to Risk Ratio
Rating – 2: Very Good Return to Risk Ratio
Rating – 3: Good Return to Risk Ratio
Rating – 4: Average Return to Risk Ratio
Rating – 5: Weak Return to Risk Ratio
Rating – 6: Very Weak Return to Risk Ratio
Rating – 7: Poor Return to Risk Ratio

A "+" indicates the rating is in the top third of the category, A "-" indicates the lower third and no "+" or "-" indicates the middle third of the category.

Fundamental Research Corp. Risk Rating Scale:
1 (Low Risk)
2 (Below Average Risk)
3 (Average Risk)
4 (Speculative)
5 (Highly Speculative)

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