Avatar Industries Limited

(A.C.N. 008 742 390)

25 September 2007

Company Announcements Office
Australian Stock Exchange Limited
Level 3, 20 Bridge Street
SYDNEY NSW 2000
Announcement Number 250

Dear Sir,

Avatar Industries Limited – Explanatory Statement for selective capital return

Please find attached the meeting document to be sent to shareholders in relation to a proposed selective capital return. The meeting document is currently being printed and will be despatched to shareholders shortly.

Please note that the meetings to consider the proposed selective capital return will be held on 31 October 2007.

Yours faithfully,

Ian Leijer
Company Secretary

Enc.

Suite 1804, Tower A, Zenith Centre, 821 Pacific Highway, Chatswood, NSW, 2067, Australia
PO Box 5038 Chatswood West, NSW 1515.
Telephone: (02) 9419 2355 Facsimile No: (02) 9411 8879

Avatar Industries Ltd

ACN 008 742 390

EXPLANATORY STATEMENT
FOR A PROPOSED SELECTIVE CAPITAL RETURN

This booklet contains notice of:

- an extraordinary general meeting of all shareholders of Avatar to be held at 10.30am on Wednesday, 31 October 2007 (**General Meeting**); and
- an extraordinary general meeting of all shareholders of Avatar other than Mr. Ian Trahar and Mr. Paul Favretto (and their Associates) to be held at 11.00am on Wednesday, 31 October 2007 (**Exiting Shareholders' Meeting**) or soon as after that time as the General Meeting has concluded,

with both meetings to be held at Suite 2, Level 14, The Forrest Centre, 221 St Georges Terrace, Perth, WA 6000

This is an important document and requires your immediate attention. It should be read in its entirety. If you have any questions in relation to the proposed selective capital return, please contact your financial or other professional adviser immediately.

Legal advisers to Avatar Industries Limited:

FranklynLegal

IMPORTANT DATES

Date of this Explanatory Statement	24 September 2007
Last time by which Proxy Forms for the General Meeting can be lodged	10.30am on 29 October 2007
Last time by which Proxy Forms for the Exiting Shareholders' Meeting can be lodged	11.00am on 29 October 2007
Time for determining entitlements to vote at the General Meeting	10.30am on 29 October 2007
Time for determining entitlements to vote at the Exiting Shareholders' Meeting	11.00am on 29 October 2007
General Meeting	10.30am on 31 October 2007
Exiting Shareholders' Meeting	11.00am on 31 October 2007*
Avatar notifies the ASX that Shareholders have approved the resolutions at the applicable meeting**	31 October 2007
Avatar lodges resolutions approving the Capital Return with ASIC**	31 October 2007
Last day of Avatar trading on ASX**	14 November 2007
Record Date**	21 November 2007
Avatar shares cancelled**	26 November 2007
Avatar is de-listed from the ASX	26 November 2007
Notices sent to Exiting Shareholders that their shares have been cancelled together with a cheque of the consideration to which they are entitled	26 November 2007
Lednium Shares distributed**	26 November 2007

Avatar reserves the right to vary the times and dates set out above and will announce any changes to ASX.

* Or as soon as after that time as the General Meeting has concluded.

** All dates subsequent to the General Meeting and Exiting Shareholders' Meeting are subject to the passing of the special resolutions of those meetings.

IMPORTANT NOTICES

Read this document

You should read this Explanatory Statement in its entirety before making a decision on how to vote on the Capital Return.

ASIC and ASX lodgement

This Explanatory Statement (including the Independent Expert's Report) has been lodged with ASIC in accordance with section 256C(5)(a) and (b) of the Corporations Act and has also been provided to ASX. Neither ASIC nor ASX takes any responsibility for the contents of this Explanatory Statement.

Investment advice

This Explanatory Statement does not take into account your investment objectives, financial situation or particular needs. You should obtain independent financial, investment, legal or taxation advice before deciding whether or not to attend and vote at the relevant meetings or to vote in favour or against the relevant resolutions.

Taxation matters

The Capital Return may have taxation implications for Shareholders. This Explanatory Statement refers to some of the potential taxation consequences arising from the Capital Return. However, as taxation implications may vary between Shareholders, Shareholders should obtain professional advice as to their individual circumstances.

Forward looking statements

This Explanatory Statement may contain forward-looking statements. Forward-looking statements may be identified by words such as "expects", "anticipates", "intends", "believes", "seeks", "estimates", "will" or words of similar meaning and include, without limitation, forward-looking statements regarding Avatar's financial position, business strategy, plans and objectives of management for future operations (including development plans and objectives), which have been based on Avatar's current expectations about future events. These forward-looking statements are, however, subject to known and unknown risks, uncertainties and assumptions that could cause actual results, performance or achievements to differ materially from future results, performance or achievements expressed or implied by such forward-looking statements. Such forward-looking statements are based on numerous assumptions regarding Avatar's present and future business strategies and the environment in which Avatar is expected to operate in the future.

Matters not yet known to Avatar or not currently considered material by Avatar may impact on these forward-looking statements. The statements reflect views held only as at the date of this Explanatory Statement. In light of these risks, uncertainties and assumptions, the matters reflected in the forward-looking statements discussed in this document might not occur. Given these conditions, you are cautioned not to place undue reliance on such forward-looking statements.

Subject to any continuing obligations under applicable law or any relevant listing rules of an applicable stock exchange, Avatar expressly disclaims any obligation to disseminate after the date of this Explanatory Statement any updates or revisions to any such forward-looking statements to reflect any change in expectations or events, conditions or circumstances on which any such statements are based.

Privacy

Avatar may collect personal information in the process of implementing the Capital Return. This information may include the names, contact details and share holdings of Shareholders and the names of persons appointed by Shareholders to act as proxy, corporate representative or attorney at the applicable meetings. The primary purpose of collecting this information is to assist Avatar in conducting the General Meeting and Exiting Shareholders' Meeting and to enable the Capital Return to be implemented by Avatar in the manner described in this Explanatory Statement.

Personal information may be disclosed to Avatar's share registry, print and mail service providers, authorised securities brokers and to related bodies corporate of Avatar.

Shareholders have the right to access personal information that has been collected. A Shareholder who wishes to access personal information should contact Avatar's share registry, Computershare.

Shareholders who appoint a named person to act as their proxy, corporate representative or attorney at a meeting should inform that person of the matters outlined above.

Defined terms

Certain capitalised terms in this Explanatory Statement are defined in Schedule 1 of the Explanatory Statement.

Avatar Industries Ltd
ACN 008 742 390

24 September 2007

Dear Shareholders

SELECTIVE CAPITAL RETURN

On 29 June 2007 Avatar Industries Limited (**Avatar** or the **Company**) announced a number of transactions which, if approved, will return surplus capital to Shareholders and seek to maximise the returns from the Company's remaining business interests.

The transactions will have the effect of returning to Shareholders an aggregate of $1.91 per Avatar Share comprising:

- $1.83 in cash per Avatar Share (which represents the net assets of the Company excluding the Lednium business); and
- one (1) ordinary fully paid share in Lednium Limited, the company that will own the Lednium business, for every one (1) Avatar Share held (based on net asset backing of Lednium of 8 cents per Avatar Share),

in return for the cancellation of Shareholders' Avatar Shares.

Mr Ian Trahar and Mr Paul Favretto and their Associates (the **Continuing Shareholders**), the two major Shareholders and directors of the Company, will not receive the distribution and will retain their Shares in Avatar.

These proceeds will be returned by way of a selective capital return (**Capital Return**). Under the Capital Return, all Shares held by participating Shareholders (referred to in the document as the **Exiting Shareholders**) will be cancelled and, save for holding shares in Lednium Limited, will cease to have any ongoing interest in the remaining assets and liabilities of Avatar. The Company will also then be delisted from ASX.

The Company has received a draft class ruling from the ATO which indicates that the Capital Return will be treated as being approximately 65% capital and approximately 35% unfranked dividend for tax purposes.

The Capital Return will not be implemented unless it has been approved at both of the Shareholder Meetings, notices of which are contained in this Explanatory Statement. These approval requirements include the approval by special resolution of the Exiting Shareholders at the Exiting Shareholders' Meeting. The Continuing Shareholders do not vote at this meeting.

The Independent Expert, KPMG Corporate Services Pty Ltd, has concluded that the Capital Return is fair and reasonable to the Shareholders of Avatar as a whole, (being the Exiting Shareholders and the Continuing Shareholders). A copy of the Independent Expert's Report is included in Annexure 1 of this Explanatory Statement.

For reasons set out in this Explanatory Statement, the Independent Directors of Avatar unanimously recommend that you vote in favour of the resolutions required to implement the Capital Return as they intend to do so in respect of shares held or controlled by them.

Messrs Trahar and Favretto intend to vote the shares they own and control in favour of the Capital Return (to the extent permitted). However, they are unable to make a recommendation to Exiting Shareholders in relation to how to vote due to the potential for a conflict of interest to arise out of their differential treatment under the Capital Return.

We encourage you to read this Explanatory Statement in its entirety. In particular, the Explanatory Statement and the Independent Expert's Report contain important information to assist in your consideration of whether or not to approve the Capital Return. If you are unsure how to vote, we recommend you speak with your investment or professional adviser.

If you are unable to attend the applicable Shareholders' meeting, you are encouraged to return your completed Proxy Form in the enclosed reply paid envelope as soon as possible.

Yours sincerely

William Cairns and Mal Hemmerling
Independent Directors

NOTICE OF GENERAL MEETING

Notice is hereby given that a general meeting of Avatar Industries Limited will be held at Suite 2, The Forrest Centre, Level 14, 221 St Georges Terrace, Perth at 10.30am (Perth time) on Wednesday, 31 October 2007.

BUSINESS OF THE MEETING

Special business

To consider, and if thought fit, pass the following resolution as a special resolution for the purposes of section 256C(2) of the Corporations Act 2001 (Cth) and for all other purposes:

> "That the Company reduce its share capital by way of a selective capital reduction in accordance with section 256B of the Corporations Act 2001 (Cth) by:
>
> (a) debiting the Company's share capital account by $39,339,533.03 (Cancelled Capital), being the share capital attributable to the Cancelled Shares;
>
> (b) debiting the Company's retained earnings account by an amount equal to the Return Amount less the Cancelled Capital, estimated to be $20.7 million;
>
> (c) cancelling all ordinary shares in the Company held by all members other than the Continuing Shareholders (being the Exiting Shareholders) immediately before 5.00pm (Perth time) on the Record Date, being 21 November 2007 (such time being the Record Time) with effect on and from the Record Time (**Cancelled Shares**); and
>
> (d) paying to each Exiting Shareholder on a date no later than 10 Business Days after the Record Date as the Independent Directors determine the sum of:
>
> – $1.83 in cash for each ordinary share in the Company; and
>
> – one (1) ordinary fully paid share in Lednium Limited for every one (1) ordinary share in the Company,
>
> held by the Exiting Shareholder immediately prior to the Record Time and cancelled with effect on and from the Record Time under paragraph (c) of this resolution."

In this Notice of Meeting, "**Return Amount**" means the aggregate of the Cancelled Capital plus the proportion of the net assets of Lednium on the date of the Capital Return attributable to the Cancelled Shares.

Interdependence of resolutions

The selective capital reduction will not proceed and the resolution above will not take effect unless the resolution at the Exiting Shareholders' Meeting is passed by the requisite majority.

Voting requirements and restrictions

Votes cast in favour of this resolution by Exiting Shareholders or their Associates will be disregarded. However, Exiting Shareholders wishing to vote against the resolution at the General Meeting may do so.

Exiting Shareholders who wish to approve the Capital Return are **not** required to vote in favour of the resolution proposed in this Notice of General Meeting.

Definitions

Definitions used in this Notice of General Meeting have the same meaning as in the Explanatory Statement.

By order of the board

Ian Leijer, Company Secretary
24 September 2007

Explanatory Statement
Shareholders are referred to the Explanatory Statement accompanying this Notice of General Meeting. The Explanatory Statement is intended to be read in conjunction with and forms part of this Notice of General Meeting.

Members entitled to attend and vote at the General Meeting
For the purposes of the General Meeting and in accordance with regulation 7.11.37 of the Corporations Regulations 2001, it has been determined that the members entitled to attend and vote at the General Meeting shall be those persons who are recorded in the register of members at 10.30am (Perth time) on 29 October 2007.

Proxies
Where a member is unable to attend the General Meeting, we encourage that member to complete and return the enclosed White Proxy Form. Each member is entitled to appoint a proxy. A member who is entitled to cast two or more votes may appoint two proxies and may specify the proportion or number of votes that each proxy is appointed to exercise. If the appointment does not specify the proportion or number of the member's voting rights, each proxy may exercise half the votes. A proxy need not be a member. To be effective, duly completed Proxy Forms, together with any relevant power of attorney, must be received not less than 48 hours before the time for holding the General Meeting. Please direct Proxy Forms and any relevant power of attorney to the company's share registry, Computershare Investor Services Pty Limited.

NOTICE OF EXITING SHAREHOLDERS' MEETING

Notice is hereby given that a meeting of Exiting Shareholders of Avatar Industries Limited will be held at Suite 2, The Forrest Centre, Level 14, 221 St Georges Terrace, Perth at 11.00am(Perth time) on Wednesday, 31 October 2007 (or as soon after that time as the General Meeting has concluded).

BUSINESS OF THE MEETING

Special business

To consider, and if thought fit, pass the following resolution as a special resolution in accordance with section 256C(2) of the Corporations Act 2001 and for all other purposes:

> "That the Company reduce its share capital by way of a selective capital reduction in accordance with section 256B of the Corporations Act 2001 by:
>
> (a) debiting the Company's share capital account by $39,339,533.03 (**Cancelled Capital**), being the share capital attributable to the Cancelled Shares;
>
> (b) debiting the Company's retained earnings account by an amount equal to the Return Amount less the Cancelled Capital, estimated to be $20.7 million;
>
> (c) cancelling all ordinary shares in the Company held by all members other than the Continuing Shareholders (i.e. the Exiting Shareholders) immediately before 5.00pm (Perth time) on the Record Date, being 21 November 2007 (such time being the Record Time) with effect on and from the Record Time (**Cancelled Shares**); and
>
> (d) paying to each Exiting Shareholder on a date no later than 10 Business Days after the Record Date as the Independent Directors determine the sum of:
>
> – $1.83 in cash for each ordinary share in the Company; and
>
> – one (1) ordinary fully paid share in Lednium Limited for every one (1) ordinary share in the Company,
>
> held by the Exiting Shareholder immediately prior to the Record Time and cancelled with effect on and from the Record Time under paragraph (c) of this resolution."

In this Notice of Meeting, "**Return Amount**" means the aggregate of the Cancelled Capital plus the proportion of the net assets of Lednium on the date of the Capital Return attributable to the Cancelled Shares.

Interdependence of resolutions

The selective capital reduction will not proceed and the resolution above will not take effect unless the resolution at the General Meeting is passed by the requisite majority.

Attendance and voting restrictions

This is a meeting of Exiting Shareholders only.

For the Capital Return to be approved, it must be approved by special resolution of the Exiting Shareholders only. No votes cast for or against the resolution by the Continuing Shareholders will be counted.

Definitions

Definitions used in this Notice of Exiting Shareholders' Meeting have the same meaning as in the Explanatory Statement.

By order of the board

Ian Leijer, Company Secretary
24 September 2007

Explanatory Statement
Shareholders are referred to the Explanatory Statement accompanying this Notice of Exiting Shareholders' Meeting. The Explanatory Statement is intended to be read in conjunction with and forms part of this Notice of Exiting Shareholders' Meeting.

Members entitled to attend and vote at the Exiting Shareholders' Meeting
For the purposes of the Exiting Shareholders' Meeting and in accordance with regulation 7.11.37 of the Corporations Regulations 2001, it has been determined that the members entitled to attend and vote at the Exiting Shareholders' Meeting shall be those persons who are recorded in the register of members at 11.00am (Perth time) on 29 October 2007.

Proxies
Where a member is unable to attend the Exiting Shareholders' Meeting, we encourage that member to complete and return the enclosed Blue Proxy Form. Each member is entitled to appoint a proxy. A member who is entitled to cast two or more votes may appoint two proxies and may specify the proportion or number of votes that each proxy is appointed to exercise. If the appointment does not specify the proportion or number of the member's voting rights, each proxy may exercise half the votes. A proxy need not be a member. To be effective, duly completed Proxy Forms, together with any relevant power of attorney, must be received not less than 48 hours before the time for holding the Exiting Shareholders' Meeting. Please direct Proxy Forms and any relevant power of attorney to the company's share registry, Computershare Investor Services Pty Limited.

ACTION REQUIRED BY SHAREHOLDERS

Step 1 – Read this Explanatory Statement

This Explanatory Statement sets out the details of the Capital Return for Shareholders. This information is important. You should read this document carefully and if necessary seek your own independent advice on any aspects about which you are not certain.

Step 2 – Vote at the Meetings

Your vote is important. Details of the relevant meetings are set out in the Notice of General Meeting and Notice of Exiting Shareholders' Meeting included in this Explanatory Statement.

Exiting Shareholders can attend in person or complete the applicable Proxy Form that accompanies this Explanatory Statement and return it in the reply paid envelope. For details on how to complete and lodge the Proxy Forms please refer to the instructions on those Proxy Forms.

HOW TO VOTE

Voting in person

If you wish to vote in person you should attend the General Meeting and the Exiting Shareholders' Meeting.

Voting by proxy

If you are unable to attend the Exiting Shareholders' Meeting and the General Meeting, please vote by completing and signing the relevant Proxy Form included with this Explanatory Statement as soon as possible, but so that the White Proxy Form relating to the General Meeting is received no later than 10.30am (Perth time) on 29 October 2007 and the Blue Proxy Form relating to the Exiting Shareholders' Meeting is received by no later than 11.00am (Perth time) on 29 October 2007. Proxy Forms received after this time will be invalid.

Exiting Shareholders who wish to approve the Capital Return are only required to complete and sign the Blue Proxy Form relating to the Exiting Shareholders' Meeting and mark the "FOR" box in that Proxy Form. Exiting Shareholders who wish to approve the Capital Return are not required to vote in favour of the Capital Return at the General Meeting. Under the Corporations Act, the Company is not permitted to accept votes cast by Exiting Shareholders in favour of the resolution proposed in the Notice of General Meeting.

Exiting Shareholders wishing to vote against the Capital Return may do so by completing and signing the Blue Proxy Form relating to the Exiting Shareholders' Meeting and mark the "AGAINST" box in that Proxy Form and by completing and signing the White Proxy Form relating to the General Meeting and mark the "AGAINST" box in that Proxy Form.

You may return the relevant Proxy Forms and any relevant power of attorney to the Company's Share registry, ComputerShare Investor Services Pty Limited, Level 2, 45 St Georges Terrace, Perth 6000 or on facsimile no. (08) 9323 2033

FREQUENTLY ASKED QUESTIONS

This section provides summary answers to some basic questions that Shareholders may have in relation to the Capital Return. *This section should be read in conjunction with the whole Explanatory Statement.*

When and where will the Meetings be held?	The General Meeting will be held at Suite 2, The Forrest Centre, Level 14, 221 St Georges Terrace, Perth on Wednesday, 31 October 2007 at 10.30am(Perth time). The Exiting Shareholders' Meeting will be held at Suite 2, The Forrest Centre, Level 14, 221 St Georges Terrace, Perth on Wednesday, 31 October 2007 at 11.00am (Perth time) (or as soon after that time as the General Meeting has concluded).
Am I an Exiting Shareholder?	All Avatar Shareholders, other than Shareholders associated with Mr Ian Trahar and Mr Paul Favretto, are Exiting Shareholders.
How much will I receive under the Capital Return?	Under the proposed Capital Return, the Exiting Shareholders will receive an aggregate of $1.91 per Avatar Share comprising: • $1.83 in cash per Avatar Share (which represents the net assets of the Company excluding the Lednium business); and • one (1) Lednium Share for every one (1) Avatar Share held (based on current net asset backing of Lednium of 8 cents per Avatar Share). The Company has received a draft class ruling from the ATO which indicates that the Capital Return will be treated as being approximately 65% capital and 35% unfranked dividend for tax purposes. See section 3 for more details.
What will happen if the Capital Return is approved?	If the Capital Return is approved, Avatar will: • cancel all of the shares of the Exiting Shareholders on or around 26 November 2007; • pay each Exiting Shareholder $1.83 per share in cash and one (1) Lednium Share for every one (1) Avatar Share held, on or around 26 November 2007; • delist from ASX; and • become 100% owned by the Continuing Shareholders.
What is the opinion of the Independent Expert?	The Independent Expert has concluded that the Capital Return is fair and reasonable to all Exiting Shareholders. You should read the Independent Expert's Report in full.
Am I entitled to vote at the General Meeting?	Exiting Shareholders who wish to approve the Capital Return are **not** required to vote in favour of the resolution proposed in the Notice of General Meeting. In any event, under the Corporations Act, the Company is not permitted to accept votes cast in favour of the Capital Return at the General Meeting by Exiting Shareholders and their Associates. However, Exiting Shareholders wishing to vote against the Capital Return at the General Meeting may do so.
Am I entitled to vote at the Exiting Shareholders' Meeting?	If you are registered as a Shareholder on the Avatar register as at 11.00am (Perth time) on 29 October 2007 and are an Exiting Shareholder, then you will be entitled to vote at the Exiting Shareholders' Meeting. You may vote in person at the Meeting or by completing and lodging the appropriate Proxy Form accompanying this Explanatory Statement.

What voting majority is required to approve the Capital Return?	The Capital Return can only proceed if: • a special resolution is passed at the General Meeting, with no votes being cast in favour of the special resolution by any Exiting Shareholders or their Associates. The Continuing Shareholders have indicated to the Company that they intend to vote in favour of the Capital Return at the General Meeting; and • a special resolution is passed by Exiting Shareholders at the Exiting Shareholders' Meeting whose Shares are to be cancelled under the Capital Return.
Should I vote?	You do not have to vote, however the Independent Directors: • unanimously recommend that Exiting Shareholders vote in favour of the resolution to approve the Capital Return at the Exiting Shareholders' Meeting; and • intend to vote their shares, if any, or open proxies they hold in favour of the resolutions to the extent that they are not excluded from doing so.
When will the result of the Meetings be known?	The result of the Meetings will be available shortly after the conclusion of the Meetings and will be announced to the ASX once available.
What happens if the Capital Return is not approved?	If the Capital Return is not approved: • subject to any alternative proposals, the Company will remain in its current form and listed on ASX; • Exiting Shareholders will not receive immediate value for their shares; • the Company will proceed with the Arlec Sale (subject to Shareholder approval); and • the Company will continue to investigate alternative means of distributing surplus capital to Shareholders and shares in Lednium to its Shareholders. The Continuing Shareholders have indicated that they would only vote in favour of such a proposal if it allowed them to retain their interest in those assets within the Avatar Group.

Avatar Industries Limited
ACN 008 742 390

This Explanatory Statement has been prepared to provide all the information known to Avatar that is material to Shareholders in deciding whether or not to approve the Capital Return being proposed by the Company. This Explanatory Statement explains the Capital Return, identifies the reason for proposing it to Shareholders and outlines some of the benefits and implications of the Capital Return. Shareholders should read the Explanatory Statement in its entirety before making a decision on how to vote on the Capital Return being proposed.

1 BACKGROUND TO THE TRANSACTIONS TO RETURN VALUE TO SHAREHOLDERS

1.1 Capital Return

As stated in the Company's Half Yearly Report in February 2007, the Board has been engaged in a process of assessing a range of different options for maximising the return of capital to Shareholders and seeking to optimise the potential of the Lednium business and the value of the remaining Arlec business.

The Board continues to be of the view that current conditions in the equity market fuelled by superannuation cash flows are restricting new "value adding" investment opportunities and that it is in Shareholders' interests to have the net assets of the Company returned to them.

This process culminated in the Board announcing on 29 June 2007 the decision to sell its Arlec business and proceed with a proposal to return to Exiting Shareholders their share of the net assets of the Company by way of capital return, comprising a cash component and shares in Lednium. The estimated cash component of the Capital Return was based on an assumed completion date for the Capital Return of the end of September 2007. As announced to Shareholders on 23 July 2007, the progress of the Capital Return was delayed due to the delays in obtaining a response from the Australian Taxation Office. As a result of this delay, the proposed date for completion of the Capital Return has extended to 26 November 2007 and the forecast net assets of the Company as at that date are expected to be slightly greater than the previous position. Consequently the amount of the proposed capital return has increased.

As a result, the Board has determined to return to Shareholders by way of capital return an amount of $1.91 per Avatar Share to Exiting Shareholders (**Capital Return**), comprising:

- a cash component of $1.83 per Avatar Share, representing the net assets per share of the Company (excluding those of the Lednium business); and
- one (1) Lednium Share for every one (1) Avatar Share held, representing each Exiting Shareholders' pro rata shareholding in Avatar, with Lednium expected to have net tangible assets of approximately 8 cents per Avatar Share (including approximately 2.5 cents in cash).

Upon the Capital Return taking effect, the Avatar Shares held by the Exiting Shareholders will be cancelled and the Company will be delisted from the ASX.

The proposed structure of the Capital Return provides, in the opinion of the Independent Directors, the best outcome for all stakeholders of the Company, including the Exiting Shareholders and Continuing Shareholders, as it provides a mechanism by which Exiting Shareholders can realise their investment in the Company whilst still participating in the potential upside that would arise from the successful development of the Lednium technology and business and is supported by the Continuing Shareholders.

Further details regarding the Capital Return, its benefits and implications are set out in section 2 of this Explanatory Statement.

1.2 Lednium Share Distribution

The Avatar Group commenced research and development into light emitting diodes (**LED**) in 1999. The Company's research and development activities into LED lighting culminated in the establishment in 2004 of a discrete business unit, in Lednium, focussed on the research and development, manufacturing and distribution of LED solid state lighting components and products, primarily to the OEM, trade and wholesale markets worldwide. Lednium commenced commercialisation of its LED technology in late 2005 and is in the early stages of its business development cycle.

As disclosed to Shareholders on 31 August 2007, Lednium has recently received claims alleging that it is infringing certain patents held by other parties (**Claims**). The Claims extend to patents in various overseas countries and are still being evaluated. The Claims create uncertainty as to the value and future prospects of the Lednium business and may take a number of months to fully evaluate.

Given the potential upside for Shareholders which would arise from successful development of the Lednium technology and business, the Board considers that it is in Shareholders' interests to maintain an interest in that business, however the considerable uncertainty as to the value of the business resulting from the Claims must also be considered by Shareholders. The Lednium Share Distribution gives Shareholders the opportunity to continue to participate in the future development of Lednium on this basis. Lednium Shares representing each Exiting Shareholder's pro rata shareholding in Avatar will be distributed as part of the Capital Return.

In considering the Lednium Share Distribution, the Board considered whether the Lednium and Arlec businesses should be retained within the same entity. However, it was thought that notwithstanding that the Lednium business had historically been incubated within Arlec, Lednium now operates as a separate entity with a different business model in terms of its products, market and operational activities, capital, people and infrastructure needs and growth prospects and development cycle. Lednium already has access to Arlec's existing distribution infrastructure to distribute its products in Australia and New Zealand through a distribution agreement, a summary of which is provided in section 4.2 below.

Accordingly, the Board believes that Avatar Shareholders would get greater value for their investment in the Lednium business if Lednium was operated as a pure LED technology business so that:

- investors who wanted exposure to the fast growing LED industry and the Lednium technology could get it without the dilution and distractions of the underperforming, relatively mature and highly competitive Arlec business;
- Lednium could raise the equity capital it requires for the development and commercialisation of its LED technology directly from the market;
- Lednium could be free from the residual assets and contingent liabilities arising from Avatar's asset sale program (such as potential warranty exposures etc).

After implementation of the Capital Return (if approved), the board of Lednium will continue to consider the suitability of Lednium to be listed on ASX. No decision can or will be made on listing until after the Claims are clarified or resolved and there is no guarantee that approval to list Lednium will be sought or, if sought, will be granted by the relevant exchange.

Further details relating to Lednium are set out in Schedule 4 of this Explanatory Statement and in section 6.1 of the Independent Expert's Report.

1.3 Arlec Sale

Having regard to various matters including the decision to return surplus capital generated from the sale of the DrillCorp businesses and the decision to separately operate Lednium, the Board formed the view that the size, growth profile and poor and volatile earnings history of the Arlec business did not warrant it remaining as what would effectively be a stand alone listed business within the Avatar corporate shell.

Accordingly, the Board concluded that it would be in the best interests of Avatar Shareholders to realise the value of the Company's investment in the Arlec business and also return the capital employed in the business to Shareholders as part of the proposed Capital Return.

To that end the Company engaged PwC in February 2007 to conduct a sale process to sell the Arlec business. PwC conducted an extensive sale process in which over 50 trade and financial parties were invited to bid.

The outcome of this sales process was that an entity associated with Mr Trahar (the Company's Chairman and major Shareholder) was the only party who was willing to offer the Company net tangible asset value for the Arlec business (currently approximately $14 million) and enter into a sale contract on terms acceptable to the Company. As the price offered by Mr Trahar was within the valuation range for the Arlec business determined by PWC and considered reasonable by the Independent Directors, the Company accepted Mr Trahar's offer and entered into a formal sale agreement on 28 June 2007.

Under the Arlec Sale, the Company will get the benefit of the earnings of the Arlec business up to the date of completion of the sale (which will be after the implementation of the Capital Return), and so the amount returned to Shareholders under the Capital Return will include an estimate of these earnings up to the date that the Capital Return takes effect. Further details relating to this valuation are set out in section 9.3 of the Independent Expert's Report.

The Arlec Sale remains subject to Shareholder approval and will be put to Shareholders if the Capital Return does not proceed. The sale is therefore independent of the Capital Return. However, the value of the Arlec business has been taken into account when determining the amount to be paid to the Exiting Shareholders on completion of the Capital Return.

Further details relating to the Arlec Sale are set out in section 4 of this Explanatory Statement and in sections 3.1, 6.1 and 9.3 of the Independent Expert's Report.

1.4 Conflict management

The Board of the Company has recognised the potential for conflict of interests arising due to the different treatment of Messrs Trahar and Favretto (as Continuing Shareholders) under the Capital Return and in relation to the Arlec Sale.

As previously announced, procedures have been established to address these issues, including the appointment of a sub committee including the non-interested directors (being Messrs W Cairns and M Hemmerling) to represent and manage the Capital Return on behalf of Avatar, and management undertakings have been obtained from Messrs Trahar and Favretto in relation to their continuing obligations to all Shareholders of the Company.

Pursuant to the conflict protocol and undertakings, each of Mr Trahar and Mr Favretto agreed that he would disclose all information relating to Avatar, its business and prospects that may be relevant to the Capital Return, all information relating to his interests in Avatar and his intentions in relation to the Company if the Capital Return is implemented and all information known by him which is material to a Shareholder's decision on how to vote at the Meetings.

1.5 Independent Expert's conclusion

The Independent Directors commissioned KPMG to prepare a report on the Capital Return to ascertain whether it is fair and reasonable to all Shareholders (including the Exiting Shareholders).

The Independent Expert has concluded in its report that in its opinion, the Capital Return is fair and reasonable to all Shareholders of Avatar.

The Independent Expert's Report is set out in full in Annexure 1 to this Explanatory Statement.

1.6 Independent Directors' recommendation

The Independent Directors have carefully considered the potential benefits, and the potential disadvantages, of the Capital Return, and the Independent Expert's conclusions in regards to the Capital Return, together with a number of other relevant transactional issues.

The Independent Directors:

- unanimously recommend that Exiting Shareholders support the proposed capital Return by voting at the Exiting Shareholders' Meeting in favour of the resolution to approve the Capital Return; and
- intend to vote their shares, if any, or open proxies they hold in favour of the resolutions.

1.7 Summary only

The information above is a brief summary only. Shareholders are urged to read this Explanatory Statement and the accompanying Independent Expert's Report in full before making a decision on how to vote on the Capital Return.

2 CAPITAL RETURN

2.1 What the Capital Return entails

If approved, the Capital Return will result in the return to all Exiting Shareholders who are registered as holders of Avatar Shares as at 5.00pm (Perth time) on the Record Date of an aggregate value of $1.91 per Avatar Share comprising:

- $1.83 in cash per Avatar Share (which represents the net assets of the Company excluding the Lednium business); and
- one (1) Lednium Share for every one (1) Avatar Share held (based on net asset backing of Lednium of 8 cents per Avatar Share).

The Company has received a draft class ruling from the ATO which states that the Capital Return will be treated as being approximately 65% capital and approximately 35% unfranked dividend for tax purposes. A final class ruling will only be issued after implementation of the Capital Return. For further details see section 3.

Following receipt of that consideration, all Avatar Shares held by the Exiting Shareholders will be cancelled.

The Continuing Shareholders (being Messrs Trahar and Favretto and their Associates) will not participate in the Capital Return and will retain their shares in Avatar. They will instead retain their interest in the Company and will remain as Shareholders in the Avatar Group. After the Capital Return, the Continuing Shareholders will own 100% of the Avatar Group.

Further details relating to the Capital Return are set out in section 3.2 of the Independent Expert's Report.

2.2 Approval Requirements

To be successfully implemented, the Capital Return must be approved by:

- a special resolution of those Shareholders not participating in the Capital Return, that is, the Continuing Shareholders. While Exiting Shareholders are entitled to attend and vote at the General Meeting, the Corporations Act requires that any votes cast in favour of the resolution at the General Meeting by an Exiting Shareholder be disregarded. The Continuing Shareholders have indicated to the Company that they intend to vote in favour of the Capital Return at the General Meeting; and
- a special resolution of Exiting Shareholders at a meeting at which only Exiting Shareholders are entitled to attend and vote (being the Exiting Shareholders' Meeting).

2.3 How has the consideration for the Capital Return been calculated?

In assessing the amount of the Capital Return to be paid to Exiting Shareholders, the Independent Directors carefully considered the fair value to be attributed to the assets and liabilities of Avatar.

To this end, the Independent Directors, together with the Company's advisers, conducted detailed due diligence investigations to ensure all material assets and liabilities within the Avatar Group were identified and their value taken into account in assessing the appropriate amount to be paid for the cancellation of the Avatar Shares held by Exiting Shareholders.

In considering the fair value to be attributed to the assets and liabilities of Avatar, it was noted that:

- Avatar currently has cash (and cash equivalents) of approximately $118 million (excluding the escrow funds), which represents, in a large part, the proceeds from the sale of the Company's Australian and South African mineral drilling businesses, plus interest accrued on those funds;
- the Company has illiquid residual financial assets of approximately $12.9 million relating to the sale of its Australian and South African mineral drilling businesses. This comprises a right to a royalty and outstanding loan repayments with a present value of approximately $2.3 million and $10.6 million held in escrow by the purchaser of the Australian drilling business. These assets cannot readily be converted to cash;
- the Avatar Group has a number of ongoing contingent liabilities and contractual obligations, including the warranty and South African tax exposures in relation to the Company's asset sales, including the sale of the Australian Drillcorp operations and (if completed) the sale of Arlec, some of which extend for periods as long as 7 years. The value to be attributed to these liabilities and potential liabilities is uncertain and the Company is required to retain reasonable capacity to meet future liabilities that may crystallise in the future;
- after the Capital Return, the Company will be delisted from the ASX and will incur costs associated with the closure of its offices and redundancy of head office employees;
- the Arlec business is the subject of the Arlec Sale for a price equal to the estimated net tangible assets at completion. However, as the Arlec Sale is not scheduled to complete until after the Capital Return, the amount distributed to Shareholders under the Capital Return will take into account the value attributable to the Arlec business up until the proposed date of the Capital Return;

- Avatar has certain realised capital losses and unrealised tax losses however, based on advice received by the Company, there is a significant degree of uncertainty as to whether Avatar will be in a position to realise any of these losses following completion of the Capital Return (see section 6.7 of the Independent Expert's Report for more details).

After taking into account all of the above factors, as set out in Schedule 3, the Independent Directors concluded that an aggregate sum of $60 million (comprising of cash and Lednium Shares) would be a fair amount to distribute to Exiting Shareholders and that such a sum represented fair value for the Avatar Shares held by Exiting Shareholders.

The Independent Expert has concluded the amount being distributed to Exiting Shareholders is "fair and reasonable". Further details of the assets and liabilities and valuation of Avatar by the Independent Expert are set out in sections 6.4 and 9 respectively of the Independent Expert's Report.

2.4 Benefits of the Capital Return to Exiting Shareholders

(a) Fair price is being offered to Exiting Shareholders

The Capital Return will have the effect of returning an aggregate of $1.91 per Avatar Share (based on net asset backing of Lednium of 8 cents per Avatar Share) to Exiting Shareholders and represents a before tax premium of approximately 15% to the closing market price of $1.66 per Avatar Share on ASX on 28 June 2007, the day prior to the Company announcing the proposed Capital Return.

The after tax premium may vary as a result of differing tax consequences which may exist depending on Exiting Shareholders' personal circumstances. Further information on the tax consequences arising from the Capital Return can be found at section 3 of this Explanatory Statement.

The following table provides a comparison of the consideration being offered under the Capital Return against Avatar's highest and lowest share price during the past 12 months. It also shows the comparison against the Company's volume weighted average market price (VWAP) for the 1 month and 3 month period prior to 29 June 2007, the date of the announcement of the proposed Capital Return:

Capital Return consideration	12 month high	12 month low	1 month VWAP	3 months VWAP
$1.91	$1.86 on 26 July 2007	$1.49 on 27 September 2006	$1.63	$1.61

Further details on Avatar's share price history and liquidity history are set out in sections 6.11 and 6.12 of the Independent Expert's Report.

The Independent Expert, who has concluded that the Capital Return is "fair and reasonable" to all Shareholders, has valued Avatar's shares excluding the value of the Lednium Shares as between a range of $1.74 and $1.88 per Share. The assumptions and qualification relating to this valuation range are set out in the Independent Expert's Report.

(b) Opportunity for Exiting Shareholders to immediately realise the value of their investment

The Capital Return enables Exiting Shareholders to realise immediate value for their Avatar Shares in the form of a cash payment (which provides them with the freedom to apply the funds they receive as they wish) and Lednium Shares.

One of the main reasons for the chosen structure of the Capital Return is that it provides Exiting Shareholders with a 'clean exit' from their investment in Avatar at fair value. Without the Continuing Shareholders agreeing that their proportionate interest in the Avatar Group may be retained in the Company (rather than paid out as part of the Capital Return) the Company would not have been able to meet its legal obligations in relation to its ongoing contractual commitments and liabilities (such as the residual and contingent liabilities resulting from the sale of the Australian drilling business). In addition, the illiquid assets of Avatar, such as the outstanding South African drilling royalties and the proceeds of the sale of the Australian drilling business (being approximately $10 million plus interest, which are required to be held in escrow until at least 30 June 2008) would have been difficult to realise in a timely fashion at full value to allow the reduction to occur expeditiously.

Realising their investment in this manner will mean that Exiting Shareholders are no longer exposed to any residual liabilities which will remain in the Company post the implementation of the transaction, or any potential contractual liabilities or obligations which may arise under contracts for sale of the Company's former mineral drilling businesses and Arlec, whilst still retaining an interest in the Lednium business through a direct shareholding in that company.

The Continuing Shareholders, whose support is required for any distribution to be made to Exiting Shareholders, have indicated to the Company and the Independent Directors that they would only vote in favour of a proposal to distribute the net assets of the Company if it allowed them to retain their interest in those net assets within the Avatar Group.

(c) No brokerage costs associated with the Capital Return

The Capital Return involves the cancellation of Avatar Shares rather than the sale of Avatar Shares. Exiting Shareholders therefore have an opportunity to dispose of their Avatar Shares without incurring brokerage fees.

(d) Retaining an interest in Lednium

While the cash component allows Avatar Shareholders to realise immediate value for their Avatar Shares, the Lednium Share Distribution component of the Capital Return allows Shareholders to retain their existing interest in Lednium.

As set out above, the Board considers that, given the potential upside for Shareholders which would arise from successful development of the Lednium technology and business, it is in Shareholders' interests to maintain an interest in that business, however the considerable uncertainty as to the value of the business resulting from the Claims must also be considered by Shareholders. The Lednium Share Distribution gives Shareholders the opportunity to continue to participate in the future development of Lednium on this basis.

2.5 Key implications for Exiting Shareholders if the Capital Return is approved

(a) Residual assets and liabilities retained by the Company

Following the Capital Return, the Company will retain certain illiquid residual assets relating to the sale of its former Australian and South African mineral drilling businesses, including a right to a royalty and outstanding loan repayments with a net present value of approximately $2.3 million, Arlec, subject to completion of the Arlec Sale agreement, and $10 million plus interest held in escrow by the purchaser of the Australian drilling business, subject to any claims made against that amount in the future. The Company will also retain its existing liabilities, contractual obligations and contingent liabilities.

These assets and liabilities have been assessed as part of the calculation of the quantum of the Capital Return. Shareholders should refer to section 9.4 of the Independent Expert's Report for further details on the valuation of these assets.

The consideration to be paid under the Capital Return is regarded by the Independent Directors as fair value for Shareholders' investment in Avatar. The assessment is supported by the Independent Expert's "fair and reasonable" opinion.

(b) No further exposure to Avatar

If the Capital Return is approved by Shareholders, Avatar will cease to exist in its current form, and will become 100% owned by the Continuing Shareholders. Exiting Shareholders will no longer have an interest in the Company. Further details on the assets and liabilities that will remain within the Company after implementation of the Capital Return are set out in sections 6.4, 6.7, 6.8 and 9.4 of the Independent Expert's Report.

Given the proposed sale of the Arlec business and the fact that Shareholders will, through the Lednium Share Distribution, continue to have an ongoing interest in the Company's other remaining business, Lednium, Avatar will cease to have a direct interest in any operating businesses and will not satisfy the requirements for listing on ASX.

(c) Tax consequences

The tax impact of the Capital Return on Exiting Shareholders will depend on the personal circumstances of Exiting Shareholders. A general summary of the possible tax implications of the Capital Return is set out at section 3 of this Explanatory Statement. However all Shareholders should seek their own independent advice on the taxation implications of the proposed Capital Return.

(d) Unable to consider a superior proposal in the future

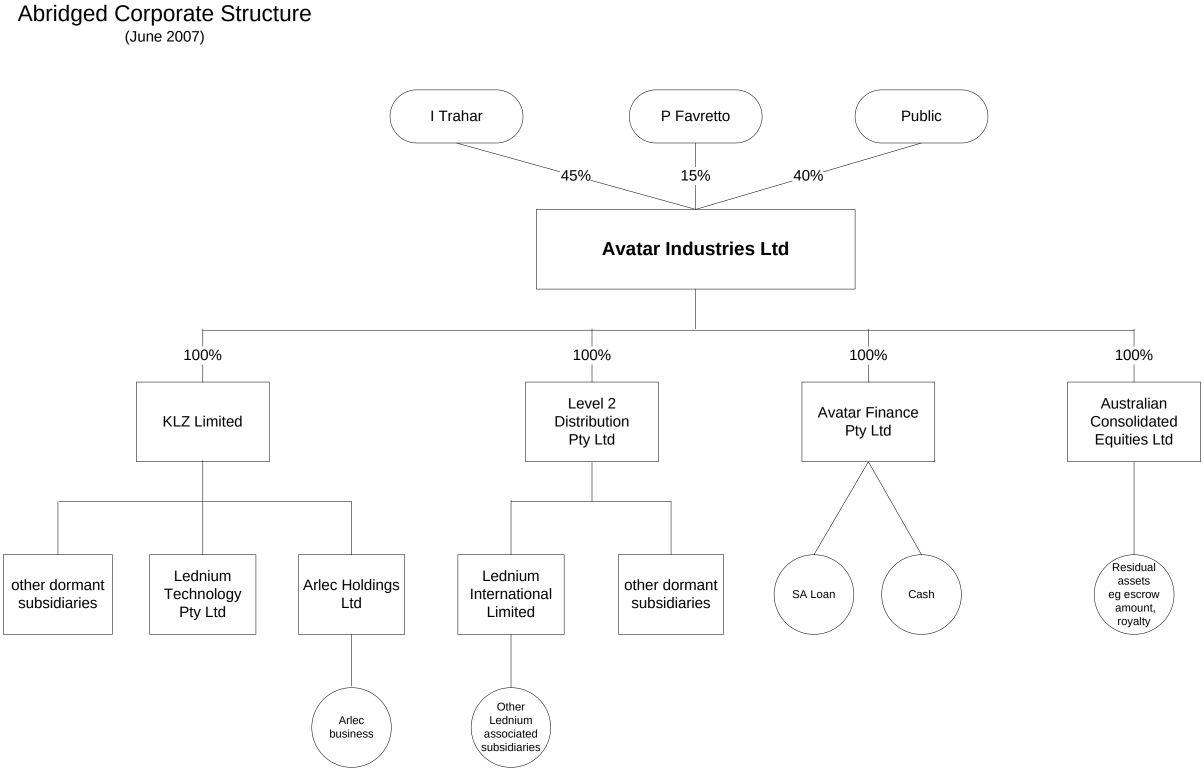
If Shareholders decide to approve the Capital Return, Exiting Shareholders will forgo the opportunity to consider a potential superior proposal in the future.

However, in structuring the Capital Return, the Independent Directors have considered a range of transaction alternatives. Based on those considerations, and the fact that the Continuing Shareholders have a combined interest in approximately 60% of Avatar, the Independent Directors consider that the possibility of a superior proposal arising in the future is low.

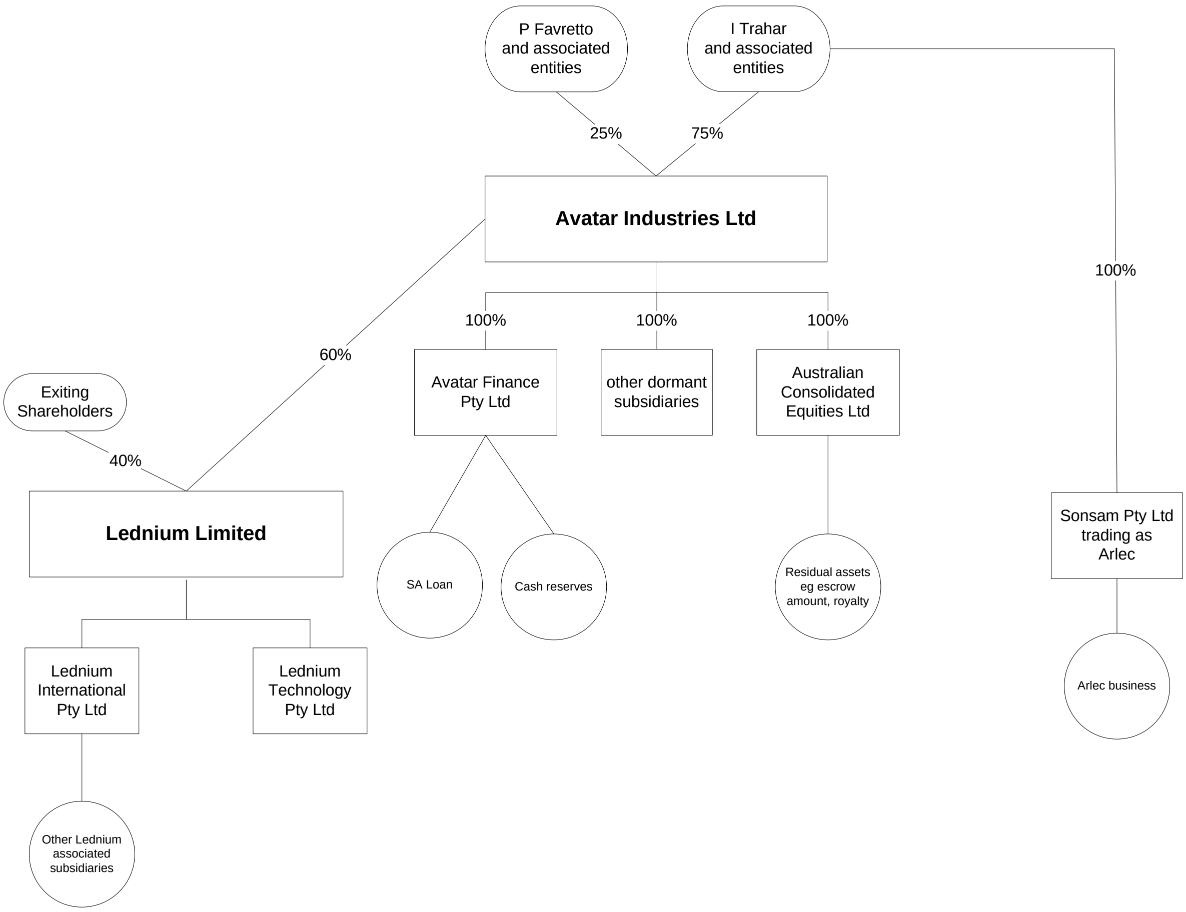
2.6 Key implications for Avatar if the Capital Return is approved

(a) Changes to group structure

The structure of the Avatar Group prior to the Capital Return can be summarised as follows:



The abbreviated corporate structure following the successful implementation of the Capital Return (and assuming the Arlec Sale to entities associated with Mr Trahar completes) is as follows:



(b) ASX delisting

If the Capital Return is approved, Avatar will be delisted from the ASX and become a private company held by the Continuing Shareholders. The Company will no longer incur the costs of being listed, which are considered to be substantial.

(c) Financial impact

The key financial impact of the Capital Return on Avatar is as follows:

- a reduction equal to the cash component of the Capital Return in the balance of the Company's cash and cash equivalents account of $57.5 million and an equivalent reduction in the balance of the Company's Shareholders funds; and
- the recognition in Avatar consolidated accounts of an outside equity interest of $2.5 million, being 40% of the equity of $6.3 million of the Lednium group held by Exiting Shareholders.

The pro forma financial statement at Schedule 2 of this Explanatory Statement provides an overview of the financial impact of the Capital Return on Avatar based on the financial statements of Avatar as at 30 June 2007.

(d) Cash

As at the date of this Explanatory Statement, Avatar's cash and cash equivalents position is $118 million.

If the Capital Return is approved, Avatar will distribute $1.83 in cash per share to Exiting Shareholders, who hold in total 31,413,979 Avatar Shares. Following the Capital Return, and accounting for cash to be retained by Lednium and other residual costs associated with the Capital Return, the Company's cash and cash equivalents reserves are likely to be reduced to $57.2 million.

Avatar therefore has sufficient funds to meet its obligations in respect of the Capital Return whilst retaining adequate funds to meet the ongoing liabilities and exposures of the Company.

(e) Capital structure

Avatar's issued share capital as at the date of this notice of meeting is 79,038,464 Avatar Shares. If the Capital Return is implemented, Avatar's issued share capital will reduce to 47,624,485 Avatar Shares held by the Continuing Shareholders.

The following table shows the impact of the Capital Return on the capital structure of Avatar:

Avatar's capital structure before the Capital Return	Number of shares	%
Ordinary shares:		
Ian Trahar and Associates	35,566,355	45.00%
Paul Favretto and Associates	12,058,130	15.26%
Exiting Shareholders	31,413,979	39.74%
Total Avatar Shares on issue before the Capital Return	79,038,464	100%
Less shares of Exiting Shareholders Cancelled if the Capital Return is approved		
Ordinary shares currently held by Exiting Shareholders	31,413,979	
Avatar's capital structure after the Capital Return		
Ordinary shares		
Ian Trahar and Associates	35,566,355	74.68%
Paul Favretto and Associates	12,058,130	25.32%
Total Avatar Shares on issue after the Capital Return	47,624,485	100%

The substantial Shareholders of the Company (both before and after the proposed Capital Return) are the two Continuing Shareholders. As shown in the table below, implementation of the Capital Return will result in the Continuing Shareholders increasing their combined voting power by 39.74%, thereby controlling 100% of Avatar.

Name	Shares held	Voting power before the Capital Return	Voting power after the Capital Return
Ian Trahar and Associates	35,566,355	45.00%	74.68%
Paul Favretto and Associates	12,058,130	15.26%	25.32%
Total	47,624,485	60.26%	100%

(f) Continuing Shareholders future intentions for Avatar

Once the Capital Return is approved, the Continuing Shareholders have advised the Company of the following intentions:

- to approve the Arlec Sale and thereby divest the wholly owned Arlec business to an entity associated with Mr Ian Trahar. Further details in relation to the Arlec Sale are provided in section 4;
- all head office employees of the Company will be made redundant and the Company's head office will be closed as soon as possible following the implementation of the Capital Return, Arlec Sale and Lednium Share Distribution, as following completion of these actions Avatar's business activities will be reduced to a minimum;
- to comply with all of the Company's existing and future contractual obligations; and
- to assess opportunities from time to time to maximise the value of their investment in the Company.

The Continuing Shareholders have advised the Company that they have no specific plans with respect to the continuation of the business of Avatar after the Capital Return, including its residual assets and cash which will remain in the business following the implementation of the Capital Return.

2.7 Key implications for Continuing Shareholders if the Capital Return is approved

The impact of the Capital Return was considered by the Independent Expert in its determination that the Capital Return is "fair and reasonable" to all Shareholders and is set out in section 8 of the Independent Expert's Report.

(a) Wholly owned private entity without a taxing event

If the Capital Return is approved, the Continuing Shareholders will retain their existing Avatar Shares thereby becoming the sole owners of Avatar. In contrast to the treatment for Exiting Shareholders, the Capital Return does not therefore result in a disposal or cancellation of the Continuing Shareholders' Shares in the Company for tax purposes.

(b) Continuation of the Company

Approval of the Capital Return will result in the Continuing Shareholders obtaining control of the Company and the benefits of its continuation. Similarly, the Continuing Shareholders will be indirectly exposed to 100% of the Company's existing and potential future liabilities through their ongoing shareholding in Avatar.

For example, the Company will:

- receive the proceeds (net tangible assets) from the Arlec Sale on completion of the Arlec Sale agreement, the outstanding South African drilling royalties and loan which have a net present value of approximately $2.3 million and approximately $10.6 million held in escrow until at least 30 June 2008 (which amount relates to the sale of the Australian drilling business);
- remain exposed to liabilities, contingent liabilities and contractual obligations that remain with the Company after the Capital Return. As such, the Continuing Shareholders will effectively remain exposed to those liabilities; and
- control the remaining cash (excluding the escrow funds) and net assets in the Company estimated at approximately $114.7 million and $149.3 million respectively, prior to the completion of the Arlec Sale.

It is noted that these assets and liabilities were considered in determining the quantum of the Capital Return payable to Exiting Shareholders and by the Independent Expert in its valuation of the Company as set out in section 9 of the Independent Expert's Report.

2.8 Implications for Avatar's creditors if the Capital Return is approved

The Board has considered the impact of the Capital Return on the Company's ability to pay its creditors. As supported by the pro forma financial information contained in Schedule 2 of this Explanatory Statement, the Board believes that implementation of the Capital Return will not materially prejudice Avatar's ability to pay its creditors.

2.9 Lednium Shares received under the Capital Return

Exiting Shareholders will receive Lednium Shares under the Capital Return.

Details in relation to Lednium and its business are set out in Schedule 4.

The Record Date for determining who is eligible to participate in the Capital Return is 21 November 2007. If the Capital Return is approved at the Meetings, the Company will issue Lednium Shares to Avatar Shareholders, and all Avatar shares held by Exiting Shareholders will be cancelled, on 26 November 2007. Share certificates for Lednium Shares will be sent by mail to the address of each Shareholder as set out in Avatar's share registry, as soon as possible after the Lednium Shares have been distributed.

Avatar Shareholders who are not resident in Australia should refer to section 2.10 for information on how they will be treated in respect of the Lednium Share Distribution.

2.10 Treatment of Foreign Shareholders

If the Capital Return is approved at the Meetings, all Exiting Shareholders, including Foreign Shareholders, will receive the cash component of the Capital Return, being $1.83 per Avatar Share.

A foreign shareholder is an Exiting Shareholder whose address as shown in the Avatar share register as at the Record Date is a place outside Australia, unless Avatar is satisfied that the laws of the place of such address permit the issue and allotment of Lednium Shares to that Shareholder either unconditionally or after compliance with conditions which Avatar in its sole discretion regards as acceptable and not duly onerous (**Foreign Shareholder**).

In respect of those Foreign Shareholders that are not eligible to receive Lednium Shares, Avatar will instead issue and allot the Lednium Shares in respect of which the Foreign Shareholder would otherwise be entitled, to a nominee appointed by Avatar (**Nominee**) for sale. The Nominee will seek to sell, for the benefit of the Foreign Shareholder, those Lednium Shares as soon as reasonably practicable (at the risk of the Foreign Shareholder) and pay the net proceeds received (ie after deducting brokerage, stamp duty and other taxes and charges) to that Foreign Shareholder, in full satisfaction of the Foreign Shareholder's rights in respect of those Lednium Shares.

The Nominee will remit the net proceeds of sale in respect of the Foreign Shareholder's entitlement to the Lednium Shares, by mail to the Foreign Shareholder's address as shown on the Avatar share register, by cheque in Australian currency, at a date not more than 15 Business Days after the sale of the last of all Foreign Shareholder entitlements.

Foreign Shareholders should be aware that, unlike their Avatar Shares, the Lednium Shares will not be listed on ASX and will therefore not be able to be traded on ASX or any other securities exchange. This may impact upon the ability of the Nominee to find a buyer for the Lednium Shares on commercial terms, or at all, and therefore Foreign Shareholders' ability to realise any value for the Lednium Shares attributable to them because of the illiquidity of those Lednium Shares.

Neither this Explanatory Statement nor the Notices of Meeting accompanying this Explanatory Statement constitute, or is intended to constitute, an offer of securities in any place in which, or to any person to whom, the making of such an offer would not be lawful under the laws of any jurisdiction outside Australia.

2.11 Implications if the Capital Return is not approved

(a) On Exiting Shareholders

If the Capital Return is not approved by Shareholders, Exiting Shareholders will not receive the consideration paid under the Capital Return and will continue to hold their Shares in Avatar.

(b) On Continuing Shareholders

If the Capital Return is not approved, Continuing Shareholders will hold their existing Shares in Avatar in the same proportions as their current holdings.

(c) On Avatar

If the Capital Return is not approved, Avatar will remain a listed entity on the ASX and the costs associated with the implementation of the Capital Return will have been incurred by the Company. Avatar will seek Shareholder approval for the Arlec Sale at a meeting at which Mr Trahar and his Associates will not be entitled to vote. Exiting Shareholders should note that if the Capital Return is not approved, the Company intends to investigate alternative methods to achieve the same objectives of returning the net assets of the Company to Shareholders.

3 TAX IMPLICATIONS

It is important that Exiting Shareholders seek their own independent taxation advice, specific to their own circumstances, in order to determine their own tax implications resulting from the proposed Capital Return. The summary of the tax implications below should not be substituted for complete taxation advice.

The Australian tax consequences will depend on each Exiting Shareholder's particular circumstances, including whether they hold their Avatar Shares on capital or revenue account, their tax residency status and the type of taxpayer they are. For example, individuals, complying superannuation funds and corporate Shareholders will attract different tax consequences. It is not possible to cover all scenarios in this summary.

Under the Capital Return, all Shares in Avatar which are held by Exiting Shareholders will be cancelled. The consideration has been set at $1.91 per Share (based on the net asset value of Lednium of 8 cents per Share). On the basis of currently available information and the draft ATO Class Ruling issued to the Company, it is estimated that $1.25 per Share will be treated as a capital amount and $0.66 per Share will be treated as a dividend amount. The dividend amount will not be franked. The final ATO Class Ruling will only be issued following implementation of the Capital Return. Only at that time will the precise capital amount and dividend amount be known.

Avatar will advise Shareholders of these amounts at the time of dispatching the cheque for the cash component and share certificate for Lednium Shares.

The following paragraphs assume that the amounts shown above reflect those that will be specified in the final ATO Class Ruling.

3.1 Treatment of the dividend component

(a) Australian resident individuals and complying superannuation fund Shareholders

Exiting Shareholders who are Australian resident individual Shareholders or complying superannuation funds should include the unfranked dividend amount in their assessable income.

(b) Australian resident corporate Shareholders

If the Exiting Shareholder is an Australian resident company, it should include the unfranked dividend amount in its assessable income.

(c) Australian resident share traders

If the Exiting Shareholder is a share trader or holds Shares on revenue account, the Australian tax implications in respect of the dividend component paid by Avatar will depend on whether they are an individual, complying superannuation fund or a company. In this context, the implications are the same as discussed above for Australian resident individuals, complying superannuation funds or corporate Shareholders.

(d) Non-resident Shareholders

Generally, Avatar will be liable to remit withholding tax from dividends paid to non-resident Exiting Shareholders. The extent of the withholding tax remitted from the dividend component will depend on the country of residence of the non-resident Exiting Shareholder.

3.2 General Treatment of the capital component

The proposed Capital Return will trigger a capital gains tax (CGT) event for Exiting Shareholders when their Shares are cancelled. The relevant CGT event is C2. The CGT rules generally apply to Shareholders that have acquired their Shares, or have been deemed to have acquired their Shares, on or after 20 September 1985. If a Shareholder has acquired Shares before 20 September 1985 and has not been deemed to have acquired those Shares on or after that date, any capital gain or loss they make under CGT event C2 is not subject to CGT.

Assuming that the estimated dividend amount and capital amount shown above are confirmed as the final amounts in the ATO Class Ruling to be issued after the implementation of the Capital Return, Exiting Shareholders who have a cost base for their Shares of between $1.25 and $1.91 per Share will have the capital gain arising on the cancellation of their Shares reduced to nil. A capital gain will still arise for those Exiting Shareholders who have a cost base for their Shares of less then $1.25 per Share.

This is because, for CGT purposes, each Exiting Shareholder will be taken to have received $1.91 per Share as capital proceeds in respect of the cancellation of their Shares. The $1.91 per Share includes a dividend component of $0.66 per Share and that will be separately included in the Exiting Shareholders' assessable income. The CGT rules operate to reduce any capital gain up to the amount of the dividend component. On the basis that the dividend component will already be included in the Exiting Shareholders' assessable income, any capital gain up to $0.66 per Share that would otherwise arise on the cancellation of those Shares will be reduced to nil.

A capital loss will arise for Exiting Shareholders who have a reduced cost base for their Shares of more than $1.91 per Share. The capital loss will be the excess of the reduced cost base over the capital proceeds of $1.91.

Each Exiting Shareholders' cost base and reduced cost base will generally include the price paid for those Shares plus incidental costs of acquisition such as stamp duty and brokerage.

(a) Australian resident individuals and complying superannuation fund Shareholders

Generally, Australian resident individual and complying superannuation fund Exiting Shareholders that have held their Shares for at least 12 months may use the CGT discount method to reduce any capital gain arising from the cancellation of their Shares. This means that if such an Exiting Shareholder makes a capital gain, they will only be required to include in their assessable income (after first offsetting any capital losses they may have):

- one half of the capital gain if they are a resident individual; or
- two thirds of the capital gain if they are a complying superannuation fund.

Alternatively, if an Exiting Shareholder acquired their Shares before 21 September 1999, they could use the indexation method to determine their capital gain. This method allows a Shareholder to index their cost base for inflation up until 30 September 1999. Indexation cannot be used to create a capital loss.

Exiting Shareholders who have held their Shares for less than 12 months must include the full capital gain in their assessable income (without any discount or indexation).

If an Exiting Shareholder is entitled to a capital loss on the cancellation of their Shares, such capital losses can be used to offset other capital gains that an Exiting Shareholder may have. Capital losses can also generally be carried forward indefinitely to offset any future capital gains.

(b) Australian resident corporate Shareholders

Australian resident companies that hold their Shares on capital account will be subject to the CGT rules if those Shares were acquired, or are deemed to have been acquired, on or after 20 September 1985. If those Shares were acquired before 21 September 1999, the Exiting Shareholder must index the cost base for inflation up until 30 September 1999. The CGT discount method is not available for corporate Shareholders.

If an Exiting Shareholder is entitled to a capital loss on the cancellation of its Shares, such capital losses can be used to offset other capital gains that the Exiting Shareholder may have or they can generally be carried forward indefinitely to offset future capital gains.

(c) Non-resident Shareholders

Under new CGT rules which took effect from 12 December 2006, foreign residents will only be subject to CGT on direct and indirect interests in Australian real property and any business assets of their Australian permanent establishment. Any capital gain or capital loss from a CGT event occurring to any other CGT asset is disregarded. In our view, it is unlikely that any foreign resident Exiting Shareholder will make a capital gain or capital loss under these new rules from the cancellation of their Shares.

If a non-resident holds Shares as trading stock or on revenue account, any gain they make may be taxable as ordinary assessable income if that gain has an Australian source according to Australian tax law. If a non-resident Exiting Shareholder has a taxable gain with an Australian source, that Exiting Shareholder will need to consider whether there is an International Double Tax Agreement in place with their country of residence and whether that Agreement will apply to prevent Australia from taxing the gain in their circumstances.

(d) Australian resident share traders

If an Exiting Shareholder is an Australian resident who holds Shares as trading stock or on revenue account, the capital component will be included in its assessable income under ordinary concepts, in addition to the dividend component.

3.3 Tax implications for Continuing Shareholders

As the Avatar Shares held by Continuing Shareholders will not be cancelled as part of the Capital Return, there will be no disposal of those Shares. This means that the Capital Return will not create any immediate tax consequences for the Continuing Shareholders.

3.4 Tax implications for Avatar

It is estimated that as at 30 June 2007, Avatar, as the head company of the Avatar tax consolidated group, will have carry forward capital losses of approximately $40.6 million. Based on its tax advice, the directors of Avatar are of the opinion that the capital losses do not meet the criteria for recognition as a deferred tax asset on the balance sheet of the Company. Given the Company's financial position and the strict rules for recoupment of capital losses, the Company is of the view that the utilisation of these losses is very uncertain. Based on its tax advice, the Company also considers that the potential crystallisation and utilisation of any currently unrealised capital losses on assets that it owns (approximately $9.4 million) is also very uncertain.

3.5 Tax implications for Lednium shareholders – cost base in Lednium Shares

The Exiting Shareholders will receive a cost base in their Lednium Shares equal to their market value.

4 ARLEC

4.1 Overview

Arlec is a wholly owned business of Avatar that primarily sources consumer electrical products (predominantly leads, power boards, wiring accessories and lighting) in Asia for distribution into the Australian and New Zealand markets. It also distributes barbecues directly from Asia into the United Kingdom.

Arlec distributes to the retail, hardware and trade markets. Its customers include Bunnings, Mitre 10, Danks, K-Mart/Coles, Big W and Dick Smith. Arlec's key products include power and power garden tools, lighting products, antennas and audio visual accessories, wiring accessories and consumer electrical products.

As announced to Shareholders on 29 June 2007, the Company entered into a sale agreement with Mr Trahar on 28 June 2007 for the sale of the Arlec business. Details of that agreement are further set out below.

4.2 The Arlec Sale

Since acquiring the Arlec business in 1995 the Company endeavoured to grow the business, organically through product and category expansion and also by acquisition, without success. As outlined to Shareholders in the 2006 Annual Report, the Company took the decision in 2006 to abandon this growth strategy and to re-focus the business back to its core traditional electrical product categories and on an acceptable return on capital employed in the business.

Whilst this strategy showed early signs of success, the Board formed the view (having regard to the decision to return surplus capital generated from the sale of the DrillCorp businesses and the decision to separately operate Lednium) that Arlec's size, growth profile and history of volatile earnings did not support it remaining as what would effectively be a stand alone listed business within the Avatar corporate shell.

Accordingly, the Board decided that it would be in the best interests of Avatar Shareholders to realise the value of the Company's investment in the Arlec business and return the capital employed in this business back to Shareholders as part of the proposed Capital Return.

To that end, the Company engaged PwC in February 2007 to conduct a sale process to sell the Arlec business. PwC conducted an extensive sale process in which over 50 trade and financial parties were invited to bid. The outcome of this sales process was that Mr Trahar was the only party who was willing to offer the Company at least net tangible asset value for the Arlec business and enter into a sale contract on terms acceptable to the Company. Further details on the Arlec sale process are set out in section 6.1 of the Independent Expert's Report.

As the price offered by Mr Trahar was within the valuation range for the Arlec business determined by PwC and considered reasonable by the Independent Directors, the Company accepted Mr Trahar's offer and entered into a formal sale agreement on 28 June 2007.

Under the Arlec Sale agreement:

- the purchase price payable to the Company is equal to the net tangible asset value of the Arlec business on the date of completion of the Arlec Sale (expected to occur around December 2007 and after the Meetings to consider and approve the Capital Return);
- the Company will get the benefit of the earnings of the Arlec business up to the date of completion of the sale (which will be after the implementation of the Capital Return), and so the amount returned to Shareholders under the Capital Return will include an estimate of these earnings up to the date that the Capital Return takes effect;
- Arlec has entered into an agreement with Lednium to distribute Lednium LED components and finished products in Australia and New Zealand. The agreement is substantially based on the distribution agreement in place between Optek and Lednium and the terms of distribution agreements Lednium has sought to negotiate with other non-related third parties in various overseas jurisdictions. This agreement can be terminated by either party giving six (6) months' notice of termination to the other at any time after the expiration of the first anniversary of the agreement. A summary of that agreement is provided in section 6.4 of schedule 4 to this Explanatory Statement;
- Arlec has also agreed to provide Lednium with serviced office accommodation (initially for 2 persons) at its offices at Mooroolbark Park Melbourne on an essentially cost recovery basis. The arrangements can be terminated at any time by either party on four months' notice;
- Avatar has agreed to make Mr Balu Jeganathan (who is currently Managing Director of both Arlec and Lednium) available to assist in the transition of the Arlec business to the new purchaser for up to 50% of Mr Jeganathan's time for a period of up to 6 months from completion. After this period expires, Mr Jeganathan will be focussed on the development of the Lednium business.

The Arlec Sale is subject to the approval of Avatar Shareholders under the related party provisions of the Corporations Act and the ASX Listing Rules (to the extent required). If Shareholders do not approve the implementation of the Capital Return, or if for any other reason the shares of Exiting Shareholders in Avatar are not cancelled, a meeting of Avatar Shareholders will be convened to consider and, if thought fit, approve the Arlec Sale. Mr Trahar (and his Associated entities) will not be permitted to vote on that resolution. If the Capital Return is implemented, the Arlec Sale will require approval by the Continuing Shareholders.

The alternative of retaining the business within the corporate group of Avatar after the implementation of the Capital Return was not considered feasible as Mr. Paul Favretto (and his Associated entities) indicated to the Company that he would not support the Capital Return if the Company was to retain an ongoing interest in the Arlec business.

The purchase of Arlec by Mr Trahar enables Exiting Shareholders to receive value for Arlec in cash as part of the Capital Return rather than requiring some other mechanism for distributing the value for Arlec to Exiting Shareholders (for example, deferring the payment of the value of Arlec until the sale of Arlec to a third party buyer or retaining an interest in the Arlec business even though the Board believes that it is not sustainable to operate as a listed company).

5 ADDITIONAL INFORMATION

5.1 Directors' disclosure

The following table sets out the current directors of Avatar and the relevant interests in the number of Shares held by or on behalf of each of those directors and executives of Avatar:

Director	Position Held	Shares Held
Mr Ian Trahar and Associates	Executive Chairman	35,566,355
Mr Paul Favretto and Associates	Managing Director	12,058,130
Mr William Cairns and Associates	Non-Executive Director	61,734
Dr Malcolm Hemmerling and Associates	Non-Executive Director	-
Executive		Shares Held
Mr Ian Leijer and Associates	Company Secretary and Chief Financial Officer	2,319,485
Mr Balu Jeganathan and Associates	Managing Director of Arlec and Lednium	464,640

5.2 Dealing in shares

There have been no dealings in Avatar Shares by the Directors of Avatar or their Associates in the past 4 months. Further, there have been no dealings in Avatar Shares by the Continuing Shareholders or their Associates in the past 4 months.

5.3 No benefits from Avatar

Neither Avatar nor any of its Associates propose to make or give any payment or other benefits to any director, secretary or executive officers of Avatar or any subsidiary of Avatar as compensation for the loss of, or as consideration for or in connection with his or her retirement from, office in Avatar or any subsidiary of Avatar in connection with or conditional upon the outcome of the Capital Return other than as disclosed in this Explanatory Statement.

As mentioned in section 2.6 above, if the Capital Return is implemented, all head office staff will be made redundant. Under their existing employment contracts, upon being made redundant, each of Mr Favretto and Mr Leijer will receive his accrued entitlements and a redundancy payment equal to one years' salary (excluding bonuses). Mr Favretto will receive a total of $375,000 and Mr Leijer will receive a total of $250,000.

5.4 No other arrangements

Neither Avatar nor any of its Associates have entered into arrangements or agreements with any of the directors of Avatar in connection with or conditional upon the outcome of the Capital Return other than as disclosed in this Explanatory Statement.

5.5 Sections 256B and 256C of the Corporations Act

Section 256B of the Corporations Act has the effect that Avatar may reduce its share capital in a way that is not otherwise authorised by law if the reduction:

- is fair and reasonable to the Shareholders as a whole;
- does not materially prejudice the ability of Avatar to pay its creditors; and
- is approved by Shareholders under section 256C of the Corporations Act.

The Independent Expert and the Independent Directors have concluded that the Capital Return is fair and reasonable to Continuing Shareholders and Exiting Shareholders. In the opinion of the Board of Avatar, the Capital Return will not materially prejudice the ability of Avatar to pay its creditors. If the resolutions are passed at the relevant Meetings, the Capital Return will be approved for the purposes of section 256C of the Corporations Act.

5.6 ASX waiver and ASIC modifications

ASX has granted Avatar confirmation that it does not consider that Listing Rules 11.1 or 11.2 apply in relation to the sale of the Arlec business.

In accordance with ASIC Regulatory Guide 188, ASIC has granted relief to exempt Avatar and Lednium from compliance with Parts 6D.2 and 6D.3 of the Corporations Act to permit the Lednium Shares to be distributed under the Capital Return and once distributed to be traded without a prospectus. The relief is granted on the basis that the distribution of the Lednium Shares under the Capital Return merely changes an indirect interest in Lednium (as a result of holding Avatar shares) to a direct investment in Lednium (that is, holding Lednium Shares) and so Shareholders are not making a new investment decision.

In accordance with the relief granted, this Explanatory Statement is in a form substantially the same as that provided to ASIC on 20 September 2007 and the disclosure set out above describes the need for, and effect of, the relief as it applies to Avatar Shareholders

Avatar is distributing Lednium Shares under the Capital Return on the expectation that Shareholders receiving Lednium Shares will be long term investors. Avatar has not distributed the Lednium Shares with the intention that those persons participating in the Lednium Share Distribution will on-sell, grant, issue or transfer interests in, or options or warrants over, the Lednium Shares they receive.

5.7 Payment methods

If the Capital Return is approved by Shareholders, the payment of the cash component of the Capital Return will be satisfied by sending a cheque addressed to those persons who are registered as Exiting Shareholders as at the Record Date.

5.8 Additional regulatory requirements

As the Capital Return results in control of Avatar by Messrs Trahar and Favretto, a list of their Associates together with the interests held by those Associates (both before and after the implementation of the proposed Capital Return) is provided below:

Mr Trahar's and his Associates' holding	Shares held	Ownership % before Capital Return	Ownership % after Capital Return
Ian Trahar	566,667	0.72%	1.19%
Gabor Holdings Pty Ltd (acting as Trustee for the Tricorp Trust)	25,950,708	32.83%	54.49%
Gersor Pty Ltd. Gabor Holdings (ATF the Tricorp Trust) holds all the issued share capital of Gersor Pty Ltd.	7,117,903	9.01%	14.95%
Gersor Pty Ltd. as trustee for the Gersor Superannuation Fund.	223,810	0.28%	0.47%
Gabor Investments Pty Ltd, a company in which director and Gabor Holdings Pty Ltd, ATF the Tricorp Trust, holds all the shares.	916,778	1.16%	1.93%
Historical Holdings Pty Ltd. Gabor Holdings Pty Ltd (ATF the Tricorp Trust) holds all the issued share capital of Historical Holdings Pty Ltd.	790,489	1.00%	1.67%
Total	35,566,355	45.00%	74.68%
Mr Favretto's and his Associates' holding			
Paul Favretto	158,667	0.20%	0.33%
Pinnacle Superannuation Pty Limited	1,006,500	1.27%	2.11%
Favcor Pty Ltd ATF Favretto Family Trust	10,092,015	12.77%	21.19%
Favcor Pty Ltd ATF Mars Investment Trust	800,948	1.01%	1.68%
Total	12,058,130	15.26%	25.32%

5.9 Other material information

Each of Mr Trahar and Mr Favretto has confirmed that, so far as they are aware:

(a) there is no material information relating to Avatar, its business and prospects that may be relevant to the Capital Return or a Shareholder's decision on how to vote at the Meetings which has not been disclosed publicly and/or included in this Explanatory Statement; and

(b) all information relating to their respective interests in Avatar and intentions in relation to the Company if the Capital Return is implemented are set out in this Explanatory Statement or have otherwise been publicly disclosed.

5.10 Continuous disclosure

Avatar is a "disclosing entity" for the purposes of 111AC of the Corporations Act. As such, it is subject to regular reporting and disclosure obligations. These disclosure obligations require Avatar to disclose to the ASX any information that a reasonable person would expect to have a material effect on the price or value of the securities of Avatar. Further information can be found at:

Website details – www.avatar-industries.com.au
ASX code – AVR

Further details in relation to Lednium and Arlec can be found at:
Lednium website details – www.lednium.com
Arlec website details – www.arlec.com.au

SCHEDULE 1 - DEFINED TERMS AND INTERPRETATION

A$ or $ means Australian dollars.

Arlec Sale means the proposed sale of the Arlec business to an entity associated with Mr Ian Trahar as described in this Explanatory Statement.

ASIC means the Australian Securities and Investments Commission.

Associates has the meaning given to that term in sections 10-17 of the Corporations Act.

ASX means ASX Limited.

ATO means the Australian Taxation Office.

Avatar Group means Avatar and its subsidiaries.

Avatar Shareholder or **Shareholder** means a holder of Avatar Shares.

Avatar Shares means fully paid ordinary shares in Avatar Industries Limited.

Board means the Board of directors of Avatar.

Capital Return means the proposed selective capital return and cancellation of shares of Exiting Shareholders of Avatar as described in this Explanatory Statement.

Claims has the meaning given to that term in section 1.2.

Continuing Shareholders means Mr Ian Trahar and Mr Paul Favretto and their Associates.

Corporations Act means the Corporations Act 2001 (Cth).

Exiting Shareholders' Meeting means the proposed meeting of Exiting Shareholders on 31 October 2007 at 11.00am (Perth time) at Suite 2, The Forrest Centre, Level 14, 221 St Georges Terrace, Perth or as soon after that time as the General Meeting has concluded.

Explanatory Statement means the explanatory statement accompanying the Notice of General Meeting and Notice of Exiting Shareholders' Meeting and includes all schedules and annexures.

Foreign Shareholder has the meaning given to that term in section 2.10.

General Meeting means the proposed meeting of all Shareholders on 31 October 2007 at 10.30am (Perth time) at Suite 2, The Forrest Centre, Level 14, 221 St Georges Terrace, Perth.

Independent Directors means directors of Avatar who are not associated with the Continuing Directors, being Messrs WH Cairns and MB Hemmerling.

Independent Expert and KPMG means KPMG Corporate Finance (Aust) Pty Ltd.

Independent Expert's Report means the report prepared by the Independent Expert and contained in Annexure 1 of this Explanatory Statement.

Lednium means Lednium Limited ACN 126 736 758, an entity that is currently a wholly-owned subsidiary of Avatar whose shares are proposed to be distributed to Exiting Shareholders as part of the Capital Return.

Lednium Share Distribution means the distribution of Lednium Shares to Avatar Shareholders as part of the Capital Return as described in this Explanatory Statement.

Lednium Shares means fully paid ordinary shares in Lednium.

Meetings means the General Meeting and the Exiting Shareholders' Meeting.

Nominee has the meaning given to that term in section 2.10.

Notice of Exiting Shareholders' Meeting means the notice of the Exiting Shareholders' Meeting dated 24 September 2007 which is enclosed in the Explanatory Statement.

Notice of General Meeting means notice of the General Meeting dated 24 September 2007 which is enclosed in the Explanatory Statement.

Proxy Forms means the proxy form for the General Meeting and the proxy form for the Exiting Shareholders' Meeting contained in this Explanatory Statement and **Proxy Form** means either of the Proxy Forms, as relevant.

PwC means PricewaterhouseCoopers.

Record Date means 5.00pm on 21 November 2007.

SCHEDULE 2 - PRO FORMA FINANCIAL STATEMENT

To enable an assessment of the effect of the Capital Return on Avatar, set out below is an abridged pro forma consolidated statement of financial position of Avatar:

	Audited statement of financial position as at 30 June 2007 $million	Pro forma statement of financial position after Sale of Arlec $million	Pro forma statement of financial position after the Capital Return $million
Cash	8.3	22.9	2.9
Interest bearing securities	107.9	107.9	70.4
Escrow Funds	10.4	10.4	10.4
Other Current Assets	20.1	3.6	3.6
Total Current Assets	146.7	144.8	87.3
Non Current Assets	9.0	7.4	7.4
Total Assets	155.7	152.2	94.7
Current Liabilities	7.6	4.1	4.1
Non Current Liabilities	0.4	0.4	0.4
Total Liabilities	8.0	4.5	4.5
Net Assets	147.7	147.7	90.2
Shareholders Equity			
Avatar Shareholders	147.7	147.7	87.7
Outside Equity Interest			2.5
Total Shareholders Equity	147.7	147.7	90.2

The pro forma financial information set out above has been provided to show the effect of the Capital Return on Avatar as if the transaction has been completed as at 30 June 2007, after adjusting for material post balance date events. The information may not represent the financial position and results of the Capital Return if and when it is implemented. The pro forma consolidated statement of financial position of Avatar should be read in conjunction with the notes below.

(a) Basis of preparation

The pro forma consolidated statement of financial position of Avatar after the Capital Return has been prepared using the audited statement of financial position of Avatar as at 30 June 2007.

The accounting policies adopted by Avatar are set out in the full year financial report of Avatar for the year ended 30 June 2007.

Pro forma adjustments have been made to reflect material post balance date events of Avatar up to the date of this Explanatory Statement based on announcements and information that is currently available to management and the effects of the Capital Return.

(b) Pro forma Adjustments made to arrive at the statement of financial position following the Capital Return

The material adjustments made to the 30 June 2007 audited accounts to reflect the impact of the Capital Return are as follows:

Adjustment for pro forma sale of Arlec

Cash increases by $14.6 million being the net operating assets of the Arlec business as at 30 June 2007 which are realised through the sale of inventory and plant and equipment to Mr Ian Trahar ($10.4 million) and the collection of the receivables and payment of liabilities (net $4.2 million).

Adjustment for pro forma distribution of cash

A cash distribution to Exiting Shareholders of $57.5 million will be made and will be sourced in part from cash reserves and in part from the sale of interest bearing securities. *Adjustment for pro forma distribution of Lednium*

Lednium is capitalised to $6.3 million (8 cents per Avatar share) comprising the net operating assets of $4.0 as at 30 June plus $2.3 million in cash. Lednium will remain a 60% owned subsidiary of the Avatar group and therefore 40% of the equity value of the Lednium group will be shown as an outside equity interest ($2.5 million).

SCHEDULE 3 - DETERMINATION OF CAPITAL RETURN PRICE

The amount to be distributed to Shareholders under the Capital Return has been calculated as being the forecast net asset value of Avatar at the time of implementation of the Capital Return. The estimated implementation date is 26 November 2007. Accordingly, the Company has prepared a forecast as at the end of November 2007. Notes in relation to the forecast are set out beneath the table below. In general terms the forecast takes account of after tax earnings including those of Arlec and the costs of closing the Avatar head office and adjusts for the realizable value of non recourse employee share loans. This calculation is set out below.

	Notes	Total $ million	Per Share $
Net Assets as at 30 June 2007	1	147.8	1.87
Profit after tax 1 July 2007 to 30 November 2007	2	2.7	0.03
Head Office Termination & Closure Costs after tax	3	(0.8)	(0.01)
Scheme Costs after tax	4	(0.4)	(0.01)
Subtotal - Net Assets as at 30 November 2007		149.3	1.89
Value of Non recourse employee loans	5	1.7	0.02
Net Assets Value attributable to Ordinary Shareholders		151.0	1.91
Comprising			
Lednium Group net assets	6	6.3	0.08
Escrow Funds	7	10.7	0.14
Arlec Net Assets	8	15.7	0.20
Receivables	9	3.5	0.04
Liabilities	10	(2.2)	(0.03)
Cash and interest bearing securities	11	114.7	1.45
Net Tax Balances	12	0.6	0.01
Subtotal - Net Assets as at 30 November 2007	13	149.3	1.89
Value of Non recourse employee loans	5	1.7	0.02
Net Assets Value attributable to Ordinary Shareholders		151.0	1.91

Based on 79,038,464 ordinary shares

	Notes	Total $ million	Per Share $
Distributed to Exiting Shareholders			
Cash		57.5	1.83
1 Lednium Share (Net Asset Value)	14	2.5	0.08
Total		60.0	1.91

Based on 31,413,979 ordinary shares

Notes on the calculation are as follows:

Note	Comment
1	Audited Net Assets of Avatar as at 30 June 2007.
2	Forecast profit after tax of the Avatar group for the period 1 July to 30 November based on actual results for July and August and forecast earnings after tax including Arlec for the remainder of the period. This is the key assumption in the determining the capital return proceeds.
3	Comprising the costs of termination Avatar staff including senior executives pursuant to their employment contracts and other closure costs including lease assignment or termination costs.
4	Legal and tax fees associated with the Scheme
5	Under accounting standards the value of non recourse employee share loans are not included in the assets of a Company but are shown as a contra to share capital. These loans are repayable from share sale proceeds or distributions made by the Company in respect of the employee shares to which they relate and hence are an asset of the Company to the extent of the unpaid value of the loan or the future sale proceeds or distributions of the Company which ever is the lesser. This amount comprises the following components:

Shares where the loan value per share is less then $1.91	$ 270K
Shares where the loan value per share is greater than $1.91 – capped at $1.91	$1,451K
Total	$1,721K

6	Prior to Completion of the Scheme (if approved) – Avatar will capitalise Lednium Limited to $6.3 million. The funds will be used to acquire the Lednium companies from the Avatar group at net asset value estimated to be $4.3 million at the end of November with the balance of capital estimated to be around $2.0 million in cash to be used to fund the operations of the business for the remainder of the Fy2008 financial year.
7	The Escrow funds are forecast to be $10.7 million at 30 November 2007 being $10 million plus interest earned to that date.
8	Arlec Net Assets are forecast to be $15.7 million at 30 November 2007 which will be realised through sale of the inventory and fixed assets and transfer of employee liabilities to Sonsam and the collection of receivables and payment of liabilities. To the extent that the net assets of the Arlec business are more or less than this amount then forecast cash (refer note 11) will less or more than forecast.
9	As at 30 November 2007 receivables are forecast to comprise the South African Royalty and Loan ($2.1 million), the estimated tax refund due from the Australian Tax Office in respect of the 2007 financial year ($0.7 million) and sundry receivables ($0.7 millon).
10	As at 30 November 2007 liabilities are forecast to comprise staff leave entitlements($0.5 million), head office staff termination costs ($0.7 million), head office closure liabilities ($0.5 million), liabilities for tax related warranty claims in South Africa ($0.2 million), liabilities for product warranties in the UK ($0.1 million) and sundry liabilities ($0.2 million).
11	Cash will be invested in interest bearing securities as appropriate with maturities reflecting the expected timing of cash required to fund the Capital Return
12	Net tax balances comprise foreign tax credits ($0.3 million) and timing differences net of income tax payable. The timing differences arise primarily from employee leave liabilities and non deductible accruals in the Arlec business which will all be satisfied in the 2008 financial year.
13	The estimated amount of cash that Avatar would hold as at 30 November 2007 were all assets (other than employee share loans) realised for book value on that date and liabilities satisfied.
14	The net book value of Lednium of $2.5 million attributable to Exiting Shareholders being 40% of $6.3 million.

SCHEDULE 4 - LEDNIUM

1 OVERVIEW OF LEDNIUM

Lednium is a wholly-owned subsidiary of Avatar, established to research and develop solid state light emitting diode (LED) lighting technology.

The Avatar Group commenced research and development into LED lighting in 1999. The Company's research and development activities into LED lighting culminated in the establishment in 2004 of a discrete business unit, Lednium.

Lednium researches, develops, manufactures, markets and distributes LED based components for lighting applications. Lednium's technology and business model relates to the packaging of light emitting diodes or "chips" acquired in wafer (unpackaged) form (together with phosphor in the case of white light), into lighting devices (lamps) or other lighting components for sale to manufacturers (OEMs) of finished products utilising LED lighting components or lamps. For example, Lednium provides components for LED powered automobile lighting products, torches, display screens, variable messaging products, architectural lighting products, outdoor lighting products etc. In addition Lednium is also developing its own range of these types of finished products powered by its LED lighting components.

Lednium is not a manufacturer of semiconductor wafers or the chemical phosphors used to produce white light. Lednium acquires these raw materials from companies such as Epistar, Cree and Intematix and, using the intellectual property it has developed, packages them into unique LED lighting components. This enables Lednium to select the most appropriate LED diodes available for sale in the market for its products in a time of rapidly advancing LED technology.

Lednium currently offers a range of single diode ("Cup") and multi diode ("Matrix") LED components, which are further processed into a range of truck and trailer after market rear and side marker lighting products and garden and night lights. A range of Lednium designed and powered garden torches have also been developed, and plug-in lamps are under development.

Lednium commenced commercialisation of its LED technology in late 2005 and remains in the early stages of its business development cycle. The objective of the commercialisation program is to transform Lednium from a research and development company with a prototype production capacity as at the end of 2005 to a profitable commercial operation. Lednium is focussed on developing the most effective optical and thermal packaging technologies for solid state lighting applications. In July 2006 the company established it own manufacturing facility in Penang Malaysia. Since that time Lednium has continued to fine tune its products, manufacturing processes and further expand production capacity. Lednium has also continued to make adjustments to its initial market entry strategy in light of market feedback. As previously reported to shareholders this has led the company to focus its marketing strategy on its single diode cup products and to develop finished applications to show case and stimulate the sale of its LED lighting components. Lednium has now started to receive significant orders for LED components for the automotive after market, garden and night lights which it has designed and made available to OEM customers and distributors.

Lednium has a small head office in Melbourne and has an agreement in place with Arlec, whereby Arlec will provide serviced offices to Lednium's staff in Melbourne on an essentially cost recovery basis. Lednium's principal place of operations is its research and development and production facility in Penang, Malaysia which currently directly employs approximately 85 people. Lednium also has arrangements in place which give it access to a highly skilled base of scientists, engineers and design experts which it employs on contract on an as required basis. Production capacity of Lednium's one production line is currently 20,000 single diode products per shift. Production can be expanded to 3 shifts per day with minimal additional capital expenditure, giving Lednium a production capacity of approximately 13.2 million single diode products per annum based on a 220 day per annum production cycle. This can be doubled by addition of a second production line.

As part of the separation of Lednium from the Avatar Group, Lednium has recently appointed a new board and will retain its senior management team and full and part time employees and contractors.

Currently, Lednium has four families of LED patent applications being processed which relate to LED lamps and the method and process for producing them. Innovation arising during the product development cycle may provide opportunities for additional patent applications.

Lednium has agreements for distribution of its products in place with Optek Technology (a global electronics company manufacturing a broad variety of components for a range of industries, including the automotive industry) (Optek) for North America and Europe and Arlec (which, as mentioned above, is the subject of a sale to an entity associated to Mr Trahar) in Australia and New Zealand. Lednium is also in the process on putting in place distribution arrangements in Asia.

Lednium also has a supply agreement with Intematix of the United States for the supply by Intematix of phosphor for use in the LED products of Lednium. This supply agreement replaced the phosphor supply agreement Lednium previously had with Osram which was terminated by Lednium in March 2007.

As disclosed on 31 August 2007 and in Avatar's Annual Report, Lednium has received claims that Lednium and the manner in which phosphor is used in the "white" cup and mutlidiode (turtle) products to produce white light are infringing certain patents of other parties (**Claims**). The Claims do not allege that Lednium's proprietary "cup" and "turtle" technology (which is the subject of granted patents and pending patent applications) itself, or that other coloured "cups" or "turtles" that do not use phosphor, otherwise might infringe the other parties patents. The Claims extend to patents in various overseas countries and are still being evaluated. The Claims create uncertainty as to the value and future prospects of the Lednium business and may take a number of months to fully evaluate.

Depending on the outcome of the Claims, the Avatar Board considers that there is considerable potential upside for shareholders which may arise from successful development of the Lednium technology and business. There remains considerable scope for growth if Lednium's technology can be successfully commercialised as a result of:

- the High Brightness High Power (**HBHP-LED**) markets in which Lednium operates have significant scope for growth;
- the price for raw materials used in producing Lednium's products is dropping with technological advances and economies of scale as the industry develops. The performance of the products is also rapidly improving;
- as a low energy lighting product, the expansion of Government policy of energy conservation is anticipated to increase demand and market share for LED illumination;
- public sentiment on energy saving and pollution – in an increasingly "green" and energy constrained and conscious world, the potential acceptance of Lednium's low energy lighting will be an important consideration in the success of the business (as set out in the table below).

The early stage of development of the business, the rapidly evolving industry with regular new developments and impact of the Claims also creates considerable uncertainty as to the value to attribute to Lednium. There are also a range of risks associated with the development of a business such as Lednium. These factors make an investment in Lednium highly speculative.

2 LED INDUSTRY AND MARKET

2.1 What is LED?

LEDs are semiconductor devices that emit light when a current is passed through them. LEDs are very small, a typical power LED for illumination will be approximately 1mm square. LEDs generate large amounts of light for their size, use a fraction of the energy of conventional bulbs, and can operate more efficiently than fluorescent tubes.

The colours of the light produced by the LEDs can be tailored, although only a single colour is produced by any single LED. To produce white light, blue LEDs are combined with a phosphor, which generates yellow light. The combination of yellow light with the blue light from the LED creates white light.

LEDs provide a range of benefits over traditional lighting sources, including:

- lower energy use – which is becoming more important given that lighting represents about 12 per cent of greenhouse gas emissions from households in Australia and about 25 per cent of commercial sector emissions and emissions from public and street lighting;
- longer life, greater robustness, on – off cycle resilience and non abrupt failure which reduces maintenance and replacement requirements;
- small size, colour and dimming capabilities and capacity to integrate readily into a range of products, such as printed circuit boards, all of which provide greater flexibility for use of LEDs.

A comparison of some of the characteristics of the main lighting sources is set out below.

	Traditional bulbs	Compact Fluorescent Lamps	LEDs
Conversion of energy to light	5% of energy received converts to light	15% (up to 30% in tube form) energy received converts to light	30% energy received converts to light (target of up to 50%)
Lifespan	1,000 hours	10,000 hours	50,000++ hours
Dimming quality	Can be dimmed, Colour becomes increasingly red as light is decreased	Can't be dimmed	Can be dimmed. Maintains colour from zero to full output.
Colours	Colours available by using substrative filters	Colour available with use of filters	Able to emit light of intended colour naturally. Can be arranged to change colour by combining different

			LEDs
On-off cycling	Slow response because of thermal dependence. Susceptible to failure from thermal shock and vibration	Not suitable for on-off cycling	Extremely fast response. Ideal for applications subject to frequent on-off cycling such as light shows
Damage	Fragile, easily damaged mechanically.	Fragile, easily damaged mechanically.	Rugged, withstand mechanical forces
Failure	Subject to catastrophic failure. Go – no go.	Similar to fluorescent tubes, darkened ends, dimming, flickering	No go very unlikely, slow decrease of output – typically will maintain 70% of output after 50,000 hours
Environmental	Contains no hazardous substances.	Contains mercury and hence special disposal is recommended	Contains no hazardous substances. Long life reduces replacement waste.
Other	Relies on a heated wire to produce light Slow response	Can have a delayed start-up Full output attained gradually	Fast response Very small Easily populated onto printed circuit boards

2.2 The LED market

(a) LED market segments

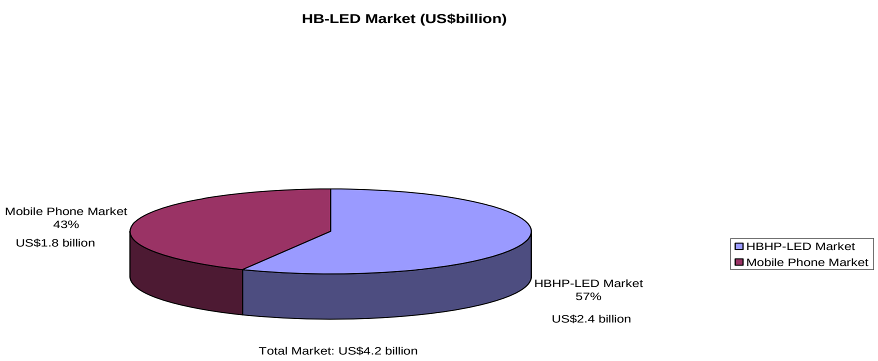
The total LED market was worth about US$7.75 billion in 2006. These include standard LED, High Brightness Light Emitting Diodes (HB-LED) and HBHP-LED.

(b) HB-LED & HBHP-LED market

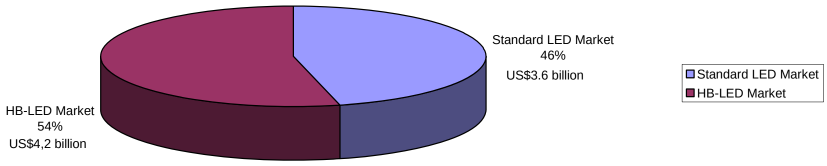
The market for HB-LED is currently one of the fastest-growing segments of the LED market in both market penetration and capacity investment of chip manufacture. This segment includes lighting functions such as mobile appliances, automobile (such as interior and exterior lighting for cars, trucks and other heavy vehicles), illuminated signs and displays, signals (such as traffic lights), general illumination (such as street lights), lighting for electronic equipment, aviation / marine / military applications and for lighting applications in medical, mining and aerospace.

The total market for HB-LEDs has grown from US$ 2.4 billion in 2003 to US$4.2 billion in 2006, for a compound annual growth rate (CAGR) of 20.4%, fuelled by new applications and deeper penetration into existing applications. Innovations are expected to continue to flow at a high rate, enabling new products to keep the marketplace active and fast moving. Growth in the market for HB LEDs is forecast at 16.7% CAGR to US$9.0 billion by 2011.

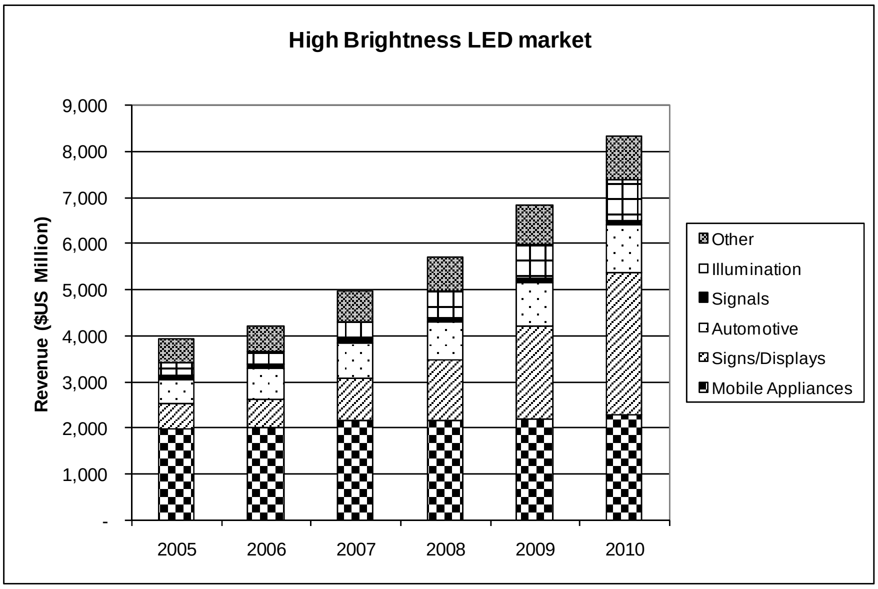
The HBHP-LED market which Lednium is targeting was worth US$2.4 billion in 2006. This market, the HB-LED excluding the mobile phone market, was worth around US$1.8 billion in 2006.



Total LED Market 2006 (US$billion)



The table below sets out historical and forecasted revenue (in US$) in the HB-LED market as well as particular sectors of that market.



General illumination and the signs/displays sectors of the market are the fastest growing segment of the HB-LED market.

2.3 The LED industry

There are three main categories of companies that make up the LED industrial chain:

- epitaxial wafer and chip manufacturers;
- LED packagers such as Lednium; and
- manufacturers of end products using LEDs purchased from packagers.

The traditional producers of wafers make up the majority of companies which package the HPHB-LED products in competition with Lednium. These include Nichia and Toyoda Gosei in Japan, Cree and Lumiled's in US and Osram in Europe, which together account for the majority of this market. A number of these companies also develop and manufacture end products.

Because Lednium does not produce its own chips, Lednium can source the latest chips available for sale from the many semiconductor manufacturers around the world. Some wafer and phosphor manufacturers who are also packagers of LEDs do not supply wafers in unpackaged form or phosphor (as the case maybe) to specialist packagers such as Lednium or only do so pursuant to cross licensing and supply arrangements. As set out above, Lednium has arrangements in place with Intematix for the supply of phosphor.

There will be increased competition as new players (like Lednium) enter the market, often based on new technology, or new or improved manufacturing of existing technology.

2.4 Lednium and the LED Market

(a) Lednium's focus in HBHP-LED market

Lednium plans to target niche sectors of the HBHP-LED market where the margin is still high, demand is growing and where Lednium has a competitive advantage on cost, efficacy, compatibility and flexibility and optical appearance. Lednium plans to target the HBHP-LED market. This would include the following areas.

- selected automotive – interior and exterior lighting for luxury cars and heavy vehicles such as trucks, trailers, heavy machinery, mining and military vehicles. The main driver for this sector will be back & side lighting currently, and forward lighting in the near future. This market has much potential, especially in trucks, heavy machinery, mining and military vehicles etc. where price sensitivity is lower;
- general illumination – street lights;
- medical - specialty lighting for medical and dental applications such as overhead surgical light and LED goggles for dental care;
- architectural designers - decorative lighting systems to be commissioned by architects in new construction projects;
- deep mining - high reliability, intrinsically safe lighting for underground mining;
- aviation and aeronautical – specialty lighting, marine beacons and vessels navigation lighting, including submarine.

(b) Lednium's paths to market

- Original Equipment Market (OEM)

  The OEM market comprises the manufacturers of finished products which use LED lighting components to incorporate some form of lighting function in their finished product. This covers a vast range of manufacturers across a multitude of industries and applications including automotive, electronic, communications, transport, aeronautical, signal and signs, defence, marine, medical and general lighting industries. Lednium works closely with OEM's at the design stage to develop applications which use Lednium lighting components.

  For example, Lednium is currently working with:

  - a company in Australia which designs, manufactures and supplies products and services to the traffic signalling industry; and
  - an OEM on two railway projects in Australia. The projects involve trialling a prototype of LED marker lights on trains as a replacement for incandescent marker lamps currently in use.

- Distributors

  In addition to marketing directly to the OEM market, Lednium has appointed a number of distributors to market and distribute its lighting components to the OEM market. Lednium and its distributors are working on a number of projects including:

  - an electronic ticketing machine; and
  - aircraft lighting.

  Lednium has appointed the following distributors to distribute its lighting components in specific markets in the world.

  <u>US and Europe</u>

  Optek Technology Inc

  Lednium signed a joint research and development, manufacturing and marketing relationship agreement with Optek, a subsidiary of TT electronics, as announced in an Australian press release on 17 October 2005.

  TT Electronics is a US $1.0 billion component manufacturing and distribution entity with three divisions involved in LED technology. They have a global sales force and distribution networks, and their LED division market LED components, and also manufacture value added and customer assembly modules and systems for the market segment that they serve such as Automotive, Backlighting, Entertainment and Accent Lighting.

  Optek will have exclusive distributor rights of Lednium products in the Americas and Member States of the Europe Union. It will also distribute in Asia, except for the Australia, New Zealand, Malaysia and Japan markets, on a non-exclusive basis.

  Optek has an extensive global network of sales, engineers, representatives and distributors. In North America, they have over 225 sales engineers operating from 48 offices and 7 distributors.

Australia and New Zealand

Arlec Australia Limited

Lednium currently has a distribution agreement in place with Arlec. Further details are set out in section 6.4 below.

India and South East Asia

In addition to the formal distribution arrangements set out above, Lednium has formed close working relationships with:

- *Richardson Electronics* in India and South East Asia. Richardson Electronics (Nasdaq-RELL) is a global provider of engineered solutions, serving the RF (Radio Frequency) and wireless communications, industrial power conversion, medical imaging, security and display systems markets; and
- *Emantras* in India (www.emantras.com).

- Subcontracting

Lednium has also made contact with a number of LED manufacturers and packagers with a view to packaging LED diodes for them using Lednium's proprietary packaging technology. At this stage the sub contracting business is in the early stage of development.

- Commercial Lighting Projects

Lednium products tenders for commercial LED lighting projects. This business is at an early stage of development.

(c) Application Design

Lednium's "cups" and "turtles" have unique features that enhance the ability of application design engineers to design LED based lighting products. These key features include:

(i) Lednium "cups" have an extremely low profile and smaller footprint than competing products with equivalent output. These features appeal to end users who consistently seek ways to miniaturise their own products;

(ii) matrix products have the advantage of an IP protected 3 dimensional shape which allows the LEDs to be positioned close together and gives the wide light distribution that is critical to general illumination; and

(iii) the matrix products have extremely low thermal resistance leading the way for thermal efficiency – which is the most important factor affecting efficient operation of power LEDs.

In order to show case these unique features and stimulate the sale of its LED lighting components, Lednium is developing a number of finished applications. Initially Lednium is concentrating on three sectors.

Automotive Aftermarket Products

Lednium is targeting this aftermarket sector first as the acceptance of LED technology into automobile sectors is wider than other sectors of the lighting markets. In Australia, there are less stringent requirements for the aftermarket auto sector where the Australia Design Rules (ADR) have less impact.

Lednium is focussed on automotive aftermarket products for heavy vehicles such as truck, bus, train and mining vehicles where pricing issue is not as intense as light vehicles.

General Illumination and Architectural Lighting

Lednium is developing replacement lamps for halogen and incandescent lamps and a range of architectural lighting that features the benefits of LED lighting and Lednium products. With the increasing efficiency and long life of LED chips, general illumination is a rapidly growing sector of the HB-LED market.

Consumer Products

Currently Lednium has a number of finished applications at an advanced stage of development including garden lighting, torches and small medical products.

3 PRODUCTS, TECHNOLOGY AND PATENTS

Lednium has produced 3 unique product ranges:

- the partially surface mounted (PSMD) Cup Series;
- the fully surface mounted (SMD) Cup Series for low profile high power applications; and
- the Matrix Series, known as 'Turtles'.

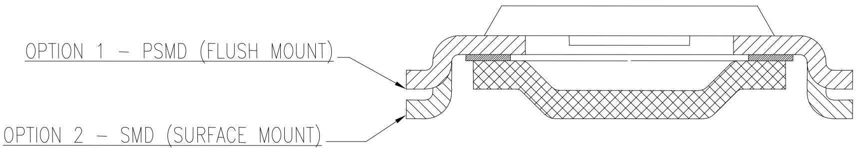
3.1 Cup Series

(a) PSMD Cups

The PSMD Cups provide the lowest profile of any large chip LED on the market and excellent thermal coupling. This design is used for the automotive aftermarket, military and marine range of application products.

(b) SMD Cups

SMD Cups are fully surface mounting devices. The SMD Cups are a popular configuration because of compatibility with the automatic board loading equipment in common use by assembly manufacturers. These two alternate configurations are achieved during forming of the electrical contacts.



3.2 Matrix series

Lednium's Matrix series is formed by mounting modified PSMD cups on to Lednium's patented leadframes. These are currently fitted with 9 such cups to give a single LED array rated at up to 10watts. The Matrix series is at the forefront of thermal performance for LED devices of equivalent power rating.

Typical applications for Matrix series products include automotive, aviation, illumination, display / entertainment / gaming and vending machines, signs and signals / variable message signs (VMS) marine, military, medical.

3.3 Overall product advantages

(a) Cost

To make a lamp using conventionally packaged LEDs entails mounting a large number of individual packages, each of which contains one LED chip. When the cost of each chip, the cost to package it and the cost of assembly are accounted, an LED lamp is an expensive item, which struggles to be cost competitive. It only becomes economically viable in applications where the maintenance cost is high and lifetime costs are the major criteria, such as for use in traffic signals.

Lednium technology provides a group of LED chips in a single package, thereby reducing the cost to produce it to little more than the cost of the LED chips. This assists to reduce the assembly cost of a lamp. This gives a cost competitive advantage to Lednium products.

(b) Thermal superiority

Dissipation of the by-product of LED operation - heat, is the single most limiting factor in LED package design. It is important because of the small size of the LED compared to the power dissipated in it. A poor thermal design can result in high temperatures being attained by the LED, which will produce reduced light output and shortened effective lifetime. The Lednium designs use metals and high thermal conductivity ceramics to provide a thermal path of very low thermal resistance. Among competing LED lamps of similar power rating, the Matrix products have the lowest thermal resistance available, giving a distinct advantage to end product designers. The thermal resistance of the matrix package has been measured to be not more than 2.5°C per watt of input power.

(c) Efficiency

To be a success, LED lighting must deliver light more efficiently than alternate light sources. Efficiency can be quantified at the lowest level by measuring the quantity of visible light (lumens) that are delivered for each watt of power supplied to the device. Practical power LEDS can produce up to 80 lumens per watt which is similar to fluorescent tubes and much more than filament lamps. Lednium products can achieve this and will undoubtedly exceed that benchmark in the near future.

To make an efficient lamp however requires more than just arithmetic efficiency. The light must be delivered in an effective manner to be of maximum use. The Lednium technology strives to maximise the spread of light, and minimise all the optical inefficiencies. The chips are mounted in wide angle reflective cups to give a divergent light distribution for each LED. These cups are then arranged in three dimensions on a part spherical convex surface such that the axis of the beam from each of the LED chips is divergent from the axes of all the other LED beams, thereby maximising the angle of the composite light beam.

(d) Compatibility and Flexibility

To be capable of widespread applicability, Lednium offers the full spectrum of LED colours and chip sizes in a single package design. LED chips are frequently square and can range in size from 8 mils (0.2mm) to 45 mils (1.2mm). The chip area is roughly proportional to the maximum input power rating of the chip. Small chips can handle only about 50 milliwatts, and the largest a little more than 1 watt. The input power requirement for Lednium products thus ranges from milliwatts to about 10 watts, which is the largest of our product range in current production. The Lednium product range makes it possible to design LED products across the full range of input and output options, which all have the same compound footprint and an excellent, even spread of light.

(e) Optical Appearance

The narrow light beam from a traditional LED package is perceived as a spot. Even when a conventional array of LEDs is viewed from a distance it looks spotty, like the appearance of modern LED traffic lights. The divergence of the combined light beam of Lednium is an improvement on these.

(f) Patented manufacturing process

The way in which the elements of Lednium cup and matrix products are assembled are detailed in Patents numbered (c) and (d) below. These give protection not only from arranging LEDs in a 3D array, but also from copying the concepts behind an LED in a metal cup (or receptacle), and from assembling LEDs in a matrix on a leadframe, and from employing any of the other innovations that Lednium has developed. And furthermore the specialised process steps which have been devised are similarly protected.

3.4 Patents and protected technology

Lednium Technology Pty Limited holds all of the intellectual property and patents of the Lednium business. At the date of implementation of the Capital Return, Lednium Technology Pty Limited will be a wholly-owned subsidiary of Lednium Limited.

Currently, Lednium has four (4) families of LED patent applications which have been published, and two (2) other patent applications which have not yet been published. The four (4) families of LED patent applications which have been published are:

(a) LED lamp – this patent family generally relates to a lamp including a plurality of recesses arranged in at least one curved conductor so as to adopt a three-dimensional array, wherein light emitting junctions are mounted in the recesses.

Country/Region	Application No.	Filing Date	Status
Australia	51948/01	15-Jun-2001	Granted
Canada	2411219	15-Jun-2001	Pending
China	01811113.0	15-Jun-2001	Pending
Europe	01942891.1	15-Jun-2001	Pending
Hong Kong	03106833.5	23-Sep-2003	Pending
India	IN/PCT/2002/01157/DEL	15-Jun-2001	Pending
India	7383/DELNP/2006	06-Dec-2006	Pending
Japan	2002-511390	15-Jun-2001	Pending
New Zealand	512392	15-Jun-2001	Granted
New Zealand	522398	04-Nov-2002	Granted

Singapore	200207147.0	15-Jun-2001	Granted
South Korea	10-2002-7017019	15-Jun-2001	Pending
South Africa	2002/9990	15-Jun-2001	Granted
Taiwan	90116693	06-Jul-2001	Granted
USA	10/049572	15-Jun-2001	Granted
USA	10/953797	29-Sep-2004	Pending

(b) A Method of Producing a Lamp – this patent family generally relates to a method of producing a lamp, including:

- forming one or more conductors having a plurality of recesses arranged therein so as to adopt a three-dimensional array of recesses; and
- mounting light emitting junctions to the one or more conductors such that the light emitting junctions are located within the recesses.

Country/Region	Application No.	Filing Date	Status
Australia	2002302196	14-Jun-2002	Granted
Canada	2450156	14-Jun-2002	Pending
China	02812023.X	14-Jun-2002	Pending
Europe	02729655.7	14-Jun-2002	Pending
Hong Kong	04106127.9	16-Aug-2004	Pending
India	02118/DELNP/2003	14-Jun-2002	Pending
Japan	2003-506005	14-Jun-2002	Pending
New Zealand	530066	14-Jun-2002	Granted
Singapore	200307050.5	14-Jun-2002	Granted
South Korea	10-2003-7016279	14-Jun-2002	Pending
South Africa	2003/9547	14-Jun-2002	Granted
Taiwan	91113106	14-Jun-2002	Granted
The Philippines	1-2003-501277	14-Jun-2002	Pending
USA	10/305294	14-Jun-2002	Pending
Malaysia	PI20024755	18-Dec-2002	Pending
Thailand	078875	18-Dec-2002	Pending

(c) A Lamp and a Method of Producing a Lamp - this patent family generally relates to a method of producing a lamp, including:

- mounting light emitting junctions in respective metallic receptacles;
- mounting the metallic receptacles with light emitting junctions mounted therein on a metallic support structure so as to form a three-dimensional array of metallic receptacles in electrical connection with the metallic support structure; and
- forming electrical connections between the light emitting junctions and the metallic support structure.

Country/Region	Application No.	Filing Date	Status
Australia	2003233248	11-Jun-2003	Granted
Canada	2488904	11-Jun-2003	Pending
China	03813853.0	11-Jun-2003	Pending
Europe	03727013.9	11-Jun-2003	Pending
Hong Kong	05106839.7	09-Aug-2005	Pending
India	3806/DELNP/2004	11-Jun-2003	Pending

Japan	2004-514135	11-Jun-2003	Pending
New Zealand	531587	11-Jun-2003	Pending
Singapore	200406931.6	11-Jun-2003	Granted
South Korea	10-2004-7020269	11-Jun-2003	Pending
South Africa	2004/9679	11-Jun-2003	Granted
Taiwan	92115951	12-Jun-2003	Pending
The Philippines	1-2004-501995	11-Jun-2003	Pending
USA	10/487040	11-Jun-2003	Pending
Malaysia	PI20032220	13-Jun-2003	Pending
Thailand	083045	12-Jun-2003	Pending

(d) A Lamp and a Process of Producing a Lamp - in one aspect, this patent family generally relates to a process for producing a lamp assembly having a plurality of light emitting semiconductor devices mounted to a non-planar support, the process including:

- forming a plurality of substantially rigid non-planar electrical connectors, each of the connectors including an electrically conductive annular portion and a plurality of contacts projecting from and electrically connected to the annular portion; and
- mounting the plurality of contacts of the non-planar electrical connectors to respective electrically conductive locations of the lamp assembly to provide at least one path for conducting electrical current through the plurality of light emitting semiconductor devices.

In another aspect, this patent family generally relates to a process for producing a lamp, including:

- forming an electrically conductive receptacle having a substantially planar base and a substantially planar peripheral region;
- forming a substantially planar electrical insulator on the substantially planar peripheral region;
- forming a substantially planar electrically conductive contact on the substantially planar electrical insulator;
- mounting a light source on the base of the receptacle;
- making a first electrical connection between the substantially planar electrically conductive contact and a first contact of the light source, and a second electrical connection between the electrically conductive receptacle and a second contact of the light source; and
- encapsulating the light source and the electrical connections to provide a light source assembly for mounting on an electrically conductive support, wherein an unencapsulated portion of the substantially planar electrically conductive contact provides a first electrical contact to the light source mounted in the receptacle, and the electrically conductive receptacle provides a second electrical contact to the light source.

Country/Region	Application No.	Filing Date	Status
Australia	2004219544	05-Mar-2004	Pending
Canada	2518625	05-Mar-2004	Pending
China	200480010621.2	05-Mar-2004	Pending
China	Not yet known	Not yet known	Pending
Europe	04717524.5	05-Mar-2004	Pending
Hong Kong	06101652.1	08-Feb-2006	Pending
India	4260/DELNP/2005	05-Mar-2004	Pending
Japan	2006-503957	05-Mar-2004	Pending
Malaysia	PI20040771	05-Mar-2004	Pending
New Zealand	542269	05-Mar-2004	Pending
Singapore	200505736-9	05-Mar-2004	Pending
South Korea	10-2005-7016995	05-Mar-2004	Pending

South Africa	2005/07277	05-Mar-2004	Granted
Taiwan	93105826	05-Mar-2004	Pending
Thailand	089229	08-Mar-2004	Pending
The Philippines	1-2005-501646	05-Mar-2004	Pending
USA	10/548498	05-Mar-2004	Pending

Lednium also has a number of design applications and/or design registrations in Australia, Europe, Japan and the United States of America.

Trade mark applications and/or registrations for LEDNIUM (in plain block letters) and the following stylised trade mark also exist in each of the countries in which applications for patents have been made:

The trade mark applications referred to above have been granted in most of the countries.

Trade mark applications for the following mark have also been made in selected countries.

As a practical measure Lednium also requires senior employees (with access to sensitive information), distributors and, in cases involving sensitive application development, suppliers and customers, to enter into confidentiality agreements.

3.5 Patent disputes

Lednium has received claims that Lednium and the manner in which phosphor is used in the "white" cup and multidiode (turtle) products to produce white light are infringing certain patents of other parties. The Claims do not, however, allege that Lednium's proprietary "cup" and "turtle" technology (which is the subject of granted patents and pending applications) itself, or that other coloured "cups" and "turtles" that do not use phosphor, otherwise might infringe the other parties' patents.

The Claims extend to patents in various oversees countries and are in the process of being evaluated. As the Claims involve complex technical and legal issues arising from patents in a number of different jurisdictions, it may take a number of months to fully evaluate them and the implications for the Lednium business. Consequently, until that evaluation is completed, the Claims create uncertainty as to the value and future prospects of the Lednium business.

As set out above, given the potential upside for shareholders which would arise from successful development of the Lednium technology and business, the Board considers that it is in Shareholders' interests to maintain an interest in that business, however the considerable uncertainty as to the value of the business resulting from the Claims must also be considered by Shareholders. If and when the Claims are resolved, Lednium will be in a position to reassess the effect (if any) on its business. Lednium will keep shareholders informed of the progress of the dispute.

If the Claims are substantiated, this may adversely impact, possibly materially, on the business of Lednium. In this event, it may be necessary for Lednium to endeavour to negotiate some form of commercial arrangement with the other parties for the use of the affected technology and/or consider implementing certain modifications to its white light products (which are presently being evaluated by Lednium's management team in the event the Claims are substantiated). At an extreme, it may require a significant change to the business strategy and business model adopted by Lednium. In these circumstances, if they arise, the Board will reassess how best to maximise the value of shareholders investment in Lednium.

4 DETAILS OF THE COMPANY

4.1 Board of directors

The board is responsible for the overall corporate governance of Lednium, including its strategic direction, establishing goals for management and monitoring the achievement of those goals.

Outlined below is a profile of the directors.

Andrew King *Non-executive Chairman*	Andrew King was appointed Chairman of Lednium on 3 August 2007. Andrew holds a Bachelor of Electrical Engineering and an MBA from Melbourne University. From 1981 to 1985, Andrew was the Communications Planning Manager for the ANZ Bank, establishing the business case and architecture for the Group's integrated global voice and data networks and from 1986 to 1991, he was the business development and development director of Catsco, a private technology start-up company.

Andrew then established himself as an independent consultant, specialising in the system architectures, business plan development and market demand modelling in the high tech and IT sectors and has provided consulting services to a range of premier technology entities including Telstra, Accenture, KPMG and established venture capital companies. His market demand modelling techniques have been applied to a diverse range of technologies including radio spectrum valuation, photonic switch business plans and intelligent automotive location systems marketing.

Balu Jeganathan
Managing Director

Balu Jeganathan was appointed Managing Director of Lednium on 3 August 2007. Mr Jeganathan holds a B Sc. (Hons) Mechanical Engineering Degree from City University London UK and a Masters in Business Administration from Victoria University of Technology Melbourne.

Before his appointment as Managing Director, Mr Jeganathan held the position of Chief Operations and Technology Officer of Lednium and in this capacity was responsible for the development of Lednium's propriety LED packaging technology (with Mr John Montagnat) and the development and implementation of Lednium's commercialisation strategy since 1999. Mr Jeganathan is also responsible for Lednium's marketing activities including the management of Lednium's relationships with distributors. He joined the Avatar Group in 1998 as Chief Operations Officer of Arlec and was appointed Managing Director of Arlec in 2003, a position he still holds. Prior to joining the Avatar Group, Mr Jeganathan held management positions with Intel (1982 -1987), Cummins Diesel (1985 -1987), Siemens (1987-1990) and Rubbermaid (1992–1998).

As set out in section 4.2 of the Explanatory Statement, Avatar has agreed to make Mr Jeganathan available to assist in the transition of the Arlec business to the new purchaser for up to 50% of Mr Jeganathan's time. After six months, Mr Jeganathan will be focussed on the development of the Lednium business.

Ian Trahar
Non-executive Director

Mr Trahar was appointed a director of Lednium in 2000.

Mr Trahar is the current Chairman of Avatar (appointed as director since 1993 and Executive Chairman since 1999) and CO2 Group Limited (appointed 12 November 2001). He has also served as a director of Gribbles Group Limited (from 1999 to 2002) and Ranger Minerals NL (director from 1988 and Chairman from 1998 to 2002), Executive Director of Mincoa NL from 1986 to 1988 and a director of Mawson Pacific Limited from 1988 until 1990.

Mr Trahar was State Manager Investment Banking for Citibank from 1983 to 1985.

Mal Hemmerling
Non-executive Director

Dr Hemmerling was appointed as non-executive director on 3 August 2007.

Dr Hemmerling is currently a Non-Executive Director of Avatar (appointed in 2003) and CO2 Group Limited (appointed 4 July 2005). Dr Hemmerling was formerly the Chief Executive Officer of Adelaide City Council and Chairman of the National Basketball League. He has held senior management positions with Trade Wind Communication Ltd, Bob Jane T-Marts and Corporation, The Sydney Organising Committee for the Olympic Games and Australian Formula One Grand Prix.

4.2 Senior management

Ian Leijer
Chief Financial Officer and Company Secretary

Mr Leijer is the current Chief Financial Officer and Company Secretary of Avatar, positions which he has held for 7 years. In his current role, he has overall responsibility for the financial and company secretarial functions of the Lednium business and will continue that role under the new structure.

Prior to his current position Mr Leijer has held senior executive positions in the Avatar Group since joining in 1994. Mr Leijer has been a chartered accountant for over 15 years

John Montagnat
Senior Engineer

John Montagnat has a Diploma Engineering (Electrical). Mr Montagnat is the leading engineer with Lednium, focusing on intellectual property and, together with Mr Jeganathan, has been responsible for developing Lednium's proprietary LED packaging technology. He has over 17 years' experience as a senior engineer with Arlec.

Pannir Velu
General Manager
Manufacturing, Malaysia

Pannir Velu has a Bachelor of Engineering (Mechanical - Hons) from the University of Malaya. Mr Velu has been employed by Lednium since 2004 and is responsible for Lednium's manufacturing operations in Penang, Malaysia. Mr Velu has 23 years experience, predominantly in semiconductor industries. This includes 5 years in high volume semiconductor lead frame manufacturing and 15 years in designing and

	developing equipment for the semiconductor industry.
K.K. Lee *General Manager, Finance & Admin Malaysia*	Mr Lee has a London Chamber of Commerce Higher Accounting Diploma. Mr Lee joined the Avatar Group in 2003 and has been responsible for Lednium's finance and accounting functions in Malaysia since 2005. Mr Lee has more than 30 years experience in the financial field, which includes the professional and commercial sectors. He has held senior management positions in a number of companies in Asia and Africa over the past 20 years.
Richard Joseph *Sales Manager South East Asia and India*	Richard Joseph joined Lednium in Malaysia in 2006 as sales manager for South East Asia and India. In this role, Mr Joseph is responsible for direct and indirect sales of Lednium's products in these regions including supporting Richardson Electronics and Emantras, Lednium's partners in these regions.

4.3 Ownership structure

Lednium Limited is a newly incorporated company for the purposes of the proposed Lednium Share Distribution and is a wholly owned subsidiary of Avatar.

Upon implementation of the Capital Return, Exiting Shareholders will be issued with Lednium Shares on the basis of one (1) Lednium Share for every one (1) Avatar Share held, which will give them an interest in Lednium in the same proportion as their current shareholding in Avatar (subject to treatment of Foreign Shareholders).

Lednium's shareholder structure will be as follows upon implementation of the Lednium Share Distribution (subject to treatment of Foreign Shareholders):

Lednium's capital structure	Number of shares	%
Avatar Industries Ltd*	47,624,485	60.26%
Exiting Shareholders	31,413,979	39.74%
Total Lednium Shares on issue	79,038,464	100%

* After implementation of the Capital Return, Avatar will be 100% owned by entities associated with Messrs Trahar and Favretto (see section 2.6(e) of the meeting documents).

The Lednium Shares will be unlisted and so will not be able to be traded on ASX or any other securities exchange. This may impact upon Exiting Shareholders' ability to realise their investment because of the illiquidity of their Lednium Shares. Further, some Exiting Shareholders may hold small parcels of Lednium Shares, which may have an increased impact upon their ability to realise their investment because of the increased lack of liquidity for parcels of that size.

4.4 Lednium's financial position

	Statement of pro forma financial position as at 30 June 2007 $million
Cash	2.3
Other Current Assets	1.8
Total Current Assets	4.1
Total Non-Current Asset	3.2
TOTAL ASSETS	7.3
Current Liabilities	1.0
TOTAL LIABILITIES	1.0
NET ASSETS	6.3
TOTAL SHAREHOLDERS' EQUITY	6.3

4.5 Expenditure Forecasts

The Company intends to apply its forecast cash reserves at the time of Implementation of the Capital Return of approximately $2.0 million to fund operations for the remainder of the financial year ending 30 June 2008 as set out below. During this period the Company is aiming to resolve the Claims and subject to satisfactory resolution of the Claims, will need to undertake a capital raising to fund its future operations.

Description	($)
Salaries & Wages	1.1
Legal & Professional Fees	0.4
Rent & other overheads	0.5
Total	2.0

The assumptions on which the expenditure projections are based include:

- that the Claims are resolved without material alteration to Lednium's business plan;
- Lednium's key milestones do not materially change and Lednium achieves those milestones on time and budget;
- that Lednium suffers no materially adverse event. These could include an intellectual property failure or dispute, including a materially adverse event arising from either of the Claims;
- that there is no loss of key staff or alliances.

Whilst the directors expect that Lednium will have sufficient capital resources after implementation of the Capital Return to enable it to achieve its short-term business objectives as stated above, this cannot be assured. In relation to the proposed use of funds described above, it should be recognised that the table above is based on the state of affairs as at 21 September 2007 and may change in line with changes in circumstances, including the fulfilment of its current order book of approximately $1.1 million. It is an overview only and must be read in conjunction with the assumptions and qualifications set out above.

There are a number of risk factors relating to the Lednium business which may affect the projected expenditure. Exiting Shareholders are referred to section 5 for a description on some of those risk factors.

No assurance can be given that expenditure will be kept at the projected level set out above or that the expenditure will lead to the achievement of Lednium's milestones.

4.6 Future funding

As a separately owned and operated business, Lednium will not have access to surplus capital currently held by the Avatar Group and so will need to seek further capital through equity or debt financing to finance its ongoing LED commercialisation activities. There is no guarantee that such capital will be available.

4.7 Listing on ASX

After implementation of the Capital Return (if approved), the board of Lednium will continue to consider the suitability of Lednium to be listed on ASX. No decision can or will be made on listing until after the Claims are clarified or resolved.

4.8 Trading of Lednium Shares

The Lednium Shares will be unlisted and so will not be able to be traded on ASX or any other securities exchange. This may impact upon Exiting Shareholders' ability to realise their investment because of the illiquidity of their Lednium Shares. Further, some Exiting Shareholders may hold small parcels of Lednium Shares, which may have an increased impact upon their ability to realise their investment because of an increase in lack of liquidity for parcels of that size.

ASIC has granted a modification in accordance with Regulatory Guide 188 to permit the Lednium shares to be transferred and traded without a prospectus on the basis that issue of the Lednium Shares under the Capital Return merely changes an indirect interest in Lednium (as a result of holding Avatar shares) to a direct investment in Lednium (that is, holding Lednium Shares) and so shareholders are not making a new investment decision.

5 RISKS / BARRIERS TO ENTRY

The business activities of Lednium are subject to risks and there are many factors which may impact the future performance of Lednium. These risks are both specific to Lednium and also relate to the general business and economic climate. Some of these risks can be mitigated by the use of safeguards and appropriate systems and actions, but some are outside the control of Lednium and cannot be mitigated.

The principal risks include, but are not limited to, those detailed below. Exiting Shareholders should carefully consider these risks, as well as the other information in this Explanatory Statement, before making a decision on how to vote at the Meetings. Neither the directors of Avatar, the directors of Lednium, Avatar, Lednium nor any person associated with Avatar or Lednium guarantee the performance of Lednium.

Exiting Shareholders with any doubt, having given due consideration to these risks and other information contained in this Explanatory Statement, should consult their stockbroker or other professional advisor.

5.1 Claims

As set out in section 3.5, Lednium has received allegations from third parties that it is infringing certain patents held by other parties.

These Claims are currently being assessed by Lednium and its external advisers. Pending completion of this assessment, Lednium's management does not believe that it is in a position to assess with certainty the potential impact that either of those Claims will have on Lednium. Details of those Claims and Lednium's current position in relation to those Claims are set out in section 3.5 above.

Due to the current uncertainty of the Claims, there is a risk that the Claims, or either of the Claims, will materially affect the Lednium business and its future prospects.

If and when the board considers that it is in a position to assess the potential impact of the claim with some certainty, it will inform shareholders of its position.

5.2 Sufficiency of funding

Whilst the directors believe that Lednium will have (after implementation of the Capital Return) sufficient capital resources to enable it to achieve its short-term business objectives set out in section 4.5 above, including funding operations to the end of the current financial year, this cannot be assured.

Lednium does not expect to be profitable for at least the next 1-2 years. Management of its capital resources is critical to Lednium's potential success and profitability. As a separately owned and operated business, Lednium will not have access to surplus capital currently held by the Avatar Group (as this is being returned to Shareholders as part of the Capital Return) and so may need to seek further capital to finance its business objectives. There is no guarantee that Lednium will be able to secure sufficient equity or debt financing to fund its objectives in the future. This will depend significantly on the outcome of the Claims (set out in more detail in section 3.5), as well as on its ability to achieve milestones, competitive forces and changes in the LED market.

The directors can therefore give no assurances that Lednium's objectives will in fact be met without further equity raisings and, if available, debt financing. Any additional equity financing will dilute shareholdings, and debt financing, if available, may involve restrictions on financing and operating activities. If Lednium is unable to obtain additional financing as needed, it may be required to reduce the scope of its operations and scale back its expansion and development programs.

5.3 Illiquidity

The Lednium Shares will be unlisted and so will not be able to be traded on ASX or any other securities exchange. This may impact upon Exiting Shareholders' ability to realise their investment because of the illiquidity of their Lednium Shares. Further, some Exiting Shareholders may hold small parcels of Lednium Shares, which may have an increased impact upon their ability to realise their investment because of an increase in lack of liquidity for parcels of that size.

5.4 Technology rights

Securing rights to the LED technology used in the manufacture of Lednium's products is an integral part of securing potential product value in the outcomes of Lednium's LED lighting research and development. Competition in retaining and sustaining protection of that LED technology can lead to expensive and lengthy disputes for which there can be no guaranteed outcome.

The commercial value of Lednium's LED technology is dependent on legal protections provided by intellectual property laws, particularly patents. The filing of a patent application does not guarantee that the patent will be granted. Furthermore, where a patent is granted, the scope of protection provided by the granted patent may be less than that originally sought in the patent application on which the patent was granted. It is also possible that a granted patent may subsequently be found to be invalid notwithstanding it having been previously granted.

The granting of a patent does not guarantee that the rights of others are not infringed nor that competitors will not develop competing technology that circumvents such patents. Lednium's success depends, in part, on its ability to obtain patents, maintain trade secret protection and operate without infringing the proprietary rights of third parties.

As the patent positions of LED lighting companies can be highly uncertain and frequently involve complex legal and scientific evaluation, neither the breadth of claims allowed in LED lighting patents nor their enforceability can be predicted. No assurance can be given that any of the patents that Lednium may own or control or licence now and in the future will afford Lednium commercially significant protection of the LED technology used in the manufacture of Lednium's products, nor that any of the projects that may arise from Lednium's LED technology will have commercial applications. Whilst Lednium will continue to use all reasonable endeavours to protect its LED technology, there can be no assurance that any measures taken (or proposed to be taken) have been, or will be, sufficient.

Further, it is possible that third parties may assert intellectual property infringement, unfair competition or like claims against Lednium under patent, copyright, or other laws.

Such claims, if made, may harm, directly or indirectly, Lednium's business. If Lednium is forced to defend claims of intellectual property infringement, whether they are with or without merit or are determined in Lednium's favour, the costs of such litigation will be potentially significant and may divert management's attention from normal commercial operations.

As set out in sections 3.5 and 5.1 above, Lednium has received notification of allegations from two industry participants that it is infringing certain patents held by those entities. If these Claims, or either of these Claims, are not satisfactorily resolved, this may adversely impact on the business of Lednium.

Shareholders should note that no formal or informal valuation has been undertaken of the intellectual property assets of Lednium and Exiting Shareholders should be aware that Lednium makes no representation as to the value of these assets.

5.5 Research and Development

Lednium can make no representation that any of its research into or development of its LED lighting technology will be successful, that the development milestones will be achieved, or that LED technology will be developed into products that are commercially exploitable.

There are many risks inherent in the development of technology products, particularly where the products are in early stages of development. Projects can be delayed or fail to demonstrate any benefit, or research may cease to be viable for a range of scientific and commercial reasons.

5.6 Probability of meeting Milestones

As a company still in the development stage and not yet earning material revenues, Lednium's most import task is to achieve its development milestones. These development milestones lead to commercialisation of its technology into the market.

Virtually every person associated with Lednium is a contributor to it achieving its milestones. Therefore the probability of Lednium achieving its milestones depends on the organisation as a whole. Failure to achieve any critical milestone could have a material adverse effect on Lednium and its prospects.

5.7 Uncertainty of future profitability

Lednium's ability to operate profitably in the future will depend significantly on the outcome of the Claims (set out in more detail in section 3.5) as well as on its ability to successfully develop competitive "white light" products that do not infringe on third party patents, particularly in relation to the use of phosphor. There is no certainty therefore that Lednium can successfully resolve the Claims in a commercially satisfactory manner nor develop competitive products that do not infringe third party claims.

Other factors that will determine Lednium's profitability are its ability to manage its costs, to execute its development and growth strategies, economic conditions in the markets Lednium operates, competitive factors and technological developments. Accordingly, the extent of future profits, if any, and the time required to achieve sustained profitability is uncertain. Moreover, the level of such profitability cannot be predicted and may vary significantly from quarter to quarter.

5.8 Rapidly changing technology

The LED lighting market is characterised by rapidly evolving technology. To the extent that any new technologies are perceived to be technologically or environmentally superior or economically more attractive than Lednium's LED technology, they could erode demand for Lednium's LED products, cause a reduction in selling prices of such products or render such products obsolete, resulting in a material adverse effect on Lednium's business, financial condition and results of operations.

5.9 Access to LED chips

A key input to Lednium's products is LED chips i.e. LED wafers in unpackaged form. Consequently Lednium's ability to compete effectively in the market is, amongst other things, dependent on being able to secure supply of LED chips whose performance (light output and thermal characteristics) and cost price is competitive in the market. The extent to which Lednium is unable to do so would render Lednium's products uncompetitive resulting in a material adverse effect on Lednium's business, financial condition and results of operation.

5.10 Competitive markets

Notwithstanding its rapid growth, the LED lighting market is very competitive with a high focus on product cost. To the extent that Lednium is unable to achieve cost efficiencies through production volumes and raw material sourcing this will have a material impact on Lednium's business.

5.11 Distribution channels

Lednium's uses a number of distributors to market its products directly to end users. To the extent that Lednium is unable to successfully negotiate ongoing distribution arrangements or Lednium's distributors are not successful in generating orders this may have a material impact on its ability to achieve its business plans.

Exiting Shareholders should consider that holding Lednium Shares is speculative.

6 ADDITIONAL INFORMATION

6.1 Rights attaching to shares

There in only one class of shares in Lednium, fully paid ordinary shares.

The rights attaching to the shares are:

- set out in Lednium's constitution; and
- in certain circumstances, regulated by the Corporations Act and the general law.

The principal rights, liabilities and obligations of the shareholders are summarised below.

Voting

At a general meeting, every member present in person or by proxy, attorney or representative has one vote on a show of hands and every member present has one vote on a poll for each fully paid share held (with adjusted voting rights for partly paid shares). Voting at any meeting of shareholders is by a show of hands unless a poll is demanded. A poll may be demanded by at least five shareholders entitled to vote on the resolution, shareholders with at least 5% of the votes that may be cast on the resolution of the poll, or the chairperson. The chairperson has a casting vote on a show of hands or on a poll.

Dividends

The profits of Lednium, which the directors may from time to time determine to distribute by way of dividend, are divisible amongst the members in proportion to the number of shares held by them (with adjusted rights for partly paid shares), subject to the rights attaching to the shares with special dividend rights. No shares with special dividend rights are currently on issue.

Issue of further shares

The directors may (subject to the restriction on the issue of shares imposed by the constitution and the Corporations Act) issue, grant options in respect of, or otherwise dispose of further shares on terms and conditions (including preferential, deferred or special rights, privileges or conditions, or restrictions) as they see fit.

Variation of class rights

Subject to section 246C of the Corporations Act, with the consent in writing of the holders of a majority of the issued shares of the affected class, or the sanction of an ordinary resolution passed at a meeting of the holders of the issued shares of the affected class, the rights attached to a class of shares may be varied or cancelled. In either case, the holders of not less than 10% of the votes in the class of shares whose rights have been varied or cancelled may apply to a court of competent jurisdiction to exercise its discretion to set aside such variation or cancellation.

Transfer of shares

Subject to any restrictions attached to the shares, shareholders may transfer shares by a written transfer instrument in the usual form or in any other form approved by the directors, or by a proper ASTC transfer. All transfers must comply with the constitution. The directors may refuse to register a transfer of shares in accordance with the Corporations Act in circumstances permitted by the constitution.

General meeting and notices

Each shareholder is entitled to receive notice of, attend and vote at general meetings of Lednium and to receive all notices, accounts and other documents required to be sent to shareholders under the constitution of the Company or the Corporations Act.

Winding up

Subject to the constitution and preferential rights attaching to any class or classes of shares, members will be entitled on a winding up to a share in any surplus assets of Lednium in proportion to the shares held by them irrespective of the amounts paid or credited as paid on the shares.

Directors – appointment and removal

The minimum number of directors is three and the maximum is fixed by the directors but may not be more than 12 unless the shareholders pass a resolution varying that number. Directors are elected at annual general meetings of the Company. Each director (other than the managing director) must retire from office at the third annual general meeting after the director was elected or most recently re-elected. The directors may also appoint a director to fill a casual vacancy on the board or in addition to the existing directors, who will then hold office until the next annual general meeting of Lednium.

Directors – voting

Questions arising at a meeting of directors will be decided by a majority of votes of the directors present at the meeting and entitled to vote on the matter. In the case of a tied vote, the Chairman of the board has a second casting vote, unless there are only two directors present or qualified to vote, in which case the proposed resolution is taken as having been lost.

Directors – remuneration

The directors, other than the Managing Director or an executive Director, shall be paid by way of fees for services the maximum aggregate sum as may be approved from time to time by Lednium in general meeting. The constitution also makes provision for Lednium to pay all reasonable expenses of directors in attending meetings and carrying out their duties.

Directors' and officers' indemnity

Lednium, to the extent permitted by law, indemnifies each officer of Lednium (and officers of its related bodies corporate, if so determined) on a full indemnity basis against any liability (including costs and expenses) incurred by that person as an officer of the company or a related body corporate of the company.

The company, to the extent permitted by law, may insure an officer of the company or its subsidiaries against a liability incurred by such person in the person's relevant capacity. The company may also insure such person for costs and expenses incurred by that person in defending or resisting proceedings whatever the outcome.

The company proposes to enter into deeds of access, indemnity and insurance with each director which confirm the Director's right of access to board papers and require the company to indemnify the director for liability incurred as a director of the company or any subsidiary of the company of which the director is appointed as a director after the date of the deed, subject to the restrictions imposed by the Corporations Act and required to use its best endeavours to maintain insurance cover for each director (including for a run-off period), subject to the terms of the deeds.

Amendment

The constitution may be amended only by a special resolution passed by at least three quarters of the votes cast by shareholders entitled to vote on the resolution.

6.2 Dividends

The Lednium directors do not anticipate paying any dividend in the foreseeable future.

The Lednium directors intend to give priority to the commercialisation of the company's existing portfolio of projects. Ultimately, the payment of dividends will depend on the successful financial performance of the company. The Lednium directors will take into account the funding needs of the company in determining future dividend policy and the specific level of any dividend. The Lednium directors do not guarantee that any dividends will be declared by the company.

6.3 Continuous Disclosing entity

After the implementation of the Capital Return, Lednium will be a 'disclosing entity' for the purposes of Part 1.2A Division 3 of the Corporations Act.

6.4 Material contract summaries

The directors consider that there are a number of contracts which are significant or material to Lednium or of such a nature that Exiting Shareholders may wish to have particulars of them when making an assessment of whether to vote in favour of the Capital Return at the Meetings. The main provisions of each such contract are summarised below. These summaries do not purport to be complete and are qualified in their entirety by reference to the text of the contracts themselves.

Supply agreement with Intematix

On 7 September 2007, Lednium entered into a Master Purchase Agreement with Intematix Corporation of the United States for the supply of selected phosphor products for use in Lednium's LED products.

In the event Intematix is unable or unwilling to continue to supply some or all of the phosphor products which have previously been supplied (other than in trivial amounts) and arrangements are not made for the continued supply of those products, Intematix may grant a licence to Lednium to manufacture such phosphor products solely in connection with Lednium's LED products. The licence is for a period of time generally to allow Lednium to fill its then existing supply agreements with its customers for LED products which use the phosphor products of Intematix.

The initial term of the agreement is for a period of 3 years commencing on 7 September 2006. The agreement will automatically be continuously renewed after that time for 1 year terms unless terminated earlier "for cause" in accordance with the terms of the agreement.

Distribution agreement with Optek

On 12 October 2005, Lednium entered into a Distribution/Marketing Agreement with Optek Technology Inc. of the United States for the distribution of certain products by Optek.

Optek was appointed the exclusive distributor and marketer of “OEM Products”, being those LED products which are intended and designated by Lednium to be used in original equipment applications, within the Americas and the European Union. Optek was appointed the non-exclusive distributor and marketer of the OEM Products within Asia (excluding Australia, New Zealand, Malaysia and Japan markets).

Optek also has the opportunity (eg. right of first refusal) to distribute and market “Complete Applications”, being those finished products which incorporate OEM Products which are intended and designated by Lednium to be used in complete applications, such as truck and trailer lights, in the above stated areas.

The initial period of the agreement was for a period of 12 months from October 12, 2005. The agreement now continues until terminated by either party on 6 months' notice (or earlier for cause).

Distribution agreement with Arlec

On 28 June 2007, Lednium entered into an Exclusive Distribution Agreement with Arlec Australia Limited for the exclusive distribution of LED component type products (eg. “OEM Products" (as generally defined above)) in Australia and New Zealand by Arlec.

The agreement also appoints Arlec as the exclusive distributor of “Complete Applications” (as generally defined above) in Australia and New Zealand.

The agreement runs for an initial term of 1 year from 28 June 2007, after which either Arlec or Lednium are entitled to terminate the Agreement on 180 days' notice (or earlier for cause).

6.5 Additional Information

Additional information on Lednium can be found on Lednium's website at www.lednium.com.

ANNEXURE 1

INDEPENDENT EXPERT'S REPORT

KPMG Corporate Finance (Aust) Pty Ltd
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The Independent Directors
Avatar Industries Limited
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19 September 2007

Dear Sirs

Independent expert report and Financial services guide

1 Introduction

On 29 June 2007, Avatar Industries Limited (Avatar or the Company) announced a proposal to return the net assets of the Company to shareholders by way of a selective capital reduction (the Capital Return). Avatar further announced that it had entered into an agreement for the sale of its consumer products business, Arlec, to an entity associated with Mr Ian Trahar, the major shareholder and a director of the Company (the Arlec Sale).

Avatar is an Australian public company listed on the Official List of ASX Limited (ASX), with a market capitalisation as at 18 September 2007 of approximately $140.7 million[1]. Avatar's business operations have changed significantly since its incorporation as a result of various business acquisitions and divestments. Today, Avatar's business operations comprise principally:

- consumer products distribution (Arlec)
- the manufacture and distribution of Light Emitting Diode (LED) lighting products (Lednium).

The broad terms of the Capital Return are that in consideration for the return and subsequent cancellation of their Avatar shares, Avatar shareholders other than Mr Trahar and Mr Paul Favretto and their associated entities (the Exiting Shareholders) will receive:

- $1.83 per share in cash
- an in-specie distribution of one share in Lednium Limited, the company that will own the Lednium business, for every one Avatar share currently held (based on net asset backing of Lednium of 8 cents per Avatar share), such that Exiting Shareholders will maintain their current pro-rata interest in the

[1] All amounts are stated in Australian dollars unless specifically noted otherwise

Lednium business (Lednium Share Distribution) immediately following completion of the Capital Return.

The Company has received a draft Class Ruling from the Australian Taxation Office (ATO) which indicates that the Capital Return will be treated as being approximately 65 percent capital and approximately 35 percent unfranked dividend for tax purposes.

Following completion of the Capital Return, it had been intended that Lednium would seek to complete a separate equity raising and listing on the Official List of ASX in the short term, while Avatar would be delisted. However, as announced on 31 August 2007, any decision to seek a listing of Lednium has been deferred pending greater clarity in relation to the validity of claims regarding the potential breach of third parties' patents. Further details on this are set out in section 6.1 below.

Mr Trahar and Mr Favretto (the Continuing Shareholders) currently control an approximate combined 60.3 percent interest in Avatar's voting shares and are also both directors of the Company.

The Capital Return is independent of the Arlec Sale and is scheduled to occur before shareholders' approval is sought for the Arlec Sale. However, the value of the Arlec business has been taken into account in determining the final amount to be paid to the Exiting Shareholders on completion of the Capital Return.

The terms and conditions of the Capital Return, the Lednium Share Distribution and the Arlec Sale are discussed in further detail in Section 3 of this report and in depth in the shareholder meeting documentation to which this report is attached.

There is no statutory requirement for Avatar to commission an independent expert report in the present circumstances. However, in order to ensure that Avatar shareholders are fully informed in making any decision as to whether or not to support the Capital Return, Avatar's independent directors have requested KPMG Corporate Finance (Aust) Pty Ltd (KPMG) to complete an independent expert report as to whether the Capital Return is fair and reasonable to all Avatar shareholders, that is, to both the Exiting Shareholders and the Continuing Shareholders.

Similarly, we have been advised there is no statutory requirement for Avatar to commission an independent expert report for the Arlec Sale. Avatar's Directors have not asked us to form an opinion on the Arlec Sale.

Avatar is now seeking approval of its shareholders for the Capital Return. The specific terms of the resolution to be approved are set out in the meeting documentation to which this report is attached.

2 Summary and conclusion

2.1 Summary of opinion

In our opinion the Capital Return is, on balance, fair and reasonable to Avatar's Exiting Shareholders

In forming this opinion, our assessed value for a share in Avatar, excluding Lednium, was the primary matter that needed to be considered. This value for an Avatar share, excluding Lednium, was key to assessing whether the consideration under the Capital Return reflected a fair return for Exiting Shareholders.

Our assessment of the key issues considered in forming our opinion, and the issues that Exiting Shareholders should consider in deciding whether to support the Capital Return, are summarised below and discussed in more detail in the remainder of this report.

The Capital Return is fair as the cash consideration falls within our range of assessed fair values for an Avatar share (excluding Lednium)

- We have assessed the fair value of Avatar, excluding the value of Lednium, to lie in the range of $136.6 million to $147.0 million, or approximately $1.74 to $1.88 per diluted Avatar share, which compares to the cash consideration to be paid to Exiting Shareholders of $1.83. As $1.83 lies within our range of assessed values for an Avatar share, excluding Lednium, we consider the cash consideration of $1.83 to be paid to Exiting Shareholders to be fair.

  We also note that the closing price for an Avatar share on the trading day prior to the date of this report was $1.78. This price includes the value of Lednium and lies below the cash consideration under the Capital Return of $1.83.

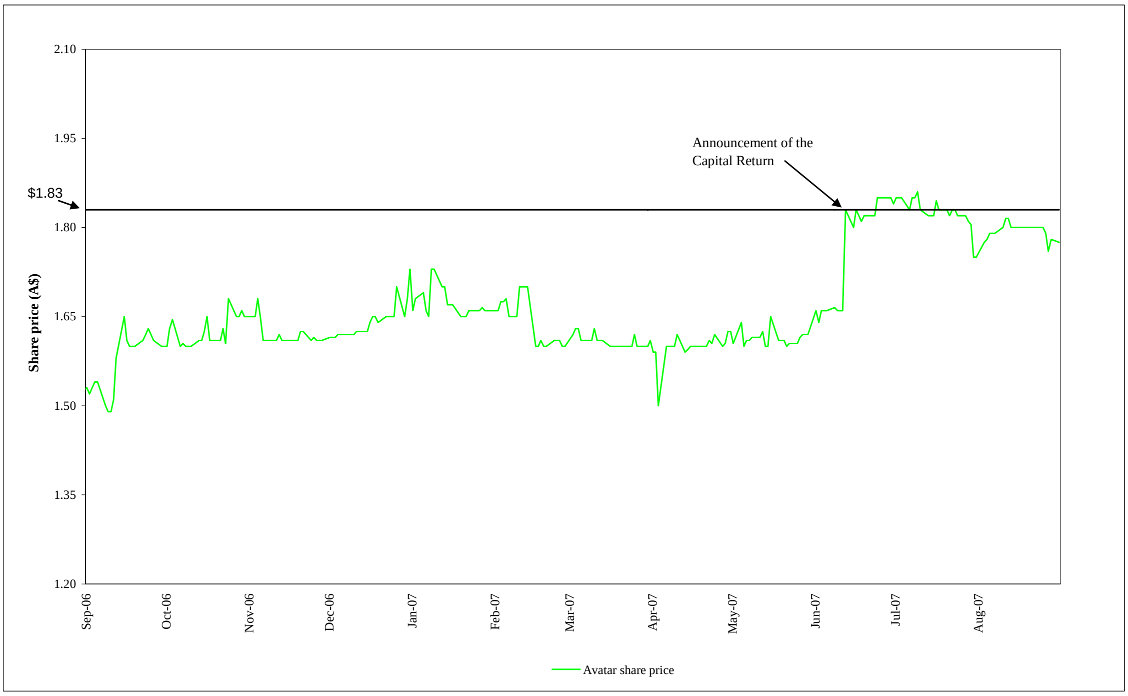
Other factors for consideration by Exiting Shareholders

We have also considered whether there are any significant factors relating to the Capital Return which suggest that Exiting Shareholders should accept the Capital Return in the absence of a higher offer. The principal factors considered by us are detailed below.

- Exiting Shareholders will receive a premium to the Company's historical share price. The 90-day volume weighted average price (VWAP) to the last trading day prior to the announcement of the Capital Return on 29 June 2007 was $1.58 per share. The VWAP for the period 29 June 2007 to 18 September 2007, being the last trading day prior to the date of this report, was $1.81 per share. Exiting Shareholders have an opportunity to receive $1.83 per share in cash. In addition, Exiting Shareholders will receive an in-specie distribution of one share in Lednium Limited, the company that will own the Lednium business, for every one Avatar share currently held.

  The graph below shows Avatar's historical share price for the 12 months to 18 September 2007 compared to the $1.83 cash component of the Capital Return.

Figure 1: Avatar share price versus $1.83 cash component of Capital Return



Source: Bloomberg

- The Capital Return provides an opportunity for Exiting Shareholders to immediately realise their interest in Avatar, without incurring transaction costs, as it involves the return and cancellation of Avatar shares rather than the on market sale of Avatar shares and therefore does not incur brokerage fees.

- The Capital Return provides an opportunity for Exiting Shareholders to immediately realise their interest in Avatar without incurring any realisation or liquidation costs that would otherwise be incurred by Avatar in winding up the Company.

- The Capital Return provides an opportunity for shareholders to make a clean exit from their investment in Avatar. In the absence of the agreement by the Continuing Shareholders to retain their proportionate interest in the Company, any returns of funds to Exiting Shareholders would likely be delayed as a result of Avatar's continuing obligations in relation to its contractual commitments and liabilities.

- The Capital Return provides an opportunity for Exiting Shareholders to exit from a relatively illiquid investment. Excluding the shareholdings of Mr Trahar and Mr Favretto (the Continuing Shareholders), who currently control an approximate combined 60.3 percent interest in Avatar's voting shares, only approximately 11 percent of Avatar's free float was traded in the six months prior to the announcement of the Capital Return.

- As Exiting Shareholders will maintain their current pro-rata interest in the Lednium business immediately following completion of the Capital Return, Exiting Shareholders will retain their current interest in any future capital growth or income from Lednium. Exiting Shareholders will retain the same pro-rata interest in the assets and undertakings of Lednium immediately following the completion of the Capital Return. We note that if Lednium does not list on ASX its capital raising options will be reduced.

- Messrs Trahar and Favretto currently hold approximately 60.3 percent of Avatar's issued share capital. Accordingly, even in the absence of the Capital Return, any takeover offer for the Company would require the support of Messrs Trahar and Favretto in order to be successful. Given the nature of Avatar's remaining businesses and assets, we do not consider it likely that an offer significantly in excess on that contemplated under the Capital Return is likely in the short term.

- As Exiting Shareholders will no longer hold any interest in Avatar or Arlec, Exiting Shareholders will not benefit in the event of any future capital growth or income from Avatar or the Arlec business that is being sold. Conversely, Exiting Shareholders will not be exposed in relation to any future claims or liabilities that may arise in relation to these businesses in the future.

- In the event the Capital Return is not approved, Avatar shareholders, other than Mr Trahar and his associated parties, will consider the Arlec Sale. We note that shareholders holding a significant percentage of potential voting shares have indicated in writing that they intend to vote in favour of the Arlec Sale in the event shareholders resolve not to approve the Capital Return.

- Avatar estimates that the total costs of implementing the Capital Return are likely to be in the order of $1.9 million. This consists of head office closure and head office staff termination costs of approximately $1.4 million and transaction costs of $0.5 million. We note that a portion of these costs will have been incurred, or committed, prior to the date that the shareholders will vote on the Capital Return and will be payable whether or not the Capital Return is approved.

- The alternative of retaining the Arlec business within Avatar after the implementation of the Capital Return was not considered feasible as Mr Favretto (and his controlled entities) indicated to the Company that they would not support the Capital Return if the Company was to retain an ongoing interest in Arlec.

In our opinion the Capital Return is, on balance, fair and reasonable to Avatar's Continuing Shareholders

In assessing whether Avatar's Continuing Shareholders are likely to be better off if the Capital Return proceeds than if it does not, we have considered the various advantages and disadvantages that are likely to accrue to them if the Capital Return proceeds as set out below.

- It provides the Continuing Shareholders with total control as opposed to majority control of Avatar. In addition, as a private company removed from the Official List of ASX, the Company will benefit from reduced administrative and compliance costs associated with a listing on ASX.

- The Continuing Shareholders will gain direct access to the remaining $70 million of cash and available for sale financial assets retained within Avatar. Whilst this does not represent an increase in value to the Continuing Shareholders, as these assets were taken into account by the Company in calculating the value of Avatar for the purpose of determining the consideration under the Capital Return, it allows the Continuing Shareholders future access to funds that are currently locked up in Avatar.

- With Avatar wholly owned by the Continuing Shareholders, the entire benefit of any future increase in the capital value of Avatar will flow to the Continuing Shareholders. Conversely, the Continuing Shareholders will be exposed to a greater extent to the impact of any future loss in capital value of Avatar.

- The Continuing Shareholders will own shares in an unlisted company which are less marketable than shares in a listed company.

- Approximately $10.4 million cash is held in Escrow by the solicitors acting on behalf of the purchaser of Avatar's mineral exploration drilling business in Australia (DrillCorp) in support of various warranties made by DrillCorp. In the event that any warranty claims or undisclosed contingent liabilities emerge under the terms of the DrillCorp sale agreement this could adversely impact the Continuing Shareholders.

- With Avatar wholly owned by the Continuing Shareholders and delisted from the ASX, Avatar's ability to raise future debt and/or equity funding may be adversely impacted.

2.2 Lednium

- We note that recently Lednium has received claims that the manner in which Lednium is using phosphor in its "white" cup and multidiode (turtle) products to produce white light are infringing certain patents of other parties. Avatar's Directors have advised the market that they are of the view that, in the context of the Avatar group as a whole, the claims are not material to the operations, results and state of affairs based on the evaluation of the claims made to date. However, the Avatar Board has decided to delay a decision on the proposed separate listing of Lednium pending completion of the further evaluation of the claims. Further details on this are set out in section 6.1 below.

- Mr Balu Jeganathan, the current Managing Director of Arlec and Lednium, will have principal responsibility for the day-to-day operations of Lednium following completion of the Capital Return and the Arlec Sale. It has been agreed that Mr Jeganathan will continue to devote up to 50 percent of his time in the capacity of a consultant to Arlec for a period of six months following completion of the Arlec Sale, after which he will work full time for Lednium. This will allow for increased focus of senior management on Lednium.

2.3 ATO Class Ruling

The Company has received a draft Class Ruling from the Australian Taxation Office (ATO) which indicates that the Capital Return will be treated as being approximately 65 percent capital and approximately 35 percent unfranked dividend for tax purposes.

Under the Capital Return, all shares in Avatar which are held by Exiting Shareholders will be cancelled. The consideration has been set at $1.91 per share. On the basis of currently available information and the draft ATO Class Ruling issued to the Company, the Company estimates that $1.25 per share will be treated as a capital amount and $0.66 per share will be treated as a dividend amount. This dividend amount will not be franked.

The final ATO Class Ruling will only be issued following implementation of the Capital Return. Only at that time will the precise capital amount and dividend amount be known. Further details on the draft ATO class ruling are set out in section 3 of the Explanatory Statement.

2.4 Taxation

In the event that the Capital Return is approved, Avatar shareholders will receive $1.91 per share comprising a cash component representing the net assets per share of the Company excluding those of the Lednium business ($1.83 per share based on completion at the end of November 2007) and shares in Lednium representing each Exiting Shareholder's current pro rata shareholding in Avatar (Lednium Share Distribution). Avatar expects Lednium will have net tangible assets of approximately 8 cents per Avatar share (including approximately 2.5 cents per share in cash) assuming that the Capital Return occurs at the end of November 2007.

Receipt of the funds will have differing taxation implications for individual Avatar shareholders depending upon their personal taxation circumstances including whether they hold their Avatar shares on capital or revenue account, their tax residency status and the type of taxpayer they are.

Avatar shareholders are strongly encouraged to read the outline of the taxation implications of approving the Capital Return prepared by Avatar, which is included in the Explanatory Statement to which this report is attached at Section 3 and, if in any doubt, should seek their own independent taxation advice regarding the taxation consequences of the Capital Return.

2.5 General warning advice

This letter is a summary of KPMG's opinion as to the merits or otherwise of the Capital Return. This opinion should be read in conjunction with, and not independently of, KPMG's detailed report and appendices as attached.

In forming our opinion, we have separately considered the interests of Avatar's Exiting Shareholders as a whole and the Continuing Shareholders as a whole. The advice does not consider the financial situation, objectives or needs of Avatar's individual shareholders. It is not practical or possible to assess the implications of the Capital Return on individual shareholders, as we do not know their specific financial circumstances.

The decision of Avatar's shareholders as to whether or not to vote in favour of the Capital Return is a matter for individual shareholders based on, amongst other things, their risk profile, liquidity preferences, investment strategy and tax position. Individual Avatar shareholders should therefore consider the appropriateness of our opinion to their specific circumstances before acting upon it.

As an individual's decision to vote for or against the Capital Return may be influenced by his or her particular circumstances, we strongly recommend that individual shareholders consult their financial and/or taxation adviser.

Our report has been prepared in accordance with the relevant provisions of the Corporations Act (the Act) and other applicable Australian regulatory requirements. We recommend residents of foreign jurisdictions who are entitled to receive this report and who are uncertain as to the consequences of this seek their own independent professional advice.

This report has been prepared solely for the purpose of assisting Avatar shareholders in considering the Capital Return. We do not assume any responsibility or liability to any party as a result of reliance on this report for any other purpose, including but not limited to investment or lending decisions in relation to Avatar.

Neither the whole nor any part of this report or its attachments or any reference thereto may be included in or attached to any document, other than the meeting documentation to be sent to Avatar shareholders in relation to the Capital Return, without the prior written consent of KPMG as to the form and context in which it appears. KPMG consents to the inclusion of this report in the form and context in which it appears in the meeting documentation.

Yours faithfully

J Hughes

D Calder

Jason Hughes	Duncan Calder
Executive Director	*Executive Director*

FINANCIAL SERVICES GUIDE

Dated 19 September 2007

KPMG Corporate Finance (Aust) Pty Ltd ABN 43 007 363 215 (KPMG or **we** or **us** or **our** as appropriate) has been engaged to issue general financial product advice in the form of a report to be provided to you.

Financial Services Guide

In the above circumstances we are required to issue to you, as a retail client, a Financial Services Guide (**FSG**). This FSG is designed to help retail clients make a decision as to their use of the general financial product advice and to ensure that we comply with our obligations as financial services licensees.

This FSG includes information about:

- Who we are and how we can be contacted
- The services we are authorised to provide under our **Australian Financial Services Licence, Licence No: 246901**
- Remuneration that we and/or our staff and any associates receive in connection with the general financial product advice
- Any relevant associations or relationships we have
- Our complaints handling procedures and how you may access them.

Financial services we are licensed to provide

We hold an Australian Financial Services Licence, which authorises us to provide financial product advice in relation to:

- Interests in managed investments schemes (excluding investor directed portfolio services)
- Securities (such as shares and debentures).

We provide financial product advice by virtue of an engagement to issue a report in connection with a financial product of another person. Our report will include a description of the circumstances of our engagement and identify the person who has engaged us. You will not have engaged us directly but will be provided with a copy of the report as a retail client because of your connection to the matters in respect of which we have been engaged to report.

Any report we provide is provided on our own behalf as a financial services licensee authorised to provide the financial product advice contained in the report.

General Financial Product Advice

In our report we provide general financial product advice, not personal financial product advice, because it has been prepared without taking into account your personal objectives, financial situation or needs.

You should consider the appropriateness of this general advice having regard to your own objectives, financial situation and needs before you act on the advice. Where the advice relates to the acquisition or possible acquisition of a financial product, you should also obtain a product disclosure statement relating to the product and consider that statement before making any decision about whether to acquire the product.

Benefits that we may receive

We charge fees for providing reports. These fees will be agreed with, and paid by, the person who engages us to provide the report. Fees will be agreed on either a fixed fee or time cost basis.

Except for the fees referred to above, neither KPMG, KPMG's Australian professional advisory and accounting practice (the KPMG Partnership) nor any of its directors, employees or related entities, receive any pecuniary benefit or other benefit, directly or indirectly, for or in connection with the provision of the report.

Remuneration or other benefits received by our employees

All our employees receive a salary. Our employees are eligible for bonuses based on overall productivity but not directly in connection with any engagement for the provision of a report.

Referrals

We do not pay commissions or provide any other benefits to any person for referring customers to us in connection with the reports that we are licensed to provide.

Associations and relationships

Through a variety of corporate and trust structures KPMG is ultimately controlled by and operates as part of the KPMG Partnership. Our directors may be partners in the KPMG Partnership.

From time to time KPMG, the KPMG Partnership and/or entities related to the KPMG Partnership may provide professional services, including audit, tax and financial advisory services, to financial product issuers in the ordinary course of its business.

Complaints resolution

Internal complaints resolution process

As the holder of an Australian Financial Services Licence, we are required to have a system for handling complaints from persons to whom we provide financial product advice. All complaints must be in writing, addressed to The Complaints Officer, KPMG, PO Box H67, Australia Square, Sydney NSW 1213.

When we receive a written complaint we will record the complaint, acknowledge receipt of the complaint within 15 days and investigate the issues raised. As soon as practical, and not more than **45 days** after receiving the written complaint, we will advise the complainant in writing of our determination.

Referral to External Dispute Resolution Scheme

A complainant not satisfied with the outcome of the above process, or our determination, has the right to refer the matter to the Financial Industry Complaints Service Limited (**FICS**). FICS is an independent company that has been established to provide free advice and assistance to consumers to help in resolving complaints relating to the financial services industry.

Further details about FICS are available at the FICS website www.fics.asn.au or by contacting them directly at Financial Industry Complaints Service Limited, PO Box 579, Collins Street West, Melbourne VIC 8007

Toll free: 1300 78 08 08
Facsimile: (03) 9621 2291

Contents of the remainder of KPMG's report

The remainder of this independent expert's report is set out below under the following headings:

3 Background to the Arlec Sale and Capital Return

On 29 June 2007, Avatar announced that:

- it had entered into an agreement for the sale of its Arlec consumer products business to Sonsam Pty Ltd (Sonsam), an entity associated with Mr Ian Trahar, for a cash consideration effectively representing the net tangible assets of Arlec at the date of completion

- in consideration for the return and subsequent cancellation of the shares of the Exiting Shareholders, it intends to complete the Capital Return, comprising the payment of $1.83 in cash to Exiting Shareholders and an in-specie distribution of shares in Lednium such that the current pro-rata interests of Exiting Shareholders in Lednium's business is maintained immediately following completion.

Following completion of the Capital Return and the Arlec Sale, Exiting Shareholders will no longer have any interest in the residual assets and liabilities remaining in Avatar or in its future operations and the Company will be delisted from the Official List of ASX.

3.1 Arlec Sale

The principal terms for the Arlec Sale include:

- Sonsam will acquire all of the Arlec business' tangible assets, other than cash, trade debtors and other debtors, for their carrying value at the date of completion. In addition, Sonsam will assume the obligation in relation to all employee entitlements and also all product warranty, defective product and like claims made against Arlec, irrespective whether such claims arise out of products sold by the Arlec business prior to or following completion.

- Avatar will be entitled to the benefit of all cash, trade debtors and other debtors on hand at the completion date and will be responsible for the payment of all liabilities other than employee entitlements.

- Avatar is entitled to retain the benefit of the Arlec business' trading results in the period between the date of execution of the sale agreement on 28 June 2007 and the final completion date.

- Title to and risk of the assets and the Arlec business shall remain with Avatar until the date of completion.

- Sonsam's obligations under the sale agreement are guaranteed by Gabor Holdings Pty Ltd (Gabor). We are advised the Directors have satisfied themselves that Gabor has sufficient funds to satisfy any future obligation of Sonsam in relation to the Arlec Sale.

Based on Avatar's forecast balance sheet as at 30 November 2007 prepared by Avatar management, the expected net sales proceeds to be received from Sonsam are approximately $10.4 million, whilst Avatar's net receivable position (after deducting the carrying value of liabilities other than employee entitlements) was approximately $5.3 million, representing a total realisable value for the Arlec business of approximately $15.7 million.

An amount equal to the estimated purchase price to be paid by Sonsam is payable to Avatar on the date of the completion, with the final purchase price subject to final completion adjustments.

The Arlec Sale is conditional on:

- Arlec and Avatar shareholder approval being obtained (to the extent required) under the related party and sale of main undertaking provisions of the Act and the Listing Rules of ASX.

- The discharge or release of the Arlec assets being sold from existing registered charges over Arlec, Level 2 Distribution Pty Limited (Level 2 Distribution) and Antenna Signal Pty Ltd (Antenna) (Level 2 Distribution and Antenna are subsidiaries of Avatar group).

- The warranties provided under the sale agreement by Arlec, Level 2 and Antenna being materially true and correct and there being no material breach of the same which has a material adverse effect on the on-going operations or earnings of the Arlec business.

- No material adverse change in the operations and profitability of the Arlec business.

The final date for satisfaction or waiver of these conditions is 30 November 2007, or such later date as is agreed between the parties.

As outlined at section 4 of the Explanatory Statement, the alternative of retaining the Arlec business within the corporate group of Avatar after the implementation of the Capital Return was not considered feasible as Mr Paul Favretto (and his associated entities) indicated to the Company that he would not support the Capital Return if the Company was to retain an ongoing interest in the Arlec business.

3.2 Capital Return

The Capital Return will comprise:

- the distribution to Exiting Shareholders of $1.83 cash per share, based on completion at the end of November 2007

- the distribution to all Avatar shareholders of shares in Lednium such that each shareholder's current pro rata shareholding in Avatar is maintained immediately following completion of the Capital Return. Lednium is expected to have net tangible assets of approximately 8 cents per Avatar share (including approximately 2.5 cents in cash), again assuming the Capital Return occurs at the end of November 2007

- the cancellation of all shares held by Exiting Shareholders.

Following completion of the Capital Return, it had been intended that Lednium would seek to complete a separate equity raising and listing on the Official List of ASX in the short term, while Avatar would be delisted. However, as announced on 31 August 2007, any decision to seek a listing of Lednium has been deferred pending greater clarity in relation to the validity of claims regarding the potential breach of third parties' patents. Further details on this are set out in section 6.1 below.

The Capital Return is independent of the Arlec Sale and is scheduled to occur before shareholders' approval is sought for the Arlec Sale. However, the value of the Arlec business has been taken into account in determining the amount to be paid to the Exiting Shareholders in completing the Capital Return.

ATO Class Ruling

The Company has received a draft Class Ruling from the ATO which indicates that the Capital Return will be treated as being approximately 65 percent capital and approximately 35 percent unfranked dividend for tax purposes. The final ATO Class Ruling will only be issued following implementation of the Capital Return. Only at that time will the precise capital amount and dividend amount be known.

4 Basis of assessment

This report has been prepared by KPMG for inclusion in the Explanatory Statement to be sent to Avatar shareholders to convene a meeting of Avatar shareholders on or about 31 October 2007 in accordance with, inter alia, Section 256B of the Act. The purpose of the meeting will be to seek approval, amongst other things, of the Capital Return.

There is no statutory requirement for Avatar to commission an independent expert report for the Capital Return. However, in order to ensure that Avatar shareholders are fully informed in making any decision as to whether or not to support the Capital Return, Avatar's independent directors have requested KPMG to complete an independent expert report as to whether the Capital Return is fair and reasonable to all Avatar shareholders, that is, to both the Exiting Shareholders and the Continuing Shareholders.

Similarly, we have been advised there is no statutory requirement for Avatar to commission an independent expert report for the Arlec Sale. Avatar's Directors have not asked us to form an opinion on the Arlec Sale.

4.1 Technical requirements

Section 256B of the Act provides that a company may reduce its share capital by way of selective capital reduction where the reduction:

- is fair and reasonable to the company's shareholders as a whole
- does not materially prejudice the company's ability to pay its creditors
- is approved by the company's shareholders.

Section 256C of the Act requires that a selective capital reduction be approved by a special resolution at a general meeting of a company with no votes in favour of the resolution being passed by any person who is to receive consideration as part of the reduction, or a resolution agreed to, at a general meeting by all ordinary shareholders.

In addition, the reduction must be approved by a special resolution passed at a separate meeting of the Exiting Shareholders whose shares are to be cancelled.

Whilst the terms of the selective capital reduction do not technically require an independent expert report to be prepared, in order to ensure that Avatar shareholders are fully informed as to whether or not to support the Capital Reduction, the Independent Directors of Avatar have requested KPMG to prepare an impendent expert report as though it were required.

In considering the most appropriate criteria upon which to assess the proposed Capital Return, we have had principal regard to Regulatory Guide 74 "Acquisitions agreed to by Shareholders" issued by the Australian Securities and Investments Commission (ASIC) as if shareholders were voting on a resolution under section 611 of the Act.

In relation to transactions to be approved under Section 611 of the Act, Regulatory Guide 74 requires that shareholders be provided with a report assessing whether the transaction is fair and reasonable when considered in the context of the interests of the non-associated shareholders.

The term "fair and reasonable" has no legal definition. Regulatory Guide 74 provides that an assessment of whether a transaction requiring approval is fair and reasonable should involve an analysis of the advantages and disadvantages likely to accrue to the non-associated shareholders if the proposed transaction proceeds. This implies that fairness and reasonableness should be assessed as a single concept. Accordingly, we consider that the terms of the selective capital reduction will be fair and reasonable if the non-associated shareholders would be better off if the selective capital reduction, and therefore the proposed transaction, proceeds than if it does not.

4.2 Factors considered in determining our opinion

In forming our opinion, we have considered in particular the following issues:

- the assessed value of an ordinary share in Avatar, excluding Lednium, compared with the cash consideration to be received under the Capital Return
- the liquidity of the market for Avatar shares
- the likelihood of an alternative offer emerging for Avatar
- any conditions associated with the Capital Return
- the consequences of not approving the Capital Return

- other advantages and disadvantages which may impact Avatar shareholders if the Capital Return proceeds.

4.3 *Sources of information*

In preparing this report and arriving at our opinions, we have considered a number of sources of information as detailed in Appendix 2 to this report.

The statements and opinions expressed in this report are made in good faith and have been based on information believed to be reliable and accurate. We have relied upon the information set out in Appendix 2 and have no reason to believe that any material factors have been withheld from us. The preparation of this report does not imply that KPMG or any of its affiliates have carried out any form of audit on the accounting or other records of any entity within the Avatar group of companies, their investments or associates.

The information provided to KPMG included financial and operational projections prepared by the management of Avatar. Prospective results are by their nature uncertain and are dependent on a number of future events, which cannot be guaranteed. Accordingly, achievement of these projections is not warranted or guaranteed by KPMG or Avatar. Actual results may vary significantly from the prospective information relied on by KPMG. Any variations from prospective results may affect our opinion.

The opinion of KPMG is based on prevailing market, economic and other conditions at the date of this report. It should be noted that conditions can change over a relatively short period of time and that our findings should be considered in light of any such changes. Any subsequent changes in these conditions could impact upon our assessments, either positively or negatively.

It is not the role of the independent expert to undertake the commercial and legal due diligence that a company and its advisers may undertake. The Independent Directors of Avatar, together with the Company's legal advisers, are responsible for conducting due diligence in relation to the Capital Return. KPMG provides no warranty as to the adequacy, effectiveness or completeness of the due diligence process, which is outside our control and beyond the scope of this report. We have assumed that the due diligence process has been and is being conducted in an adequate and appropriate manner. The directors have further advised us that their due diligence procedures have not, to date, identified any material issues not disclosed to KPMG.

5 Profile of the principal industries in which Avatar operates

Avatar's two remaining trading businesses operate in the consumer products distribution sector (Arlec) and in the manufacture and distribution of Light Emitting Diode (LED) products (Lednium).

To provide context for assessing the prospects of Avatar's operating businesses, we have included at Appendix 3 an overview of recent trends in the consumer electrical products and electrical lighting industries.

6 Profile of Avatar

6.1 Corporate background

The Company was incorporated in Western Australia on 20 November 1970 as Osborne Metals Ltd and was admitted to the Official List of ASX on 1 June 1979. The Company changed its name to Barrack Industries Limited on 5 October 1989 and its current name was adopted on 8 January 1993.

The business operations of Avatar have changed significantly since its incorporation as a result of various business acquisitions and divestments. Some of the sectors in which the Company has been previously but is no longer involved in include:

- building products
- fuel distribution and retail
- printing
- manufacture and sale of office furniture, compost tumblers, gas room heaters and hot water heaters
- mineral exploration drilling.

Over the period 1998 to 2000, Avatar witnessed a significant deterioration in its trading environment and the competitive profile of the industries in which many of its businesses at that time competed. This, coupled with relatively high levels of debt carried by the Company, created a crisis of confidence in the market as to Avatar's prospects and, in turn, a sharp decline in the Company's share price.

In response, Avatar developed a recovery plan based on substantially reducing debt through asset sales. As a result the number of Avatar's operational business units was reduced from nine as at 30 June 1999 to three by the end of 2002. These remaining businesses comprised Arlec, its mineral exploration drilling business in Australia and Africa (DrillCorp), and its barbeque manufacturing business (Sunshine Barbeques). In addition, Avatar had commenced the research and development of a new LED lighting technology through Lednium.

Despite significantly improved overall trading results in the immediate period following its restructuring, Avatar's performance continued to be adversely impacted by the disappointing results of its barbeque business, largely reflecting uncompetitive manufacturing operations in Malaysia and difficult trading conditions in the United States (US) and Europe. As a result, the Company decided during the year ended 30 June 2005 to close of its manufacturing operations in Malaysia and also to withdraw from the US market.

In addition, the Company entered into an agreement for the sale of the South African arm of its mineral exploration drilling business, principally due to the adverse impact of black empowerment policies in that country and the effective high tax rates for Australian shareholders.

During the 2006 financial year, Avatar resolved to take advantage of buoyant conditions in the mineral drilling services industry and private equity markets through the sale of DrillCorp's Australian operations to Boart Longyear, realising a significant profit on disposal at completion. In contrast, Avatar's barbeques business continued to record disappointing results, which ultimately led the closure of the Company's operations in the United Kingdom (UK) and Europe in February 2007.

Today, Avatar has two remaining trading businesses, being its consumer products business, Arlec and its LED lighting business, Lednium.

Since the sale of its DrillCorp operations in Australia, Avatar has been engaged in a process of assessing a range of opportunities and processes for maximising the return of surplus assets to the shareholders and optimising the value of the Arlec business and the potential of the Lednium business. Avatar continues to be of the view that current conditions in the equity market are restricting new value adding investment opportunities. As such, the Board has formed the view that it is in the interests of shareholders to return the excess capital to shareholders.

On 28 June 2007, the Company agreed to the sale of its Arlec business to Sonsam for a price approximating the Arlec business' net tangible assets. As at 17 September 2007, the sale proceeds expected to be received from Sonsam for the Arlec business were approximately $10.4 million, with further net assets of $5.3 million to be collected directly by Avatar.

In relation to Lednium, it is intended that this business will be 'spun-out' by way of the Lednium Share Distribution, with each Exiting Shareholder retaining the same pro-rata interest as they currently hold in the Company immediately following the Capital Return.

In considering the Lednium Share Distribution, the Board considered whether the Lednium and Arlec businesses should be retained within the same listed entity. However, it was thought that notwithstanding that the Lednium business had historically been incubated within Arlec, Lednium now operates as a separate entity with a different business model in terms of its products, market and operational activities, capital, people and infrastructure needs and growth prospects and development cycle. Furthermore, Lednium already has access to Arlec's existing distribution infrastructure to distribute its products in Australia and New Zealand through a distribution agreement on similar terms to Optek, Lednium's exclusive distributor for North America and Europe.

As such, the Avatar Board is of the view that Company shareholders will realise greater value for their investment in this business if Lednium:

- is separately operated as a 'pure' LED technology business
- can raise the equity capital it requires for the development and commercialisation of its LED technology directly from the market
- is free from the residual assets and contingent liabilities (including warranties and tax) arising from Avatar's previous discontinued business interests.

Following completion of the Capital Return, it had been intended that Lednium would seek to complete a separate equity raising and listing on the Official List of ASX in the short term, while Avatar would be delisted. However, as announced on 31 August 2007, any decision to seek a listing of Lednium has been deferred pending greater clarity in relation to the validity of claims regarding the potential breach of third parties' patents. Consequently, until this evaluation of the claims in completed the claims create uncertainty as the value and future prospects of the Lednium business.

An overview of Arlec, its sale process and Lednium is set out below.

Arlec

The principal operating companies within the Arlec group comprise:

- Arlec and Antenna, which are engaged in the development, sourcing, marketing, distribution and sale in Australia of various consumer and trade products

- Q1 Pacific Holdings Pty Ltd and its subsidiaries, which run consolidation and "free on board" sales (and related operations) in the People's Republic of China (China) and Hong Kong to support the operations of Arlec and Antenna

Level 2 owns stock that was previously purchased by Arlec for sale to its customers but because of the slow moving nature of that stock was sold to Level 2 and since that time Arlec has held and endeavoured to sell that stock on a consignment type basis.

Arlec's business model is to source electrical, gas and other consumer products in Asia (particularly China) for distribution into the Australian and New Zealand retail and trade markets primarily under the Arlec (hardware and electrical) and Ansig brands. Arlec also distributes barbeques directly from Asia into Australia.

Arlec's main Australian headquarters are in Mooroolbark, Victoria. There are also warehouse facilities in Perth, Western Australia and Laverton, Victoria, as well as an office and showroom in Sydney, New South Wales.

In addition, Arlec manages two locations in China – one main site in Shanghai and a second representative office in Chiwan, southern China. The facilities in China operate as consolidation centres, which facilitate the packaging and shipping of mixed product lines directly to customers in Australia. This process has reduced Arlec's shipping and warehouse costs and improved product sourcing in terms of pricing, consistency of quality and timeliness of delivery.

Major customers of Arlec include mass retailers like the Coles Group, Big W and Metcash, hardware retailers such as Bunnings, Mitre 10 and Danks, automotive accessories retailers such as Repco and Supercheap Auto and speciality retailers like Dick Smith.

Over time, Avatar had pursued a number of growth strategies through product and category expansion seeking to leverage off Arlec's infrastructure and brand. In doing so, Arlec expanded into a number of consumer electrical product categories outside its historical core categories of lighting and electrical accessories with mixed success.

Products distributed by Arlec have included:

- electrical products, such as leads and powerboards, torches and batteries, lighting (outdoor, work and entertainment), exhaust fans and other electrical accessories
- audio & visual products, such as antennas and audio visual accessories
- trade products, such as wiring, cables and transformers
- household products, such as lamps and appliances, cooling products (including ceiling fans) and portable air conditioners
- power and air tools
- barbeques into Australia.

Early in 2006, the Board recognised that its strategy of product expansion was not yielding the results anticipated for a number of reasons, including the on-going consolidation in the Australian retail sector placing margin pressure on smaller manufacturers/suppliers and a fundamental change in the nature of the supply chain with retailers increasingly sourcing products directly from Asia. In response, Arlec discontinued some product categories including non-portable air conditioners as well as some hardware and heating products, so that the business could concentrate on its core traditional electrical products categories and focus on bringing its cost structure more in line with a narrower product range.

Whilst this strategy is showing early signs of success, the Board has formed the view (having regard to the decision to return the surplus generated from the sale of DrillCorp and the seeking the spin out of Lednium) that Arlec's size, growth profile and history of volatile earnings does not support it remaining as what would effectively be a stand alone listed business within the Avatar corporate shell.

Accordingly, PricewaterhouseCoopers Securities Ltd (PwCS) was appointed in February 2007 to sell the Arlec business. This followed several attempts by the Company in the preceding 3 years to sell the business. Of the 55 potential third party purchasers approached by PwCS in relation to the potential divestment of Arlec, 27 entered into confidentiality agreements to receive an Information Memorandum, of which in turn only two parties lodged indicative offers. One of these offers was later withdrawn and the other, from an industry participant, was significantly reduced following the review of further detailed financial and operational information. This reduction effectively based the purchase price on the net tangible assets of Arlec, but with a cap on the value to be ascribed to stock, excluded all stock over two years old and included the payment of approximately 50 percent of the purchase price on unsecured interest free terms (the Third Party Proposal).

We are advised that two principal reasons were consistently advised to PwCS by parties not wishing to pursue an acquisition of Arlec, being the current industry dynamics in which Arlec operated and Arlec's recent disappointing financial performance. These views were expressed notwithstanding the Company's internal expectations in relation to a projected improvement in earnings.

During the sale process an offer was also received from Sonsam, an entity controlled by Mr Ian Trahar, offering an effective purchase price of the net tangible assets of the Arlec business payable in cash on completion.

The directors (other than Mr Trahar) reviewed the offers from Third Party and Sonsam assessing the issues, risks and benefits associated with each and noted the following:

- The purchase price under the Third Party Proposal was approximately $200,000 less than the purchase price under the Sonsam offer (based on Arlec's balance sheet at the time) and was subject to a cap on stock value.

- The Sonsam offer was effectively more certain as the Third Party Proposal remained conditional on the Third Party being satisfied with the results of future due diligence enquiries into the Arlec business (including in respect of the value of stock and plant and equipment). In comparison the Sonsam offer provided for the purchase the Arlec business based on NTA as recorded in Arlec's books subject only to a physical stock take.

- The Sonsam offer provided for Avatar to retain the benefit of all Arlec earnings up to completion of the sale, which, based on the likely dates for completion of each sale under each offer, was in the Directors' view likely to result in an increased return to Avatar shareholders.

- The purchase price payment terms under the Third Party Proposal were less attractive than those offered under the Sonsam offer, with the Third Party Proposal based on an initial part payment on completion, with the balance of the purchase price payable on an unsecured interest free basis at a later date. In comparison the Sonsam offer provided for the full purchase price to be paid on completion (subject to later completion adjustment), guaranteed by Gabor.

- The Sonsam offer provides for Sonsam to assume responsibility for all product and warranty claims against Arlec from the date of completion, whether or not those claims relate to the trading of Arlec prior to completion of the sale.

In the view of the above, the Board concluded that the offer from Sonsam was superior to the Third Party Proposal in terms of the price offered, the payment terms and the certainty of outcome for the Company given its intention to seek to return surplus capital to shareholders. Accordingly, an agreement in relation to the Arlec Sale was entered into on 28 June 2007.

Lednium

Avatar established Lednium in 1999, originally as a division of Arlec, to assess and develop LED solid-state lighting components and technology. The Company's development activities culminated in the establishment in 2004 of the discrete Lednium business unit. Lednium commenced the commercialisation of its LED technology in late 2005, based on a 9-diode dome shaped lighting devices encapsulated in aluminium to be produced initially by a dedicated sub contract factory in Penang, Malaysia. In July 2006 Lednium established its own manufacturing facility in Penang, Malaysia.

Today, Lednium researches, develops, manufactures, markets and distributes LED based components for lighting applications. Avatar believes that Lednium's technology is suitable for a wide range of industries and lighting applications including:

- architectural, automotive and aviation
- deep mining
- medical
- general illumination.

During the first half of 2006, Lednium determined that its strategic and operational interests would be better served by establishing its own manufacturing facility in Penang, Malaysia. The move to a company owned manufacturing facility was completed in July 2006 at a cost of $2.4 million. Since then additional automated production and testing equipment has been installed and production processes fine-tuned.

Currently, the Lednium business offers a range of single diode (cup) and multi diode (matrix) LED components and a range of truck and trailer rear and side marker lighting products, garden and nightlights. Furthermore, a range of Lednium designed and powered garden torches are also scheduled to be released to the market in the next few months. Lednium is developing replacement lamps for halogen and incandescent lamps and a range of architectural lighting that features the benefits of LED lighting and Lednium products.

As disclosed in the Avatar's Financial Report for the year ended 30 June 2007, since the close of the financial year and the announcement of the proposed Capital Return Lednium has received claims that Lednium and the manner in which phosphor is used in the "white" cup and multidiode (turtle) products to produce white light are infringing certain patents of other parties. The claims do not, however, allege that Lednium's proprietary "cup" and "turtle" technology (which is the subject of granted patents and pending patent applications) itself, or that other coloured "cups" and "turtles" that do not use phosphor, otherwise might infringe the other parties' patents.

The claims extend to patents in various overseas countries and are in the process of being evaluated. As the claims involve complex technical and legal issues arising from patents in a number of different jurisdictions it may take a number of months to fully evaluate them and the implications for the Lednium business. Consequently until that evaluation is completed the claims create uncertainty as to the value and future prospects of the Lednium business.

The Avatar Directors have stated that they are of the view that, in the context of the Avatar group as a whole, the claims are not material to the operations, results and state of affairs based on the evaluation of the claims made to date. However the Avatar Board has decided to delay a decision on the proposed separate listing of Lednium pending completion of the further evaluation of the claims.

The Avatar Directors have also stated that they do not view the claims (whether valid or not) as an impediment to the proposed Capital Return. The Capital Return is expected to proceed shortly after receipt of a favourable tax ruling and requisite shareholder approval. The Capital Return will include a distribution of Lednium shares to all exiting shareholders on a pro rata basis, and ensures that all shareholders continue to hold the same interest in the Lednium business after the Capital Return as they held in Avatar prior to the Capital Return becoming effective.

We are advised that any claim against Lednium is quarantined to that business, in which Exiting Shareholders will retain their pro rata interest following completion of the Capital Raising, and therefore does not impact other assets of the Avatar Group and in any event, given the Lednium business is still in the commercialisation phase and revenues for the 2007 financial year were approximately $0.6 million, is unlikely to be material in amount.

Lednium has a distribution arrangement with Optek Inc, a subsidiary of global electronics company TT electronics plc, to manufacture a broad range of advanced electronic components, assemblies and sensor modules for various markets in North America and Europe.

We note that Lednium has recently entered into two agreements with Arlec:

- A distribution agreement pursuant to which Arlec is appointed the exclusive distributor of Lednium products in Australia and New Zealand. We have been advised that this agreement including the pricing of Lednium products is substantially on the same terms and conditions as that which currently exist between Lednium and Optek Inc in respect of North America and Europe and those that have been provided to other parties with whom Lednium is in the process of negotiating distribution arrangements. The distribution agreement with Arlec can be terminated by either party on six months notice at any time after the expiry of the first anniversary of the agreement.

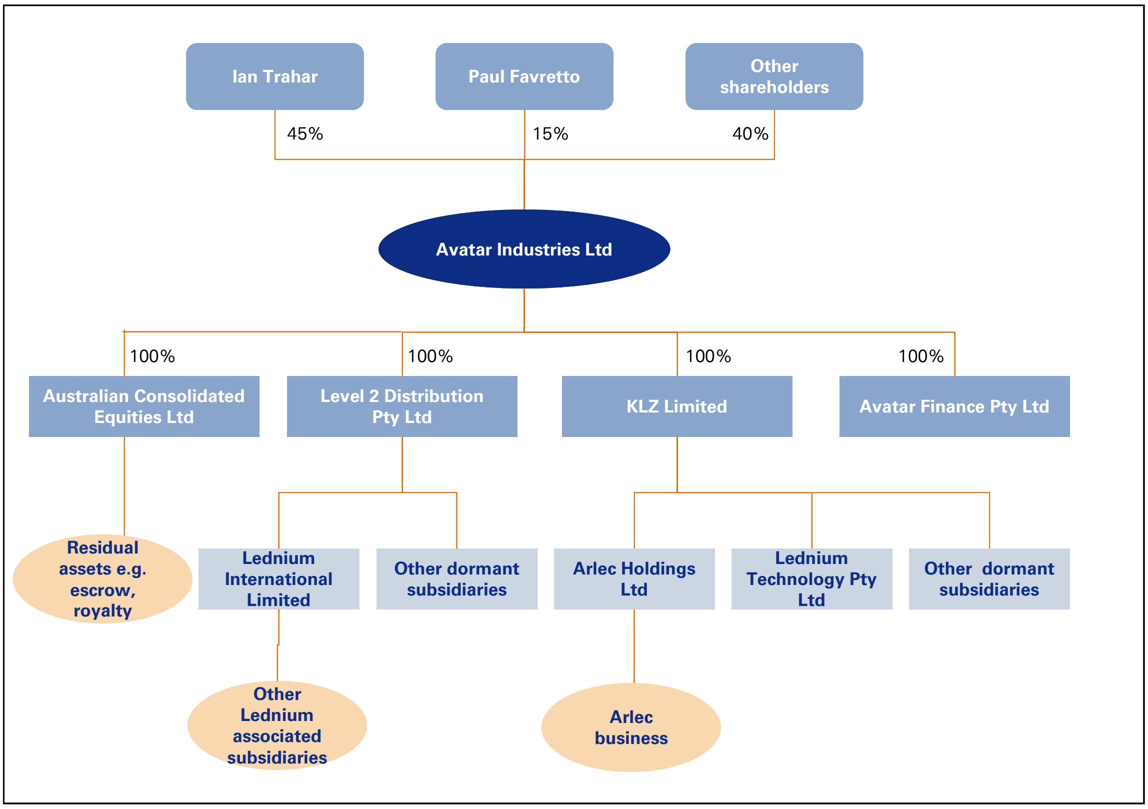
- An agreement pursuant to which Arlec will provide serviced offices to Lednium staff (currently 2 persons) at Mooroolbark, Melbourne on a cost recovery basis (estimated at approximately $2,000 per month). This agreement will be able to be terminated by either party on four months notice.

Given Exiting Shareholders will retain the same pro-rata interest in the assets and undertakings of Lednium immediately following the completion of the Capital Return, it is not necessary for KPMG to form a view as to the likely prospects and opportunities of the Lednium business and has not done so although we note that if Lednium does not list on ASX its capital raising options will be reduced.

6.2 *Corporate structure*

The principal operating companies remaining in the Avatar Group are set out diagrammatically below.

Figure 2: Principal companies in the Avatar Group



Source: Avatar

6.3 *Financial performance*

Avatar's historical audited consolidated financial results for each of the three years ended 30 June 2004, 2005, 2006 and 2007 are summarised in the table below.

Table 1: Summary of Avatar's historical consolidated financial performance

	Audited Year ended 30 Jun 2004[9] $000	Audited Year ended 30 Jun 2005[8,9] $000	Audited Year ended 30 Jun 2006[9] $000	Audited Year ended 30 Jun 2007[9] $000
Revenue from continuing operations[1]	136,936	126,809	-	-
Other revenue	196	603	1	3
Total revenue[2]	**137,132**	**127,412**	**1**	**3**
Gain on sale of plant and equipment	2,768	508	-	-
Cost of sales and services	(89,499)	(79,420)	-	-
Sales and marketing expense	(12,490)	(12,792)	-	-
Logistics and distribution expense	(6,922)	(8,261)	-	-
Administration expense	(18,355)	(14,869)	(3,075)	(5,436)
Other expenses	(3,439)	-	-	-
EBIT	**9,195**	**12,578**	**(3,074)**	**(5,433)**
Net financing revenue/(expense)	(2,847)	(2,396)	(789)	5,537
Operating profit before income tax	**6,348**	**10,182**	**(3,863)**	**104**
Income tax benefit/(expense)	(956)	(1,400)	826	(156)
Operating profit after income tax	**5,392**	**8,782**	**(3,037)**	**(52)**
Profit after tax from discontinued operations	-	2,224	14,782	104,408
Net profit after tax attributable to members	**5,392**	**11,006**	**11,745**	**104,356**
Total revenue growth[2]- %	*-2.7%*	*-7.1%*	*n/a*	*n/a*
EBIT margin[3]- %	*6.7%*	*9.9%*	*n/a*	*n/a*
NPAT margin[3]- %	*3.9%*	*6.9%*	*n/a*	*n/a*
Interest cover – times[4]	*3.2*	*5.2*	*n/a*	*n/a*
Basic earnings per share – cents	*6.8*	*13.9*	*14.9*	*132.0*
Basic earnings per share from continuing operations – cents	*6.8*	*11.1*	*n/a*	*(0.1)*
Dividend per share[5,]– cents	*1.5*	*4.0*	*7.0*	*11.0*
Closing 30 June share price - $	*0.45*	*0.92*	*1.75*	*1.83*
Dividend payout ratio[6,] - %	*22.1*	*28.8*	*47.0*	*8.3*
Dividend yield[7,]- %	*3.3*	*4.3*	*4.0*	*6.0*
Amount of dividend franked[7,] - %	*100.0*	*100.0*	*100.0*	*54.5*

Notes

1 *Revenue excludes interest revenue*

2 *Total revenue is revenue from continuing operations plus other revenue less interest revenue*

3 *EBIT is earnings from continuing operations before net interest and tax. EBIT margin is calculated as EBIT divided by total revenue. NPAT is net profit after tax attributable to members of Avatar. NPAT margin is calculated as operating profit after income tax divided by total revenue*

4 *Interest cover is calculated as EBIT divided by net financing expense*

	Audited Year ended 30 Jun 2004[9] $000	Audited Year ended 30 Jun 2005[8,9] $000	Audited Year ended 30 Jun 2006[9] $000	Audited Year ended 30 Jun 2007[9] $000

5 *Dividend per share represents dividends actually paid during the year*

6 *Dividend payout ratio is calculated as dividend per share divided by diluted earnings per share*

7 *The dividend yield has been calculated using the closing share price at the end of the financial period*

8 *30 June 2006 was the first financial report prepared based on Australian equivalents to International Financial Reporting Standards (AIFRS) and 30 June 2005 has been restated for AIFRS*

9 *We note that various businesses have been sold during the period being considered. Therefore we note that results for each year are not directly comparable, specifically:*
- Business classified as discontinued for the year ended 30 June 2007 are DrillCorp Australia and the South African drilling business, Arlec & Level 2, Sunshine BBQs and Lednium
- Business classified as discontinued for the year ended 30 June 2006 are DrillCorp Australia and the South African drilling business, Arlec, Sunshine BBQs and Lednium
- Business classified as discontinued for the year ended 30 June 2005 is the South African drilling business

Source: 30 June 2006 and 30 June 2007 from Avatar's 2007 Financial Statements, 30 June 2005 from comparatives in Avatar's 2006 Annual Report, 30 June 2004 from comparatives in Avatar's 2005 Annual Report, KPMG analysis

Observations in relation to Avatar's consolidated historical and forecast financial performance are set out below:

Year ended 30 June 2004

- Avatar recorded NPAT of approximately $5.4 million compared to a loss of approximately $0.5 million for the year ended 30 June 2003.
- Arlec recorded improved earnings over the prior year following the introduction of new higher margin products in existing categories, lower product costs flowing from the establishment of partnership style supplier relationships and a favourable foreign exchange environment.
- Sustained activity within the minerals exploration sector, with DrillCorp's Australian operations in particular enjoying high levels of rig utilisation, resulted in DrillCorp recording an increased level of profitability.
- The Company's Sunshine Barbeques business continued to incur losses, primarily due to a switch of production from Indonesia to China in January 2004, disrupting its production schedule. This also left the business vulnerable to securing supply on short notice in an environment of rising metals and other raw material costs. These conditions resulted in higher product and freight costs and late deliveries, which had a significant adverse effect on sales and margins. Another contributing factor was a lack of success in securing new customers and ranging in the US due to intense competition from Chinese manufacturers and the lack of a competitive stainless steel range.

Year ended 30 June 2005

- The Company recorded a strong improvement in financial performance, largely driven by strong earnings growth in DrillCorp, which was attributed to improved productivity in DrillCorp's South African operations, completion of a number of international drilling contracts, higher capacity utilisation in Australia, lower overheads and the sale of the Company's loss making Tanzanian operations.

- Arlec's EBIT of $4.2 million was slightly lower than in the previous year as a result of higher costs (particularly in warehousing) due to a change in product mix and the temporary overstocking of two new product categories. Additionally, second half sales were severely constrained by a weaker retail environment and stock reduction programs that major customers implemented.

- Sunshine Barbeques recorded a loss of approximately $6.1 million, reflecting:

    - costs and write-offs from the closure and disposal of the Company's Malaysian and US operations

    - difficult trading conditions in the UK and European markets arising from an oversupply of barbeques in these markets, a shift by major customers to the import of barbeques directly from China and the loss of garden centre customer market share to larger hardware chains and retailers.

Year ended 30 June 2006

- The Company recorded a slight increase in NPAT to approximately $11.7 million.

- DrillCorp performed strongly contributing EBIT of approximately $22.3 million, reflecting high levels of rig utilisation, improved productivity and contract prices as a result of strong demand, particularly from the base metals and gold sector. Furthermore, Avatar recorded a further NPAT of approximately $5.6 million on the completion of the sale of its South African drilling business.

- Arlec continued to experience difficult trading conditions, recording a loss of approximately $2.2 million. Avatar attributed this to retailers' increasingly sourcing products directly from manufacturers in Asia, the impact of high fuel and commodity prices on the cost of providing a distribution service and continued inventory reduction initiatives undertaken by major customers. In light of the above, Arlec changed its strategy during the year to focus on its traditional core product categories of lighting and electrical accessories. As part of this strategy, the Company incurred further costs in exiting or repositioning a number of product categories which did not meet the Company's risk/return criteria.

- The Sunshine Barbeques business recorded a loss of approximately $3.2 million as a result of winding down the Company's barbeque distribution business in the UK and Europe, clearing stock remaining at the end of the 2005 season and writing off surplus accessories and components.

- The Company substantially increased the level of resources committed to the commercialisation of the Lednium business. As a result, Lednium incurred a loss at the EBIT level of approximately $2.2 million.

Year ended 30 June 2007

- Avatar recorded NPAT of approximately $104.4 million for the year ended 30 June 2007. The key driver of this result was the completion of the sale of DrillCorp's Australian operations for approximately $133.7 million, which realised a net profit on sale of approximately $103.2 million.
- The restructured Arlec business also delivered an improved financial performance, contributing EBIT of approximately $1.9 million. Underlying EBIT after normalising for non-recurring costs was approximately $2.9 million.
- Avatar's result for they year ended 30 June 2007 also reflects the tail of one-off write offs and costs incurred in ceasing the international operations of Sunshine Barbeques.

Summary of estimated financial performance by business unit

An analysis by business unit of Avatar's audited consolidated financial performance for the year ending 30 June 2007 is summarised below.

Table 2 : Avatar's historical financial performance by business unit for the year ending 30 June 2007

	DrillCorp $000	BBQ Group $000	Arlec & Level 2[1] $000	Lednium[2] $000	Head Office[3] $000	Avatar Consol $000
Revenue (excl. interest)	23,945	578	57,900	553	-	82,976
Other revenue	18	-	-	-	3	21
Expenses	(15,061)	(2,849)	(58,417)	(4,124)	(5,436)	(85,887)
EBIT	**8,902**	**(2,271)**	**(517)**	**(3,571)**	**(5,433)**	**(2,890)**
Net financing expense						5,407
Gain from disposal of business						100,997
Operating profit before income tax						**103,514**
Income tax benefit						842
Net profit after tax attributable to members						**104,356**

	DrillCorp $000	BBQ Group $000	Arlec & Level 2[1] $000	Lednium[2] $000	Head Office[3] $000	Avatar Consol $000

Note: To assist readers in assessing the Capital Return and the Arlec Sale:

1. *Arlec comprises those entities and assets that form part of the Arlec Sale. Other entities in the Arlec Group not being acquired by Sonsam have been included under Head Office*
2. *Lednium includes Lednium Pty Ltd and Lednium Sdn Bhd (formerly Assay Manufacturing Sdn Bhd). Lednium Limited (the special purpose vehicle formed to facilitate the Lednium Share Distribution did not form part of the Avatar Group as at 30 June 2007 and has minimal assets at the date of this report.*
3. *Head Office includes Avatar, Avatar Finance Pty Limited and all other Avatar Group entities not otherwise included in one of the business units. Head Office also captures all material account balances relating to tax (i.e. deferred tax assets, deferred tax liabilities and income tax payable).*

Source: Avatar's management accounts and consolidation worksheets and Avatar management

6.4 *Financial position*

Avatar's historical audited consolidated net assets as at each of 30 June 2004, 2005, 2006 and 2007 are summarised below.

Table 3: Summary of Avatar's historical consolidated financial position

	Audited 30 Jun 2004 $000	Audited 30 Jun 2005 $000	Audited 30 Jun 2006 $000	Audited 30 Jun 2007 $000
Cash assets	822	4,882	8,926	8,256
Available for sale financial assets	-	-	-	107,865
Restricted cash held in escrow	-	-	-	10,440
Receivables	23,144	23,803	21,217	8,662
Inventories	25,709	27,404	21,485	-
Other	1,079	1,377	1,009	1
Assets of disposed group held for sale	-	-	-	16,326
Total current assets	**50,754**	**57,466**	**52,637**	**151,550**
Receivables	3,641	1,054	3,307	2,147
Other financial assets	11	11	11	7
Property, plant and equipment	25,849	24,499	20,716	306
Deferred tax assets	7,305	5,476	2,455	1,726
Total non-current assets	**36,806**	**31,040**	**26,489**	**4,186**
TOTAL ASSETS	**87,560**	**88,506**	**79,126**	**155,736**
Payables	12,588	16,169	13,917	5,594
Interest-bearing liabilities	27,529	3,465	9,392	-
Income tax payable	195	177	578	19
Derivative financial instruments	-	-	-	197
Provisions	-	-	-	188
Other	2,159	940	799	-

	Audited 30 Jun 2004 $000	Audited 30 Jun 2005 $000	Audited 30 Jun 2006 $000	Audited 30 Jun 2007 $000
Liabilities associated with assets held for sale	-	-	-	1,560
Total current liabilities	**42,471**	**20,751**	**24,686**	**7,558**
Interest-bearing liabilities	-	16,941	-	-
Deferred tax liabilities	2,641	2,661	3,465	410
Other	115	73	21	-
Total non-current liabilities	**2,756**	**19,675**	**3,486**	**410**
TOTAL LIABILITIES	**45,227**	**40,426**	**28,172**	**7,968**
NET ASSETS	**42,333**	**48,080**	**50,954**	**147,768**
Number of shares on issue – 000s	*78,928*	*79,238*	*79,038*	*79,038*
Net assets per share - $	*0.53*	*0.61*	*0.64*	*1.87*
Net tangible assets per share - $	*0.53*	*0.61*	*0.64*	*1.87*
Gearing[1] - times	*0.63*	*0.32*	*0.01*	*n/a*
Total tangible assets/Total liabilities – times	*1.9*	*2.2*	*2.8*	*19.5*

Notes

1 *Gearing represents net borrowings (interest-bearing liabilities minus cash assets) divided by net assets.*

Source: Avatar's 2004, 2005 and 2006 annual reports and 2007 Financial Statements

Summary of financial position by business unit

An analysis by business unit of Avatar's audited consolidated financial position as at 30 June 2007 is summarised below.

Table 4: Avatar's financial position by business unit as at 30 June 2007

	Arlec[1] $000	Lednium[2] $000	Head Office[3] $000	Avatar Consol $000
Cash assets	-	-	8,256	8,256
Available for sale financial assets	-	-	107,865	107,865
Restricted cash held in escrow	-	-	10,440	10,440
Receivables	6,761	158	1,901	8,820
Inventories	9,287	861	-	10,148
Other	405	822	1	1,228
Total current assets	**16,453**	**1,841**	**128,463**	**146,757**
Receivables	-	-	2,147	2,147
Other financial assets	-	-	7	7
Property, plant and equipment	1,626	2,989	306	4,921
Deferred tax assets	-	178	1,726	1,904

	Arlec[1] $000	Lednium[2] $000	Head Office[3] $000	Avatar Consol $000
Total non-current assets	**1,626**	**3,167**	**4,186**	**8,979**
TOTAL ASSETS	**18,079**	**5,008**	**132,649**	**155,736**
Payables	2,747	1,024	2,847	6,618
Derivative financial instruments	197	-	-	197
Income tax payable	-	-	19	19
Employee provisions	536	-	188	724
Total current liabilities	**3,480**	**1,024**	**3,054**	**7,558**
Deferred tax liabilities	-	-	410	410
Total non-current liabilities		**-**	**410**	**410**
TOTAL LIABILITIES	**3,480**	**1,024**	**3,464**	**7,968**
NET ASSETS	**14,599**	**3,984**	**129,185**	**147,768**

Note: To assist readers in assessing the Capital Return and the Arlec Sale:

1 Arlec comprises those entities and assets that form part of the Arlec Sale. Other entities in the Arlec Group not being acquired by Sonsam have been included under Head Office

2 Lednium includes Lednium Pty Ltd and Lednium Sdn Bhd (formerly Assay Manufacturing Sdn Bhd). Lednium Limited (the special purpose vehicle formed to facilitate the Lednium Share Distribution did not form part of the Avatar Group as at 30 June 2007 and has minimal assets at the date of this report.

3 Head Office includes Avatar, Avatar Finance Pty Limited and all other Avatar Group entities not otherwise included in one of the business units. Head Office also captures all material account balances relating to tax (i.e. deferred tax assets, deferred tax liabilities and income tax payable).

Source: Avatar's management accounts and consolidation worksheets and Avatar management

We make the following observations in relation to the principal assets and liabilities comprising Avatar's unaudited financial position as at 30 June 2007.

Cash assets

Cash Assets are held either in Australian Dollar or US dollar term deposits or for working capital purposes in trading accounts.

The Directors have indicated that of the Company's existing cash assets, approximately $2 million will be required to support the future working capital and on-going development until 30 June 2008.

Available for sale financial assets

Available for sale financial assets are a mixture of floating notes ($101 million) and hybrid securities ($7 million) with varying maturities. These assets are convertible to cash and have been issued by banks and other corporations and have a Standard and Poors risk rating of at least BBB. Avatar has advised that these funds currently attract a weighted average interest rate of approximately 7.2 percent per annum.

Escrow funds

Cash of approximately $10.4 million is held on deposit in escrow by the solicitors acting on behalf of Boart Longyear, the purchaser of DrillCorp's Australian operations, in support of various warranties made by DrillCorp.

These funds currently attract an interest rate of 6.7 percent per annum for the benefit of Avatar and are, subject to certain circumstances giving rise to an extension of time, repayable to DrillCorp on 30 June 2008. Circumstances that may give rise to an extension include the existence of any unresolved actual and/or contingent claims against DrillCorp by the purchaser commenced prior to 30 June 2008. Avatar has advised that it has no reason to expect any warranty claims or undisclosed contingent liabilities will emerge under the terms of the DrillCorp sale agreement that would result in either an extension of time or a reduction in the level of funds available to Avatar.

We note that notwithstanding any release of funds from escrow, Boart Longyear remains entitled to make a claim against DrillCorp in respect of any loss incurred in relation to tax and/or environmental matters relating to the sale in the period to October 2012.

Receivables

Consolidated current and non-current receivables totalled approximately $10.9 million, including principally:

- Trade debtors due to Arlec totalled $6.5 million (for which Avatar will retain the benefit of and responsibility for collection following the Arlec Sale). Arlec's aged debtors listing as at 30 June 2007 indicated that approximately $68,000 were older than 90 days. Avatar management has advised the Company has raised a doubtful debts provision for approximately $29,000 and that it has no reason to expect the remaining debts will not be collected in full.

- An amount of $1.4 million in relation to a royalty agreement entered into between DrillCorp and Bacarac Trading 4 (Pty) Ltd (Bacarac), pursuant to which DrillCorp is entitled to receive a royalty of 3 percent of turnover of the business for a period of 5 years capped at Rand $2.6 million per annum as consideration for licensing the DrillCorp trade name in Southern Africa and South America and certain drilling technology to Bacarac.

  The amount adopted by Avatar represents the Company's assessment as to the present value of the pre tax royalty stream, having regard to the future projected earnings of the African operations and a nominal pre-tax discount rate of 10.5 percent per annum.

- An amount of $1.2 million in respect of the vendor finance provided by Avatar to Bacarac, the purchaser of DrillCorp's South African mineral exploration drilling operations. This advance is fully amortising over a period of 5 years and attracts interest at approximately 10.5 percent per annum. The loan is subordinated to a senior debt facility provided by Investec Bank.

Given this loan is interest bearing Avatar considers the current book value is reflective of the present value of the receivable including the entitlement to interest.

In the initial period following its change in ownership to Bacarac, the South African drilling business experienced trading and operational difficulties. As a result, a repayment moratorium in respect of the loan and royalties was requested by Bacarac, which was approved by Avatar on 6 December 2006.

We are advised that the business has experienced improved results in 2007 and notwithstanding various scheduled payments of principal, interest and royalties are yet to be received, the Company expects to recover these receivables in full. Avatar has advised that Bacarac's obligations are secured by second ranking fixed and floating charges over the assets of the African drilling business.

These contractual entitlements will remain with Avatar after the Capital Return and Avatar will effectively be responsible for the collection of these outstanding assets.

- Trade receivables and other receivables of approximately $0.2 million recorded in respect of Lednium.

Inventory

Inventory associated with the Arlec business (with an audited value of approximately $9.0 million as at 30 June 2007) will be sold to Sonsam at book value on completion, subject to a physical stocktake.

Inventory includes Level 2 Distribution stock with a book value of approximately $0.9 million at cost and $0.3 million net of provisions reflecting the slow moving nature of the stock. The Directors expect this stock to be cleared prior the date shareholders meet to consider the Capital Return and the Arlec Sale at a value consistent with its current carrying value. Any remaining stock will be acquired by Sonsam at its written down value.

Inventory with a book value of $0.9 million is being carried in respect of the Lednium business.

Property, plant and equipment (PPE)

Included in PPE is $3.0 million in respect of the written down value of Lednium's manufacturing equipment and $1.6 million in respect of the written down value of PPE utilised in the business of Arlec.

Deferred tax assets

Comprises principally $0.6 million in relation to foreign tax credits, which are expected to be realised against the royalties and interest payable by Bararac in respect of the purchase of DrillCorp's South African drilling business; $0.2 million in relation to the write-off of stock, with the balance reflecting normal temporary taxation timing differences.

Other assets

An amount $0.8 million is recorded in the books of Lednium in respect of capitalised licence costs paid and payable to Intematix for the use of that company's phosphor technology in Lednium's lighting products.

Other liabilities

Other liabilities of $5.1 million comprise principally:

- liabilities of $1.1 million in respect of staff bonuses and leave entitlements
- liabilities of $1.0 million in relation to Arlec customer incentive payments
- a liability of $0.5 million for license fees recorded in the books of Lednium payable to Intematix for the uses of that company's phosphor technology (refer other assets above)
- a liability of $0.3 million in relation to Fringe Benefits Tax and Goods and Services Tax payable
- an accrual of $0.3 million in relation to a potential warranty claim in relation to South African capital gains tax (CGT) on the previous sale of the Company's South African mineral exploration drilling operations. Avatar has indicated that whilst no claim or notice of assessment has been made by the South African tax authorities and it does not believe CGT is payable, there is a prospect that South African taxation authorities may apply a different methodology to that adopted by the Company in valuing the divested business, giving rise to a CGT liability. Accordingly the Company has considered it appropriate to raise a provision
- liabilities of $0.2 million in respect of future warranty claims for barbeques previously sold in United Kingdom/Europe and agreed break fees in relation to premises previously leased by Sunshine Barbeques
- liabilities of $0.6 million for professional fees in relation to the company tax legal and accounting advisors
- accruals of $0.4 million for expenses incurred up to 30 June 2007.

Deferred tax liabilities

Comprises the expected future liability for tax arising out of Avatar's up-front recognition as income of the full present value of the amounts receivable in relation to the royalty agreement entered into with Bacarac as discussed above.

6.5 *Summary of cash flow statements*

Avatar's audited consolidated cash flows for each of the three years ended 30 June 2004, 2005, 2006 and 2007 are summarised below.

Table 5: Summary of Avatar's Cash Flows Statements

	Audited Year ended 30 Jun 2004 $000	Audited Year ended 30 Jun 2005 $000	Audited Year ended 30 Jun 2006 $000	Audited Year ending 30 Jun 2007 $000
Cash flows from operating activities				
Receipts from customers	138,790	144,206	140,831	92,807
Payments to suppliers and employees	(123,572)	(124,643)	(119,325)	(89,329)
Interest received	141	73	748	5,827
Borrowing costs paid	(2,988)	(2,436)	(1,615)	(420)
Income taxes paid	(2,506)	(265)	(1,899)	(3,075)
Net cash inflow from operating activities	***9,865***	***16,935***	***18,740***	***5,810***
Cash flows from investing activities				
Net cost of PPE	(2,919)	(4,583)	(1,031)	(4,444)
Vendor financing provided	-	-	(2,083)	-
Vendor loan repayments received	(2,664)	1,692	1,088	1,161
Proceeds from sale of business	-	-	7,567	143,572
Restricted cash held in escrow	-	-	-	(10,440)
Cash in businesses sold	-	-	-	(9,815)
Net cash inflow (outflow) from investing activities	***(5,583)***	***(2,891)***	***5,541***	***120,034***
Cash flows from financing activities				
Dividend payments	(1,183)	(2,984)	(5,533)	(8,694)
Return of capital	-	-	(4,235)	-
Repayment of employee share loans		82	469	164
(Repayment) of borrowings	(7,952)	(7,981)	(9,625)	(7,963)
Net cash (outflow) from financing activities	***(9,135)***	***(10,883)***	***(18,924)***	***(16,493)***
Net increase (decrease) in cash	***(4,853)***	***3,161***	***5,357***	***109,351***
Opening cash	4,115	(931)	2,300	7,690
Exchange rate adjustments to cash	(193)	70	33	(920)
Closing cash	***(931)***	***2,300***	***7,690***	***116,121***
Note: 2007 opening and closing cash includes cash equivalents and available for sale financial assets				

Source: Avatar's 2004, 2005 and 2006 annual reports, 2007 Financial Statements

6.6 Hedging arrangements

Avatar currently has foreign exchange forward contracts to purchase approximately US$5.87 million, at an average rate of AUD:USD 0.8046, with settlement to occur between July and December 2007. As at 30 June 2007 these contracts were out of the money to the extent of $0.2 million on a mark to market basis. Avatar have advised that as at September 2007 these are now all in the money. However, these contracts are expected to be used up by 30 November 2007 and the hedge rate has been assumed in Avatar's Board endorsed forecast for the period to 30 November 2007.

6.7 Taxation

It is estimated that as at 30 June 2007, Avatar Industries Limited as the head company of the Avatar tax consolidated group will have carry forward capital losses of approximately $40.6 million. Based on tax advice received by the Company, the Directors of Avatar are of the opinion that the capital losses do not meet the criteria for recognition as a deferred tax asset on the balance sheet of the Company. Given the Company's financial position and the strict rules for recoupment of capital losses the Company is of the view that the utilisation of these losses is very uncertain. Based on its tax advice, the Company also considers that the potential crystallisation and utilisation of any currently unrealised capital losses on assets that it owns (approximately $9.4 million) is also very uncertain.

6.8 Franking credits

As at 30 June 2007, Avatar had only minimal franking credits, totalling $24,590. Under the terms of the Capital Return the proposed dividend component of the cash to be returned to Exiting Shareholders will be in the form of an unfranked dividend.

6.9 Other contingent assets and liabilities

Avatar has advised that it is not aware of any contingent assets or liabilities likely to have a material impact upon the financial position of Avatar.

6.10 Share capital and ownership

Top ten shareholders

Avatar currently has on issue 79,038,464 ordinary fully paid shares, which are quoted on ASX. Avatar's top 10 shareholders as at 17 September 2007 are set out below.

Table 6: Avatar's top 10 shareholders

	Number of shares held 000s	% of issued capital
Gabor Holdings Pty Limited	24,217	30.6%
Favcor Pty Limited	10,893	13.8%
Gersor Pty Ltd	7,118	9.0%
Pan Australian Nominees	3,709	4.7%
Zero Nominees Pty Ltd	2,150	2.7%
Gabor Holdings Pty Ltd Tricorp Fund A/C	1,730	2.2%
Kristen Margaret Manning Leijer	1,677	2.1%
National Nominees Limited	1,588	2.0%
Citicorp Nominees Pty Limited	1,276	1.6%
Rejiel Pty Limited	1,136	1.5%
Total number of shares held by the top 10 shareholders	**55,494**	**70.2%**
Other shareholders	23,544	29.8%
Total number of shares on issue	**79,038**	**100.00%**

Source: Avatar share registry as 17 September 2007

Substantial shareholders

Substantial shareholders notices received by the Company are set out in the table below.

Table 7: Avatar's substantial shareholders

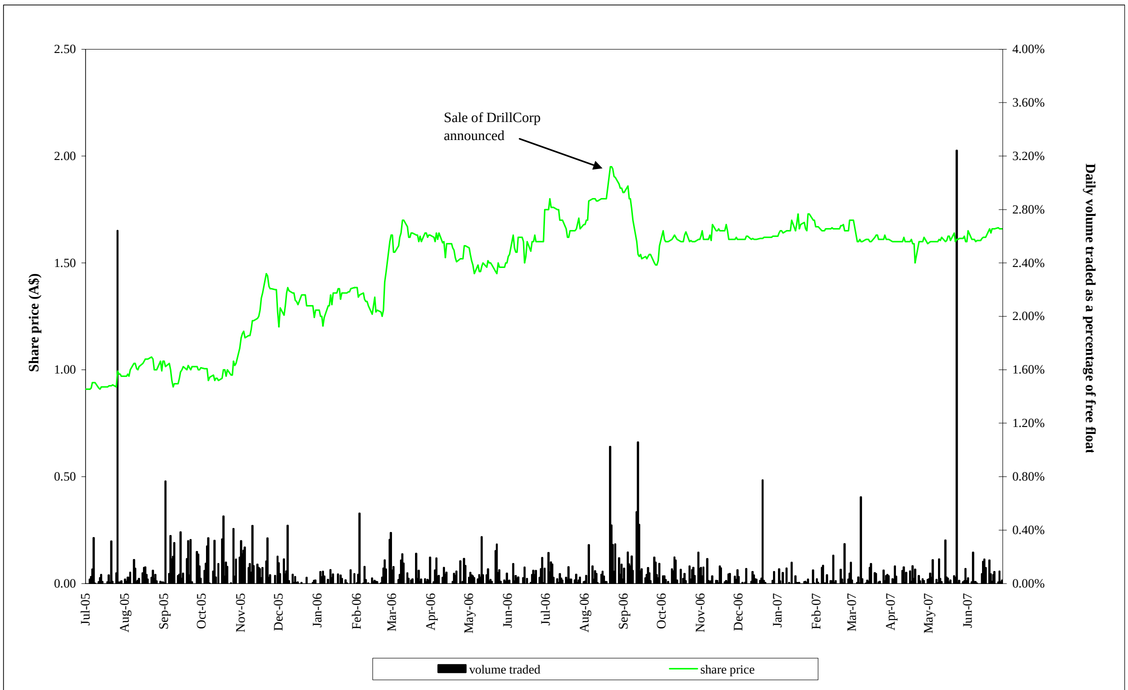
	Number of shares held 000s	% of issued capital
I N Trahar and associates	35,566	45.0%
P J Favretto and associates	12,058	15.3%
Total number of shares held by substantial shareholders	**47,624**	**60.3%**

Source: Avatar2007

6.11 *Share price history*

The chart below depicts Avatar's daily closing share price since 1 July 2005 to 28 June 2007, being the last day prior to the announcement of the Capital Return, and the volume of shares traded expressed as a percentage of 'free-float'. Free-float excludes the 47.6 million shares or 60.3% of issued capital that Mr Trahar and Mr Favretto held between 1 July 2005 and 28 June 2007.

Figure 3: Avatar share price and volume trading history



Source: Bloomberg

Avatar's share price exhibited an overall positive trend with minor volatility over the period between 1 July 2005 to the last trading day prior to the announcement of the Capital Return, closing between a low of $0.86 on 1 July 2005 and a high of $1.95 on 21 August 2006. Avatar's shares generally exhibited very modest liquidity over this period.

Significant announcements made by Avatar since 30 June 2006 to 28 June 2007 that may have impacted its share price include:

- 27 February 2007 – Avatar released its results and results briefing for the six months ended 31 December 2006.
- 20 October 2006 – Avatar announced that the sale of DrillCorp's Australian operations to a subsidiary of Boart Longyear had completed.
- 20 September 2006 – Avatar announced that Lednium had entered into a phosphor supply agreement with Intematix Corporation. Under the terms of the agreement Lednium has the right to use Intematix's patented white LED phosphor technology in its Lednium Series LED products.
- 5 September 2006 – Avatar released its annual report. NPAT for the year to 30 June 2006 was approximately $11.7 million, a 6.4 percent increase on the previous year.

- 21 August 2006 – Avatar announced the signing of an agreement for the sale of its Australian mineral drilling business to Boart Longyear.

6.12 Liquidity History

An analysis of the volume of trading in Avatar's shares in the 12 month period to the last trading day prior to the announcement of the Capital Return on 29 June 2007 is set out below.

Table 8: Trading liquidity in Avatar shares pre-announcement

Period up to and including 28 June 2007	Closing share price (high) $	Closing share price (low) $	VWAP $	Cumulative volume 000s	As a % of issued capital
1 day	1.66	1.66	1.66	8	0.09%
1 week	1.67	1.66	1.66	71	0.09%
1 month	1.67	1.60	1.63	489	0.62%
3 months	1.67	1.50	1.58	2,261	2.86%
6 months	1.73	1.50	1.55	3,386	4.28%
12 months	1.95	1.49	1.60	7,576	9.59%
18 months	1.95	1.21	1.54	10,510	13.30%

Source: Bloomberg

Avatar shares have exhibited very modest liquidity in recent times with 4.3 percent of shares on issue being traded in absolute terms over the 6 months prior the announcement of the Capital Return. We note, however, that the shareholdings of Mr Trahar and Mr Favretto can be considered to be strategic rather than traded holdings. In the event these shares are excluded, Avatar's percentage of free-float traded in the past six months increases to approximately 10.8 percent.

An analysis of the volume of trading in Avatar's shares in the period from 29 June 2007 (inclusive) to the day prior to the date of this report is set out below.

Table 9: Trading liquidity in Avatar's shares post announcement

Period from 29 June 2007 to 18 September 2007	Closing share price (high) $	Closing share price (low) $	VWAP $	Cumulative volume 000s	As a % of issued capital
58 trading days	1.86	1.75	1.81	6,137	7.76%

Source: Bloomberg

6.13 Options

The Company currently does not have on issue any options over unissued shares.

6.14 *Employee share plan*

Pursuant to the terms of Avatar's Employee Share Plan, fully paid shares in the Company are issued to eligible employees at market value calculated by reference to the weighted average sale price of the shares in the Company on ASX during the five trading days immediately preceding the date of the invitation to participate. There are currently approximately 1.15 million shares issued to four existing employees under the scheme, which are included in the current issued capital of the Company.

The purchase of shares is funded by an interest-free loan provided by the Company to the relevant employee and the conditions of the loan are governed by the loan scheme which forms part of the plan. All loans are limited recourse, unsecured and interest-free and are repayable by instalments equal to the amount of any cash distributions in respect of the underlying shares. The relevant loan agreements provide that in the event of the termination of the employment, the relevant employee is required to either repay the loan in full or in the case of "out of the money" share, sell those shares on market with the entire net proceeds applied in part satisfaction of the then outstanding loan, with the balance outstanding to be forgiven by the Company.

We note that, based on the indicative value ascribed to the Capital Return of $1.91, 0.76 million employee shares, held by Messrs Trahar and Favretto, are currently well "out of the money". Accordingly, in determining the amount to be returned under the Capital Return, Avatar has assumed employees with "in the money" shares will pay out the remaining balance of their loans in order to fully participate in the Capital Return, whilst the "out of the money" shares are simply returned to the Company and cancelled. We note this results in a favourable outcome for the Exiting Shareholders in that the net assets of the Company are assumed to be spread over a reduced total number of shares.

In contrast, Avatar management has advised that, the absence of the Capital Return and Arlec Sale, it would expect the underlying loans to be repaid would be repaid to the extent of any distributions made in respect of the shares or from the proceeds of sale of the shares as the obligation of the employee to repay the loans is limited to these amounts i.e. there is no personal obligation on the employee to repay the loans from their other sources of income or assets.

7 Profile of Messrs Trahar and Favretto

Set out below is a brief profile of Mr Trahar and Mr Favretto.

Ian Trahar, B.Ec, MBA – Executive Chairman

Mr Trahar was appointed Executive Chairman of the Company on 30 July 1999 and has been a director since 20 January 1993. Mr Trahar was State Manager Investment Banking for Citibank from 1983 to 1985 and has also sat on the Board of a number of public companies, including Mincoa NL, Mawson Pacific Limited, General Gold Resources NL, Ranger Minerals NL and The Gribbles Group Limited.

Mr Trahar is also a director of CO2 Group Limited.

Paul Favretto LLB – Managing Director

Mr Favretto was previously Managing Director of KLZ Limited. Mr Favretto was appointed a director of the Company on 10 November 1993.

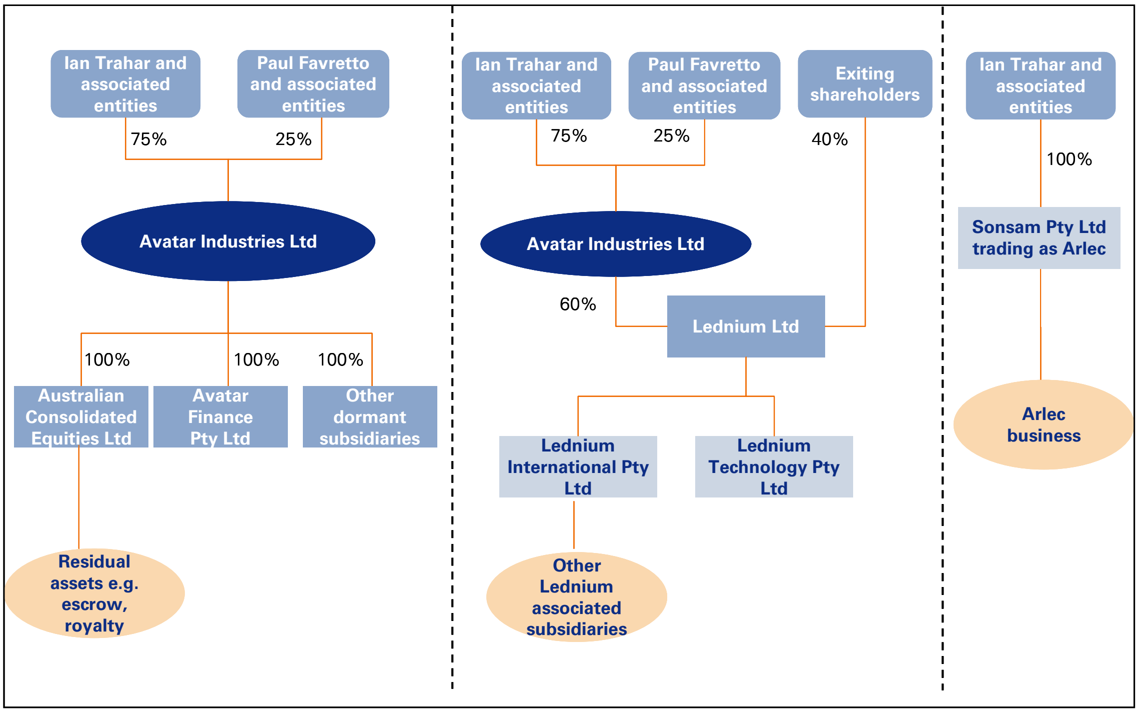
Prior to joining the Avatar Group Mr Favretto worked in the financial services industry for 20 years, holding senior management positions with Citibank (1976 to 1985) and Bankers Trust Limited (1986 to 1994). Mr Favretto was also a director of Ranger Minerals NL.

8 Impact of the Proposed Transaction

8.1 Corporate structure

Avatar's expected effective corporate structure after completion of the Capital Return and Arlec Sale is summarised diagrammatically below.

Figure 4: Expected effective post-transaction corporate structure



Source: Avatar

We note that Mr Trahar's and Mr Favretto's interest in Lednium will be held indirectly through their interests in the post transaction Avatar and its subsidiaries

Following completion of the proposed transaction, Exiting Shareholders will no longer have any interest in the residual assets and liabilities or the future operations of the Avatar group, other than that they will receive a directly held interest in Lednium. Lednium's pro-forma net asset position as at 30 June 2007 was set out above in section 6 above.

Mr Balu Jeganathan, the current Managing Director of Arlec and Lednium, will have principal responsibility for the day-to-day operations of Lednium following completion of the Capital Return and the Arlec Sale. Mr Jeganathan currently apportions approximately 50 percent of his time to each of Lednium and Arlec. It has been agreed that Mr Jeganathan will continue to devote up to 50 percent of his time in the capacity of a consultant to Arlec for a period of six months following the Arlec Sale in order to assist in the transition of the Arlec business to Sonsam, after which he will work solely for Lednium.

Shareholders are also referred to section 2.6 of the Explanatory Statement, where other key implications for Avatar in the event the Capital Return proceeds are discussed.

The Company has advised that in the event the Capital Return is not approved

- subject to any alternative proposals, the Company will remain in its current form and will remain listed on ASX
- Exiting Shareholders will not receive immediate return of the cash portion of the proposed Capital Return of $1.83 per share
- the Company will proceed with the Arlec Sale (which will require shareholder approval)
- the Company would proceed with its plan to de-merge Lednium from Avatar
- the Company will continue to investigate alternative means of distributing surplus capital to shareholders. However, we note that the Continuing Shareholders have indicated that they would only vote in favour of such a proposal if it allowed them to retain their interest in the Avatar Group.

9 Valuation of Avatar

9.1 Valuation methodology

Pursuant to the terms of the Capital Return, Exiting Shareholders will receive $1.83 cash and an in-specie distribution of shares in Lednium such that the current pro-rata interest of Exiting Shareholders in this business is maintained immediately following completion of the Capital Return. Accordingly, in assessing the fairness of the Capital Return it is necessary to compare the current fair market value of an Avatar share, excluding the value of the business operations of Lednium as Exiting shareholders will retain their interest in this business, against the proposed cash component of the Capital Return, being $1.83.

In our experience and having regard to the nature of Avatar's remaining businesses and assets, the most appropriate methodology for determining the value of Avatar is by aggregating the estimated market value of its continuing businesses operations (excluding Lednium), being Arlec, together with the orderly realisable value of non-trading assets and deducting external borrowings and non-trading liabilities.

Due to the various uncertainties inherent in the valuation process, we have determined a range of values within which we consider the value of an Avatar share to lie.

9.2 Summary of valuation of Avatar prior to completion of the Capital Return and Arlec Sale

We have assessed the value of Avatar, excluding Lednium, on the basis of the fair market value of the Company's underlying diluted net assets, to lie in the range of $136.6 million to $147.0 million, which equates to an assessed fair value per diluted Avatar share of between $1.74 and $1.88.

We have assessed the value of Avatar, excluding Lednium, by aggregating the estimated market value of Avatar's consumer products trading business, adding the assessed value of other assets considered to be surplus to current trading operations and, if appropriate, deducting any external borrowings and non-trading liabilities. The value of Avatar has been assessed on the basis of fair market value, that is, the value that would be negotiated between a knowledgeable and willing, but not anxious buyer, and a knowledgeable and willing, but not anxious seller, acting in an arm's length transaction, where both buyer and seller are fully informed.

Set out below is a summary of the range of fair market values at which Avatar's shares have been assessed.

Table 10: Summary of assessed fair market value of Avatar (excluding Lednium)

	Assessed values	
	Low $m	**High $m**
Arlec	15.7	19.1
Cash	2.7	5.2
Available for sale financial assets	109.4	109.4
Escrow funds	7.5	10.6
Royalty and loan receivable	1.7	2.1
Other net assets / (liabilities)	(0.1)	0.9
Less: Future corporate overheads	(0.6)	(0.6)
Total value of assets excluding Lednium (diluted)	**136.3**	**146.7**
Add: Employee Shares Loans on "in the money" shares	0.3	0.3
Total value of assets excluding Lednium (fully diluted)	**136.6**	**147.0**
Current shares on issue (000)	79,038	79,038
Less: Employee shares "out of the money" (000)	(760)	(760)
Diluted number of shares on issue (000)	**78,278**	**78,278**
Value per Avatar share (excluding Lednium) (diluted) - $	**$1.74**	**$1.88**

Source: KPMG analysis

The above valuation of Avatar assumes that shareholders approve the Arlec Sale whether or not the Capital Return is approved.

9.3 Valuation of Arlec

As noted previously, during February 2007 Avatar engaged PwCS to undertake a trade sale of Arlec as part of a broader plan by Avatar to realise assets and return capital to shareholders. This followed several attempts by the Company to sell Arlec in the previous 3 years. Following an approach to a wide range of parties, only two firm offers were received by the Company, with the proposed purchase consideration of both offers effectively based on or slightly below the carrying value of Arlec's net tangible assets at the date of settlement. We note that, based on Arlec's audited balance sheet as at 30 June 2007, Arlec's net tangible asset value was approximately $14.4 million at that date.

Prior to entering into any agreement for the sale of Arlec, Avatar commissioned PwCS to prepare a fair market valuation of Arlec. PwCS considered a range of valuation methodologies including the capitalisation of earnings, the value implied by Avatar's market capitalisation and the value that could be realised on an orderly realisation of Arlec's assets. PwCS concluded that the fair market value for the equity in Arlec as at 22 June 2007 was in the range of $13.6 million to $17.0 million. Having considered the methodologies adopted by PwCS and the current trading profile of Arlec, we consider the methodologies adopted by PwCS and its overall conclusion are not unreasonable.

Having regard to the results of the full trade sale process conducted by PwCS, the outcome of PwCS's valuation, the historical and budgeted earnings of the Arlec business unit, current industry dynamics and the risks attaching to Arlec's future earnings stream in general, we do not believe a third party purchaser would consider Arlec has traded at a level of consistent profitability sufficient to justify a value significantly in excess of the value of its net tangible assets in an orderly realisation. Accordingly, we have adopted a range of $13.6 million to $17.0 million in the absence of the Capital Return and the Arlec Sale.

We note that pursuant to the terms of the Arlec Sale, Avatar is entitled to retain the benefit of trading until the date of completion. Whilst it is arguable that any purchaser may seek to adjust the value of the purchase consideration to reflect the benefits foregone between the date of this report and the date of completion, given the expected short duration of the period to expected settlement, we do not consider that the impact of this delay would fundamentally alter a purchaser's view as to underlying value of Arlec, either positively or negatively.

Accordingly, in assessing the market value of Arlec we have included an additional value of $2.1 million in our range of values, representing the Board endorsed forecast after tax trading results for Arlec over the period 1 July 2007 to 30 November 2007.

9.4 Other net assets

Net assets not valued as part of Avatar's trading operations comprise cash, various trade and other receivables, non-trading items of property, plant and equipment and sundry other assets and liabilities. Except as specifically noted below, having regard to their nature and quantum, these assets and liabilities have been incorporated in our valuation at net book values as at 30 June 2007.

Cash

Avatar's cash balance of $8.3 million as at 30 June 2007 comprises principally cash on hand and US dollars. We have made the following adjustments to Avatar's cash balances as at 30 June 2007.

- In order to ensure consistency with the basis upon which Avatar has calculated the cash component of the Capital Return, we have included an additional interest accrual net of tax in respect of the period to 30 November 2007 in our range of values. This has been calculated at the average interest rate currently realised on these funds of approximately 5.0 percent per annum.

- We have reduced the cash holdings by $2 million to reflect the Directors' estimate of the ongoing working capital requirements for Lednium.

- At 30 June 2007, Avatar's inventory balance included Level 2 Distribution stock with a book value net of provisions of $0.3m. We have adjusted cash to increase it by $0.3 million based on the assumption it is expected to be realised and converted into cash by 30 November 2007.

- We have adjusted Avatar's cash holdings to reflect an allowance for cash required to be maintained within the Arlec business for working capital purposes, all other things being equal.

- Based on our assessed valuation range, 0.39 million employee shares are "in the money". Based on an assumption that employees with "in the money" shares will pay out the remaining balance of their loans in order to fully participate in the Capital Return we have increased Avatar's valuation by $0.3 million to take into account this additional cash and have also adjusted Avatar's issued capital for those employee shares "out of the money".

Available for sale financial assets

Avatar's available for sale financial assets balance of $107.9 million comprises a mixture of floating notes ($101 million) and hybrid securities ($7 million) with varying maturities. In order to ensure consistency with the basis upon which Avatar has calculated the cash component of the Capital Return, we have included an additional interest accrual net of tax in respect of the period to 30 November 2007 in our range of values. This has been calculated at the average pre-tax return currently realised on these funds of approximately 5.0 percent over the five months to 30 November 2007.

Escrow funds

Funds currently held in escrow pursuant to the terms of the previous sale of DrillCorp's Australian operations are interest bearing and as at 30 June 2007 totalled $10.4 million including accrued interest to that date.

In order to ensure consistency with the basis upon which Avatar has calculated the cash component of the Capital Return, we have included an additional interest accrual net of tax in respect of the period to 30 November 2007 at the high end of our range of values. This has been calculated at the average interest rate currently realised on these funds of 6.6 percent over the five months to 30 November 2007.

Notwithstanding that the Company has indicated it has no reason to expect any claims of a material nature will be made by the purchaser of DrillCorp's Australian operations, we believe it is a possibility that a purchaser of Avatar may not prepared to take on the collection risk of this receivable without some form of financial inducement. Accordingly, we have valued this receivable in the range of $7.5 million to $10.6 million.

Receivables

Royalty receivable and loan due from Bacarac

Given Bacarac has, in the recent past, experienced trading difficulties requiring a repayment moratorium in relation to both its royalty and loan obligations, some scheduled repayments remain past due and the logistical and cost difficulties in pursuing any recovery action in a foreign jurisdiction should one be required, we believe it likely that any purchaser would apply an additional risk premium in assessing the value of these assets. As such, at the low end of our range we have applied a 20 percent discount to the present value of these post tax cash flow streams.

We have assessed the realisable value of royalty receivable from Bacarac to be approximately $0.8 million to $1.0 million and the loan due from Bacarac to be approximately $0.9 million to $1.1 million[2].

Net deferred tax assets

Avatar has estimated it has net deferred tax assets (excluding Lednium) of $1.3 million available to it. Avatar has forecast that during the five months ended 30 November 2007 the Company will realise in the order of $0.6 million of its net deferred tax assets.

Provisions

- Given there is some uncertainty as to whether the South African taxation authorities will make any claim in relation to CGT in relation to the previous sale of DrillCorp's South African operations, we have not included this $0.3 million provision at the high end of our range of values.

- In order to reflect the value of Avatar in the absence of the Capital Return and Arlec Sale, we have not included the provision of $0.5 million included in the 30 June 2007 accounts in respect of costs associated with the completion of the Capital Reduction and the Arlec Sale. We note however that in the event the Capital Raising and/or the Arlec Sale are not completed a large portion of these costs will be required to be satisfied in any event.

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[2] Value of royalty and loan receivable based on an exchange rate of $1 to 6.020 South African Rand (ZAR) as at 17 September 2007

9.5 Off-balance sheet items

Net payable on foreign currency hedge contracts

Avatar has foreign currency forward contracts to purchase US$5.9 million which Avatar has advised are now all in the money. However, these contracts are expected to be closed out by 30 November 2007 and the hedge rate has been assumed in Avatar's Board endorsed forecast for the period to 30 November 2007. Therefore we have not ascribed any value to these contracts as at the end of November 2007.

Net realised and unrealised capital losses

It is estimated that as at 30 June 2007, Avatar Industries Limited as the head company of the Avatar tax consolidated group will have carry forward capital losses of approximately $40.6 million. The Directors of Avatar Industries Limited are of the opinion that the capital losses do not meet the criteria for recognition as an deferred tax asset on the balance sheet of the Company. Given the company's financial position and the strict rules for recoupment of capital losses the Company is of the view that the utilisation of these losses is uncertain. The Company also considers that the potential crystallisation and utilisation of any currently unrealised capital losses on assets that it owns is also uncertain. Given the uncertainty surrounding the future financial performance of Avatar and the Company's alibility to realise these losses in the absence of the Capital Return and Arlec Sale, we have not included any value in respect of these capital losses.

Future corporate overheads

Avatar currently incurs administrative overhead costs in the order of $2.3 million per annum in managing its business and maintaining its operating assets. These costs have not been incorporated into the valuation of Arlec or the Company's other assets and therefore, in considering the value of Avatar in its current form (excluding Lednium), it is necessary to deduct the anticipated future after tax management and administrative costs for the period 1 July 2007 to 30 November 2007.

Reflecting the reduction in the scale of the Company's operations following the divestment of DrillCorp's Australian and South African businesses, the unwinding over time of various other matters associated with discontinued operations such as barbeque product warranties and excluding overheads expenses associated with Lednium, it is reasonable to expect the Company's administrative costs will fall significantly from historical levels.

For the purpose of our valuation, Avatar's core corporate overheads have been estimated at approximately $1.4 million per annum on a post-tax cash flow basis (in 2007 dollars). In order to ensure consistency with the basis upon which Avatar has calculated the cash component of the Capital Return, we have included a pro-rata amount of Avatar's estimate annual corporate overheads for the 5 months from 1 July 2007 to 30 November 2007 in our range of values being $0.6 million.

Patent claims

For the purposes of our valuation we have not included any adjustment for this contingent liability as this matter would appear to be quarantined to Lednium and Exiting Shareholders will retain a pro-rata interest in the outcome of this dispute post completion of the Capital Return. Existing shareholders will however need to consider the outcome of this dispute in deciding whether or not to dispose of their shares in Lednium in the future.

10 Assessment of the Proposed Transaction

In assessing whether shareholders as a whole in Avatar are likely to be better off if the Capital Return proceeds than if it does not, we have considered the various advantages and disadvantages that are likely to accrue to them if the Capital Return proceeds, together with other considerations as set out below.

10.1 In our opinion the Capital Return is, on balance, fair and reasonable to Avatar's Exiting Shareholders

In forming this opinion, our assessed value for a share in Avatar, excluding Lednium, was the primary matter that needed to be considered. This value for an Avatar share, excluding Lednium, was key to assessing whether the consideration under the Capital Return reflected a fair return for Exiting Shareholders.

Our assessment of the key issues considered in forming our opinion, and the issues that Exiting Shareholders should consider in deciding whether to support the Capital Return, are summarised below and discussed in more detail in the remainder of this report.

The Capital Return is fair as the cash consideration falls within our range of assessed fair values for an Avatar share (excluding Lednium)

- We have assessed the fair value of Avatar, excluding the value of Lednium, to lie in the range of $136.6 million to $147.0 million, or approximately $1.74 to $1.88 per diluted Avatar share, which compares to the cash consideration to be paid to Exiting Shareholders of $1.83. As $1.83 lies within our range of assessed values for an Avatar share, excluding Lednium, we consider the cash consideration of $1.83 to be paid to Exiting Shareholders to be fair.

  We also note that the closing price for an Avatar share on the trading day prior to the date of this report was $1.78. This price also includes the value of Lednium and lies below the cash consideration under the Capital Return of $1.83.

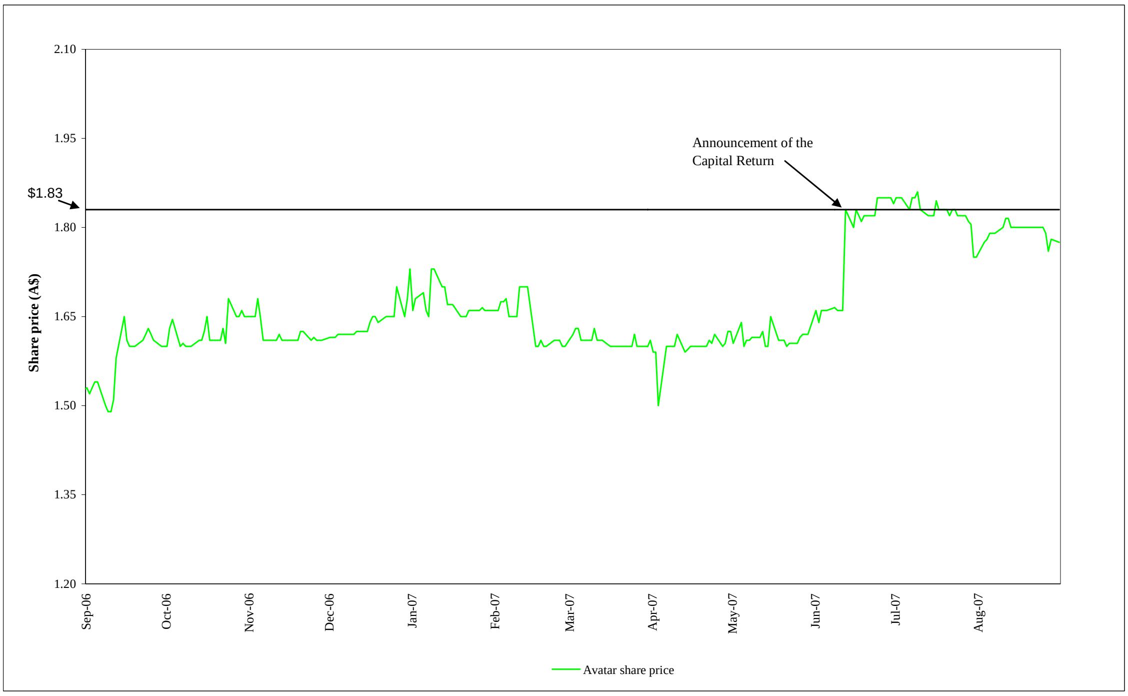
Other factors for consideration by Exiting Shareholders

We have also considered whether there are any significant factors relating to the Capital Return which suggest that Exiting Shareholders should accept the Capital Return in the absence of a higher offer. The principal factors considered by us are detailed below.

- Exiting Shareholders will receive a premium to the Company's historical share price. The 90-day volume weighted average price (VWAP) to the last trading day prior to the announcement of the Capital Return on 29 June 2007 was $1.58 per share. The VWAP for the period 29 June 2007 to 18 September 2007, being the last trading day prior to the date of this report, was $1.81 per share. Exiting Shareholders have an opportunity to receive $1.83 per share in cash. In addition, Exiting Shareholders will receive an in-specie distribution of one share in Lednium Limited, the company that will own the Lednium business, for every one Avatar share currently held.

  The graph below shows Avatar's historical share price for the 12 months to 18 September 2007 compared to the $1.83 cash component of the Capital Return.

Figure 5: Avatar share price versus $1.83 cash component of Capital Return



Source: Bloomberg

- The Capital Return provides an opportunity for Exiting Shareholders to immediately realise their interest in Avatar, without incurring transaction costs, as it involves the return and cancellation of Avatar shares rather than the on market sale of Avatar shares and therefore does not incur brokerage fees.

- The Capital Return provides an opportunity for Exiting Shareholders to immediately realise their interest in Avatar without incurring any realisation or liquidation costs that would otherwise be incurred by Avatar in winding up the Company.

- The Capital Return provides an opportunity for shareholders to make a clean exit from their investment in Avatar. In the absence of the agreement by the Continuing Shareholders to retain their proportionate interest in the Company, any returns of funds to Exiting Shareholders would likely be delayed as a result of Avatar's continuing obligations in relation to its contractual commitments and liabilities.

- The Capital Return provides an opportunity for Exiting Shareholders to exit from a relatively illiquid investment. Excluding the shareholdings of Mr Trahar and Mr Favretto (the Continuing Shareholders), who currently control an approximate combined 60.3 percent interest in Avatar's voting shares, only approximately 11 percent of Avatar's free float was traded in the six months prior to the announcement of the Capital Return.

- As Exiting Shareholders will maintain their current pro-rata interest in the Lednium business immediately following completion of the Capital Return, Exiting Shareholders will retain their current interest in any future capital growth or income from Lednium. Exiting Shareholders will retain the same pro-rata interest in the assets and undertakings of Lednium immediately following the completion of the Capital Return. We note that if Lednium does not list on ASX its capital raising options will be reduced.

- Messrs Trahar and Favretto currently hold approximately 60.3 percent of Avatar's issued share capital. Accordingly, even in the absence of the Capital Return, any takeover offer for the Company would require the support of Messrs Trahar and Favretto in order to be successful. Given the nature of Avatar's remaining businesses and assets, we do not consider it likely that an offer significantly in excess on that contemplated under the Capital Return is likely in the short term.

- As Exiting Shareholders will no longer hold any interest in Avatar or Arlec, Exiting Shareholders will not benefit in the event of any future capital growth or income from Avatar or the Arlec business that is being sold. Conversely, Exiting Shareholders will not be exposed in relation to any future claims or liabilities that may arise in relation to these businesses in the future.

- In the event the Capital Return is not approved, Avatar shareholders, other than Mr Trahar and his associated parties, will consider the Arlec Sale. We note that shareholders holding a significant percentage of potential voting shares have indicated in writing that they intend to vote in favour of the Arlec Sale in the event shareholders resolve not to approve the Capital Return.

- Avatar estimates that the total costs of implementing the Capital Return are likely to be in the order of $1.9 million. This consists of head office closure and head office staff termination costs of approximately $1.4 million and transaction costs of $0.5 million. We note that a portion of these costs will have been incurred, or committed, prior to the date that the shareholders will vote on the Capital Return and will be payable whether or not the Capital Return is approved.

- The alternative of retaining the Arlec business within Avatar after the implementation of the Capital Return was not considered feasible as Mr Favretto (and his controlled entities) indicated to the

Company that they would not support the Capital Return if the Company was to retain an ongoing interest in Arlec.

10.2 In our opinion the Capital Return is, on balance, fair and reasonable to Avatar's Continuing Shareholders

In assessing whether Avatar's Continuing Shareholders are likely to be better off if the Capital Return proceeds than if it does not, we have considered the various advantages and disadvantages that are likely to accrue to them if the Capital Return proceeds as set out below.

- It provides the Continuing Shareholders with total control as opposed to majority control of Avatar. In addition, as a private company removed from the Official List of ASX, the Company will benefit from reduced administrative and compliance costs associated with a listing on ASX.

- The Continuing Shareholders will gain direct access to the remaining $70 million of cash and available for sale financial assets retained within Avatar. Whilst this does not represent an increase in value to the Continuing Shareholders, as these assets were taken into account by the Company in calculating the value of Avatar for the purpose of determining the consideration under the Capital Return, it allows the Continuing Shareholders future access to funds that are currently locked up in Avatar.

- With Avatar wholly owned by the Continuing Shareholders, the entire benefit of any future increase in the capital value of Avatar will flow to the Continuing Shareholders. Conversely, the Continuing Shareholders will be exposed to a greater extent to the impact of any future loss in capital value of Avatar.

- The Continuing Shareholders will own shares in an unlisted company which are less marketable than shares in a listed company.

- Approximately $10.4 million cash is held in Escrow by the solicitors acting on behalf of the purchaser of Avatar's mineral exploration drilling business in Australia (DrillCorp), in support of various warranties made by DrillCorp. In the event that any warranty claims or undisclosed contingent liabilities emerge under the terms of the DrillCorp sale agreement this could adversely impact the Continuing Shareholders.

- With Avatar wholly owned by the Continuing Shareholders and delisted from the ASX, Avatar's ability to raise future debt and/or equity funding may be adversely impacted.

10.3 Other factors for consideration by shareholders

Lednium

- We note that recently Lednium has received claims that the manner in which Lednium is using phosphor in its "white" cup and multidiode (turtle) products to produce white light are infringing certain patents of other parties. Avatar's Directors have advised the market that they are of the view that, in the context of the Avatar group as a whole, the claims are not material to the operations, results and state of affairs based on the evaluation of the claims made to date. However, the Avatar Board has decided to delay a decision on the proposed separate listing of Lednium pending completion of the further evaluation of the claims. Further details on this are set out in section 6.1 above.

- Mr Balu Jeganathan, the current Managing Director of Arlec and Lednium, will have principal responsibility for the day-to-day operations of Lednium following completion of the Capital Return and the Arlec Sale. It has been agreed that Mr Jeganathan will continue to devote up to 50 percent of his time in the capacity of a consultant to Arlec for a period of six months following completion of the Arlec Sale, after which he will work full time for Lednium. This will allow for increased focus of senior management on Lednium.

ATO Class Ruling

The Company has received a draft Class Ruling from the Australian Taxation Office (ATO) which indicates that the Capital Return will be treated as being approximately 65 percent capital and approximately 35 percent unfranked dividend for tax purposes.

Under the Capital Return, all shares in Avatar which are held by Exiting Shareholders will be cancelled. The consideration has been set at $1.91 per share. On the basis of currently available information and the draft ATO Class Ruling issued to the Company, the Company estimates that $1.25 per share will be treated as a capital amount and $0.66 per share will be treated as a dividend amount. This dividend amount will not be franked.

The final ATO Class Ruling will only be issued following implementation of the Capital Return. Only at that time will the precise capital amount and dividend amount be known. Further details on the draft ATO class ruling are set out in section 3 of the Explanatory Statement.

Appendix 1 – Qualifications and declarations

KPMG Corporate Finance (Aust) Pty Ltd (KPMG) is the holder of an Australian Financial Services Licence, No 246901, under the Corporations Act 2001 and is controlled by the partners of KPMG Chartered Accountants (the KPMG Partnership). The KPMG Partnership is a long established firm of chartered accountants which provides a full range of professional services, including advising on valuations, acquisitions, takeovers, restructuring proposals, reorganisations and related matters.

The following persons, whose qualifications and experience are stated below and which are appropriate to the tasks performed, were responsible for the preparation of this report.

Mr Jason Hughes is an Executive Director of KPMG, an Associate of the Institute of Chartered Accountants in Australia and a Fellow of the Financial Services Institute of Australasia and holds a Bachelor of Commerce from the University of Western Australia. Jason has extensive experience in the preparation of independent expert reports and corporate valuations.

Mr Duncan Calder is a Partner of the KPMG Partnership and an Executive Director of KPMG. Duncan is an Associate of the Institute of Chartered Accountants in Australia and of the Institute of Chartered Accountants in England and Wales as well as an Associate of the Financial Services Institute of Australasia. Duncan has over 19 years experience in the preparation of independent expert reports and has been personally involved in a wide range of valuation assignments conducted by KPMG.

Mr Hughes and Mr Calder were assisted in the preparation of this report by other KPMG staff.

Declarations

The statements made in this report are given in good faith and have been derived from information believed to be reliable and accurate. We have examined this information and have no reason to believe that any material factors have been withheld from us.

During the course of the engagement, KPMG provided draft copies of this report to Avatar for comment as to factual accuracy, as opposed to opinion, which is the responsibility of KPMG alone. Changes made to this report as a result of these reviews have not changed the opinions reached by KPMG.

Interests

KPMG is entitled to receive a fee of $90,000 for the preparation of this report. Except for these fees, KPMG has not received and will not receive any pecuniary or other benefit, whether direct or indirect, for or in connection, with the preparation of this report.

Employees of KPMG, the KPMG Partnership and its affiliated entities may hold shares in Avatar. However, no individual involved in the preparation of this report, or review thereof, holds a direct interest in Avatar shares.

With the exception of these matters, none of KPMG or the KPMG Partnership will receive any other benefits, whether directly or indirectly, for or in connection with the making of this report.

Consent

KPMG consents to the inclusion of this report in the form and context in which it is included with the shareholder meeting documentation to be issued to the shareholders of Avatar. Other than this report, neither KPMG nor the KPMG Partnership has been involved in the preparation of the shareholder meeting documentation or any other document prepared in respect of the Capital Return. Accordingly, we take no responsibility for the content of the Explanatory Statement as a whole or other documents prepared in respect of the shareholder meeting documentation.

Reliance on information

The sources of information upon which this report has been based are set out in Appendix 2 to this report. Whilst KPMG, has no reason to believe that such information is anything but reliable and accurate, KPMG has not in any way caused such information to be independently verified or audited. We have no reason to believe that any information relied on by us is incomplete or incorrect.

The opinion of KPMG is based on prevailing market, economic and other conditions at the date of this report. Conditions can change over relatively short periods of time. Any subsequent changes in these conditions could impact upon value either positively or negatively.

We note that any forecasts and projections as supplied to us are based on assumptions about events and circumstances that have not yet transpired. Accordingly, KPMG cannot provide any assurance that the estimates will be representative of the results that will actually be achieved during the forecast period.

As this report has been prepared specifically for Exiting Shareholders, none of KPMG, the KPMG Partnership, or any director, member or employee thereof undertakes responsibility to any other person in respect of this report, including any errors or omissions howsoever caused.

Indemnification

A condition of KPMG's agreement to prepare this report was that Avatar indemnifies KPMG against any and all losses, claims, damages and liabilities arising out of or related to reliance on information provided by the Company.

Appendix 2 – Sources of information

In preparing this report and arriving at our opinion, we have considered, amongst others, the following principal sources of information:

- draft Meeting documentation as at 14 September 2007
- Avatar audited financial statements for the years ending 30 June 2004 to 30 June 2007
- Avatar's internal income forecast for the five months ended 30 November 2007
- agreements relating to the sale of DrillCorp
- agreements relating to the DrillCorp South African loan and royalty
- Arlec Sale of Business Agreement
- documentation relating to the previous unsuccessful Arlec sales process completed by the company and its advisers, including independent valuation of Arlec
- correspondence between Avatar and its tax advisers
- copy of the Tax Ruling submitted to the ATO in relation to the treatment of the Capital Return
- documents prepared by external advisers relating to the restructure
- Avatar directors' responses to due diligence questionnaire prepared by Franklyn Legal
- discussions with Avatar directors and management
- discussions with Avatar's legal advisers, Franklyn Legal
- Avatar list of top 10 shareholders as at 31 August 2007
- various Avatar announcements to ASX
- Avatar's website
- various databases including:
  - Bloomberg
  - IBISWorld Pty Ltd

Appendix 3 – Industry overview

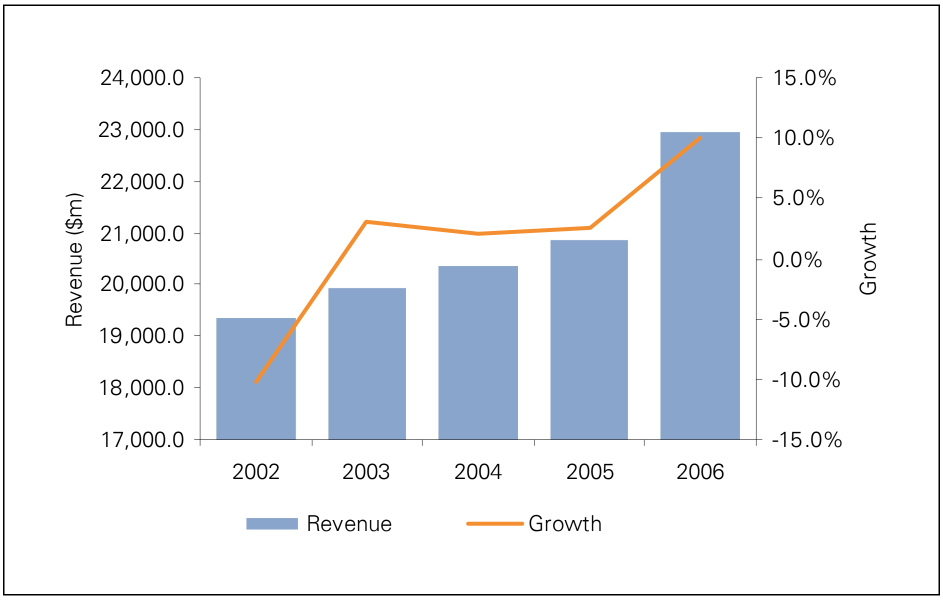
To provide a context for assessing the prospects of Arlec in the electrical consumer product and electrical lighting industries we set out our observations on these markets in Australia below.

Consumer Electrical Products Industry

Market size

For the financial year ended 30 June 2006, Avatar Industries derived approximately 48% of its revenue from Arlec, the electrical and electronic equipment division. IBISWorld forecast that in 2006-07 industry revenues will increase by 7% in real terms bringing the average annualised real rate of growth for the five years to 2006/07 to 4.9%. It is noted however that while there is strong growth in sales volumes of electrical and electronic equipment industry products there is, conversely, a declining trend in the average unit selling prices which will result in reduced gross profit margins for companies in the industry.

Figure 3-1: Electrical and electronic equipment industry revenue and growth



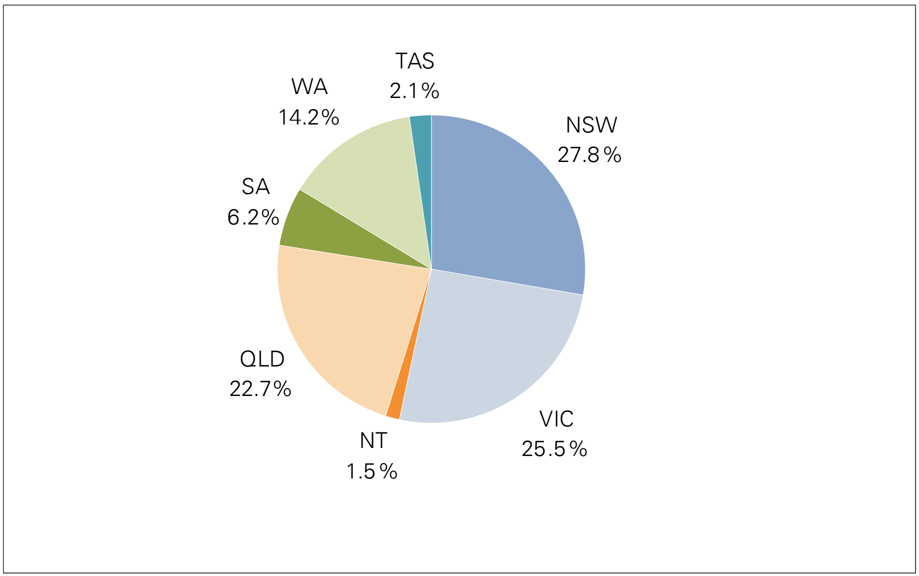
Source: IBISWorld

Demand

The level of economic activity is the primary determinant of demand. The amount of building and construction, mining and manufacturing activity, and expenditure on capital equipment and large scale development projects all significantly influence the demand on the electrical and electronic equipment wholesaling industry.

Industry demand has also been affected by the location of major corporate head offices and the concentration of energy consumption. The Australian geographical spread of electrical and electronic equipment consumption in 2007 driven by the determinants of demand is shown in the figure below.

Figure 3-2: Electrical and electronic equipment industry forecast revenue and growth



Source: IBISWorld

Supply

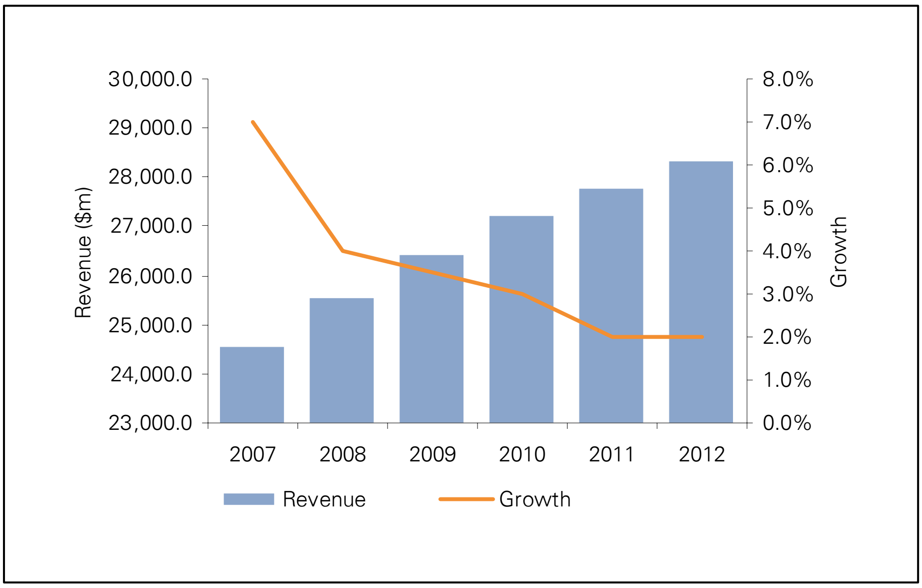
Four large companies, namely Cochlear Ltd, ERG Ltd, Vision Systems Ltd and Lemarne Corporation Ltd, dominate the supply of electrical and electronic equipment, however, a significant number of small companies also operate in the industry. Of these entities, some companies are involved in design or research and development, while others specialise in the manufacture of certain components, such as computer chips, under contract for other companies.

The ability to negotiate distribution agreements with good suppliers (e.g. with manufacturers) can be important to ensuring receipt of high quality stock with strong brand names. Many wholesalers in the industry have ownership ties with manufacturers or have established long-term distribution agreements which can inhibit supply to other wholesalers and effectively cut out new entrants to the market.

Outlook

IBISWorld's forecasts for revenue growth in the industry are shown in the figure below.

Figure 3-3: Electrical and electronic equipment consumption by state



Source: IBISWorld

Strong growth in investment in electrical and electronic equipment is expected to continue largely as a result of:

- Australia's escalating mining activities
- technological advancements in electronics and telecommunications
- strong growth in equipment and infrastructure investment
- growth in the Australian population.

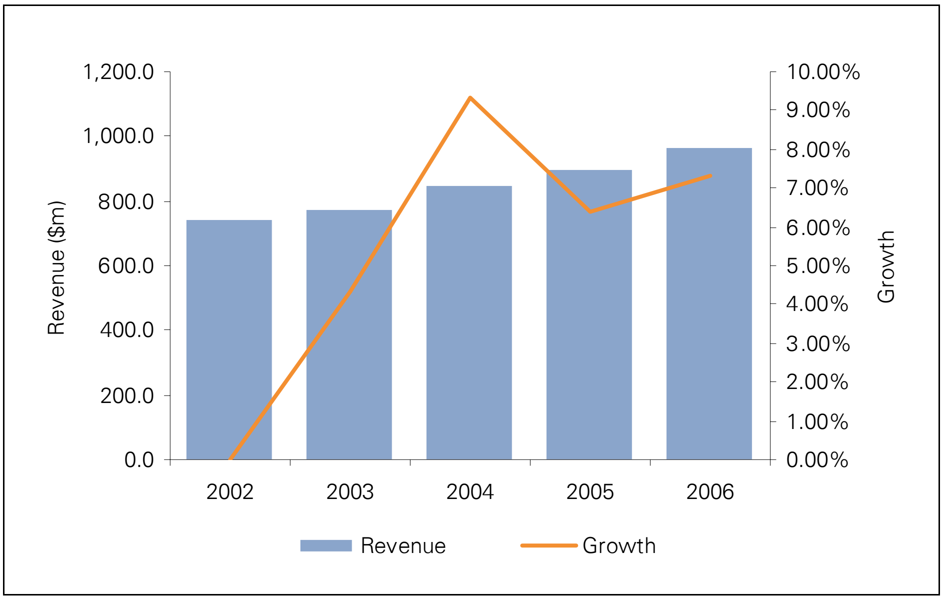
Despite this favourable outlook, there is still likely to be a continuing decline in real unit selling prices for most products; although this will positively effect sales volumes.

Electrical lighting

Market size

Avatar is active in a number of large and highly fragmented markets. In the market for electrical lighting in Australia, IBISWorld estimates revenues in 2006 were approximately $965 million. Estimates for sales and nominal growth rates in the years from 2002 to 2006 inclusive are shown in the figure below.

Figure 3-4: Electrical lighting industry revenue and growth



Source: IBISWorld

IBISWorld anticipates that there will be further growth in the electrical lighting industry in Australia in 2007 and 2008.

The lighting industry in Australia is highly fragmented. IBISWorld estimates that there were 750 enterprises active in the industry in 2006, with the top four players in the industry making up only ten percent of industry revenue.

Demand

Demand for consumer electrical products is principally driven by residential and non-residential construction. This in turn is dependent on the wider level of economic activity. Other influences on demand include:

- replacement cycle for lighting and other electrical equipment and accessories
- moves towards energy conservation and more efficient products such as fluorescent bulbs.

Demand for certain types of lighting will be affected by the recent government policy to phase out use of standard incandescent light bulbs. As a result this change, the demand for fluorescent light bulbs can be expected to increase in future.

Supply

In general, markets for consumer electrical products feature numerous small operators. Furthermore, products are often generic and substitutable, making price the basis of most competition in the industry. Other bases on which suppliers compete include:

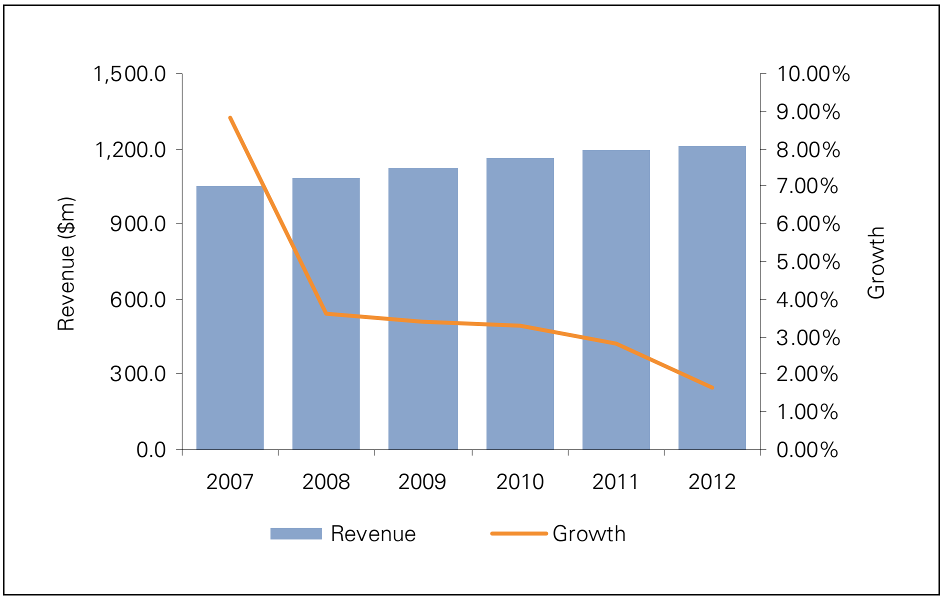
- level of technical innovation
- product reliability
- internal engineering and manufacturing processes, with lower production costs making stronger price competition possible
- brand recognition through delivery of a quality product and a large product range.

There are a number of significant barriers to entry which operate to deter new market entrants. Among these are high setup costs for new operations, requirement for technical expertise and skilled labour, trading history of established players and the level of import competition.

Outlook

The outlook for consumer electrical products in Australia is for consistent moderate levels of growth. IBISWorld's forecasts for revenue growth in the electrical lighting industry are shown in the figure below.

Figure 3-5: Electrical lighting industry forecast revenue and growth



Source: IBISWorld

The major contributors to the forecast revenue growth for the period is a combination of the forecast increase in the value of new building construction, the growth in alterations and additions to existing premises and increases residential construction activity.

Proxy forms to be printed in different colours

Proxy Form

Avatar Industries Limited

ACN 008 742 390

All correspondence to:

ComputerShare Investor Services
GPO Box D182

Perth WA 6840
Enquiries +61 8 9323 2000

Facsimile +61 8 9323 2033

Mark this box with an 'X' if you have made any changes to your address details ☐

Reference Number

Appointment of Proxy

I/We being a member/s of Avatar Industries Limited and entitled to attend and vote hereby appoint

☐ The Chairman of the General Meeting (mark with an "X") OR [ ] Write here the name of the person you are appointing if this person is someone other than the Chairman of the General Meeting.

or failing the person named, or if no person is named, the Chairman of the General Meeting, as my/our proxy to act generally at the meeting on my/our behalf and to vote in accordance with the following directions (or if no directions have been given, as the proxy sees fit) at the meeting of Avatar Industries Limited to be held at 10.30am 31 October 2007 at Suite 2, Level 14, The Forrest Centre, 221 St Georges Terrace, Perth, WA, 6000 and at any adjournment of that meeting.

IMPORTANT: FOR RESOLUTION BELOW

☞ ☐ If the Chairman of the General Meeting is to be your proxy and you have not directed your proxy how to vote on Item 1 below, please place a mark in this box. By marking this box you acknowledge that the Chairman of the General Meeting may exercise your proxy even if he has an interest in the outcome of Item 1 and that votes cast by him, other than as proxy holder, would be disregarded because of that interest. If you do not mark this box, and you have not directed your proxy how to vote, the Chairman of the General Meeting will not cast your votes on the relevant Item and your votes will not be counted in computing the required majority if a poll is called on this item. The Chairman of the General Meeting intends to vote undirected proxies in favour of Item 1.

Voting directions to your proxy – please mark ☒ to indicate your directions

	For	Against	Abstain*
1. Resolution – Special Resolution To approve the Capital Return	☐	☐	☐

*If you mark the Abstain box for a particular item, you are directing your proxy not to vote on your behalf on a show of hands or on a poll and your votes will not be counted in computing the required majority on a poll.

PLEASE SIGN HERE

This section *must* be signed in accordance with the instructions overleaf to enable your directions to be implemented.

Individual or Security Holder 1	Security Holder 2	Security Holder 3
Sole Director and Sole Company Secretary	Director	Director/Company Secretary

		/ /
Contact Name	Contact Daytime Telephone	Date

How to complete the Proxy Form

1 Your Name and Address

This is your name and address as it appears on the company's share register. If this information is incorrect, please mark the box and make the correction on the form. Security holders sponsored by a broker should advise their broker of any changes. Please note you cannot change ownership of your securities using this form.

2 Appointment of a Proxy

If you wish to appoint the Chairman of the General Meeting as your proxy, mark the box. If the person you wish to appoint as your proxy is someone other than the Chairman of the General Meeting please write the name of that person. If you leave this section blank, or your named proxy does not attend the meeting, the Chairman of the General Meeting will be your proxy. A proxy need not be a security holder of the company.

3 Votes on Items of Business

You may direct your proxy how to vote by placing a mark in one of the boxes opposite each item of business. All your securities will be voted in accordance with such a direction unless you indicate only a portion of voting rights are to be voted on any item by inserting the percentage or number of securities you wish to vote in the appropriate box or boxes. If you do not mark any of the boxes on a given item, your proxy may vote as he or she chooses. If you mark more than one box on an item your vote on that item will be invalid.

4 Appointment of a Second Proxy

You are entitled to appoint up to two persons as proxies to attend the General Meeting and vote on a poll. If you wish to appoint a second proxy, an additional Proxy Form may be obtained by telephoning the company's share registry or you may copy this form.

To appoint a second proxy you must:

(a) on each of the first Proxy Form and the second Proxy Form state the percentage of your voting rights or number of securities applicable to that form. If the appointments do not specify the percentage or number of votes that each proxy may exercise, each proxy may exercise half your votes. Fractions of votes will be disregarded; and

(b) return both forms together in the same envelope.

5 Signing Instructions

You must sign this form as follows in the spaces provided:

Individual:	where the holding is in one name, the holder must sign.
Joint Holding:	where the holding is in more than one name, all of the security holders should sign.
Power of Attorney:	to sign under Power of Attorney, you must have already lodged this document with the Company. If you have not previously lodged this document for notation, please attach a certified photocopy of the Power of Attorney to this form when you return it.
Companies:	where the company has a Sole Director who is also the Sole Company Secretary, this form must be signed by that person. If the company (pursuant to section 204A of the Corporations Act 2001) does not have a Company Secretary, a Sole Director can also sign alone. Otherwise this form must be signed by a Director jointly with either another Director or a Company Secretary. Please indicate the office held by signing in the appropriate place.

If a representative of the company is to attend the General Meeting the appropriate "Certificate of Appointment of Corporate Representative" should be produced prior to admission.

Lodgement of a Proxy

This Proxy Form (and any Power of Attorney under which it is signed) must be received at the address given below not less than 48 hours before the commencement of the General Meeting. Any Proxy Form received after that time will not be valid for the scheduled General Meeting.

Documents may be lodged:

By posting, delivery or facsimile to the address below

ComputerShare Investor Services Pty Limited
Level 2, 45 St George's Terrace

Perth , Western Australia 6000
Facsimile: 61 8 9323 2033

Telephone: 61 8 9323 2000

By facsimile to:

Avatar Industries Limited

Facsimile: 61 2 9411 8879

Proxy forms to be printed in different colours

Proxy Form

Avatar Industries Limited

ACN 008 742 390

All correspondence to:

ComputerShare Investor Services
GPO Box D182
Perth WA 6840
Enquiries +61 8 9323 2000
Facsimile +61 8 9323 2033

Mark this box with an 'X' if you have made any changes to your address details ☐

Reference Number

Appointment of Proxy

I/We being an Exiting Shareholder/s of Avatar Industries Limited and entitled to attend and vote hereby appoint

☐ The Chairman of the Exiting Shareholders' Meeting (mark with an "X") OR [ ] Write here the name of the person you are appointing if this person is someone other than the Chairman of the Exiting Shareholders' Meeting.

or failing the person named, or if no person is named, the Chairman of the Exiting Shareholders' Meeting, as my/our proxy to act generally at the meeting on my/our behalf and to vote in accordance with the following directions (or if no directions have been given, as the proxy sees fit) at the meeting of Avatar Industries Limited to be held at 11.00am 31 October 2007 at Suite 2, Level 14, The Forrest Centre, 221 St Georges Terrace, Perth, WA, 6000 and at any adjournment of that meeting.

IMPORTANT: FOR RESOLUTION BELOW

☞ ☐ If the Chairman of the Exiting Shareholders' Meeting is to be your proxy and you have not directed your proxy how to vote on Item 1 below, please place a mark in this box. By marking this box you acknowledge that the Chairman of the Exiting Shareholders' Meeting may exercise your proxy even if he has an interest in the outcome of Item 1 and that votes cast by him, other than as proxy holder, would be disregarded because of that interest. If you do not mark this box, and you have not directed your proxy how to vote, the Chairman of the Exiting Shareholders' Meeting will not cast your votes on the relevant Item and your votes will not be counted in computing the required majority if a poll is called on this item. The Chairman of the Exiting Shareholders' Meeting intends to vote undirected proxies in favour of Item 1.

Voting directions to your proxy – please mark ☒ to indicate your directions

	For	Against	Abstain*
1. Resolution – Special Resolution To approve the Capital Return	☐	☐	☐

*If you mark the Abstain box for a particular item, you are directing your proxy not to vote on your behalf on a show of hands or on a poll and your votes will not be counted in computing the required majority on a poll.

PLEASE SIGN HERE

This section *must* be signed in accordance with the instructions overleaf to enable your directions to be implemented.

Individual or Security Holder 1	Security Holder 2	Security Holder 3
Sole Director and Sole Company Secretary	Director	Director/Company Secretary

		/ /
Contact Name	Contact Daytime Telephone	Date

How to complete the Proxy Form

1 Your Name and Address

This is your name and address as it appears on the company's share register. If this information is incorrect, please mark the box and make the correction on the form. Security holders sponsored by a broker should advise their broker of any changes. Please note you cannot change ownership of your securities using this form.

2 Appointment of a Proxy

If you wish to appoint the Chairman of the Exiting Shareholders' Meeting as your proxy, mark the box. If the person you wish to appoint as your proxy is someone other than the Chairman of the Exiting Shareholders' Meeting please write the name of that person. If you leave this section blank, or your named proxy does not attend the meeting, the Chairman of the Exiting Shareholders' Meeting will be your proxy. A proxy need not be a security holder of the company.

3 Votes on Items of Business

You may direct your proxy how to vote by placing a mark in one of the boxes opposite each item of business. All your securities will be voted in accordance with such a direction unless you indicate only a portion of voting rights are to be voted on any item by inserting the percentage or number of securities you wish to vote in the appropriate box or boxes. If you do not mark any of the boxes on a given item, your proxy may vote as he or she chooses. If you mark more than one box on an item your vote on that item will be invalid.

4 Appointment of a Second Proxy

You are entitled to appoint up to two persons as proxies to attend the Exiting Shareholders' Meeting and vote on a poll. If you wish to appoint a second proxy, an additional Proxy Form may be obtained by telephoning the company's share registry or you may copy this form.

To appoint a second proxy you must:

(a) on each of the first Proxy Form and the second Proxy Form state the percentage of your voting rights or number of securities applicable to that form. If the appointments do not specify the percentage or number of votes that each proxy may exercise, each proxy may exercise half your votes. Fractions of votes will be disregarded; and

(b) return both forms together in the same envelope.

5 Signing Instructions

You must sign this form as follows in the spaces provided:

Individual:	where the holding is in one name, the holder must sign.
Joint Holding:	where the holding is in more than one name, all of the security holders should sign.
Power of Attorney:	to sign under Power of Attorney, you must have already lodged this document with the Company. If you have not previously lodged this document for notation, please attach a certified photocopy of the Power of Attorney to this form when you return it.
Companies:	where the company has a Sole Director who is also the Sole Company Secretary, this form must be signed by that person. If the company (pursuant to section 204A of the Corporations Act 2001) does not have a Company Secretary, a Sole Director can also sign alone. Otherwise this form must be signed by a Director jointly with either another Director or a Company Secretary. Please indicate the office held by signing in the appropriate place.

If a representative of the company is to attend the Exiting Shareholders' Meeting the appropriate "Certificate of Appointment of Corporate Representative" should be produced prior to admission.

Lodgement of a Proxy

This Proxy Form (and any Power of Attorney under which it is signed) must be received at the address given below not less than 48 hours before the commencement of the Exiting Shareholders' Meeting. Any Proxy Form received after that time will not be valid for the scheduled Exiting Shareholders' Meeting.

Documents may be lodged:

By posting, delivery or facsimile to the address below

ComputerShare Investor Services Pty Limited
Level 2, 45 St George's Terrace

Perth , Western Australia 6000
Facsimile: 61 8 9323 2033

Telephone: 61 8 9323 2000

By facsimile to:

Avatar Industries Limited

Facsimile: 61 2 9411 8879