The Manager
Companies Announcements Office
Australian Securities Exchange

29 January 2018

Dear Sir/Madam,

Quarterly letter to shareholders

Please find attached a copy of the latest in a series of letters that the Managing Director of the Company addresses to its shareholders some time after the end of each quarter.

The letter is intended to provide information on the Company's activities and highlight the progress that has been made, while providing some insight into the Board's rationale for the Company's actions and its plans.

Yours sincerely,

Ms Vicky Allinson
Company Secretary

Suite 805, Aurora House, 147 Pirie Street
Adelaide SA 5000
T (08) 8227 2482 F (08) 8312 2020
kipt.com.au
ACN 091 247 166

Quarterly Letter

December Quarter 2017

Dear Shareholder,

We have just finished the most transformative year in the Company's history and, as a result, we are stronger and better resourced than ever, and considerably closer to achieving our goal of being a sustainable and profitable exporter of high quality timber products.

Having said that, I expect 2018 to be equally transformative, although much less stressful for our staff and our shareholders. The people and the financial resources that we need are now in place. Everything that we can control is under control. We have confidence in our partners and know that they have confidence in us. The remaining risks that we face are known and to a large extent manageable. The main concerns now are delays to development approval, restrictive consent conditions and unforeseen construction challenges. We believe that none (or even all) of these has the capacity to endanger the project or the Company. And meanwhile our trees keep on growing.

We continue to work on finalising our Environmental Impact Statement (EIS) for the Smith Bay deep-water wharf[1] and will keep the market informed about our progress. Of course, we want development approval as soon as possible, so that we can begin to export and unlock value for shareholders and for the Kangaroo Island community. We also want to make the right decisions now about our future operations, so that we can design a high-quality production system that is as efficient and reliable as possible. This feeds into the EIS because it affects our site layout at Smith Bay.

In this newsletter, I want to share some of our thinking about our future operations. But first, let me provide a bit more information on the recent equity capital raising. Several shareholders have contacted me about this and I have talked with them and answered their questions … but it seems appropriate to canvass the issues more broadly.

Project funding

When I wrote the September quarterly letter, the Company had already announced a "short-term" loan from its largest shareholder to complete the purchase of the large floating pontoon that will form the berth face of the KI Seaport. And, in the letter itself, I wrote that one of the ways in which we planned to manage construction risk was through maintaining "adequate cash provisions". So, it probably surprised few close observers of the Company that we raised extra cash in the December quarter.

Of course, we could have taken on more debt, but the Board considered that this would be imprudent without current income to service increased borrowings. Development projects

[1] We now refer to this facility as the KI Seaport.

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can fall over because they take on too much debt too soon and pay interest from borrowings. Second-ranking debt also carries a high price and onerous conditions, so equity capital was the prudent option. We could have used a preference share structure but that would have been manifestly prejudicial to existing non-participating shareholders. So, that left either an entitlements issue or a placement (or a blend of the two) as the realistic options for the board.

Using a placement, without an entitlement offer, was a big decision and not one taken lightly. The rights offered in April 2017 (at the same price) had a low take-up from retail shareholders. The costs, in time and resources, did not justify such an exercise again and, in any case, the low level of take-up in April meant that we could not easily find a sub-underwriter willing to take up the unsubscribed rights on terms acceptable to the Company.

With our broker Petra Capital, we worked hard to raise capital at the highest possible issue price. In the end, the raise was over-subscribed at $2.00, but a higher price might have jeopardised the participation of some significant bidders, causing the whole exercise to fail. It is a tricky thing to get right, but I am confident that we achieved a favourable outcome for existing shareholders.

I have no doubt that the Board did what was best for the Company. And the placement has benefited non-participating retail shareholders enormously, by materially reducing an important source of risk: that we would be unable to execute our project through lack of cash. The share price has responded well to the placement, unlike the last rights issue, when the traded share price fell to the issue price. Accordingly, those incoming shareholders who, by their participation, helped us manage that risk, have themselves benefitted, which is only fair. A win-win.

So, on behalf of existing shareholders, I want to welcome new shareholders and to thank those existing institutional holders who supported the placement. Our Company is stronger as a result and our share register is better balanced, with several large new owners and a much-improved number of marketable parcel holders.

The Corporations Act forbids directors from participating in a placement without express shareholder approval. Around the board table we are very positive about the Company and wanted to signal our support for the placement by announcing that we would seek permission (and publicly commit) to take a part of the placement ourselves. So, if the share price had fallen below the issue price, we would still be seeking consent and still committed to taking up new shares, subject to shareholder approval. Participants in the placement welcomed this commitment on the board's part.

And the last question that has been put to me by one shareholder is "why did the board decide to accept $20m in new subscriptions, rather than the planned $15m?" The answer is reasonably simple, although I accept that not everyone would agree with our decision. As much as we enjoy working with Petra, we do not want to be in a position in which we must

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again raise equity capital. We believe that the extra $5m, while it may yet prove to be surplus to the Company's requirements, makes the Company just that much more resilient to unexpected adverse events … providing we don't find ways to fritter it away.

In other words, that $5m is valuable to the Company only if we can discipline ourselves to think and act as if it didn't exist. So, if you want to chat with me about it on the evening Sydney flight following the General Meeting next month, book yourself on Tiger Airways. But if you are on Qantas and want to usher me into the Club as your guest, I will accept.

Designing our operation

Paul Samuelson, who was awarded the 1970 Nobel Prize in economics, once said "Well, when events change, I change my mind. What do you do?" Many people mistakenly attribute this to JM Keynes.

Anyway, not long ago I wrote "we will be chipping in field". While it remains technically true, it is no longer a strictly accurate statement. Events have changed and Graham Holdaway (Director of Operations) and I have changed our minds. In-field chipping will definitely be a part of our operations, but there may be a case for taking some, or even most, logs to a central static chipping facility. This comes about as a result of our investigations into similar operations in other parts of Australia - Bunbury WA in particular. With Graham's help, I have written a summary of the considerations below.

As we get closer to having a means of exporting forest products from KI, we are giving thought to the operating model(s) we will adopt to achieve this. These operating models are of interest to shareholders because they determine how products are produced and, more importantly, at what cost. KIPT confronts the same imperative that faces every commodity supplier ... the lower we are on the cost curve, the better. This means both better profits in good times and more certain survival (and buying opportunities) in difficult times.

Our immediate task is to determine the systems by which we will harvest the trees already in the ground. We refer to these trees as Rotation 1 or R1. Trees that we will plant in future (or re-grow from stumps of R1 trees) we refer to as R2. The considerations include:

Harvest timing

Do we harvest R1 trees 'when ready' or do we seek to 'smooth' supply to ensure a consistent supply through to the availability of R2 trees? There are factors that could pull us in either direction, but our expectation is that market demands, and workforce and operational continuity, will push us towards the 'smoothed' harvest - at least for our main E. globulus (Tasmanian bluegum) crop. How we deal with the Radiata Pine and E. nitens components of the estate are separate questions.

Harvest approach

There are various options for harvesting our plantations including what is termed Cut to Length (CTL) systems and feller-buncher systems. In order to understand the sort of machinery involved you can look here, or here. The actual cutting of the trunk can be

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achieved with either a rotating disc saw, a set of shears (like oversize secateurs) or, more usually, a chainsaw. An important part of the consideration is the impact each system has on establishment of R2. Some options protect stumps that might support a coppice rotation better than others. CTL, which involves removing bark, foliage and lateral branches at the stump, results in better nutrient retention but generally produces slightly lower yields, because bark, tops and branches fall to the ground. For this reason, some people refer to CTL as "processing at the stump". In contrast, if a feller-buncher is used, bunches of whole trees are dragged by heavy machinery to be fed into an in-field chipper.

Chipping

While we will sell some of our resource as logs, the majority is likely to be sold as chips to mills in Asia that produce Dissolving Pulp. Pulp mills require a quite tight specification chip size and the absence of contaminants such as bark, soil, plastic and metal. The main options we are considering here are whether we can use in-field chipping (IFC) and/or a central static chip mill. Each option has far-reaching implications for other parts of the supply chain. For example, a CTL approach to harvesting can be used with either IFC or a static chip mill, whereas harvesting with a feller-buncher necessitates the use of IFC, simply because it is impractical to cart whole trees by road. And IFC means that we are mainly moving chips by road, whereas a static mill requires logs to be delivered, with implications to the format of the trailers to be used and the loading and unloading systems. To complicate matters further, there are at least four different systems for unloading chips from trucks.[2]

Coppiced R2 crops generally need to be harvested by a feller-buncher and put through an IFC system, because they often have multiple stems. Therefore, even if our preference is to put most of our R1 trees through a static chip mill as CTL logs, we will still need an IFC receival facility for R2, so that, in the 2030s and beyond, our stockpile can be built by either IFC or a static mill chip.

Haulage

Logs and chips are transported by road in trucks. Semis are the smallest feasible option, and can legally use any road in South Australia. However, our preliminary advice from the regulators is that B-doubles or A-doubles[3] involve similar axle loads on roads, but reduce the number of truck movements and cost per tonne carried. We will be guided by safety, rather than productivity, although both considerations probably militate in favour of fewer and larger vehicles.

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2 The most exciting of these is called "a rocket launcher", in which the whole articulated truck is secured to a platform and lifted to a steep angle. Disappointingly, we will probably use a less spectacular system of bins unloaded by walking floors or forklifts.

3 As with beer glasses, every state and country has its own terminology for trucks. An A-double is best thought of as a two-trailer road train: a prime mover with two full size trailers, the second of which is a fully-wheeled dog trailer. In contrast, a B-double has a shorter first trailer with a turntable to which a standard rear-wheeled trailer is attached. We hope and expect to use A-doubles. If it can be shown to be safer, we will seek permission to use A-triples (three car road trains). This will be a safety decision, not an economic one.

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B-doubles are widely used on Kangaroo Island roads for livestock transport. A-doubles are used in many other parts of the State but do not easily fit on the ferry to Kangaroo Island. That need not concern us, given that we are building a deep-water wharf and can import whatever machinery we need.

Different log and chip options involve different logistics solutions at the KI Seaport. We have the advantage of plenty of space and the freedom to get the layout we want.

Screening and quality control

Chipping is basically chopping up a tree into small pieces. Pulp mills require the chip dimensions to be tightly controlled. They don't want chips that are too big to break down in their thermo-mechanical and chemical processes. And they don't want too many tiny splinters or dust, which reduce the quality of their pulp. So, a great deal of effort goes into setting up and fine-tuning the IFC or the static mill to produce a high proportion of "accepts".

Even so, all chips will be screened through a giant pair of vibrating sieves, with undersize fragments becoming a waste stream for nutrient recycling and oversize chips being broken into accepts. Rather than having two screening facilities, it makes sense to have IFC receival and a static mill discharging into the same screening system and building a single stockpile of screened chips. Metals also need to be detected and removed and this is typically done as the chips are on the conveyor to the ship.

Plastic is more difficult to detect and remove. The pulp mill customers strongly disapprove of it, so anywhere that woodchips are processed must be a plastic-free zone … and yes, a smoke-free zone too, for obvious reasons.

Silviculture

While shareholders will not see net positive cash flow from R2 until the 2030s, we need to think about the best means of establishing the next rotation now. E. globulus planted now will be harvestable in about 12 years' time. A coppice rotation (a crop grown from the stumps left from R1) may be available as soon as 10 or 11 years from harvest. And, given the sustained growth rates we observe on KI, we may elect to stretch out the rotations a bit, for example to take advantage of market conditions or to spread fixed harvest costs over larger recovered volumes. Forestry is a long-term business, as I say in every investor presentation!

We have some land that has grown excellent volumes of pine, but may grow only average E. globulus. Although our preference is to produce as much hardwood for chip as we can, we are considering the criteria by which we might establish or replant pine. A more important set of rules will guide us in our choice between coppice rotation versus replant. Longer term, there is also the opportunity to dispose of some less suitable land and acquire other land that we believe will perform better under E. globulus, although current planning rules make this process complicated.

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One of the damaging legacies of the MIS debacle is the extent to which "other priorities" have undermined the proper focus on long-term silvicultural performance. KIPT is in the happy position of having land well suited to either E. globulus or P. radiata - and, in many cases, both.

What next?

We are working with our forest managers PF Olsen on a detailed financial evaluation of the various options for our operating model. We have also identified experts in components of the task and we are drawing on their experience and expertise. As usual, our marketing partner Mitsui is offering valuable insights. This work will proceed, in parallel with and as input to our wharf approval efforts, so we will be well placed when development approval is obtained.

You will notice that we have changed our thinking on not one but two questions over the last few months. Up until now, we have been assuming that we would use IFC for all our eucalypts. We are now considering the possibility of a static mill located somewhere *en route* to Smith Bay. Also, we have always assumed that we will move to 100% E. globulus. Again, there may be good reasons for maintaining a small part of our estate in pine, if that will result in better returns to shareholders.

In conclusion

The Board and I look forward to seeing shareholders at the GM in Adelaide early next month, and I will bring some "accepts" so you can see the end product that we are selling. In the meantime, please feel free to contact me at any time.

With best wishes and thanks,

John Sergeant
Managing Director

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Adelaide SA 5000
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