

The Manager
Companies Announcements Office
Australian Securities Exchange

24 April 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 following the end of each quarter.

The letter is intended to provide background 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

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Quarterly Letter

March Quarter 2018

Dear Shareholder,

In this letter, I want to consider how KPT could look, well beyond the time when our plantations on Kangaroo Island have moved from the development phase into the sustainable production phase.

The Board is eager to begin paying dividends and, at the same time, to meet the Company's debt repayment obligations. Having said that, KPT will be lightly geared, given the ability of the plantations to produce free cashflow, so there is no pressing need to reduce debt rapidly at the expense of dividends. So, you can assume that, at the very least, KPT will be a yield stock ... and probably the best way for non-institutional investors to get direct exposure to timberland as an asset class.¹ That is an easy claim to make, given that no other companies focused on timberland are currently ASX-listed.

But should the Company seek to grow and change, and, if so, what are the opportunities?

Carbon sequestration

If, when you travel by air in Australia, you elect to tick the box and pay the small surcharge to fly carbon neutral, you are likely to be paying someone for carbon credits generated by commercial forestry in another country. Despite the fact that forestry is carbon positive (or perhaps because of this fact) existing forestry is largely outside Australia's carbon accounting regime. One day, this will change and the excellent growth rates on KI will give us a very large saleable carbon sequestration capacity. So, that will be a part of our future, although we don't know when. The Australian Forest Products Association (AFPA) is working hard on this issue.

Just grow slowly

Forestry is a long-term business anywhere, and particularly on KI. The fact that we have an extended growth curve on our eucalypt plantations means that, even if we get new trees in the ground as soon as we secure approval of the KI Seaport, it may be financially optimal to let them grow for 15-20 years. We need to do more work to identify the optimum length of a rotation, but the evidence we already have suggests that trees on KI grow very, very well, for a very long time. It makes sense then to spread the largely fixed costs of planting and harvesting over as many tonnes of timber as possible, so one should not harvest a plantation until its growth rate slows to somewhat below its associated discount rate. We expect that this is in the 15-20 year window but we don't yet have the data that we need to optimise performance. Based on experience in other areas of Australia, there will probably be a KI-specific growth curve, with a characteristic shape reflecting the island climate. The

¹ You can find an interesting discussion on timberland as an asset class [here](#), albeit from a North American perspective.

slope (i.e. productivity) of that curve will of course vary from site to site and based on plant genetics.² However, the shape tells us when we should harvest.

Turning back to the future, a simple strategy for KPT is to increase the area under forestry on those parts of the Island where there is suitable land. As a first step, cleared unplanted areas of our existing landholding need to be assessed for their suitability. We can do that work over coming months. Even poorly-suited areas need to be considered for planting, given that the alternative rate of return is zero or thereabouts.

Looking beyond land that we already own, high-rainfall land on KI is relatively inexpensive and eucalypt forestry is clearly the highest and best use for much of it. So, KPT could steadily increase its landholdings, get more trees in the ground and gradually increase the amount of timber we export each year.

There are a few problems with this as a strategy. The first is that there are planning restrictions that limit the size of forestry on KI. The Board is not particularly worried about this, simply because we anticipate that it will be changed once forestry becomes the biggest industry on KI and when individual private landholders also want to plant trees on their own land. Indeed, the wholesale reversion of mainland eucalypt plantations back to grazing and cropping shows the farming community that forestry is just another land use and that forestry is not something that irreversibly colonises “farmland”. Especially given the carbon-positive nature of our business, we do not anticipate any great resistance to allowing greater tree planting on the Island.

The main problem with the “grow slowly” model is that, on its own, it is simply ... too slow. Land sales are sporadic on KI, and less than half the land is suitable for forestry. But let’s be optimistic and say that we could bid enough to expand our estate by 10% per annum (over its current size) for ten years, doubling our landholding in the process. We would still not sell a single extra tonne of timber for a further five years at least, although we would be booking the growth in our accounts as changes in inventory. Sometime in the mid to late 2030s, we would be selling three quarters of a million tonnes per annum, with a stable inventory. However, we would have spent a good deal of time, energy and money identifying and buying suitable land ... and we may not be too popular with the farming community if we mop up available land at what would seem, by today’s standards, to be above-market prices.

This reminds me that it will be very important, once we have wharf approval, to ensure that our valuation of inventory, while remaining conservative, is not so conservative that it materially understates the value of our growing tree crop. Otherwise, planting additional trees will look like foolishness! More importantly, we have a duty to shareholders to

² Refer to my June 2017 quarterly letter to shareholders for a discussion of how we measure the standing volume of a plantation and monitor its rate of growth, thereby generating a growth curve. A copy can be found [here](#).

represent the value of the Company's assets accurately, so that people using KPT as a way of buying and selling timberland do so on a fully informed basis.

Anyway, this grow slowly model is a perfectly acceptable strategy and one with very few risks, other than possibly alienating other landholders. The Company would simply do what it currently plans to do, but on a steadily larger scale and with a more attractive return on its investment in the KI Seaport, over which all timber will inevitably pass. Kangaroo Island is big enough to accommodate this expansion, providing it is gradual and has community support. So, while the Board will make its decisions over coming years, it seems that an orderly and gradual expansion in the Company's estate has to be a part of any imagined future. But the Company can probably walk and chew gum, so let's think about what sort of gum we might want to chew on.

Farmers as partners

I am writing this newsletter in Rotorua, where I am travelling with a group of foresters and farmers looking at models for farm forestry, which accounts for about 34% of New Zealand's timber crop. Here is a picture of some trees on Wharenui Farm, part of a Maori land trust aggregation. The trip has been organised by AFPA and the National Farmers Federation, along with their NZ equivalents. North America and Scandinavia have even higher levels



of private and farm forestry than New Zealand, but shareholders need not worry about the Managing Director spending shareholders' money on that sort of travel. New Zealand will do just fine, as will SW Western Australia, where there is also a fair bit of farm forestry.

Traditionally, in Australia, relations between farmers and foresters have been strained, largely due to perceptions that they are in competition for land and for water. To some extent, this is true. But no more so than any other two competing land uses. Sheep and grain also compete for land and for water, but no one has worried much about this since certain regrettable events in the Highlands of Scotland about 200 years ago.³

Anyway, timber is just another land use, an alternative and, quite often, complementary crop. There is no such thing as farmland and timberland. There is only land. A person or

³ Interestingly, many of those farmers displaced in the Highland Clearances ended up on the land in Australia and New Zealand, after helping bring about another sort of dispossession in these two countries.

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company who owns land is usually looking for a good return on that asset, and for a diversity of income sources.

There is good evidence that, in a dry country like Australia, planting trees on a proportion of a cropping or grazing farm makes the remaining land more productive, through sheltering effects and by improving soil moisture retention. Of course, the big impediments are that farmers are usually not silviculture experts (and have little motivation to acquire this knowledge), and a timber crop takes so long to pay off, even if it is much more profitable than the next best land use. Still, the NFF is supportive of increasing farm forestry and you can read about it [here](#). As well as the diversification and productivity benefits, farm forestry allows graziers to offset the massive emissions of greenhouse gases caused by ruminants, and to limit the run-off of nitrates and phosphates into waterways.

Farm forestry opens up a possible expansion path for KPT that is less capital-intensive than buying land, and makes other landholders our allies, rather than our competitors. KPT could become an enabler of on-farm forestry, providing the expertise and seed capital (seedling capital?), along with the end-of-rotation harvest, haulage and marketing services that need scale to be economic.

There are very many ways of achieving this: assisting individual tree-growers to become suppliers to KPT on a stumpage basis, incubating farmer co-op groups to enable scale advantages, sharecropping with landholders, progressive purchase arrangements or straight leasing. There is also the possibility of working with large institutional landholders, utilising staggered plantings to create an even woodflow and cashflow.

Whatever system is employed, it needs to deal with the two impediments I mentioned above: knowledge asymmetry and the long wait for a harvestable crop. And where better to develop the idea of farm forestry and turn it into a scalable product than on KI, where we believe that forestry is much more profitable than alternative land uses?

So, whatever else KPT does, it would seem to make sense to explore the possibility of a significant expansion of the KI estate by working with existing landholders on the western half of the Island, the South Coast and parts of the Dudley Peninsula, all of which have sufficient rainfall to grow timber productively.

Managing projects for other capital providers

Growing the business, whether by land acquisition or using farm forestry, requires capital. If the only source of this is retained earnings, then the Company's growth will always be constrained by debt servicing requirements and the legitimate expectations of shareholders for a steady dividend stream. After all, that is one of the main reasons why one owns a forestry asset.

One possible way of addressing this requirement for capital is to transform KPT into a manager of institutional capital looking for high-quality forestry and agro-forestry projects run by an organisation with a track record of successfully developing productive forestry. As

we near the end of our development journey on KI, it is clear that we have the skills, in the Company and its business partners, that are needed to make things happen in the forestry space. So, we could leverage these skills to do it again, and again, creating and managing forestry assets to meet the growing demand for fibre in our region ... and the growing demand among institutions here and overseas for investment-grade forestry and agro-forestry assets.

In such a scenario, we might vend the KI assets into the first such fund, so that shareholders would be faced with the opportunity to cash-out their ownership of the underlying assets, perhaps by way of a special dividend, or convert them into units in the KPT Forestry Fund Number One⁴, alongside new institutional money. In this scenario, shareholders would retain ownership of the listed forestry asset manager. This is a proven and scalable business model (think of Real Estate Investment Trusts). It would almost certainly involve expanding beyond Kangaroo Island.⁵

Of course, before we can capitalise on a track record, we have to have one, so whatever the future of KPT looks like, the main game is still getting the wharf approved and selling our timber.

We will continue to make regular announcements as we get closer to this outcome. Perhaps in a future letter I will write about the KI Seaport itself, how the Company plans to manage this asset and what its long-term future might look like.

With best wishes and thanks,



John Sergeant
Managing Director

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⁴ We have plenty of time to think of a better name, if we decide to go down this path.

⁵ No, there is no suggestion of changing the company's name back to RuralAus or Australian Growth. After all, BHP's name still reflects its origins, for example.