

The Manager
Companies Announcements Office
Australian Securities Exchange

30 July 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 to provide some insight into the Board's rationale for the Company's actions and its plans.

Yours sincerely,



Ms Vicky Allinson
Company Secretary

Quarterly Letter

June Quarter 2018

Dear Shareholder,

Thank you for all the positive comments on last quarter's letter. I have spoken with a number of shareholders over the last three months and most seem to like the idea of KPT one day evolving to manage a larger plantation area, on and off the Island, including some farm-forestry ... and the idea of transforming the Company into a specialist forestry asset manager, once the KI Seaport is operational and dividends are flowing to our investors. When discussing this idea in my last letter, I used the analogy with a REIT management company.

As several shareholders subsequently pointed out, an analogy with another sector was quite unnecessary, given that more than half of the world's timber plantations are already held in structures called TIMOs (timberland investment management organisations), almost all of which are based in North America. So, we wouldn't have to invent a business model, we would just need to replicate an existing one, here in Australia. Most of the money behind TIMOs is from pension (superannuation) funds and long-term endowments but plenty of individuals also invest in timberland via TIMOs. Australians, for the most part, are still too bruised by tax-driven timber investment schemes to act similarly, for now.

When the time does come to expand KPT's timberland under management, we believe that it would be a mistake simply to buy other existing plantations. Most are fully-priced, and it is hard to create value that way. Better to look at opportunities to establish new plantations in partnership with farmers, or in areas that have been overlooked by foresters, but which already have the necessary export infrastructure.

However, before we lift our collective gaze up to the horizon and imagine KPT as a listed TIMO, we have to complete the final stages of the development project now underway on Kangaroo Island, as I am frequently reminded. We will maintain the flow of news about that, as we move steadily towards approval and try to influence the terms of approval to benefit the business, while protecting the environment and our neighbours.

This quarterly letter has ceded priority to finalising the EIS (for lodgement by the end of September).

Growing and selling timber

This quarter, I want to talk about the markets in which our Company operates, so that shareholders can get a sense of why the Board believes that timber is a great business to be in. I am greatly indebted to Shaw & Partners and to Bell Potter, both of which have initiated

coverage of Midway (MWY)¹ and, in doing so, have assembled much of the statistical data about the timber market that I would otherwise have had to source for myself.

Just as wool and lamb can be produced by the same animal, softwood and hardwood can be produced by the same land. Some types of sheep do better growing wool for our clothing and some do better (economically, if not personally) producing lamb for us to eat. Likewise, some land is better at growing softwood (pines) and some is better at growing hardwood (eucalypts). Most of our land does best growing eucalypts.

Demand for wool and demand for red meat have different dynamics. Prime lamb is often consumed domestically, whereas wool is almost totally exported. And so it is with timber. Local pine prices are driven by housing activity here and abroad, whereas prices for eucalypt chip are almost totally governed by international markets.

But then the analogy breaks down. This is largely because timber takes so much longer to produce than a flock of sheep. So, with reasonably inelastic supply, pine prices are related to the building cycle. When the world's two biggest economies are not in recession and are busy erecting buildings, as they are today, then there is strong export demand for pine, both for structural timber in smaller buildings and for formwork in large construction projects. Prices go up, but they can just as easily fall if building activity falls.

Right now, lumber prices are rising rapidly, and there is such high demand that even thin logs that would in the past have been chipped and used to make newsprint and cardboard are now being sawn to make lumber for building. The result is that there is a shortage of



softwood chip. Its price is rising too. Markets are wonderful like that. So, no matter what sort of pine trees one is growing (good, bad or indifferent) it is a good time to be selling. On Kangaroo Island, we have a mix, from the very best appearance-grade trees (good enough to make skirting boards and architraves) right down to some twisted, scrawny trees that will end up in *The People's Daily*, or as cardboard boxes.

Of course, these favourable market conditions won't last. So, we are thinking of selling as much pine as we can, as quickly as we can, most of it as logs and, probably, some as pine chip. That will allow us to take advantage of favourable pricing and convert our land to near 100% eucalyptus globulus, which is the proven best performer on the Island. It may also

¹ MWY is a forestry services, processing and marketing business, so a little different from KPT, which is a pure timberland player, albeit one with ambitions to be an infrastructure (port) owner.

For personal use only

mean that we produce timber (and cash) at above the long-term sustainable rate for a few years, before settling down to a more steady production rate.

Hardwood is a very different market. Supply is almost completely inelastic. A tree planted today will take at least 12 years to mature, probably longer ... and there is not much evidence that anyone is expanding production: Australia's plantation estate is still contracting, according to ABARES², and all major countries in the Pacific Rim are forecasting flat (Thailand, Chile, South Africa) or declining (Australia, Vietnam, Indonesia) export supply over the next ten years.³

Demand is also more or less fixed in any given year. It is determined by the appetite of hardwood pulp mills; huge pieces of expensive equipment that simply must get their feedstock. Mazawa san, Mitsui's head of woodchip marketing in Tokyo, puts it this way: "some mills are gourmets and some are omnivores, but they are all hungry". The gourmets generally demand FSC® certified Australian eucalyptus globulus. The others take it when they can get it ... but will happily eat acacia or nitens when they can't. And, increasingly, some will go hungry.



With a fixed supply and a fixed demand, the only thing that can adjust is price. We are seeing increasing prices for hardwood chip, as pulp mills in China and Japan compete for a scarce resource and try to outbid each other. Unlike softwood prices, about which it is difficult to make long term predictions, we believe that hardwood price strength is locked in for the foreseeable future and that further rises are inevitable. The Chinese population is using more and more of the products made from pulp. And China is exporting these products to other developing and developed nations. This leads to rising pulp prices and rewards pulp mill owners. It is a good time for woodchip suppliers, and it appears set to last for a good while.

² ABARES Australian plantation statistics 2018 update. It shows that 19,900ha of former plantation land was repurposed in 2016-17, while only 200ha of new plantation land was established, for a net loss of 19,700ha.

³ Source: Bell Potter report on MWY

For personal use only



If you are familiar with how the Uranium market works, then it provides a reasonably good proxy for the hardwood chip market. Nuclear reactors are very expensive and must have their feedstock, so they tend to produce at or near full capacity, regardless of the electricity price. Uranium prices move around but the big supply contracts always specify the volume and typically

run for several years. So it is with woodchips. There is a sporadic spot market but much of the volume is traded on long-term contracts for volume, with an annual or semi-annual price reset process. Owning a pulp mill is very like owning a nuclear reactor. It's big. It's expensive. It has one or two environmental challenges, shall we say. The customer, keen to assure continued supply, usually bears the shipping risk and some customers even have their own fleet of woodchip carriers.⁴ But the big difference is this: uranium supply adjusts in response to price. Hardwood chip supply doesn't, because it can't.

For this reason, we, and all the experts⁵, predict that hardwood chip prices will rise over the next decade. To put this in perspective, FOB prices are still about 25% below the nominal 2012 USD prices, before the MIS production bubble had its devastating effect. Thankfully, that bolus of tax scheme-driven production has now largely moved through the market. The last of it will be gone by 2020. For pulp mill owners, the good times are almost over. Luckily for them, as for nuclear powerplants, the feedstock is not a big part of their cost structure.⁶

But what is happening to the demand for the products that pulp mills produce? There are several types of pulp, made using different processes, from different feedstocks and suited to different end uses. The most important product, from KPT's standpoint, is dissolving pulp, a 90-95% pure form of cellulose, which can be extracted from eucalyptus globulus, the species that grows so well on Kangaroo Island. Globulus has a naturally high cellulose content, and requires less



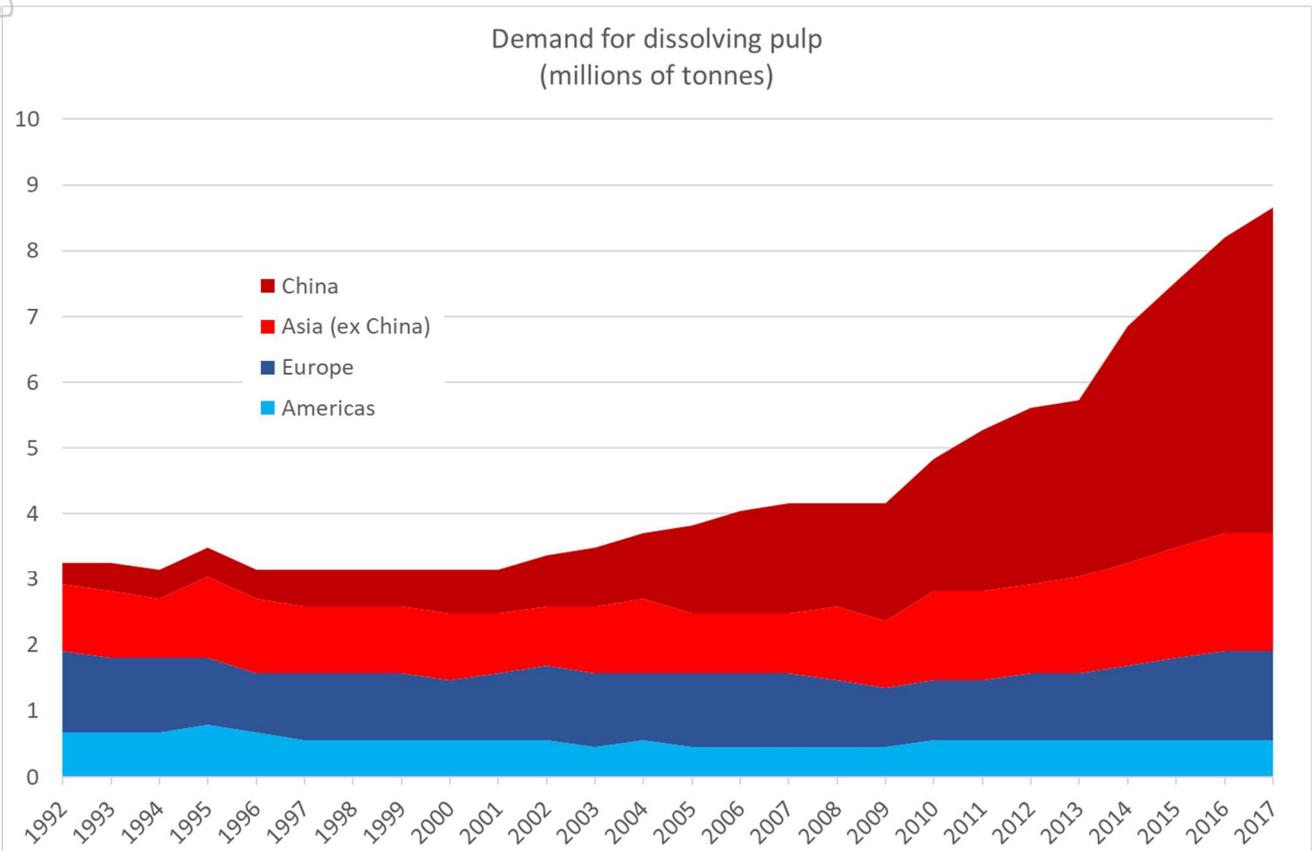
⁴ The vessel shown here is fully laden but still sits high in the water. That is because of the low density of woodchips compared to other cargoes that move in bulk carriers. Woodchips have only 10% of the density of iron ore, for example.

⁵ For example, RISI International Pulpwood Trade Review 2018

⁶ Most pulp mills even look like nuclear power plants. If you are travelling around Japan and cannot read the script, you may find it hard to tell the difference. The two pictures in this letter are of pulp mills, in case you are wondering.

For personal use only

chemical treatment than other wood sources of cellulose. RISI publishes its International Pulpwood Trade Review annually. The following chart is from the 2018 edition, showing global dissolving pulp demand.



Charts for just about any commodity will show how much China has come to the fore in the last quarter century. Indeed, rising demand has seen pulp prices in China rise 50% just in the last two years.⁷ However, it is interesting that the rest of the world is also using more dissolving pulp than it did a decade ago. While demand for paper itself has levelled off or is in decline in most parts of the developed world, steadily increasing global affluence means greater demand for household products such as nappies and tissues, for high-quality packaging and for textiles such as rayon. And the developing world is increasing its demand for paper, offsetting declines elsewhere.

Why does all this matter to KPT? After all, demand for our woodchip products is driven by the need to feed hungry pulp mills, rather than by demand for pulp itself. It matters because charts like the one above are what cause businesses to install new pulp mills and additional lines in existing mills ... and these will also have to be fed. All our projections are

⁷ RISI 2018

For personal use only

based on the pulp mills we already know about. But, with such strong demand for pulp, there will surely be more.

That is enough for now. Sooner or later, with such excellent market fundamentals (and I haven't even mentioned India, or carbon sequestration) , Australians will overcome their well-founded aversion to timberland as an investment class. That will be a good thing for KPT, in the long term.

With best wishes and thanks,



John Sergeant
Managing Director

DISCLAIMER: The Company has taken all reasonable care in publishing the information contained in this letter. The information is a selective summary and is not represented as being complete. The information contained is not intended to be used as the basis for making any investment decision and you are solely responsible for any use you choose to make of the information. We advise that you seek independent professional advice before making any investment decisions. The Company is not responsible for any consequences of the use you make of the information, including any loss or damage you or a third party might suffer because of that use.