



Adviser Edge

TFS Sandalwood Project 2014

INDEPENDENT ASSESSMENT

This report has been prepared for financial advisers only

24 March 2014

Scope

Adviser Edge independent assessments are conducted by Barik Pty Ltd trading as Adviser Edge Investment Research (Adviser Edge) which has developed a key industry sector review process that follows a methodology developed specifically for this asset class.

Key Principles

The underlying principles of the assessment process are to:

- identify the long term commercial potential of the project;
- evaluate project management's capabilities, previous performance in the specific industry and the stability of the organisation;
- evaluate identified markets (domestic and international – existence, stability and growth potential);
- benchmark key performance assumptions and variables against industry and other MIS projects;
- weigh up the relevant risks of the project against projected returns;
- assess project structure and ownership;
- compare and substantiate project fees and expenses;
- determine if the project is structured in such a way as to protect investor's interests; and
- allow an opinion to be formed regarding the investment quality of the project.

Site Assessment

Adviser Edge conducts a detailed site inspection of the project, meets with all levels of project management and inspects the project's infrastructure and market accessibility.

The site assessment considers the following areas:

- suitability of the project site for the purpose intended;
- performance of previous project stages located within close proximity to the proposed site;
- management skills, qualifications, capabilities and experience; and
- associated project risks and their management.

Star Rating

Projects are awarded a star rating out of a possible five stars and placed on the Adviser Edge web site www.adviseredge.com.au

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Star ratings applied to 2013/14 projects are independent of previous year's star ratings.

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Adviser Edge Rating



Recommended Client Risk Tolerance

Project Details

Project Name	TFS Sandalwood Project 2014
Product	Indian sandalwood timber
Responsible Entity	TFS Properties Ltd
Parent Company	TFS Corporation Ltd

Investment Details

Investment Term	Approximately 15–17 years
Investment Unit Size	0.083ha
Units Available	4,800
Application Fee	\$6,750 (ex. GST) per lot (when between one and eleven lots are purchased)
Ongoing Fee Structure	Two alternative fee structures (annual or annual/deferred)
Minimum Investment	One lot
Close Date for FY2013	30 June 2014
Investor Finance	Available
ATO Product Ruling	PR 2014/3

Investor Returns	Annual Investment Opt.	Annual Deferred Investment Opt.
Potential Investment Returns (p.a.) – pre tax	5.35%–12.30%	7.25% – 13.25%
Adviser Edge Base Case (pre and post-tax)	11.10%	12.15%

Investor suitability

As a general note, investment in agribusiness should represent a balance between the various potential risks and the forecast returns. The level of investment should reflect the risk tolerance of the investor to ensure an over-weighting bias does not occur.

The Project offers a medium to high-risk profile over the long-term, with strong returns across the estimated range. The Project should be considered as part of a well-diversified portfolio.

Key Points:

Key Investment Risks

- Ability to achieve sandalwood survival rates above 80%.
- Ability of the sandalwood trees to produce heartwood in line with TFS expectations.
- Whether sandalwood oil inside the heartwood develops sufficiently within a 14 to 16 year rotation.
- Ability of TFS to remain solvent throughout the term of the project.

Strengths of Project

- TFS has 15 years of sandalwood experience to bring to the project, with improved site selection and silviculture skills leading to improved survival and growth.
- Recent harvest trials have provided support for the projected heartwood and oil harvests.
- An extension of the project to 16 years increases the likelihood that heartwood yield and oil extraction levels predicted will be achieved.
- There is strong existing and latent demand for Indian sandalwood, both for oil and carving.
- Developing pharmaceutical markets will be important to future supply and demand dynamics.

Weaknesses of Project

- The factors that drive heartwood development and oil levels are still not well understood, although a strong commitment to R&D by TFS is reducing the knowledge gap.
- The ability of TFS to continue developing new markets for Indian sandalwood oil, such as pharmaceutical use, will be required to prevent oversupply occurring.

Other Project considerations

- While the investment should be considered generally long-term and illiquid, there is a secondary market for TFS project units, albeit at reduced values to reflect the risk that a buyer is taking on.

Investment Specifications

Maximum subscription	4,800 lots (400ha)
Location	Western Australia, Northern Territory, Far North Queensland
Investment unit size	0.083ha (one lot)
Number of trees per unit	Approximately 42 Indian sandalwood trees, plus host trees
Minimum application	One lot
Liquidity	Yes but at discounts to NPV. Most trades occurring after four years.
Insurance	Not compulsory (unless finance is utilised)
Investor finance provider	Finance available through Arwon Finance Pty Ltd

TFS Properties Limited (TFS Properties) is offering investors the opportunity to participate in the plantation Indian sandalwood industry through the offer of up to 4,800 lots in the TFS Sandalwood Project 2014. Each lot will be 0.083ha in size, and will be planted with approximately 42 sandalwood trees. The stocking rate aims to provide 35 trees per lot at harvest, based on an estimated survival rate of approximately 83%.

The Project, which involves the establishment, growing and harvesting of Indian sandalwood trees, will be established in one or more of the regions where TFS has existing sandalwood plantations: the Ord River Irrigation Area (WA), Katherine (NT) or Burdekin (QLD).

The Indian sandalwood logs produced by the Project will most likely be sold to TFS, which will then sell the processed Indian sandalwood oil and heartwood into the international fragrance, carving and pharmaceutical markets. The plantation will be harvested 14 to 16 years after planting, which must occur prior to 31 December 2015.

Proceeds from the sale of the sandalwood (excluding seeds, which remain the property of TFS) will be pooled and distributed to investors on a pro-rata basis, after the deduction of all relevant costs and deferred fees. It is expected that proceeds will be distributed following the harvest of the 2014 Project plantation, which will occur within the three-year period leading up to 30 June 2031. The precise timing of the harvest may fluctuate in order to maximise the revenue of the Project, with TFS responsible for harvest scheduling.

TFS Properties will insure the trees, both in the nursery and when planted, against fire for 90% of their full value at cost until the end of the establishment period, being 18 months from the Project commencement date (30 June 2014). Any proceeds from an insurance claim during this period will be used to replace or replant the trees. TFS Properties has also indicated in the PDS that

Key Points

- Investors can choose from two different fee options.
- A discount on the application fee is provided for an investment in 12 or more lots.
- Two security accounts have been put in place to ensure that the plantations will be established regardless of TFS solvency, and to provide incentive for a new Responsible Entity.
- The term of the Project is now more flexible, with TFS having the power to delay harvest by up to two years at its discretion.
- Establishment and management fees are comparatively high on a per hectare basis.

it will replant any relevant lots where it is deemed necessary by the Responsible Entity (RE), at the cost of the RE. However, there is no minimum stocking guarantee in place.

Project structure and agreements

When investors are accepted into the Project, they will be bound by a number of legal agreements that outline the rights and responsibilities of each party involved in the investment scheme. These agreements are outlined in the Project's Product Disclosure Statement (PDS).

It is recommended that each potential investor and their adviser read and understand the Project agreements so as to ensure that the Project is suitable for the investor's objectives.

Investors in the Project will have direct and indirect counterparty risk to the Responsible Entity, TFS Properties, and the parent entity, TFS Corporation Limited (TFS). As a result of a cross guarantee in accordance with ASIC Class Order (98/1418) between TFS and its subsidiaries, counterparty exposure mainly lies with the parent entity. TFS is responsible for the provision of plantation management services under the Plantation Management Agreement, and TFS Properties provides Responsible Entity services to the Project. Land is leased from TFS Leasing Pty Ltd (TFS Leasing). As the Project is structured so that a substantial amount of fees are collected upfront, investors are reliant on TFS, TFS Properties and TFS Leasing to remain solvent in order to meet obligations to growers. However, the large deferred fee, or ongoing annual fee, helps to mitigate this to an extent, and acts as a strong financial incentive for TFS.

While investors have the option of paying fees annually, they also have the option to defer these fees until harvest. This may affect TFS Properties' ongoing cash flow. It should be noted that this risk reduces as plantations age, as ongoing management costs decrease due to the effects of canopy closure and as the inherent value in the plantation increases.

In the event that the RE, TFS Properties, enters administration, the presence of a switching fee means that all investors are compulsorily required to pay ongoing annual fees, regardless of which payment option they elect. This structure is designed to facilitate change to an alternative manager in the event of the insolvency of any of the management counterparties.

At the commencement of the Project, TFS will establish two separate accounts with the independent custodian, Australian Executor Trustees Ltd: the Establishment Fund, and the Maintenance Reserve Fund.

The Establishment Fund will hold funds equivalent to 50% of the application fee of each investor. These funds must be deposited in the established trust account within 14 days from the Commencement Date, being 30 June 2014. Half of the funds will be released quarterly as the plantation is established, with the remaining half held in reserve to be released in the event that a replacement RE is required prior to establishment of the plantation.

The Maintenance Reserve Fund will hold the equivalent of one year's annual management fee and rent, which are prepaid by investors at the time of application. Similar to the Establishment Fund, these funds would also become available to a replacement RE in the event TFS Properties becomes insolvent to assist in the payment of any ongoing lease and management fees. If TFS Properties remains solvent as expected for the course of the Project, these funds will be released to meet the final annual payment of management and rent fees, which will be dependent on the timing of harvest.

These accounts will accrue interest on the funds held, which will remain in the account for the benefit of investors.

Within 15 months of the commencement of the Project, TFS will ensure that an instrument conferring the right to use the relevant land is lodged for registration with the land titles office in the state or territory where the plantations are established in the name of TFS Properties, either as trustee for the growers or otherwise in accordance with its duties as RE of the Project. While this does provide some protection against third parties with respect to growers' Woodlots, it should be noted that rent payments are payable by TFS Properties or TFS Leasing, and may need to be met in order to maintain investor protection.

The establishment of the two security accounts with the independent custodian provides investors with a level of security that initial establishment services will be completed. This reduces the reliance on the solvency of TFS and TFS Properties in the establishment phase of the Project, which has been an inherent risk in past projects offered by TFS and certainly a broader industry issue in the past. However, the ability of investors to defer all of their annual management and lease fees exposes them to

the solvency of TFS throughout the life of the Project. The segregation of one year's annual lease and management fee in a security account mitigates this reliance to some extent.

If an insolvency event occurs in a year following the establishment period, such as year three, due to the switching mechanism, all investors will be required to commence the payment of annual management and lease fees, which will be slightly subsidised through the release of one year's annual management and lease fee from the security account.

Fee schedule

The fees outlined in the following tables relate to an investment made on or before 30 June 2014. The fee structure for the Project involves two payment options. These are:

- *Annual investment option* – this includes an upfront establishment fee, and ongoing annual lease and management fees.
- *Annual deferred investment option* – this includes an upfront establishment fee, and ongoing annual lease and management fees, although investors may elect to forgo some or all of the annual payments. When this option is selected, these fees are deferred and deducted as a percentage of harvest proceeds.

Initial Cost to the Investor – Both payment options

Payment Type	Cost Per Woodlot (ex GST)
Application fee	
Between 1 and 11 Lots	\$6,250
12 or more lots	\$6,000
One year's annual management fee*	\$375
One year's annual lease fee*	\$125
TOTAL	
Between 1 and 11 lots	\$6,750
12 or more lots	\$6,500

* Held in custodial accounts.

Investors are required to pay an application fee which covers the costs associated with the initial development of the Indian sandalwood plantation, including land preparation, irrigation works, procuring the supply of seedlings, and planting. The application fee due per lot reduces for investors that invest in 12 lots or more.

In addition to the application fee, investors are required to pay one year's annual management and rent fee per woodlot. This amount will be held by an independent custodian, and will not be released until the earlier of either Project year 14 or an insolvency event, in which it becomes available to a replacement Responsible

Entity. While this amount (\$500) is technically an ongoing fee, investors are required to pay it along with the establishment fee, and it is therefore considered as part of the application fee.

Ongoing Fees (per lot, excluding GST)

Payment Type	Annual Investment Option	Annual Deferred Investment Option
Annual management fee	\$375*	When deferring lease and management fees, the percentage of Gross Proceeds of Sale to be paid for each year that the management and lease fee is deferred is set out below: FY2016–17: 3% per year FY2018–19: 2% per year FY2020–29: 1% per year
Annual lease fee	\$125*	
Selling and marketing fee	5.0% of Gross Proceeds of Sale	
Harvesting and processing costs	Actual harvesting and processing costs, determined at harvest. Deducted from Gross Proceeds of Sale	
Incentive fee	30% of Net Proceeds of Sale above threshold	

* Subject to an increase of 3% p.a., first invoiced on 1 January 2016 and thereafter annually through to the year prior to harvest.

'Gross Proceeds of Sale' means the gross amount received by TFS from the sale of the sandalwood.

'Net Proceeds of Sale' means the Gross Proceeds of Sale, less the cost of harvesting and processing, and the selling and marketing fee.

Each year investors are provided with the option to pay or defer annual management and lease fees. Investors that select the annual fee option in any given year will be invoiced for annual management and annual lease fees. The last payment will occur in year 14 of the Project. In addition to annual fees, investors will be required to pay a selling and marketing fee of 5% of the Gross Proceeds of Sale.

For investors selecting the deferred fee option in any given year, the annual lease and management fees are replaced by a fee calculated as a percentage of Gross Proceeds of Sale, as set out in the previous table. If an investor decides to forgo all annual payments, the total deferred fees to investors are 20% of the Gross Proceeds of Sale for annual lease and management, plus 5% of Gross Proceeds of Sale for selling and marketing.

In the event that the RE becomes insolvent, the annual fee option switches from being optional to compulsory for all investors. There is no switching fee charged when this occurs.

If plantation trees are wholly destroyed, investors who elect to defer part or all of their annual lease and management fees will be liable to pay 55% of all Lease and Management fee payments that were deferred prior to the destruction event, and which would otherwise have been paid if they had taken the annual investment option. TFS believes that, as long as the appropriate

cover has been taken out, insurance will cover this amount. The typical destructive event is fire, with there being no referral to the cause of such an event. Significant events that are not covered include pest and cyclone damage.

Performance incentive fee

TFS is entitled to a performance incentive fee equalling 30% of the amount of any Net Proceeds of Sale that exceed \$100,000 per lot. The Net Proceeds of Sale refers to the Gross Proceeds of Sale, less harvesting and processing costs and the selling and marketing fee. Gross Proceeds of Sale refers to the gross amount received by TFS Properties from the sale of the clean sandalwood logs.

Fee Analysis

With any forestry MIS project, the application fee is controlled by the actual development cost of establishing the plantation, including land preparation, seedling supply and planting costs, and other administration costs such as corporate overheads, marketing and PDS development expenses, and the profit margin taken by the Project Manager.

Both the establishment fee and the annual management and rent fees remain unchanged from the 2013 Project.

It is difficult to conduct a comparative analysis of the GST exclusive, per-hectare establishment fee of \$75,000 (\$72,272 excluding GST when 12 or more units are purchased), as the Project is the only standalone MIS Indian sandalwood project in the market. As a result, Adviser Edge has compared the establishment fee with the estimated cost of establishing an Indian sandalwood plantation in the ORIA.

While the costs associated with establishing an Indian sandalwood plantation are high due to the complexity of management and high labour requirements, Adviser Edge estimates the cost is around half the \$75,000/ha charged by TFS, which incorporates a healthy profit margin for the company. However, investors in the Project are benefiting from considerable intellectual property associated with the growing of Indian sandalwood gained by TFS over the past ten years, access to an established land bank, and an established and experienced forestry team, as well as from TFS' commitment to market development and continuing research and development.

Adviser Edge believes that the establishment fee is high when compared to the costs of establishing an Indian sandalwood plantation. However, the healthy profit margin has been an important factor in TFS' financial stability, especially when the high level of investors electing the deferred fee option is considered.

Ongoing expenses for managing Indian sandalwood plantations include weed and pest control, soil nutrition, irrigation, the

removal of vines and dead host species, fire management and stand monitoring.

Following analysis of the annual costs involved in the management of an Indian sandalwood plantation, Adviser Edge considers the annual management fee of \$4,500 per hectare (excluding GST), which is payable and indexed from FY2016 onwards, to be high, with the actual costs incurred by TFS estimated to be much lower than this figure.

Adviser Edge is not aware of the average head lease cost, so it is difficult to see whether the annual lease fee would cover ongoing head lease obligations in the event of manager insolvency. This is considered reasonable, as the timing of harvest will only be pushed out if it is considered the most economical option.

Adviser Edge has compared the annual fees payable under the annual fees option with the corresponding deferred fees under the deferred fees option. Whether an investor should opt for the deferred fee option or the annual fee option depends on the investor's personal circumstances, including the investor's expected cash flow over the term of the Project, the investor's marginal rate of tax (both at harvest and in the year the annual fee is payable), and the investor's cost of capital. Adviser Edge's analysis of the two pricing options indicates a preference for the deferred fee option in terms of returns, particularly if it is assumed that investors are subject to static marginal tax rates.

Adviser Edge believes that one factor in deciding whether to pay the annual fee or to defer is investors' performance expectations of the Project. If investors defer the annual fees, TFS is entitled to a higher proportion of the harvest proceeds, and therefore the total fees paid are higher when the performance of the Project is higher.

Although the deferred fee option appears to be more attractive, Adviser Edge recommends that investors obtain independent financial advice in determining whether to use the deferred fee option or the annual fee option.

The calculation of the incentive fee is the same as previous years and is not activated if TFS' base case assumptions prevail over the Project term.

Adviser Edge believes that the benchmark and the level of the Incentive Fee is appropriate, particularly under the Annual Investment Option, providing added incentive for TFS to maximise investor returns.

Harvesting costs will be determined once the harvest is completed, and invoiced to growers at actual cost. TFS has estimated a current-day harvest cost of \$16,000/ha to produce cleaned heartwood logs at the farm gate, although it is important to note that the actual cost could vary significantly from the estimated amount. TFS commenced its first commercial harvest in 2013, and

will harvest each year from now on. By the time the 2014 Project is due for harvest it is expected that the process will be refined and costs reflective of economies of scale that TFS should be able to achieve as a consequence of its large estate.

Risk apportionment

Risk apportionment refers to the level of risk that a Project Manager/RE shares with investors as a consequence of the Project fee structure. When ongoing Project fees are linked to harvest proceeds, and therefore Project performance, the risk sharing between investors and the Project manager is considered to be more evenly aligned. It also provides a measure of risk mitigation in the event of the RE's insolvency by providing the potential for adequate compensation for a replacement RE.

The Project fee structure incorporates both a deferred fee option and an annual fee option. Adviser Edge believes that the deferred fee investment option not only provides extra incentive for TFS to perform, but also reduces investor exposure to the volatility of underlying performance factors. Consequently, the deferred fee results in an alignment of risk between both the manager and the investor. However, the higher the proportion of investors that elect the deferred fee option, the greater the pressure on TFS' operating cash flows. The commencement of commercial harvests should act to ameliorate this risk to some extent.

In the event that an investor elects to pay annual fees, the marketing fee in combination with the incentive fee also helps to provide a degree of risk apportionment. The structural safeguards put in place in order to ensure the trees are adequately established also need to be considered.

Additional Information

Taxation

TFS has applied for and received an ATO product ruling for the Project, which is PR 2014/3. A product ruling is considered important as it provides a degree of certainty in relation to the taxation consequences of investing in the Project. It should be noted that Growers cannot rely on the product ruling for the Project if they elect to collect their own sandalwood, as opposed to having it processed and sold by TFS.

Adviser Edge does not conduct detailed analysis on the implications of the Project's product ruling, and it is advised that investors seek appropriate professional advice in relation to the full financial and taxation implications of their investment. An investment in the Project is not recommended until a product ruling is issued.

Insurance

TFS will insure the trees until the end of the establishment period for 90% of their value. However, following this investors will

be responsible for arranging insurance themselves if they wish to insure their Indian sandalwood investment. The RE will assist investors to acquire appropriate insurance, which has been the case for previous TFS sandalwood projects. They will not charge a fee for doing so. Insurance will be compulsory for investors who obtain finance through Arwon Finance.

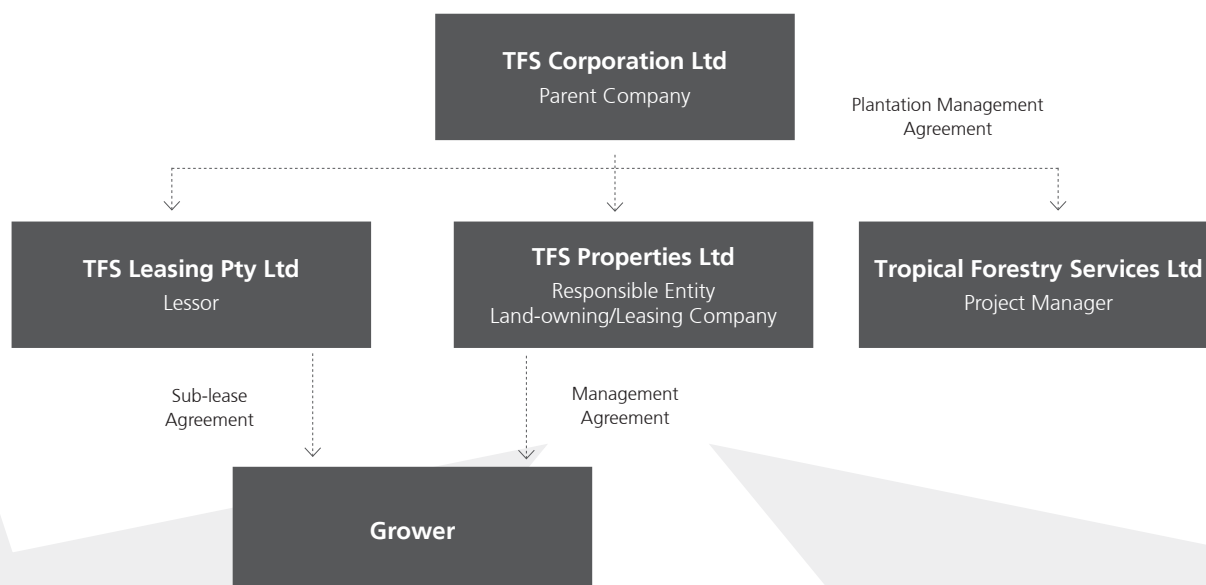
While investors' harvest proceeds are pooled, should any lots be destroyed due to some unforeseen event these lots may be removed from the pool and the investors may not receive or will otherwise have a reduced entitlement to income from their investments. Insurance should help to protect investors from this risk.

Given the high value of the sandalwood lots, it is expected that insurance will be a considerable cost over the Project term. Adviser Edge recommends that investors strongly consider the cost and benefits associated with insuring their lots, particularly given that TFS has the right to recoup deferred fees in the event of plantation failure.

Finance

Short and medium term finance is available to approved applicants through Arwon Finance Pty Ltd, which is a subsidiary of TFS. The options are a 12-month interest free loan or a seven-year principle and interest loan. Interested investors should contact TFS or the finance provider for full loan terms and conditions.

Key Counterparties



TFS Corporation Limited (Parent Company)

TFS Corporation Limited (TFS) was incorporated in 1997 and subsequently listed on the Australian Securities Exchange (ASX) in December 2004 under the stock ticker code TFC. TFS is the parent company and sole owner of the key management and operational entities for the TFS Sandalwood Project 2014.

TFS first established commercial plantations of Indian sandalwood on behalf of investors in 1999. Since then, TFS has grown considerably to become the largest provider of Indian sandalwood Managed Investment Schemes (MIS), now managing over 7,500ha on behalf of over 3,000 individual growers and companies associated with TFS. While the majority of these plantations have been established via the utilisation of MIS, in the past few years TFS has placed a greater focus on plantation management for institutional investors.

In 2009, TFS launched a wholesale investment product, Beyond Carbon, with the first institutional investment coming from a US-based pension fund. Since then, TFS has established more than 3,500ha on behalf of institutional investors based in the US, Europe and the Middle East, and continues to manage the plantations on their behalf.

While the majority of TFS managed plantations are located in the East Kimberley region of Western Australia, since 2011 TFS has established plantations in other regions in order to satisfy growing institutional investor demand, and to achieve some geographic diversification. These additional plantations are located in the Burdekin region of northern Queensland, and at Katherine and the Douglas Daly in the Northern Territory.

TFS employs around 25 personnel at its head office in Perth, as well as approximately 60 permanent employees and at peak times,

Key Points

- TFS has transitioned from a pure MIS operator to a more diversified business including Sandalwood production and marketing and an institutional investment program.
- The Board has stabilised after significant upheaval in FY2013.
- TFS boasts an experienced operations management team, with significant levels of intellectual property held by the company.

and between 200 and 300 casual employees at its plantation operations in Kununurra, Queensland and the Northern Territory. TFS' staffing levels have grown significantly as a consequence of the acquisition of Mount Romance and the expansion into Queensland and the Northern Territory, and numbers are expected to continue to increase.

In July 2008, TFS acquired Mount Romance Australia, a Western Australian sandalwood processor and essential oils business, vertically integrating TFS' business. This acquisition has provided TFS with sandalwood processing and distillation capabilities, and allows the company to defer capital expenditure on its planned Kununurra distillation plant until harvest volumes are sufficient to justify the cost. Mount Romance exports Australian sandalwood oil across the globe and has supply contracts with a number of leading industry participants. It is expected that the first commercial harvest of the Indian sandalwood will be transported to the Mount Romance facility in Albany.

In October 2009, TFS entered into a conditional sandalwood supply agreement with United States biotech company Viroxis, and the pharmaceutical uses of Indian sandalwood are currently being explored. Viroxis has completed enrolment of 176 patients

for its commercial phase II clinical trials as approved by the US Food and Drug Administration (FDA), for the development of drugs containing Indian sandalwood oil to treat topical viral skin diseases such as warts caused by infection from the human papillomavirus (HPV). Viroxis is also planning to apply for testing of a second drug containing Indian sandalwood for the treatment of Molluscum contagiosum, a highly prevalent skin condition.

TFS, together with parties associated with Viroxis, has also established a new company, Santalis Pharmaceutical Inc. (Santalís) to explore the non-viral pharmaceutical applications of Indian sandalwood. TFS advises that a phase two clinical study of a paediatric over-the-counter product line for treating eczema is nearing completion, with promising interim results.

TFS has completed its transition from a pure MIS operator to a more diversified business which encompasses the management of Indian sandalwood plantations for retail and wholesale investors, as well as the processing and marketing of Indian sandalwood via Mount Romance.

Board of Directors

The board of TFS has endured numerous changes in recent years, following attempts by shareholders to spill the board over corporate governance issues. This prolonged period of instability appears to have come to an end following the appointment of Patrick O'Connor as independent Chairman in August 2013. Mr O'Connor's background is in the mineral and water industries, and has deep experience as a board member and chairman of both listed and unlisted companies. Mr O'Connor's appointment sees TFS' founder and major shareholder Frank Wilson become an Executive Director, after a period as interim Chairman.

The appointment of an independent Chairman significantly improves the level of corporate governance. This, along with the fact that the majority of the board is now considered independent and appears to be stable, should provide investors with confidence.

Corporate governance and compliance

TFS has established a Compliance Committee for the Project, as required under the Corporations Act. The Compliance Committee is required to monitor the extent to which the RE complies with the Project Compliance Plan, and to report any breaches to the directors of the RE and, if necessary, ASIC.

The Compliance Committee is comprised of two external members, Chartered Accountant John O'Brien, and Robert Marusco, as well as one representative of the RE, Ronald Eacott, who is also the Chairman of the committee. In addition to this, TFS employs an external Compliance Officer, Doug Verley, who monitors the compliance of the RE and then reports to the Compliance Committee on the adherence to the Project's Constitution and the Lease and Management Agreements. Doug Verley has 26 years of experience in senior corporate roles

internationally and in Australia. Mr Verley is currently a corporate consultant with Focus 2XL Consulting.

Adviser Edge believes that TFS has adopted acceptable corporate and financial management procedures.

The oversight of the Compliance Committee will be critical to achieving sound corporate governance for the Project, given the relationship between the Responsible Entity, TFS Properties, and the contracted parties, particularly Tropical Forestry Services Ltd, which share a common Board of Directors. The engagement of an external compliance officer is viewed very positively by Adviser Edge, providing the Project with an added level of oversight.

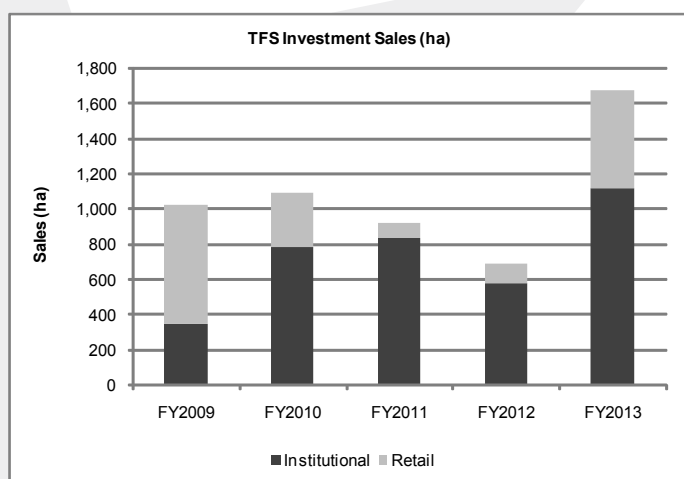
Financial performance

The following table presents the key financial data for TFS for the financial years FY2013 and FY2012.

Key Financial Data – As at 30 June		
Financial Profitability	2013	2012
Revenue (\$m)	122.9	103.4
Net profit (\$m)	55.7	25.9
Profit margin (%)	45.36	25.03
ROCE (%)	17.0	11.5
ROE (%)	17.2	9.6
Market Measures	2013	2012
EPS (basic/cents)	19.93	9.29
P/E ratio	2.6	5.4
DPS (cents)	3.00	0.00
Dividend yield (%)	5.9	0.00
Dividend payout ratio	0.15	0.00
Financial Liquidity/Solvency	2013	2012
Net working Capital (\$m)	139.88	148.76
Current Ratio	3.89	5.77
Quick Ratio	3.36	4.37
Net debt to equity ratio	0.33	0.34
Interest Cover	5.71	3.08
NTA per Share (\$)	0.86	0.66

Source: TFS Corporation Ltd, Annual Report 2013.
The financial ratios are based on share price information provided for the close of trading on the last day of the financial year for which they are quoted.

TFS' transition to institutional sales can be considered complete, with FY2013 being the fourth consecutive year where sales to institutional investors have accounted for the majority of sales. Institutional sales in FY2013 totalled 1,118ha, almost double that of FY2012, which was an unusually poor year for sales. The large difference is also due to the fact that a large portion of sales made in FY2012 were recognised as income for FY2013. TFS also experienced a significant increase in retail sales, largely due to the development of a tailored product for high net worth investors. Of the 557ha raised from retail investors, pure MIS sales accounted for only 11% of this, indicating the structural transition TFS has undergone in recent years. MIS sales actually fell compared to FY2013. Sales to high net worth investors were a new initiative from the company in FY2013, and therefore achieving the \$18.4 million in sales was unexpected.



With product sales accounting for around 80% of TFS' annual revenue, the significant increase in total sales led to revenue growth of 18%, with net profit after tax up more than 100% on FY2012. EBIT and EBITDA also surged by around 80%. The large increase in these headline figures was affected by several non-recurring items. The most significant was the fact that non-cash revenues were affected by a gain of \$50 million due to the reclamation of 580ha from a wholesale investor which defaulted on its payment terms leading to the termination of the contract. This, couple with the acquisition of an additional 359ha from six existing growers resulted in TFS' direct ownership of plantation increasing to 1,346ha.

The move to increase direct ownership of plantations has been driven by the TFS board, which wants the company to take advantage of the strong long-term fundamentals for the Indian sandalwood industry.

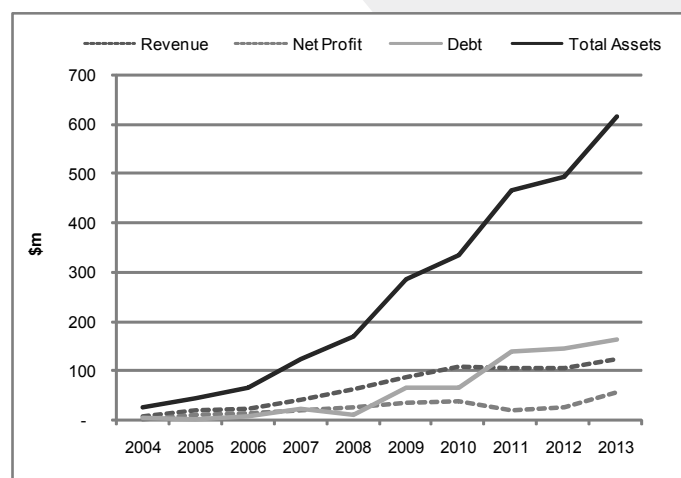
While the strategy of having a greater direct interest in sandalwood plantations may result in the delivery of greater value to TFS shareholders, there is a risk that the company's cash flow may be unable to sustain the drain in managing the plantations through to harvest. The counter-

balance to this is TFS' ability to trade these plantations at some point in the future if and when required.

In line with the huge growth in profit, net operating cash flow was \$21.8 million; a good result considering FY2012 recorded an outflow of more than \$60 million. The operating cash flow result was boosted by the partial sale of the MIS grower loan book for \$22 million in cash. While this is considered a strategically positive move for the company through the divestment of non-core assets, it should be treated as a one-off item. Excluding this sale, net operating cash flow for FY2013 was break-even, which is still an improvement on the previous year. Significantly, receipts from operations exceeded payments to suppliers and employees by \$33 million in FY2013, which is a turnaround of approximately \$49 million from FY2012.

The strong profit and operating cash flow led the board to reinstate a dividend of 3.0 cents per share.

Mount Romance continues to provide a valuable revenue stream, rising 13% to \$18.4 million, while EBITDA from the business also rose by 6% to \$3.15 million. This was a strong result considering the impact of the persistently high Australian dollar throughout the year.



As the plantations approach harvest, the liquidity risk associated with being reliant on investment sales begins to diminish as the expectation of cash generated from deferred fees becomes closer. To manage these plantations until harvest, TFS needs to maintain a robust financial position to ensure that it has the financial resources to meet its ongoing obligations. In FY2011, TFS raised US\$150 million in senior secured notes to meet the financial requirements associated with the development of plantation land for institutional clients. This facility has now been fully drawn. As a consequence, TFS is now reliant on its existing cash reserves (\$56million) to meet its immediate liquidity needs. While gearing is still relatively moderate at 33%, given the lumpy nature of its revenue Adviser Edge does not consider raising further debt capital a prudent option. Adviser Edge also notes that TFS, as a

listed company, has the option of raising further equity should it be required to do so. Given the strong appreciation in TFS' share price during FY2014 to date, this may become attractive.

With its strong cash balance, Adviser Edge does not consider TFS to have any immediate liquidity needs to meet current operational requirements. However, should a mismatch again occur between the time of establishment works and the settlement of institutional investments, additional cash may be required. Given the surge in TFS' share price over the past six months, a market based capital raising cannot be ruled out as one of the options for TFS to further strengthen its balance sheet.

Adviser Edge has reviewed TFS' financial position and believes its current balance sheet is sufficient for its current operations. TFS should maintain continued vigilance in ensuring the organisation has sufficient flexibility in its fixed costs, in the event that institutional sales significantly decline.

Following the successful transition from MIS operator to institutional product sales, TFS will begin to transition from plantation manager to a major global producer and marketer of sandalwood.

TFS Properties Ltd (Responsible Entity)

TFS Properties Ltd (AFSL no. 241192) is the Responsible Entity (RE) for the Project and is a wholly-owned subsidiary of TFS Limited. As a wholly-owned subsidiary of TFS, TFS Properties is covered by deed of cross guarantee and, as such, TFS has applied the ASIC Class Order (98/1418) applicable to wholly-owned entities. TFS is therefore not required to file accounts for TFS Properties. As a result of this guarantee, Adviser Edge has not analysed the financial position of the RE, but rather that of the parent entity.

TFS Properties has the same Board of Directors as the parent company, TFS Corporation Limited. Given that there is likely to be a number of related party transactions involved in the Project, including contracting of the plantation management operations and possibly the purchase of the heartwood logs, the oversight of the Compliance Committee will be critical to ensure that TFS Properties fulfils its obligations to investors as the RE.

TFS Properties and TFS Leasing Pty Ltd have provided a guarantee to the Bank of New York Mellon in relation to the US\$150 million in secured notes raised by TFS in 2011. Under the guarantee, TFS Properties and TFS Leasing guarantee the full payment of all amounts owing under the bonds. This applies to other subsidiaries of TFS, and should not affect the operation of the Project unless TFS itself becomes unable to repay the bonds.

In this report, unless specified, TFS refers to the parent company or any underlying subsidiary.

Responsible Entity financial requirements

ASIC has issued new financial requirements for Responsible Entities of managed investment schemes. While these changes are not designed to prevent REs from becoming insolvent, the changes are designed to limit the risk that an RE becomes insolvent as a result of assuming liability for the debts of others and to provide some level of assurance that, if the RE does fail, there is sufficient money available for the orderly transition to a new RE or to wind up the scheme.

The changes include amendments to the minimum net tangible assets required, with a new requirement being that REs must hold a minimum level of liquid assets, being cash or cash equivalents. These changes came into effect on 1 November 2012.

ASIC amended these requirements in 2013, raising the financial requirements for REs that hold 'self-custody' scheme assets (which TFS does) from \$5 million in net tangible assets to the greater of either \$10 million or 10% of the average RE revenue. REs must comply with these new amendments by 1 July 2014. TFS has advised that it complies with these requirements.

Adviser Edge is of the view that while these changes will improve the financial position of REs, they will not necessarily prevent the failures of forestry MIS managers, such as those which have occurred in recent years. Many of these managers failed, in part, because their project structures provided a cash flow mismatch due to high up-front fees and the substantial deferral of ongoing fees.

TFS Properties expects that the funding sources of the TFS Group will be sufficient to meet the costs of managing, harvesting and processing the trees. However, TFS Properties cannot guarantee that it will have sufficient working capital to meet these costs. This is a risk of which advisers and investors must be aware.

While the Project does have an ongoing fee structure option, there is still a risk associated with the deferred fee option and its effect on working capital requirements for the Project. Balancing this risk is the requirement of investors to pay one year's management fees in advance, which will be held in trust in the event of RE insolvency and the switching fee mechanism.

Tropical Forestry Services Ltd (Project Manager)

Under the Plantation Management Agreement, the RE will engage Tropical Forestry Services Limited (TFSL) to fulfil the plantation management requirements over the Project term. TFSL has acted in this capacity for projects since 1999 and employs tertiary-qualified staff to manage each of the plantation sites. TFSL is a wholly-owned subsidiary of TFS Corporation Ltd.

Key Operational Personnel – Tropical Forestry Services Ltd

Key Personnel	Credentials	Industry	MIS
Frank Wilson – CEO	★	★	★
Paulo Correa – General Manager of Operations	★	★	★
Malcom Baker – Operations Strategic GM	★	★	★
Dan Raymond – National Project and Development Manager	★	★	★
Brett Blunden – Regional Manager WA	★	★	★
Matt Barnes – Regional Manager QLD	★	★	★
Nick Common – Regional Manager NT	★	★	★
Chris Done – Senior Forester	★	★	★
Research Development & Regulatory Manager – Andrew Brown	★	★	★

TFS has historically had a very structured organisational structure, with different divisions established for each section of operations (i.e. land acquisition, development, seedling supply, plantation establishment and plantation management). However, the expansion into the Northern Territory and Queensland has resulted in the relocation of some senior staff members. This has resulted in a relatively flat management structure with several regional managers, and a number of support staff at each location.

Adviser Edge is confident of TFS' ability to manage the Project to the highest possible standard. The company now employs a large number of skilled personnel with many years' experience developing and managing sandalwood plantations. TFS' ability to retain key personnel is enhanced under the relatively flat organisational structure, which provides career enhancement opportunities within the organisation.

Independent experts**Independent Foresters**

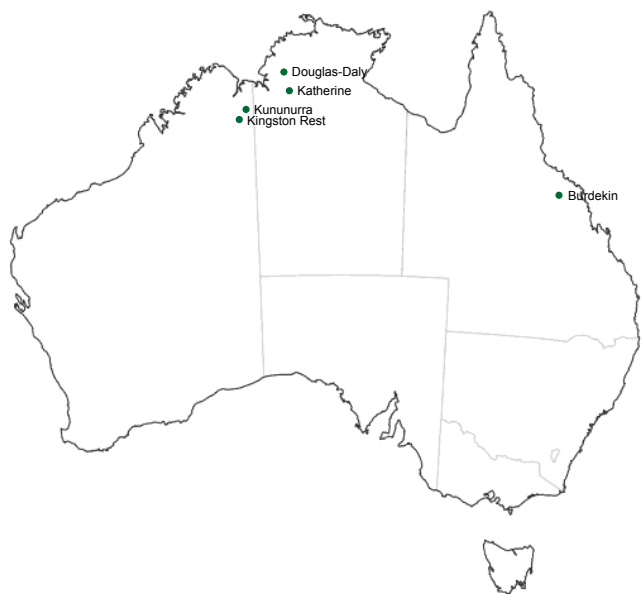
Independent Foresters	Company	Focus
Name	Company	Focus
Peter Kimber	Kimber Environmental Services	Sandalwood silviculture
Richard Fremlin	Fremlin Consulting	Independent Expert's Report
Anantha Padmanabha	H.S Anantha Padmanabha	Market and pricing

TFS has engaged two independent foresters to provide independent verification of the performance assumptions made in the offer documents, and to provide an overview of the global Indian sandalwood market.

Peter Kimber of Kimber Environmental Services (KES) has considerable experience in the development and management of plantation Indian sandalwood, having worked on species trials with the Western Australian Forests Department (now the Department of Conservation and Land Management (CALM)) during the 1980s. His knowledge has been instrumental in developing the complex silvicultural methods used in Indian sandalwood plantations. As the Principal Forestry Consultant to TFS since 2000, Mr Kimber has a first class honours degree in forestry and is a member of the Institute of Foresters, Australia.

Richard Fremlin has more than 45 years' experience in the forestry sector. After training in South Africa, he spent many years at the Western Australian Forest Department and the Western Australian Forest Products Commission specialising in plantation establishment and silviculture. In 2006 he joined Great Southern, and is now a full time forestry consultant. He has extensive experience with tree improvement and silviculture in tropical plantations in northern Australia, Africa, Indonesia and Africa.

Anantha Padmanabha has more than 35 years' experience in the scientific and marketing elements of the Indian forestry industry. Based in Bangalore, Mr Padmanabha is currently employed as director of Karnataka Research Foundation and Advances Science Technology Transfer, and is a consultant to Karnataka Soaps and Detergents Ltd (a major long-term buyer of Indian sandalwood). Mr Padmanabha also has considerable exposure to Indian sandalwood auctions, having attended sandalwood auctions to assess and buy sandalwood for over eight years.



As part of its due diligence, from 11 to 13 November Adviser Edge conducted an inspection of TFS-managed sandalwood plantations in the East Kimberley region, Western Australia, and the new plantations in the Douglas-Daly and Katherine regions in the Northern Territory. Accompanying Adviser Edge was Malcom Baker, Operations Strategic General Manager and Duncan Caldwell, General Manager – Sales and Marketing, Financial Products.

Over the course of the four days allocated to inspect TFS operations, Adviser Edge visited three planting regions and visually inspected numerous plantations and infrastructure such as nursery, log processing and irrigation.

The key focus of the visit was to assess the performance of plantations across a variety of age classes, including recently established sites and the 1999 EKS plantation that is in the process of being harvested. Adviser Edge also took the opportunity to view the properties that will most likely be planted to trees under the 2014 project.

TFS has taken full control of nursery operations in the ORIA, with the output from the two nurseries in the region also providing sandalwood and host trees for planting in the Northern Territory and Queensland. The focus of nursery activities continues to be quality at volume, aided by TFS's R&D and tree breeding programs.

Over two days Adviser Edge inspected plantations in the ORIA and at Kingston Rest, which is the site of a large proportion of TFS' institutional plantings.

In the ORIA there is some variation in performance across plantation age classes, although the overall impression is that the majority of sandalwood plantations are in good health and being well managed.

Key Points

- TFS has expanded its forestry operations over the past three years, both in terms of area under management, human resourcing, and the establishment of plantations in NT and QLD.
- TFS has heavily invested in R&D to improve its knowledge of sandalwood and host trees.
- TFS has substantially improved survival and growth rates since 2008.
- Growth rates at the Katherine properties were impressive but weed control is presenting some challenges.

In 2013 TFS undertook a full and detailed inventory of every plantation. This inventory confirmed survival rates and has provided an excellent guide to how TFS plantation management has evolved over time. Most notably, there has been a sharp improvement in sandalwood survival levels since 2008.

Higher survival rates and improved growth are clearly evident when inspecting sandalwood plantation, reflecting refined site selection processes and a more proven host tree mix. This is not to say that there have not been areas which have under-performed but the survival rates certainly indicate that TFS is learning from its past and making good evidence-based decisions.

One of the big changes in sandalwood management is the increased use of high volume drip systems. TFS does not use drip irrigation exclusively, as the cost is significantly higher. In the ORIA there is still a mix of drip and flood, with soil type being the main driver of decision-making. In addition to broadening the soils that can be planted to sandalwood, drip irrigation also reduces weed burden relative to flood irrigation by targeting water where the trees really need it. The decision to use drip irrigation will ultimately be dictated by the type of soils present.

The TFS management team remains stable, although with the focus of new plantation shifting to the Northern Territory and Queensland, some of the senior management team are allocating more time to these new regions. The continued expansion of operations in other states has helped TFS to maintain a stable management team by offering opportunities for career advancement within the company.

During the ORIA site inspection Adviser Edge visited the log processing facility, which is located on Packsaddle Road. This facility, which has been developed over the past 12 months, is where harvested logs are brought for first stage processing. Logs are graded, cleaned and, where appropriate, chipped for shipment south to Albany where the oil will be extracted at the Mount Romance facility.

Given the relatively small volume of logs that has been processed in this facility, it is expected that there will be refinements of the various processes, whether that is harvesting, cleaning or processing.

After leaving the ORIA and over the course of two days, Adviser Edge inspected three properties near Katherine and a further property in the Douglas Daly region. The soils present on the properties were generally lighter than in the ORIA but more consistent in type. All properties are drip irrigated with water sourced under licence from the large Ooloo aquifer.

The first things to strike Adviser Edge during the Katherine site inspection were the prodigious growth rates of the 2012 plantations (both sandalwood and host trees), and the variety and density of weeds in plantations established in 2013.

The first plantation visited is located close to Katherine on land previously owned by the Peanut Company of Australia. This property undoubtedly has a good fertiliser history, although the combination of good soils (predominantly sandy loam), good host tree mix and drip irrigation appear to be the main factors driving growth rates.

The strong growth of the 2012 sandalwood plantation means that TFS is already required to control the vigour of host trees through pruning and topping. The high growth rates mean that the trees will quickly control the site, creating shadow, which aids weed management going forward.

The second site inspected is a large property which was partially established in 2013. Significant areas of the property were being prepared for 2014 planting at the time of inspection. The soils on this property vary, with lighter soils prevalent in the newly developed area. There is evidence of some compaction in the sands (naturally occurring), which require ripping to allow the irrigation pipes to be installed. These compacted sands generally dissolve when wet, so they are not expected to inhibit root penetration.

The most striking thing about the 2013 plantings in this property is the weed burden, which at the time of the inspection was proving challenging to manage. This is largely due to the high density of the weeds and the mix of narrow and broad leaf weeds, which meant that a variety of methods and significant manpower is required to gain control of the site before the wet season commenced. After discussions with the regional manager and using the 2012 planting as a guide, Adviser Edge is confident that TFS can gain control over the weed situation. Notwithstanding these assurances, the weed burden will be monitored post-wet season.

Overall Adviser Edge was impressed with the Northern Territory operations. The plantations are performing well and there is an expectation that the weed issues present

in younger plantations will be resolved. While the region is less developed than the ORIA from a sandalwood perspective, TFS has proven its ability to adapt its knowledge and management systems to new regions and deliver good outcomes for investors.

Region

The plantations to be established under the Project may be located in the ORIA, the Northern Territory or the Burdekin in Queensland.

Kununurra is situated in the heart of the ORIA, which is the major irrigation district of northern Western Australia. The ORIA covers an area of approximately 17,000ha of flat productive soils, with the main industries being sandalwood, mangoes, citrus, melons, bananas, and a range of other fruit and vegetables.

At approximately 16°S latitude, the ORIA experiences a hot tropical climate with a wet season from November through to March, with approximately 94% of its 800mm average annual rainfall falling during this period. As the Project will be irrigated from the highly reliable Lake Argyle, annual rainfall levels are less relevant than for other regions.

The mean monthly minimum and maximum temperature ranges between 24°C and 39°C in the wet season, and 15°C to 39°C in the dry season. Although vulnerable to tropical cyclones, the ORIA is a reasonable distance from the ocean, and most cyclones can be expected to have reduced in intensity by the time they reach Kununurra.

TFS established its first Indian sandalwood plantation in 1999 and currently manages around 6,500ha of plantations in the East Kimberley region (ORIA and Kingston Rest). It has recently established plantations in the Northern Territory (Katherine and Douglas-Daly regions) and in Queensland (Burdekin).

The Douglas-Daly region is located approximately 150km south of Darwin. The region covers an area of around 100,000ha, supporting cattle, mixed farming crops such as peanuts, melons, sorghum and hay, and more recently, African mahogany plantations. The majority of these activities rely on natural rainfall, with water for stock and domestic use and irrigation sourced from bores that tap into the Ooloo aquifer. The area west of Katherine is similar in nature to the Douglas-Daly.

The region experiences a very similar climate to Kununurra, with a hot-humid tropical climate delivering a distinct six-month dry season and a wet season between November and March providing rainfall of approximately 1,200mm. This is more than the average rainfall in Kununurra, and is mostly due to the fact that the Douglas-Daly is located further north, at approximately 13°S latitude.

The Queensland site is located at Dalbeg, which is in the Burdekin region approximately 150km south of Townsville. Although this

site is more southerly than Kununurra, it experiences a similar climate. Its average annual rainfall of 950mm is higher than Kununurra, and although it experiences a similar hot tropical climate, the wet and dry seasons are less pronounced. In addition, the risk of cyclones is higher in this region, although the plantations sites are located approximately 50km inland, which should reduce the impact of any cyclone.

Adviser Edge would prefer all of the Project plantations to be located within the ORIA. However, due to the strong bank of knowledge associated with plantation establishment and ongoing management held by TFS, plantations located in the Northern Territory and Queensland should perform well.

Species and varieties

The species to be grown in the Project is *Santalum album* (Indian Sandalwood), which is a semi-parasitic plant that relies on a number of host species for nutrients and water. The Indian sandalwood seedlings are germinated from seed collections collected from existing seed sources in the ORIA, with the majority of the provenances originating from the Western Australian Conservation and Land Management (CALM) plantations, which were established during the 1980s and 1990s, as well as from maturing TFS plantations. TFS has established its own seed orchards, and this allows TFS to conduct provenance trials focused on identifying and bulking-up selected provenances with desired traits such as volume, and heartwood and oil yield.

TFS has refined its host species mix over a number of years, with actual host tree performance in earlier Projects being a strong factor in the mix of hosts selected for the 2013 Project. Adviser Edge believes that an evidence-based approach is likely to deliver better sandalwood growth rates, and reiterates the view that production risks for 2013 growers are considerably reduced relative to earlier projects.

As a consequence of the parasitic nature of the Indian sandalwood and the requirement for host species, the required silvicultural management regimes are complex, with varying requirements for the weed, pest and irrigation controls to be applied across the plantations.

The sandalwood seedlings are planted next to the pot host, *Alternanthera nana*. The short-term host, *sesbania*, is in the same row as the Indian sandalwood seedlings to ensure that strong root associates are formed in the early stage of the plantation. The short-term hosts have served their purpose by the time the tree is around three years old, and the root volume of the Indian sandalwood tree will expand and form root associations with the long-term hosts after three to four years. Indian sandalwood generally experiences a minor shock at three years of age as the *sesbania* host naturally dies off and the Indian sandalwood becomes more reliant on the long-term host, predominantly *Cathormium bellatum* (cathormium), as well as *Dalbergia*

latifolia (Indian rosewood) and *Cassia siamea* (cassia). However, once strong root associations are established with the long-term host, growth is expected to pick up again.

TFS has made significant progress in host species selection and seed orchard capabilities. This is demonstrated by the improvement in the growth and uniformity of the TFS plantations over the years. It is expected that further advancement will occur as results from current research and development activities become available. The approach to selection of host species is very evidence-based, which has been a factor in improved sandalwood survival and growth rates, particularly notable in the past three years.

Site selection

Generally, sites are selected on clay soils, which are free draining and have good moisture-holding characteristics. Topography needs to be flat or slightly undulating to minimise the risk of water-logging and, where flood irrigation systems are used, to minimise the costs of plantation establishment.

Adviser Edge is confident in TFS' ability to secure suitable land for the Project.

Site development program

Sites will be laser levelled and planting lines ripped to a depth of 0.5m to promote drainage across the plantation sites, and to eliminate the compacted soils created by previous agricultural activities. Laser levelling ensures that sites are adequately drained in a way that prevents erosion or water-logging issues. Deep ripping is considered to be especially important on blocks that have previously experienced high levels of compaction. This can occur after the use of harvesting machinery on wet soils, such as in sugar plantations, and may require amelioration. Following cultivation, mounding takes place with raised beds formed at approximately 1.8m intervals.

Planting is generally carried out in the coolest part of the year, between April and September, in order to minimise stress on the seedlings. The use of drip irrigation extends the planting season, as water can be constantly applied and thus reduce stress on the seedlings.

The plantations are expected to grow rapidly in the first few years, with material differences in growth across the early plantings based on whether the trees were planted early or late in the planting season.

Site maintenance

Weeds will be controlled using both mechanical and chemical methods, with a particular focus on control in the first two years of the plantation's life, in order to ensure that the trees gain dominance over the site. The introduction of drip irrigation on most new planting sites has led to a significant reduction in the prevalence of weeds. Fertilisers will be applied to the Indian

sandalwood and selected host species if there are obvious signs of nutrient deficiencies. While the Lease & Management Agreement only incorporates a general obligation to perform fertiliser, pesticide and herbicide applications as and when required, TFS has previously demonstrated its commitment to this obligation, with previous plantations appearing to have had appropriate and timely applications as seasonal conditions allowed.

Firebreaks will be established around the perimeter of the plantation sites and maintained at the start of each dry season, while roads will be formed to facilitate easy access for the harvesting equipment prior to harvest. The Indian sandalwood trees will be pruned to a height of 2.5m to 3.0m to ensure a clean butt log at harvest, while the host species will be pruned when necessary if these trees interfere with the growth of the Indian sandalwood trees, or impede access to the site.

One of the risks to Indian sandalwood plantations is attack by corellas, and ongoing vigilance of this pest is required. In addition, the native cathormiom host species is susceptible to pest attacks. Pumpkin vines are also an issue, particularly for younger trees, and must be manually removed. If left unchecked, such weeds could affect tree survival and growth rates. While these issues have been common in the ORIA, the new sites in Queensland and the Northern Territory are likely to present a range of new issues, which may be foreign to TFS staff trained in the ORIA.

The site development and ongoing management plans employed by TFS are comprehensive, and appear to be in line with industry best practice. However, the introduction of new plantation sites in the Northern Territory and Queensland may mean that some new management practices will need to be adopted to deal with the differences associated with the sites.

Irrigation

For plantations located in the ORIA, both flood and drip irrigation will be used to manage the plantations' water requirements. These different techniques will be used either in tandem or separately, depending on the site. For example, drip irrigation has been used by TFS on sandier sites and in order to increase survival rates in young plantations.

The main water source in the Douglas-Daly is groundwater, and all plantations will be drip irrigated. Both drip and flood irrigation will be used on plantations located in the Burdekin region.

Drip irrigation is more expensive to develop and maintain, although there are significant advantages to the system. As the water is delivered directly to the Indian sandalwood and host species trees, the drip irrigation system makes it difficult for weeds to become established, particularly in the inter-row spaces. This reduces the costs associated with weed management, and better utilises water resources.

The trickle system also provides a more efficient way of delivering water to the plantation, and eliminates water going onto unplanted access rows.

The plantation will be irrigated when soil moisture levels, which are measured using soil moisture probes and soil pits, reach a pre-determined low level.

In the ORIA, the irrigation water is supplied from Lake Argyle, a storage dam located 55km south of Kununurra. The dam was constructed in the 1970s to provide a reliable source of water for 70,000ha of farmland in the region. To date, 14,000ha have been developed under Ord Stage 1, with 8,000ha of land being developed under Ord Stage 2 and approval for a further 6,000ha also being progressed.

The irrigation water source for the plantations in the ORIA is considered to be highly reliable.

For any plantations located at Katherine and the Douglas-Daly in the Northern Territory, water will be sourced from bores that tap into the Ooloo aquifer. This aquifer is located beneath the Daly and Katherine Rivers and stretches from south-west of Katherine to beyond the Douglas River. A water allocation plan for the aquifer was completed in 2013, outlining rules for the sustainable use of water in terms of equitable allocation of water between the environment and human needs. The Ooloo aquifer has historically been unregulated, and while this plan will enforce maximum annual allocations for all bores that draw water from it, it is unlikely to affect existing holders of water licences, such as TFS.

TFS will need to effectively manage its water requirements within the constraints of the new water management plan.

Plantations in the Burdekin region will be drip-irrigated with water drawn from the Burdekin River. The Burdekin River Irrigation Area (BRIA) was established in the 1950s, and in 1980 the largest land and water conservation scheme undertaken in Queensland was established, forming the Burdekin Houghton Water Supply Scheme. The large Burdekin Falls Dam feeds the system, in conjunction with the Clare and Gorge Weirs. Water is drawn from the scheme under high and medium security water licences.

High security water allocations under the Burdekin Houghton scheme are considered incredibly reliable, with 100% allocation each year for the last ten years.

The Project should benefit from drip-only irrigation, which enables strong early growth and high survival rates. The success of drip-only irrigation at the Kingston Rest property and the Northern Territory plantations is encouraging for plantations to be located in the Northern Territory and the Burdekin region.

Harvesting and processing

As a result of extensive research, TFS has lengthened the time to harvest, and expects to harvest the trees between ages 14 and 16. TFS will determine the exact timing of the harvesting operations based on market conditions and the state of the trees.

TFS commenced its first commercial harvest in 2013. Two pieces of machinery were utilised during the harvest. The first cuts the tree down at the base. A 'coring' machine then drills into the ground around the stump, cutting free small roots around the periphery before extracting the stump from the ground. This harvesting process is likely to be refined prior to the harvest of the Project.

TFS has established a processing centre in Kununurra, with all harvested timber processed and stored here prior to dispatch to Mount Romance or elsewhere. The processing involves removing the sapwood from the log, and chipping all the residual timber that does not contain heartwood.

Market Overview

Product type	Indian sandalwood heartwood
Primary use	Fragrance oil, carvings, mouth fresheners, incense, natural medicine, and pharmaceuticals
Key target market	France, India, China, USA, Taiwan, Hong Kong and UK
Competition	India, East Timor, Indonesia
Product Sales Agreements	No specific agreement in place for the Project

Marketing strategy

TFS anticipates that the timber produced from the Project will be sold as cleaned heartwood logs at the farm gate. The sale of the logs will be overseen by the Project Compliance Committee.

The integration of Mount Romance Australia, a specialist Australian native sandalwood processor and distributor, has made TFS a fully vertically-integrated sandalwood producer, processor and marketer. Mount Romance provides TFS with an established sales network, strong customer relationships, and intellectual property relating to the processing and distillation of native sandalwood.

In recognition that there will be a significant increase in market supply when Indian sandalwood plantations mature, TFS has begun developing marketing and supply relationships for Indian sandalwood products, including the following:

- Lush Ltd, a cosmetics company that specialises in handmade products such as soaps, shower gels, shampoos and body lotions. The agreement is a five-year term that begins when TFS starts producing Indian sandalwood oil. The agreement requires Lush to purchase a minimum of one tonne of Indian sandalwood oil and up to a maximum of 15% of TFS' oil production in each 12-month period.
- On 26 February 2014, TFS, via its 50% owned joint venture entity Santalis Pharmaceuticals Inc., announced the execution of a licence agreement with a global pharmaceutical company for the marketing of certain Santalis' dermatology products. These dermatology products will contain TFS's Indian sandalwood oil via a new long-term supply agreement that has been executed in conjunction with the licence.

The supply agreement has been set at an initial price of US\$4,500 per kg and represents a significant advancement in demonstrating the market for and commerciality of Indian sandalwood products. The transaction has the potential to consume a significant portion of TFS's oil output into the long-term. On 5 March 2014 TFS announced it had received the first order under this

Key Points

- The sandalwood produced under the Project is likely to be sold as logs to TFS.
- It is difficult to obtain accurate information on the sandalwood market due to its opaque nature and high incidence of illegal harvests.
- Although India is the largest sandalwood producer, native stocks and production under government control continue to decline.
- Latent demand, market growth and development of new products provide a positive outlook for the demand for Indian sandalwood products.
- TFS is expected to be the largest player in the Indian sandalwood market once plantations have matured.

contract for 100kgs, the oil being held by TFS having been previously distilled from TFS-owned trees.

- Viroxis, a US-based pharmaceuticals company that is developing new treatments for skin conditions.

However, with the Project timber likely to be sold as logs, it is anticipated that TFS will be the ultimate buyer of the logs. TFS will then on-sell the logs or extract the oil at its Mount Romance facility. This poses a conflict of interest issue that TFS will need to manage to ensure that Growers receive an appropriate and fair price. This is made more difficult by the lack of transparency on sandalwood log prices. By comparison, TFS' wholesale product business model provides investors with the opportunity to process the sandalwood logs and sell the sandalwood oil, subject to the payment of an oil processing fee, selling and marketing fee and a performance fee.

While there is no specific off-take agreement in place for the Project, TFS has been active in pursuing both new and existing markets for the potential supply of plantation-grown Indian sandalwood. However, there is a potential conflict associated with the fact that the ultimate buyer of the sandalwood logs is likely to be TFS, which will need to be managed by the company.

Product analysis

Indian sandalwood is a fragrant wood that is highly valued for its oil content, which is sourced from the heartwood of the tree. While the majority of the wood is sold for the extraction of this oil, some is also utilised for wood carving and worship or cremation purposes. Being relatively versatile, sandalwood is utilised in a number of industries and in a range of products. The most common use for sandalwood oil is in the fragrance industry, with the mouth freshener industry (i.e. chewing tobacco) recently becoming a source of demand.

Other uses include woodcarving, as an incense constituent, an additive in soaps and toiletries, and as an important ingredient in Indian and Chinese natural medicines. The pharmaceutical industry has also recently shown interest in the use of sandalwood oil.

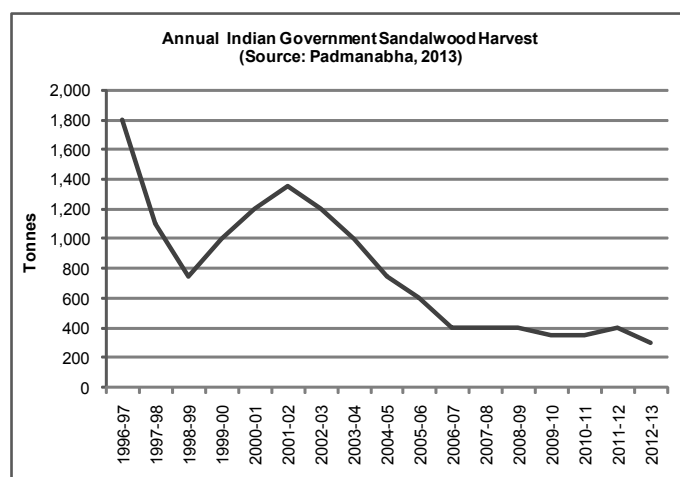
While there are several different species of sandalwood, Indian sandalwood is the most prized in terms of oil quality and fragrance value. Other sandalwood species include *Santalum yasi*, which is a tree native to Fiji, and *Santalum macgregorii*, which is native to Papua New Guinea.

Market overview

As the name of the species suggests, India has long been the centre of the Indian sandalwood industry, in production, trade and consumption. However, Indian sandalwood is also indigenous to Sri Lanka, Indonesia and Fiji. Prior to the 1980s, Indonesia was the dominant exporter of unprocessed sandalwood; however, an export ban in 1978–79 resulted in India having to meet export demand. India now dominates the supply of Indian sandalwood, accounting for around 95% of global production. Nearly all of Indian supply is sourced from native stands, with the southern states of Karnataka and Tamil Nadu providing most of the Indian supply. The balance of global supply is mostly from Indonesia, which is similarly affected by unsustainable harvesting rates.

Traditionally sandalwood trees in India are not harvested until they reach a much higher age, with harvesting of trees below 30 years of age illegal. However, due to the high value of the wood, a high proportion of Indian sandalwood is harvested illegally, and harvesting rates in the country have long been unsustainable. Containing illegal harvests and establishing plantations in India is difficult, as the high value of the wood requires a significant security presence to discourage theft. Nonetheless, Adviser Edge is aware of a small number of plantations established in India. In addition to this, Adviser Edge is also aware of plantations established in Sri Lanka, and plantations planned in a number of other south-east Asian countries.

As a result of the high level of wood illegally harvested, the Indian government has reduced its official annual harvest from around 5,000 tonnes in the 1970s to a level of around 400 tonnes, in an attempt to promote sustainability (Padmanabha, 2013). The following graph illustrates the decline in Indian government sandalwood harvest official quotas. Since 1998, Indian sandalwood has been listed as vulnerable on the International Union for Conservation of Nature (IUCN) red list of threatened species.

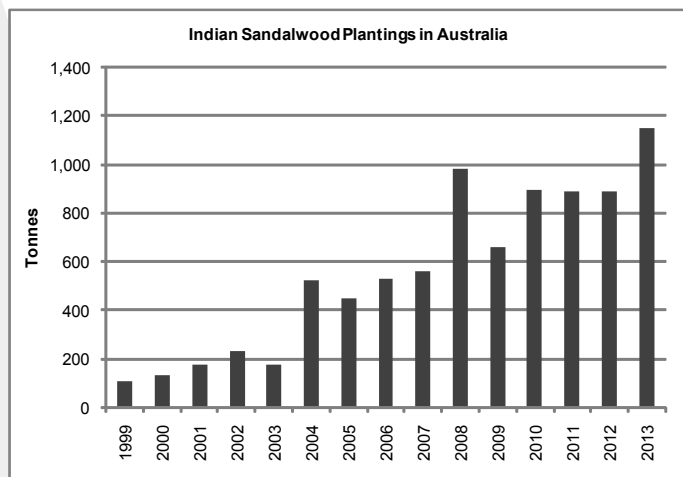


The Indian sandalwood market is characterised by the frequent use of substitutes due to the scarcity of resources. These substitutes include synthetic products, oil from alternative sandalwood varieties (i.e. Australian and African sandalwood), and alternative wood products for the non-oil applications of Indian sandalwood. The market is highly opaque, unregulated and decentralised, resulting in limited information sharing and limited visibility with respect to the supply chain. In this context, and as a consequence of the high prices for Indian sandalwood, this has led to the prevalence of fake wood being marketed as Indian sandalwood and the acceptance of fake wood by the market in order to satisfy latent market demand (Inl, 2010).

Given the large amount of illegal harvesting, estimating annual supply of Indian sandalwood is notoriously difficult. The sandalwood industry is highly secretive with the large wholesalers reluctant to share information, and any publicly shared information may not be completely reliable. However, there is some suggestion that output from illegal supply is four times that of the official harvest (Clarke, 2006). Consistent with this, Padmanabha estimates the annual harvest of Indian sandalwood at 2,000 tonnes per annum (Padmanabha, 2012). Other market participants have indicated production levels of Indian sandalwood at between 3,000 tonnes and 4,000 tonnes, and oil at between 120 tonnes and 150 tonnes, with approximately 80 tonnes being consumed in the Indian domestic market. In addition to India, there are a number of minor markets that produce sandalwood, including Indonesia, Timor Leste, Pacific nations such as Tonga, Fiji, Vanuatu and New Caledonia, and African countries such as Chad, Sudan, Ethiopia, Uganda, Kenya and Tanzania. However, these countries have historically produced non-Indian sandalwood varieties and future production is limited by over-harvesting and population pressures.

As a result, part of the market traditionally serviced by Indian sandalwood has increasingly been met by the supply of Australian sandalwood. The harvest from native stands has allowed Australia to supply around half of the world sandalwood exports (Foster and Bird, 2009). As previously discussed, Australian sandalwood is considered to be an inferior substitute and the

growth in consumption of this species has largely been borne by the increasingly depressed supply out of India and Indonesia, compelling merchants to seek out substitutes to satisfy their requirements. However, it is expected that in the near future, current supplies of Indian sandalwood from native stands will be substantially supplemented with the expected harvests from plantation sources in Australia. The following graph illustrates the rapid increase in Indian sandalwood plantings in Australia, with TFS managing a majority of these plantations.



Indian sandalwood is used in a number of countries including China, India, Taiwan, Singapore, Australia, various Middle Eastern countries, Germany, Switzerland, France, the United Kingdom and the United States. Demand in western countries is predominantly driven by the fragrance industry, where Indian sandalwood oil is an important ingredient in perfumes, soaps and other toiletries. In addition to its uses in the fragrance industry, Indian sandalwood is used in Eastern countries for a variety of other uses such as in wood carving, chewing products, and cultural application such as in pastes (for the application of tilak), cremation and incense.

India remains the largest consumer of Indian sandalwood products. Compounding the difficulty in assessing the size of the market by reference to supply due to illegal harvests, measurement by reference to consumption is also difficult due to the sizeable and opaque domestic consumption in India. The Food and Agriculture Organisation of the United Nations (FAO) have previously stated that it believes consumption in India is probably greater than the rest of the world combined, making the size of the market difficult to estimate (FAO, 2011).

Padmanabha estimates the global demand for Indian sandalwood heartwood is in excess of 8,000 tonnes per annum (Padmanabha, 2010). He states that in India alone, sandalwood demand is estimated to be 5,000 tonnes per annum. Using a bottom-up analysis, Incipient Capital Group has estimated that current demand for Indian sandalwood heartwood is approximately 24,000 tonnes per annum (Morris, 2012), although no opinion was provided with respect to the price points for this level of demand.

Having surveyed the main consumers of Indian sandalwood, Inl expressed a view that the Indian market for Indian sandalwood logs at a price point of \$45/kg may be as much as 10,000 tonnes per annum. For wood below this price point (to \$2/kg), such as those used in the carving and cremation markets, the demand for Indian sandalwood is as much as 150,000 tonnes. These estimates are based on an expectation of a substitution back to Indian sandalwood from inferior and fake products when a greater supply of Indian sandalwood is available. However, it should be noted that there has been a recent decline in demand due to government and legal action on food products containing tobacco such as gutka, which also includes sandalwood oil as one of its ingredients. There have been a number of estimates made with respect to the global supply of Indian sandalwood oil. Clarke suggests global Indian sandalwood oil supply at approximately 170 to 220 tonnes per annum (Clarke, 2006). The annual export of Indian sandalwood oil from India in recent years is estimated at between 5 tonnes and 15 tonnes. This is significantly less than the 100 tonnes India officially exported in the 1970s, and does not take into account the illegal quantities that may have been exported at that time.

Based on the research undertaken by a number of third parties, it is clear that existing and latent demand for Indian sandalwood heartwood can absorb the estimated production from TFS managed plantations.

Market outlook

Mitigating the effect of the expected increase in the supply of Indian sandalwood from TFS-managed plantations is long-term global economic growth, the development of new products that use sandalwood oil, and an increase in demand from existing users resulting from the anticipated higher, and more consistent, supply of Indian sandalwood oil.

While the market for Indian sandalwood is global, it is expected that India will remain the largest market where Indian sandalwood has cultural significance. One of the important drivers of the potential growth in the Indian sandalwood market in India is population growth. The FAO estimated the Indian population will grow by an additional 225 million by 2030, being an approximate 19% increase in its current population.

However, the market for Indian sandalwood products is expected to increase at a rate higher than the projected increase in population. Adviser Edge believes the size of the Indian sandalwood market should outpace population growth as a result of income growth by substantial segments of the Indian population and changes in demographics.

McKinsey & Co has estimated that with the economic growth expected in India, the size of the middle class will grow from 50 million currently to 583 million people by 2025, representing approximately 41% of the population (Farrell, 2007). Accordingly, the transition of Indian families into the middle class is projected

to be a significant multiplier to increases in demand as a result of population growth. However, McKinsey & Co has indicated that this growth is expected to be more characterised by increases in volume than by increases in per capita spending.

The positive economic outlook for the Indian market suggests a significant increase in size in the Indian middle class, which may translate into increased demand for Indian sandalwood products.

As previously mentioned, TFS is currently exploring the potential for Indian sandalwood to be used in the pharmaceutical industry, particularly in the treatment of the human papillomavirus (HPV). The potential market for this product is significant as HPV warts are a very common occurrence. There is no known cure for HPV infection and current therapies are aimed at eliminating signs of symptoms (Lipke, 2006). However, there are a wide range of treatments with varying degrees of effectiveness and there can be no assurances whether Viroxis' research will result in the development of a new treatment that is more effective or is at a lower cost than existing treatments.

There is also a potential premium, which may be applied to plantation-sourced Indian sandalwood, due to increasing consumer preferences for products that come from sustainable sources. TFS is in a unique position, given its position as the dominant Indian sandalwood plantation manager, to warrant the sustainability and authenticity of its resource. In the context of the current opaque markets, this may prove to be valuable. Now that commercial supplies of Indian sandalwood are becoming closer to reality, TFS has advised of buyer demand for the product at prices that demonstrate a significant premium to the spot prices that have been quoted in Indian auction markets.

A combination of latent demand, market growth and the potential development of new products provides a positive outlook for the demand for Indian sandalwood products.

It is widely accepted that the native stocks of Indian sandalwood are dwindling due to unsustainable harvest practices (i.e. illegal harvests) driven by high prices and the death of many trees as a result of spike disease. As a long recognised issue, the Indian state governments have been attempting to encourage the planting of Indian sandalwood. However, past efforts have been limited due to difficulties in containing theft, the risk of spike disease, government regulation, and the long lead time until harvest.

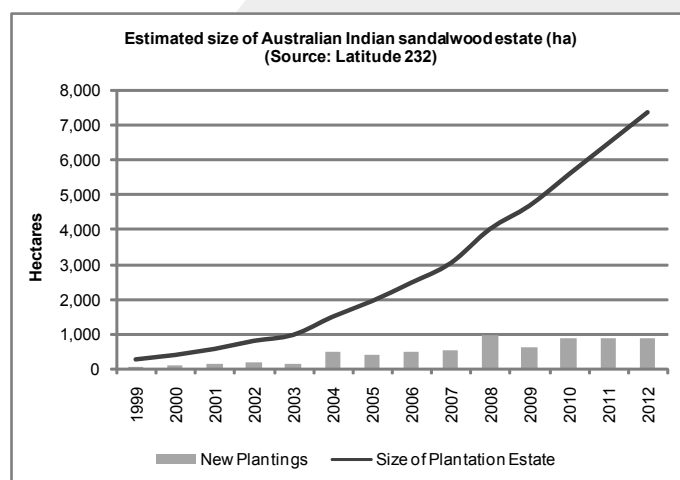
The Indian government has attempted to encourage plantation establishment by providing private ownership of plantations; however, establishment remains limited, with significant government restrictions acting to curtail plantation investment such as the control of harvesting and sales (in addition to the other barriers).

Given the lead time to plantation establishment, there is unlikely to be significant competition from other non-TFS managed sources to supply Indian sandalwood at the projected time of harvest.

Adviser Edge expects that imbalances in demand and supply will persist in the future, even if existing regulatory and other barriers are overcome, as the market response to increase the area planted to Indian sandalwood is complicated by the long lead time until harvest. As a consequence, Adviser Edge believes that, other than the expected supply from TFS-managed sources (MIS and institutional plantations), there will be limited supply from other sources at the time the plantations are expected to be harvested.

The establishment of Indian sandalwood plantations in Australia has been significant in recent years with over 7,500ha established since 1997. Indian sandalwood was first grown in 1993 by the Western Australian Forest Products Commission (FPC) at Kununurra, Western Australia. The majority of these plantations have been established under agricultural managed investment schemes and are located in the ORIA region of Western Australia, with a small proportion located in far north Queensland. TFS is the largest manager of Indian sandalwood plantations in Australia, managing approximately 6,500ha of Indian sandalwood plantations.

The size of the Indian sandalwood estate has grown markedly in recent years, with TFS successfully establishing plantations for wholesale clients in conjunction with plantations for retail clients. Since 2008, average plantation establishment has exceeded 900ha per annum.



An important barrier to the increased supply of Indian sandalwood is the availability of suitable land. While new areas are currently being explored, they are still some way behind the ORIA in becoming established Indian sandalwood regions.

TFS will commence harvesting in 2013 and is predicted to become one of the largest producers and exporters of Indian sandalwood heartwood oil by 2023. Clarke has projected that Kununurra plantations will produce 130 tonnes per annum by 2023 (Clarke, 2006). Based on an oil yield of 3.7%, this translates to approximately 3,500 tonnes of Indian sandalwood heartwood. However, it is likely that Indian sandalwood heartwood production in 2023 will be significantly higher and will peak at around 8,000 tonnes per annum based on current plantings.

While there are a number of small plantations being established around the world, TFS is by far, the dominant manager of Indian sandalwood plantations in the world. Accordingly, at the time of harvest, Adviser Edge believes TFS will be able to exercise a significant degree of control on prices and the supply of Indian sandalwood oil at the time of the expected harvest.

While future supplies are expected to significantly increase compared to present levels, Adviser Edge has also considered TFS' unique ability to manage global supplies over the medium-term when assessing the potential future state of the Indian sandalwood market.

Adviser Edge Returns Modelling				
	Annual Investment Option		Annual Deferred Investment Option ³	
	Pre-Tax	Post-Tax ²	Pre-Tax	Post-Tax ²
Adviser Edge Base Case ¹	11.10%	11.10%	12.15%	12.15%
IRR Range ²	5.35%–12.30%	5.35%–12.30%	7.25%–13.25%	5.35%–13.25%
Median Return	8.30%	8.30%	9.75%	9.75%
Percentage of results that are break even or better	97%	97%	98%	98%
Percentage of results with an IRR of 10% or better	30%	30%	47%	47%

¹ The IRR range represents the range of results that occur within the 20th and 90th percentile in the simulated model. The range is based on Adviser Edge's modelling of potential outcomes for the Project using Monte Carlo simulations. These are subject to a number of limitations, which are discussed further below. Accordingly, the range is provided as a guide only. Investors should seek additional professional advice regarding the impact of changes in key variables on Project returns given their individual financial circumstances. The analysis does not consider investor finance arrangements.

² The analysis assumes a 46.5% marginal tax rate, that investors are registered for GST, and that all GST is rebated in the year paid.

³ The Annual Deferred Investment Option assumes that all annual fees are deferred and deducted as a percentage of harvest proceeds.

The following section provides an analysis of the potential investment returns for the Project. Please note that this analysis is based on estimated performance assumptions, which may change over the Project term. Investors need to be aware of the way in which these assumptions may influence investment returns, and should seek additional professional advice to determine whether or not this investment is suitable for their own risk and return objectives.

Scenario testing

In reviewing the Project, Adviser Edge has undertaken scenario testing of potential returns from the Project using Monte Carlo simulations. The scenario testing is based on variations to key assumptions relating to price, yield, quality, and the potential for severe adverse events to occur, and the relative impact of these events on returns. Investors should be aware of the limitations associated with this kind of scenario testing. The model used incorporates a number of subjective judgements made by Adviser Edge, which may not be empirically verifiable, and does not include all the variables that affect returns. Accordingly, the predictive capability of financial modelling is limited. Nonetheless, Adviser Edge believes that the use of such modelling practices provides an improved insight into the risk/return profile of a particular investment, when compared with static investment modelling techniques.

Returns modelling undertaken by Adviser Edge suggests that the annual deferred investment option provides a higher median return of 9.75% before tax when compared to the annual investment option's median return of 8.30% before tax. This is due to the higher net present value of fees paid under the annual investment option, as discussed in the Fee Analysis section of this report. However, investors should consider personal circumstances when determining the most suitable investment option. The Monte Carlo analysis demonstrates an estimated returns range of

between -100% and 20.00% for the annual deferred investment option, with 70% of values returns falling between 7.25% and 13.25%.

This wide returns range is largely caused by the modelling of the potential impact of manager insolvency or a natural disaster event. Ignoring the risk of manager insolvency increases the median return to 11.10% before tax for the annual investment option, and 12.15% for the annual deferred investment option. This reflects the skewed nature of modelled returns when such an event is included, and is caused by the low probability of an insolvency or natural disaster event occurring, but the high impact associated with such an event. The following graph illustrates the distribution of returns that resulted from Adviser Edge's analysis.

Key Investment Analysis Performance Assumptions

The estimated Project returns provided by Adviser Edge have been calculated using various performance assumptions. The key assumptions adopted by TFS and Adviser Edge are presented in the following section. These assumptions have been determined from information provided in the PDS, directly by TFS, from the independent foresters and independent market report, and from independent research performed by Adviser Edge.

Performance assumptions

Performance Assumptions	TFS	Adviser Edge
Age at harvest (rotation length)	14	16
Heartwood yield (kg/tree)	22.5 ¹	24.72
Sandalwood survival rate	83%	83%
Heartwood oil content	3.70%	3.20%

¹ TFS' forecast at 14, 15 and 16 years of age.

² Adviser Edge's forecast at 16 years of age.

Rotation length

TFS has indicated in the PDS that it intends to harvest the sandalwood plantations between the ages of 14 (FY2029) and 16(FY2031). As the leases have a defined termination date, the latest the trees can be harvested is at age 16. While the optimal rotation length for Indian sandalwood has not been determined, the extension of the harvest window is supported by Adviser Edge. Research undertaken to date indicates that heartwood development and sandalwood oil levels increase with age, potentially well beyond 16 years. Consequently, Adviser Edge has a preference for harvest to occur as close to the 16 year threshold as possible, and has modelled accordingly.

Sandalwood survival

TFS has undertaken an extensive and intensive inventory that covers all plantations under management. The data from the inventory provides a clear picture of sandalwood survival across a range of age classes. The inventory data clearly illustrates an improvement in sandalwood survival rates over time as a consequence of changes TFS has made to site selection and sandalwood silviculture practices.

Leaving aside the East Kimberley Sandalwood (EKS) Project and the TFS Sandalwood Project No.2 (TFS No.2), which were established using existing knowledge at the time, the TFS estate (2000 to 2011 projects) achieved average sandalwood survival rate of 72.70% as at 30 June 2013. A more granular analysis shows a clear upward shift in survival from the 2008 project, with Project years 2008 through 2011 achieving 92.95% survival, as opposed to 63.70% for the 2000 to 2007 projects.

The improved survival from 2008 to 2011 can also be seen in visual assessments of the 2012 and most recently planted 2013 projects. The key factors that appear to be supporting the higher survival rates include:

- Improved site selection
- A settled and proven host species mix
- Weed control
- The high quality of seedlings being produced by the TFS nursery
- An increasing percentage of seedlings being produced from seed from the TFS seed nursery or selected trees within the estate
- The ability to use either drip or flood irrigation depending on soil conditions
- Skilled management

Based on the information at hand, Adviser Edge has decided to adopt a final sandalwood survival rate of 83% at age 16 years. Adviser Edge expects that survival after the first wet season will exceed 95% and may be as high as 99% (e.g. 2011), with an allowance made for mortality year to year. The adopted survival rate is below the TFS expectation and is considered to be a realistic assumption for the purposes of modelling investment outcomes.

Heartwood yield

The usual method of estimating the potential yield from a plantation forestry stand is to use developed biometric models, which predict future forest inventories (ACFA, 2009). These models are usually developed using existing plantation stand information to determine, statistically, the growth rate of the plantations. There is very limited third party information available to estimate the growth rates for Indian sandalwood plantations. Older data from trial plantations undertaken by the Forests Products Commission has limited value due to the experimental nature of the plantations, limited management regime, older provenances being used, and the limited amount of information recorded on these plantations.

In order to determine the reasonableness of TFS' yield estimate Adviser Edge originally sought to estimate the potential yield of the plantation using traditional volumetric techniques with verifiable data provided by TFS on basal area, bole length and taper assumptions to calculate the estimated yield of heartwood. However, it was concluded that differences between Indian sandalwood plantations (i.e. non-homogenous) limited the ability to predict volumes of Indian sandalwood heartwood and oil using this method.

The main difference is that the growth of heartwood is not proportional to the growth of the overall volume of the tree, which means the determination of heartwood volumes requires the inclusion of another factor, which can predict the volume of heartwood as a proportion of overall tree growth.

As a consequence Adviser Edge has given consideration to research and development work undertaken by TFS. While bole height, taper and other factors are widely used in the plantation forestry industry to calculate plantation volumes, work undertaken by TFS has indicated that bole length and taper do not provide significantly improved estimations of yield for an Indian sandalwood plantation. Rather, TFS has developed a growth model, which uses tree age and diameter over bark (DOB) at 20cm (above ground level) as the main inputs. Based on the trial harvests and other data obtained by TFS, heartwood volume predictions based on DOB size contained in the TFS research have so far demonstrated a high level of statistical significance.

The TFS research was a culmination of studies and data collection looking at tree growth rates, inventory and heartwood development, oil yield and quality, and processing techniques. It

involved the collection of data from five destructive harvests of 170 trees that ranged in age from 11 to 23 years, in conjunction with FPC, RIRDC and private foresters. This research was peer reviewed (to independently verify the results) by Dr Tanner of the University of Western Australia.

Given TFS' research and the absence of alternative models that can be reliably used to estimate volume, Adviser Edge has adopted TFS' growth model in estimating the potential yield for the plantation.

The best available source of information for estimating Indian sandalwood yield is from TFS' own research and development. Adviser Edge has noted the potential risk of bias in using TFS' own research; however, it has also been noted that this research and development work is used for TFS' own internal planning purposes and has been peer reviewed by an appropriate external body. Adviser Edge has adopted a higher heartwood yield per tree to reflect the expectation that harvest will occur at or near to 16 years.

Sandalwood oil yield

In native sourced timber, oil yields from Indian sandalwood heartwood are typically between 3% and 8% as a percentage of dry ground heartwood. However, oil content is known to improve with age and ascertaining the oil yield content at the time of harvest is fraught with difficulties, given very few plantations have been brought to maturity and harvested. It is expected that the oil yield results from the 1999 EKS plantation harvest will significantly improve the confidence with which predictions can be made regarding oil yields.

It is believed that, in the majority of instances, Indian sandalwood heartwood does not start to produce oil until around 10 years of age, although some trial sampling indicates the presence of oil slightly earlier. In its financial model, TFS has estimated oil yields to be 3.70% of heartwood weight (at 25% moisture content).

The most comprehensive results recorded so far for Australian plantation-grown Indian sandalwood oil is the 2010 trial harvest. This trial, in which 90 trees were harvested, recorded a mean oil yield of 4.9% of the heartwood woodchips at a moisture content of 25% by dry weight. There was a degree of variation in yields between 1.7% and 7.3%.

TFS has since undertaken a number of other harvests with trees aged between 11 and 17 years old, which have provided further confirmation on the oil content of sandalwood trees at different age groups. This research has enabled TFS to develop a growth model that can be used to estimate oil volumes in a standing plantation. Together with estimated growth rates in DOB, this model can be used to estimate future yield of Indian sandalwood oil plantations.

Based on this reported data, and confidential information provided by TFS, Adviser Edge has estimated that the sandalwood oil yields at 16 years of age will be 3.2% (with a range between 3.0% and 3.7%). The rate at which oil develops in the heartwood is not linear and increases as the trees age. This is an important point as, when combined with increasing heartwood growth, the total volume of oil that can be extracted from harvested heartwood increases significantly each year from 10 years of age and would be expected to continue doing so beyond 16 years based on TFS' and other research.

Past performance

TFS established its first Indian sandalwood plantation in 1999, and has since planted around 7,500ha. The area established year-to-year varied, with the period from 2008 to 2013 representing a significantly larger proportion of total plantings. Adviser Edge, as noted previously, has taken a view that the 2000 to 2013 plantations are more representative of the current production system and hence are more appropriate for peer comparison purposes.

At the time that the 1998 and 1999 plantations were established there was a strong reliance on existing knowledge primarily linked to the WA Department for Conservation and Land Management (WA CALM) research. Due mainly to inappropriate host selection and poor sandalwood survival, these plantations have performed poorly. The 1998 EKS plantation and TFS Sandalwood Project No.2 achieved only 40.55% and 37.91% survival respectively, well below the average of 63.7% for 2001 to 2007 plantations and far below the 92.95% average for 2008 to 2011 projects.

While the volume of timber harvested is not considered to be a useful guide to the future prospects of the trees that will be established as part of the 2014 Project, the level of heartwood and oil extraction that has been achieved from the 1998 EKS harvest will be informative, as it represents the largest commercial sample of its kind for the industry.

At the time of the site inspection TFS had completed harvesting 8ha of the EKS plantation, with the remaining 136ha to be taken out for processing in 2014, after the wet season has finished. The heartwood and oil results were not available at the time this report was completed.

The 1998 and 1999 projects will deliver timber volumes that are well below current expectations principally due to poor survival and low growth rates. However, it is anticipated that prices will exceed original forecasts, offsetting this to a large extent.

Adviser Edge has been assessing TFS plantations since 2003 and during this time has seen gradual improvement in the performance of plantations, most notably through improved survival rates and sandalwood growth. TFS has a strong commitment to R&D, including harvest trials, which has led to

a significant improvement in the knowledge of heartwood and oil development relative to age. TFS changes its management practices where appropriate and particularly where there is strong evidence in support of it.

The first harvest of real significance will be the 2000 project in FY2015. From this project onwards the changes that occurred to plantation management were more iterative, including host species selection. The 2013 inventory supports this view and provides very encouraging signs that harvests from the 2000 project onwards will yield significant volumes of both heartwood and oil. Adviser Edge still expects variation in outcomes from year to year, particularly with respect to the pre-2008 projects, which had significant variation in survival levels.

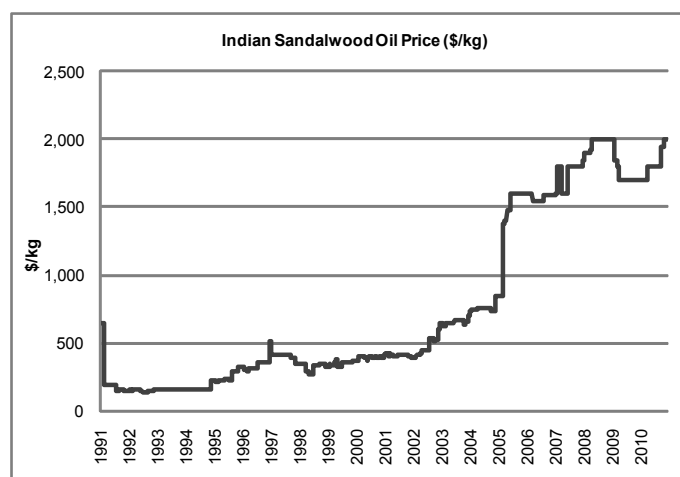
Based on Adviser Edge's review of the TFS estate and the 2013 inventory data provided by the company, Adviser Edge believes that the existing estate reflects well on TFS as a sandalwood manager. Investors in the 2014 Project will gain from the 15 years of collective knowledge of TFS and the company's stable management team. Notwithstanding, it will not be until 2015 or potentially 2016 that Adviser Edge will be in a position to assess the performance of a sandalwood plantation from a peer perspective.

Price

Performance Assumption	TFS	Adviser Edge
Farm-gate heartwood price (\$/kg)	A\$49.17/kg	A\$49.17/kg
Sandalwood price inflation	2.90%	2.90%
Estimated harvesting cost (\$/ha)	A\$16,000/ha	A\$16,000/ha
Cost inflation	2.30%	2.90%

In terms of pricing, the aromatic characteristics of the sandalwood oil largely determine the final price achieved, and these are normally judged by the buyer based on eventual end use. Because Indian sandalwood oil is deemed to have superior characteristics, it attracts a premium heartwood and final oil price compared with substitutes such as Australian sandalwood.

Since 1990, and as native stocks started to decline, Indian sandalwood oil prices have grown at an annual compound rate of around 8% to 9% per annum, while world population growth over that period of time was only 1.3% per annum. This dynamic can be characterised as a supply constrained market, resulting in substantial increases in prices.



Source: Datastream.

However, Adviser Edge does not believe that the expected increase in supply as a result of the increased availability of plantation sources will result in any significant changes in this dynamic, despite projections of up to 8,000 tonnes per annum of Indian sandalwood heartwood being produced from plantation sources (being two to four times the estimated current supply). This is due to the projected increase in the demand for Indian sandalwood products as a result of the predicted massive growth in the Indian middle class, as well as the growth of emerging markets, including:

- Pharmaceutical industry demand for oil
- Chinese demand for carving wood
- Demand for sustainably harvested sandalwood (e.g. fragrance industry)

Notwithstanding the positive factors supporting a larger market over the medium to long-term, Adviser Edge believes that there will be limited scope for significant real price increases for Indian sandalwood above current elevated prices in more developed markets. Significantly higher prices are likely to be prohibitive for current customers and this could increase substitution and lead to a substantial reduction in consumption in response to markedly higher prices. This is less likely to be an issue in developing markets such as pharmaceuticals, as demonstrated by the recent announcement by TFS detailing a new supply agreement with an initial price of \$4,500/kg.

In terms of downside risks, Adviser Edge does not expect prices to fall to long-term historical levels. It should be noted that current supply is approximately between 5% and 10% of the amounts produced in the 1970s, when official Indian exports of sandalwood oil were approximately 100 tonnes per year, and at a time when the global and Indian population was approximately 3.7 billion and 550 million respectively. With a current global population of around 7 billion and an Indian population of 1.2

billion, we would expect that even if historical supply levels were being achieved today, Indian sandalwood will still be trading at a significantly higher real price than what was being achieved in the 1970s.

Adviser Edge has conducted returns modelling for the Project using a base Indian sandalwood oil price, accounting for variations in exchange rates, transportation and processing costs, and variations in the heartwood oil content.

Adviser Edge has adopted a base price of US\$1,500/kg of Indian sandalwood oil, and assessed a large range of prices in the returns modelling process. While this value is lower than prices currently being reported, Adviser Edge believes that a level of conservatism needs to be applied given the 14 to 16 year timeframe of the Project and the large volumes of heartwood and sandalwood oil that will be produced by TFS managed plantations.

A base farm-gate price of A\$49.17/kg for cleaned heartwood logs has been estimated by Adviser Edge. This is based on an oil price of US\$1,500/kg and a heartwood oil content of 3.20%. The estimated price also takes into account harvest costs, oil extraction costs, and transport costs to the point of sale.

TFS has indicated that at the time of harvest for the Project, a transparent mechanism will be in place to ensure that investors in the project achieve fair market value for heartwood produced at harvest. The compliance committee is tasked with ensuring that the TFS sale process is both transparent and capable of achieving the best price for investors. The risk for investors is that the process designed for the purpose may not achieve the fair result expected.

Given the significant changes expected to occur in the Indian sandalwood market, it is extremely difficult to estimate the price likely to be achieved for Indian sandalwood oil, and therefore for the heartwood logs at the time of harvest. Accordingly, Adviser Edge has incorporated a relatively large real price range for Indian sandalwood prices at the time of harvest.

Harvesting costs

The harvesting costs for Indian sandalwood are substantially higher than traditional timber plantations due to the need to remove the entire tree including the butt and larger roots, which contain sandalwood oil.

Harvesting equipment was designed for the first commercial harvest in 2013, and found to be effective. The harvesting process is likely to be significantly refined prior to the harvest of the 2014 Project.

TFS estimates harvest costs to be \$16,000 per hectare. It should be noted that, based on the harvesting completed in 2013 and

extrapolating that to a fully-stocked plantation of scale, TFS expects the cost of harvesting to be less than the long-held assumption of \$16,000 per hectare.

Adviser Edge has adopted TFS' harvest cost assumptions for investment modelling purposes. These harvest costs assumptions are only an estimate; however, due to the high value, low volume characteristics of sandalwood, harvesting costs are expected to be minimal when compared to heartwood prices.

Adviser Edge has indexed harvesting costs at the long-term forecast inflation rate of 2.9% p.a. A sensitivity analysis conducted around this assumption reflects the potential for changes in the CPI to affect harvesting costs.

Other assumptions

As well as assessing the key variables of yield and price, Adviser Edge has incorporated the potential for RE insolvency and its expected impact into the investment modelling, as well as the potential for destruction of the Project trees.

In assessing the likelihood of an insolvency event, Adviser Edge has taken into account TFS Limited's balance sheet, its ability to generate future cash flow, and its access to capital. TFS is in a decent financial position with a strong balance sheet but will continue to rely on future sales to institutional and retail investors as harvest and processing volumes begin to come online. As such, Adviser Edge has applied a relatively low default rate in its investment modelling.

The Project is structured in such a way that, in the event of the insolvency of the Responsible Entity, it is possible that a replacement RE will be appointed. This is facilitated by the incorporation of an annual fee, and the presence of the custodial accounts which hold the equivalent of one year's management and lease fees. However, given the heavy reliance on the experience of TFS in the sandalwood industry, any insolvency is expected to have a significant negative impact on Project outcomes. The impact of an insolvency event diminishes where the insolvency event occurs at a later stage in the Project's term, due to the increased value of the Project resource (i.e. the standing trees).

The modelling of Project returns has also incorporated the cost of insurance, the probability of an insurable event occurring, and the proceeds should an insurable event occur.

To reflect an unforeseen and uninsured natural disaster, or a disease or pest event which eliminates the ongoing production of a specific lot, Adviser Edge has incorporated a small probability of an investor's interest being terminated, with no returns being provided to investors.

It is difficult to estimate the probability and impact of these assumptions with regards to investment returns due to the limited information available to verify the underlying assumptions. However, Adviser Edge believes that by including its judgment on the potential impact of these events, investment returns modelling will be more reliable when compared to less sophisticated assessments.

Sensitivities

The Project's ability to achieve key assumptions is a function of both the inherent volatility of the underlying activity but also assumption risk, which is the accuracy of the initial estimate. Accordingly, the volatility used in Adviser Edge's modelling depends on the quality of the data supporting the assumptions, and an assessment of the expected volatility of the underlying activity during the course of the Project.

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IRR sensitivity

Project returns are highly sensitive to heartwood oil yields, which are expected to significantly affect the price paid for the plantation-grown Indian sandalwood. Due to the limited empirical data to support oil yields, a reasonably high standard deviation has been applied when modelling returns (this is consistent with the results of the trial harvests), which affects the sensitivity displayed above. Oil price and survival rates are also expected to have a strong contribution to the variance in project returns, as does the potential for an uninsurable event and fluctuations in the prevailing AUD/USD exchange rate. As previously discussed, while the likelihood of an insolvency event is low, the potential consequences are considered to be high.

Yield



While the supporting information around yields continues to improve, the yield risk remains high and there remains a risk that the plantations will not achieve the anticipated heartwood or oil yields.

Price



There are significant risks associated with the price estimates used to model Project returns. The market is relatively shallow at present, making it challenging to predict future levels of demand and the ability of the market to absorb the significant increase in supply from TFS' managed plantations. The developing pharmaceutical market could play an important role in maintaining prices into the future.

Costs



Investors in the Project are directly exposed to the costs associated with harvesting the sandalwood. While there is limited information to support the estimated cost of harvesting and extraction, given the relatively low cost compared to the high value of the commodity, the variances in harvesting costs are not expected to significantly affect Project returns.

Investors in the TFS Indian Sandalwood Project 2014 will be subject to the risks associated with long-term forestry investments. All potential investors should carefully consider the risks outlined in the Project PDS, and the specific risks outlined in the Adviser Edge research report.

Management, structure, and fees risks

MIS management encompasses not only the operational capabilities of the Project counterparties, but also the corporate abilities of TFS Properties to monitor operational performance, and to meet the regulatory and statutory responsibilities required of it as Project RE.

For all MIS projects there is a risk that if the financial position or performance of management deteriorates, asset condition, project outcomes and/or regulatory outcomes may be temporarily or permanently compromised.

The Project incorporates two fee structures, whereby investors can elect to pay annual ongoing management and lease fees, or choose each year whether to pay or defer these fees to be taken as a percentage of harvest proceeds. The fee structure means that investors have some protection from unexpected increases in plantation management costs over the Project term. However, with overall fees weighted towards up-front fees rather than deferred fees, the Project is subject to continued Project manager solvency.

The continued solvency of TFS Properties, TFS Limited and TFS Leasing is required in order to meet ongoing obligations associated with plantation management and any land rental payments. While a cross-guarantee entered into by entities in the TFS group provides protection to investors contracting with TFS Properties, it should be noted that, under certain circumstances, this cross-guarantee can be revoked.

Should TFS Properties fail to meet any rental payments under any head lease, there is a risk that investors' interests in the Project will be terminated. Should this occur, this may result in individual investors not being able to participate in the Project pool. This risk is partly mitigated by the segregation of one year's lease and management fee, which is held by the custodian in a security account.

While the relatively large up-front fee provides investors with a tax-effective investment structure, the structure does mean that the Project is subject to higher risks earlier in the Project term, as the value of interests are significantly less marketable in the early years of the Project term.

Should the Project be wound up for any reason, it is expected that consideration for the interests will be subject to significant discounts due to the relative risk associated with the time to maturity and the ongoing costs of management. However,

the establishment of a secondary market for interests in TFS sandalwood projects mitigates the risk of interests being sold at a loss.

The most serious consequence of insolvency is if it results in the Project being wound up prior to the Sub-Land Interest Agreement being registered. Should this occur, there is a risk that investors will lose all, or substantially all, of the Establishment Fee paid to TFS Properties.

In addition to this, in the event of insolvency investors are reliant on an externally-administered Responsible Entity to act in their best interests. Such Responsible Entities may be subject to a number of conflicting interests. As a consequence, and in the absence of the establishment of systems mitigating this risk, investors may need to collectively organise appropriate representation to ensure that their interests are properly considered.

Site and silvicultural risks

Investors should be aware of the risks associated with the site and management of the Project. Key areas of risk identified by Adviser Edge are as follows.

Site selection

There is a risk that the selected land is unsuitable for an Indian sandalwood plantation. With a large area of Indian sandalwood established by TFS, the company is in an excellent position to implement site selection protocols that should ensure the selection of suitable land. However, with no established plantations of a significant age in the Northern Territory or Queensland, it is unknown how the Project plantations will perform if a portion of the Project is planted there. As such, there is a risk that the soils and climate in the Northern Territory and Queensland sites are unsuitable for an Indian sandalwood plantation.

Pests and weeds

Insect damage can adversely affect yield. Weeds, especially pumpkin vine, can also affect growth rates through competition for water and nutrients, or can act as a vector for unwanted insects or diseases. TFS will monitor the plantations through frequent site visits, and will implement immediate treatments if weed invasion or pest damage exceed predetermined levels.

While TFS is familiar with the pests and weeds prevalent in the ORIA, if Project plantations are located in the Northern Territory or Queensland, there is a risk that there will be pests and weeds unique to these regions that TFS is not accustomed to managing.

Infrastructure

Infrastructure risks include the factors associated with transportation, processing, and the availability of skilled labour. This poses a significant risk, given the isolation of the region. However, TFS possesses a strong operational team and has

developed significant regional infrastructure. TFS has also invested in Mount Romance, demonstrating its commitment in developing upstream processing facilities. In addition to this, given the expected high-value nature of the product by weight, the location of processing facilities is significantly less important when compared to lower value commodities.

Performance risks

Yield and quality

Activities that deal with forestry are exposed to similar risks as those inherent in other agricultural production systems. Risks relevant to the plantation sandalwood industry include the impact of climatic events such as low rainfall, excessive heat and wind, and seasonal aspects such as fire and flooding. Irrigation of the plantations mitigates the impact of low rainfall.

Investors should be aware that even conservative yield estimates are prone to failure due to adverse growing conditions. However, these threats can be mitigated by good site selection.

While recent trials have shown that plantation-grown Indian sandalwood yields oil, limited information remains regarding the yield and quality achieved in 14 to 16-year-old plantations, which is the age at which TFS anticipates harvesting the trees. As such, there is a risk that the Project plantations may yield sandalwood heartwood and oil at lower levels than those estimated by TFS.

Information risk

Given the infancy of the plantation sandalwood industry in Australia, significant information risk exists regarding the performance assumptions used to model investor returns. This risk is particularly prevalent when estimating the price of plantation-grown Indian sandalwood, as well as the heartwood yield and heartwood oil content.

Prices and costs

Investor returns will be directly affected by the price received for the Project resources, and the costs of harvesting and processing. While prices and costs are generally dictated by the dynamics of supply and demand, changes in certain macro-economic factors can also have an impact. Such factors include exchange rates, interest rates, and inflation. Investors need to be aware that these factors can both positively and negatively affect investor returns.

In addition, with it being likely that TFS will purchase the logs produced under the Project, due to the conflict of interest there is a risk that TFS will not pay a competitive price in accordance with markets for Indian sandalwood oil and logs.

Marketing risks

As with any MIS project, there is a risk that the market for the

Project resources will encounter a significant downturn at the time of harvest. This may be due to factors such as competition, regulation, and/or market preferences. The effect of reduced demand may affect prices, which could potentially reduce investor returns. The flexibility around the timing of the harvest, albeit relatively small, mitigates this to an extent.

Fire risk

As with all forestry plantations, there is a risk of fire on the Project plantations over the dry season. TFS has advised that it has not experienced any damaging wildfires. TFS is required to maintain adequate fire breaks.

Security risk

Due to the high value of Indian sandalwood heartwood and oil, once the plantations are of a reasonable age, theft becomes a possibility, potentially diminishing investors' concerns.

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11.08, 9 Yarra St,
South Yarra, VIC 3004
Telephone: 03 8849 0003
Facsimile: 03 8849 0006
Email: info@adviseredge.com.au
Web: www.adviseredge.com.au