Adviser Edge

# TFS Sandalwood Project 2012

INDEPENDENT ASSESSMENT

This report has been prepared for financial advisers only

22 March 2012

### 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

The Adviser Edge web site provides a service to subscribers, allowing them to view the final assessment reviews. Only subscribers are permitted access to download completed assessment reviews.

Star ratings applied to 2011/12 projects are independent of previous year's star ratings.

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### Report Date

22 March 2012

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★★★★½

**Adviser Edge Rating**

Low Medium High

**Recommended Client Risk Tolerance**

| **Project Details** | |
|---|---|
| Project Name | TFS Sandalwood Project 2012 |
| Product | Indian sandalwood timber |
| Responsible Entity | TFS Properties Ltd |
| Parent Company | Tropical Forestry Services Ltd |
| **Investment Details** | |
| Investment Term | Approximately 15 years |
| Investment Unit Size | 0.083ha |
| Units Available | 4,800 |
| Application Fee | $6,250 (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 FY2011 | 30 June 2012 |
| Investor Finance | Short and long term finance available |
| ATO Product Ruling | PR 2012/8 |

| **Investor Returns** | **Annual Investment Opt.** | **Annual Deferred Investment Opt.** |
|---|---|---|
| Potential investment returns (p.a.) – pre tax | 4.00%–14.45% | 6.70%-15.70% |
| Adviser Edge Base Case (pre and post-tax) | 10.89% | 12.35% |

## Investor suitability

As a general note, investment in agribusiness should represent a balance between the various potential risks and the forecast returns. 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.

### Other Project considerations

- A small liquid secondary market may be available, through an arrangement between TFS and wholesale investors.

## Key Points:

### Key Investment Risks

- MIS investors in TFS projects are subject to solvency risk. Countering this risk is TFS' sound financial position, strong equity position following a recent capital raising, and diversified income streams (retail and institutional).
- The first harvest of a TFS plantation, scheduled for 2013, will provide a true base line on actual yield performance. However, the results of the most recent FPC trial provide supporting data for TFS' heartwood and oil yield assumptions.
- Tropical forestry is exposed to conventional agricultural risks. However, TFS has yet to experience significant events and appears to have the management plans in place to deal with such scenarios.
- A proportion of the Project plantations may be located in the Douglas-Daly region, and it is unknown how the plantations will perform in this environment.

### Strengths of Project

- TFS is in a strong financial position, following recent debt and equity raisings. In addition, the company has diversified its cash flows into the wholesale market and manufacturing operations.
- TFS has gained significant expertise in the management of plantation sandalwood, and continues to improve on its high standards.
- Adviser Edge has a positive market outlook, with depletion of native sandalwood stands expected to compensate for increased Australian plantation production, and maintain the current supply/demand imbalance.

### Weaknesses of Project

- While the establishment fee is high, it provides TFS with greater financial stability and strength in the event of unforeseen cost increases.
- While TFS has displayed an ability to achieve high survival rates in young plantations which form the basis of productive harvests, actual heartwood and oil yields are yet to be confirmed.
- Sandalwood oil pricing sourced independently has not reached full transparency relative to other global commodities. However, actual transactions completed by TFS provide greater clarity around price discovery.

| Investment Specifications | |
|---|---|
| Maximum subscription | 4,800 lots (400ha) |
| Location | Kununurra, Western Australia |
| Investment unit size | 0.083ha (one lot) |
| Number of trees per unit | Approximately 43 Indian sandalwood trees, plus host trees |
| Minimum application | One lot |
| Liquidity | Recently established secondary market may provide liquidity |
| Insurance | Not compulsory (unless finance is utilised) |
| Investor finance provider | Finance available through Arwon Finance Pty Ltd |

### 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 RE.
- Establishment and management fees are comparatively high on a per hectare basis.

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 2012. Each lot will be 0.083ha in size, and will be planted with approximately 43 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 involves the establishment of Indian sandalwood trees in the Ord River Irrigation Area (ORIA), near Kununurra in Western Australia, and in the Douglas-Daly region of the Northern Territory. Based on discussions with TFS management, it is likely that the majority, if not all, of the 2012 Project plantations will be located in the ORIA. However, in the event that maximum subscription is achieved under the Project, 35% to 50% of the plantations may be established in the Douglas-Daly region, exposing investors to site risk, as Indian sandalwood is yet to be successfully grown in this region.

The sandalwood heartwood to be produced is expected to be sold largely to the international fragrance, carving and pharmaceutical markets. The Project has an expected term of 14 years from the planting date, which must occur before 31 December 2013.

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 plantations at age 14 (FY2027), although the precise timing of the harvest may fluctuate in order to maximise the revenue of the Project. The Project Agreements appear to provide some flexibility with respect to the timing of the harvest should a force majeure prevent completion of harvest at age 14, or should the heartwood and oil yields be deemed insufficient by TFS.

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 2012). 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 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 provides a strong financial incentive for TFS.

***While investors have the option of paying fees annually, they also have the option to defer these fees to harvest. This may affect TFS Properties' ongoing cash flow. It should be noted that this risk reduces as the Project term nears maturity, as ongoing management costs decrease and 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. One of these accounts, the Establishment Fund, will hold 50% of the application fee. These funds must be deposited in the established trust account within 14 days from the Commencement Date, being 30 June 2012. The funds in this account will only be released once tree planting is completed, or in the event that TFS Properties (the RE) becomes insolvent. These funds would then become available to a replacement RE to assist in funding the continuation of the Project. The remaining 50% of the application fee is available to TFS to fund the establishment of the Project plantations.

The second account to be established with the independent custodian will hold the one year's annual management fee and rent, which are prepaid by investors at the time of application. These funds will not be released until the final annual payment is due, which is likely to be FY2025, if the trees are harvested at age 14 as expected. 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.

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 Landgate (the Western Australian land titles office) 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 was 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 an 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 2012. 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<br>Between 1 and 11 Lots<br>12 or more lots | <br>$6,250<br>$6,000 |
| One year's annual management fee* | $415 |
| One year's annual lease fee* | $125 |
| TOTAL<br>Between 1 and 11 lots<br>12 or more lots | <br>$6,790<br>$6,540 |

*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 twelve 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 final annual payment is due at the end of the Project, or in the event of an insolvency event, it becomes available to a replacement Responsible Entity. While this amount

($540) is technically an ongoing fee, investors are required to pay it along with the application fee, and is therefore considered an initial cost.

| Ongoing Fees (per lot, excluding GST) | | |
|---|---|---|
| Payment Type | Annual Investment Option | Annual Deferred Investment Option |
| Annual management fee | $415* | 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:<br>FY2013–14: 3% per year<br>FY2015–18: 2% per year<br>FY2019–24: 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 2013 and thereafter annually through to 2024.
'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.

Investors that select the annual fee option will be invoiced for annual management and annual lease fees from 1 January 2013 onwards, until the last payment on 1 January 2024. 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 the annual deferred payment option, investors may elect to have the annual lease and management fees deferred, replaced by a fee calculated as a percentage of Gross Proceeds of Sale, as set out in the previous table. These investors may elect to defer annual fees on a year-by-year basis. If they decide 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 of TFS becoming insolvent, these deferred fees may be viewed and classed as a debt. If this occurs, investors will be liable to pay an estimated amount dependant on the age of the trees at the time of insolvency.

***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 the plantation trees are permanently damaged, 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 has advised 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.

The application fee and all the ongoing fees remain the same on a pro rata equivalent basis to the previous years

A key change to the TFS Sandalwood Project 2012 from the 2011 Project is that the investment unit size has been halved to 0.083ha. However, the application fee and the ongoing rent and management fees have remained the same on a pro rata basis. Considering an increase occurred in the application fee for the 2011 Project, this is viewed positively by Adviser Edge, especially when the extra administration required for the management of the smaller units is considered.

It is difficult to conduct a comparative analysis of the GST exclusive, per hectare application fee of $75,000 ($72,272.70 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 application 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 believes that 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 application 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 the decrease in the annual management fee for the past two projects offered by TFS, the management fee for the 2012 Project is unchanged from the 2011 project on a per hectare basis. The previous lowering of the management fee was made possible by TFS achieving economies of scale, and reaching greater efficiencies in its management of the plantations.

***Following analysis of the annual costs involved in the management of an Indian sandalwood plantation, Adviser Edge considers the annual management fee of $4,980 (excluding GST), which is payable and indexed from FY2013 onwards, to be reasonable, with the actual costs incurred by TFS estimated to be close to this figure.***

The annual lease fee also remains unchanged from 2011 on a per hectare basis. It should be noted that Adviser Edge is not aware of the average head lease cost, and therefore it is difficult to see whether the annual lease fee would cover ongoing head lease obligations in the event of manager insolvency.

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, 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 incentive fee has remained static 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 for 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 $16,000/ha to produce cleaned heartwood logs at the farm gate, although it is important to note that, given the exact harvesting method is not yet known, the actual cost could vary significantly from the estimated amount.

**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.***

***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. In addition, the structural safeguards put in place in order to ensure the trees are adequately established need to be considered.***

## Additional Information

**Taxation**

TFS has obtained a product ruling for the Project (PR 2012/8). 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 product ruling for the Project if they elect to collect their own sandalwood, as opposed to having it processed by 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.***

**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. They will not charge a fee for doing so. Insurance will be compulsory for investors who obtain finance.

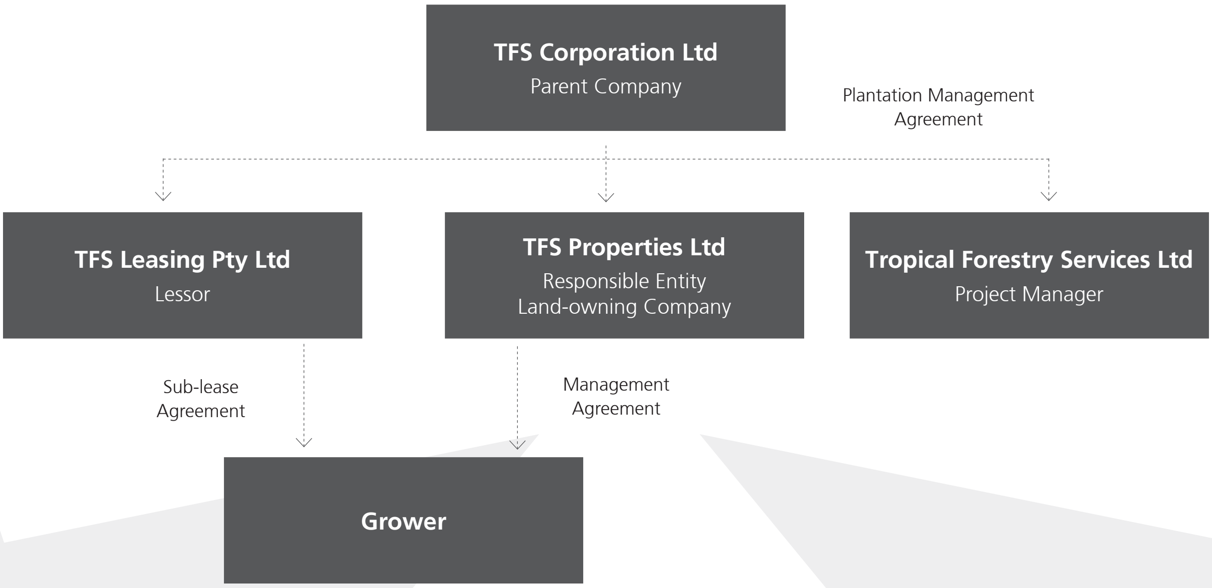
***While investors' harvest proceeds are pooled, should any lots be damaged due to some unforeseen event these lots may be removed from the pool and the investors may not receive or will otherwise have a reduced entitlement to income from their investments. Insurance should help to protect investors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

**Finance**

Long-term finance up to a term of six years is available from Arwon Finance Pty Ltd to approved applicants. In addition, 12 months interest free finance is also available to approved applicants. 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 2012.

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 5,000ha on behalf of 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 sold approximately 2,500ha to institutional investors based in the US and the Middle East, and continues to manage the plantations on their behalf.

While the entire sandalwood estate currently managed by TFS is located in the Kimberley region of north-east Western Australia, in late 2011 and early 2012 TFS began acquiring land in other regions in order to satisfy the growing institutional investor demand and to achieve some geographic diversification. The land acquired by TFS is located in the Townsville region of northern Queensland, and at Katherine and Douglas Daly in the Northern Territory.

TFS employs approximately 20 staff at its head office in Perth, as well as approximately 40 permanent employees and between 40 and 80 casual employees at its plantation operations in Kununurra. TFS' staffing levels are expected to expand significantly in the next 12 months as a consequence of the expansion into Queensland and the Northern Territory.

### Key Points

- The board of TFS has recently been restructured, providing a greater level of independence.
- TFS is in a sound financial position.
- TFS's transition from an MIS operator to a plantation manager and processor of Indian sandalwood is partially complete.
- TFS boasts an experienced operations management team, with significant levels of intellectual property held by the company.

In July 2008, TFS acquired Mount Romance Australia, a Western Australian sandalwood processor and essential oils business, vertically integrating TFS' business. This acquisition provides TFS with a sandalwood processing and distillation capability, and allows the company to defer capital expenditure on its planned Kununurra distillation plant. 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 is currently being explored. ViroXis has been given approval to enter into commercial phase II clinical trials for the development of the botanical drug albuterpenoids for the treatment of topical viral skin diseases such as warts caused by infection from the human papilloma virus (HPV). TFS has reported that the US FDA has insisted that a future phase III trial must use Australian sourced plantation sandalwood oil. TFS, together with parties associated with ViroXis, has also established a new company, Santalis Pharmaceutical Inc. (Santalis) to explore the non-viral pharmaceutical applications of Indian sandalwood. TFS has advised that preliminary testing indicates that Indian sandalwood has a variety of pharmacological properties, including anti-inflammatory, anti-microbial, anti-fungal and anti-bacterial.

***In recent years TFS has transitioned from an MIS operator to a more diversified business encompassing the management of Indian sandalwood plantations for retail and wholesale investors, and the processing of Indian sandalwood via Mount Romance.***

**Board of Directors**

A number of changes were made to the board of TFS in 2011 with two resignations and the appointment of three new independent directors: Richard Alston, Adam Gilchrist and Julius Matthys. These new directors bring significant experience in corporate finance, asset management and international relations to the board. In addition, Mr Alston was appointed as the Non-Executive Chairman, replacing Frank Wilson, who has now become the Chief Executive Officer of the company.

The remainder of the board is comprised of one other Non-Executive Director (Ronald Eacott), and two Executive Directors (Ian Thompson and Tim Croot).

***As flagged by the company sometime ago, the reshuffling of the board has brought it into line with the ASX Corporate Governance Principles and Recommendations, which state that the majority of the board should be comprised of independent directors. The board is now comprised of four independent directors and two executive directors, with greater corporate governance also achieved through the appointment of an independent chairman.***

**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 its adherence to the Project's Constitution and Lease and Management Agreements.

Doug Verley has 26 years of experience in senior corporate roles internationally and in Australia. Doug 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, namely 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 FY2011 and FY2010.

| Key Financial Data – As at 30 June | | |
|---|---|---|
| Financial Profitability | 2011 | 2010 |
| Revenue ($m) | 104.5 | 108.1 |
| Net profit ($m) | 20.2 | 37.1 |
| Profit margin (%) | 19.30% | 34.32% |
| ROCE (%) | 11.50% | 20.40% |
| ROE (%) | 8.30% | 19.00% |
| Market Measures | 2011 | 2010 |
| EPS (basic/cents) | 8.33 | 16.90 |
| P/E ratio | 10.6 | 5.0 |
| DPS (cents) | 4.75 | 4.75 |
| Dividend yield (%) | 5.40 | 5.10 |
| Dividend payout ratio | 0.57 | 0.25 |
| Financial Liquidity/Solvency | 2011 | 2010 |
| Net working Capital ($m) | 129.63 | 51.02 |
| Current Ratio | 3.66 | 1.75 |
| Quick Ratio | 4.08 | 2.23 |
| Net debt to equity ratio | 0.26 | 0.24 |
| Interest Cover | 2.13 | 14.04 |
| NTA per Share ($) | 0.80 | 0.77 |

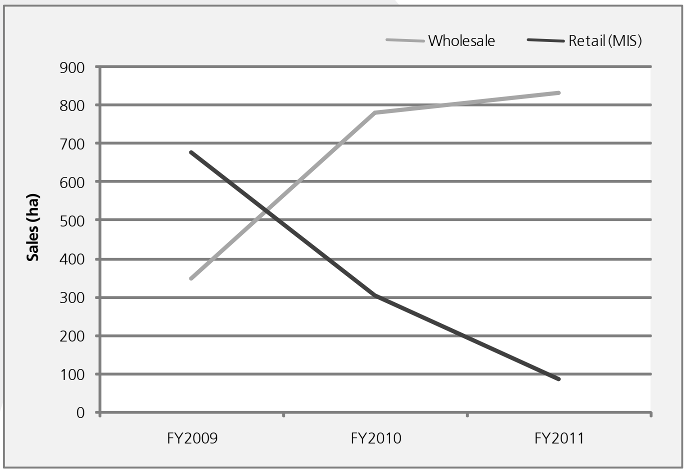
Source: TFS Corporation Ltd, Annual Report 2011.
The financial ratios are based on share price information provided for the close of trading on the last day of the financial year for which they are quoted.

Following the collapse of the MIS industry in 2008 and 2009, TFS proactively began diversifying its earnings away from MIS sales, placing a greater focus on managing plantations for wholesale investors and processing, through its acquisition of Mount Romance.

However, TFS is still partially reliant on MIS sales to generate revenue and hectares under management, albeit a small portion. MIS sales for FY2011 were poor with only 88ha to be planted, reflecting the difficult trading conditions for the sector following the collapse of the major players. This figure compares with 306ha in FY2010 and 677.5ha in FY2009.

FY2011 produced the third year of sales of TFS' new product targeting institutional investors. This non-MIS product targets institutional investors looking to invest in the growing of trees, the trade of trees in the secondary market, and the sale of Indian sandalwood oil. This 'wholesale' product differs from the normal MIS product in that investors own both the land and the trees as opposed to just the trees, reducing the capital expenditure requirement of TFS in regards to land acquisition.

In stark comparison to the MIS division, institutional sales to wholesale investors totalled 832ha, which does not include an additional 610ha sale that was made during the period but not recognised until FY2012 due to a revenue recognition treatment. The sale of 832ha represents a 6.4% increase on the 782ha sold to institutional investors in FY2010, with FY2009 being the year TFS first offered its wholesale product. The graph below indicates the divergence in MIS sales and institutional sales achieved by TFS since FY2009.




***Through both natural decline, as a result of the general state of the MIS industry, and proactive measures taken by the company, TFS has significantly reduced its sales revenue exposure to retail MIS by targeting and growing sales to institutional investors. This provides greater diversification of TFS' sources of cash. TFS will continue to be reliant on raising capital from this and other sources to meet its operating cash flow requirements.***

In line with the fall in total plantation sales, TFS's overall revenue fell slightly, by 3.4%. However, net profit fell by a more significant amount, decreasing by more than 45% to $20.17 million. This lower profit result is largely due to one-off transaction costs relating to US$150 million of debt raised in senior secured notes during the year. In addition, the unexpected accounting treatment of a sale to a wholesale investor meant that a sale made during the year will not be accounted for until FY2012. This sale would have improved the profit result significantly.

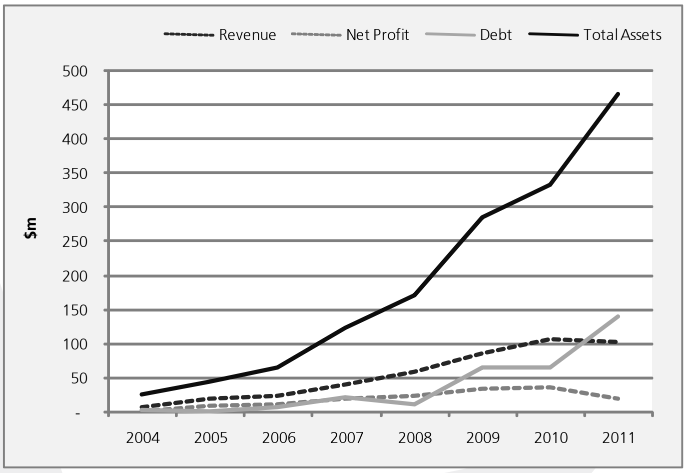
Adding to TFS' overall profit was the wholly-owned subsidiary, Mount Romance Australia (Mount Romance). The acquisition of sandalwood processor and distributor Mount Romance in 2008 transformed TFS' level of vertical integration in the industry by diversifying its operations into the processing and distillation of sandalwood. Mount Romance exports Australian sandalwood oil across the globe and has supply contracts with many leading industry participants. It provides TFS with the capability to process its own Indian sandalwood plantations as the trees approach harvest.

The volume of sandalwood oil (Australian sandalwood oil) processed by Mount Romance remained relatively static in FY2011, with the key constraint being the supply of native sandalwood for processing. As a result, revenue also remained stable, while the divisional EBITDA fell slightly by 3.7% to $5.2 million. TFS indicated that this was due to product margins being squeezed mainly as a result of the high Australian dollar. The supply constraints exhibited by the native sandalwood industry, upon which Mount Romance currently solely relies, are exemplified by the fact that the plant has a processing capability of 1,200 tonnes of wood per annum, yet is only able to source approximately 800 tonnes. Constraints in supply are expected to deepen in the coming years, with the cost of sourcing supply likely to increase as result. TFS will begin to harvest its Indian sandalwood plantations from FY2013, and this is expected to slowly fill the surplus capacity.

The gradual diversification of TFS' business model over the past few years away from MIS sales has been successful, with MIS sales accounting for only 9% of total cash revenue in FY2011.

Operating cash flow increased significantly from -$25.1 million in FY2010 to $40.4 million in FY2011. The operating cash flow result essentially reflects a temporary timing mismatch between when a sale to a wholesale investor is reported and when settlement and transfer of land titles occur. In this case, the positive operating cash flow is due to the conversion of wholesale sales at Kingston Rest into cash, with the relevant subdivision and transfer of titles to investors being completed in FY2011 resulting in settlement.

**TFS – Financial performance (2004–2011)**




As the TFS-managed projects approach harvest, the liquidity risk associated with being reliant on ongoing plantation sales (both MIS and institutional) diminishes over time as cash flow from deferred fees is generated. TFS' first harvest is expected to occur around FY2014. However, it should be noted that TFS has dramatically increased its MIS sales since FY2006, with these younger plantations accounting for the majority of TFS' overall estate.

Accordingly, with such a large plantation estate to manage over a long period of time, it is important that TFS maintains a robust financial position to ensure that it has the financial resources to meet its ongoing obligations. TFS' financial position was significantly improved in FY2011 through a capital raising of $35.8 million, and the private placement of US$150 million in senior secured notes. The capital raising, conducted in March 2011, was used to repay a $20 million facility with the Commonwealth Bank of Australia (CBA), which matured on 30 April 2011, with the remainder applied to the repayment of $10 million in shareholder loans. While this left TFS effectively debt free, the company required significant working capital and this was the reason for the US$150 million raised through the senior secured notes. These funds will be utilised by TFS to acquire and develop enough land so as not to constrain the opportunities relating to the wholesale investment product.

The senior secured notes were placed to several international institutions and have a headline rate of 11% per annum with the interest paid semi-annually. The facility matures in July 2018; however, TFS may redeem some or all of the notes prior to this, although at a premium to the face value. The notes are not covered by any maintenance covenants, providing TFS with certainty around its availability. However, TFS is prevented from raising further debt unless it is able to maintain an interest cover of greater than 2.5 times EBITDA. The reported interest cover of 2.13 times EBITDA for FY2011 is low due to the significant transaction costs associated with the issue of the notes. TFS anticipates this will improve in FY2012.

The foreign currency risk inherent in this facility is being managed by a specially formed Treasury Committee, which is advising the board. TFS has stated that its hedging policy relies on natural hedges. While there is a limited amount of natural hedging in core operations through the fact that wholesale investment flows can be denominated in USD and the commercial sales of oil are priced and valued in USD, the balance sheet remains exposed to foreign currency risk.

Following two significant capital raisings, TFS is well positioned to pursue new development opportunities and focus on operational performance. This is demonstrated by the fact that since the balance date, TFS has secured several properties in the Northern Territory and Queensland to aid its growth into these new regions.

***Adviser Edge has reviewed TFS' financial performance and believes that the company is in a solid financial position. Following significant capital raisings in FY2011, TFS is adequately positioned to pursue new sandalwood developments with the view of increasing the flow of wholesale investment.***

***However, the senior secured notes have a high rate of interest, and once the $150 million is fully deployed, TFS' level of gearing will also increase significantly. In addition, a condition of the notes prevents TFS from raising further debt, unless it has (and can maintain) an interest cover of greater than 2.5 times cash EBITDA. Adviser Edge believes this may cause problems if sales (particularly to wholesale investors) evaporate in any particular year, leaving TFS with insufficient funds available to pay for annual management of the plantations and other annual costs. Due to the resulting low level of earnings, which would likely result in interest cover of less than 2.5 times cash EBITDA, TFS would be unable to fund this deficit with debt. However, this risk is only short-term, as TFS begins to harvest early plantations and oil production based revenues begin to come online.***

***The restructure of the business away from its previous reliance on the retail MIS market to institutional investment and processing activities provides added security to future cash flows. Once TFS begins harvesting sandalwood, which is expected to begin in 2013, revenue from oil production will come online and continue to grow as the amount of wood harvested gradually increases. This will significantly diversify TFS' cash flows and provides it with a greater level of liquidity. Nonetheless, TFS will need to be adept in its financial management should there be a deterioration in any one of these sources.***

## 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 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.

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

**Responsible entity financial requirements**

Following the release of a number of proposals for comment in 2010, 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 come into effect on 1 November 2012.

Adviser Edge has consulted with TFS as to whether or not it currently complies with these new requirements. TFS has advised that it already complies with the amendments.

Adviser Edge is of the view that while these changes will improve the financial position of REs, it 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. Also, with respect to projects with ongoing fees, RE solvency can be affected if a significant number of investors or a large investor default on their obligations.

***While the Project does have an ongoing fee structure option, there is still a risk around the deferred fee option and the effect on working capital requirements for the Project. While TFS Properties expects that the funding sources of the TFS Group will be sufficient to meet the costs of management, harvesting and processing the trees, 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.***

## 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 | ★ | ★ | ★ |
| Malcolm Baker – General Manager, Forestry Operations | ★ | ★ | ★ |
| Glenn Taylor – Head of Plantations | ★ | ★ | ★ |
| Nick Common – Head of Development | ★ | ★ | ★ |
| Dan Raymond – Head of Project Service | ★ | ★ | ★ |
| Chris Done – Senior Forester | ★ | ★ | ★ |
| Zoe Higgins – Head of Seedling Supply | ★ | ★ | ★ |

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 meant that some senior staff have been relocated to these sites to oversee the development. 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, which is demonstrated by the company's strong commitment to resourcing in the ORIA and the strength, both in size and quality, of the management team.***

**Independent experts**

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.

| Independent Expert | | |
|---|---|---|
| Name | Company | Focus |
| Peter Kimber | Kimber Environmental Services | Sandalwood silviculture |
| Anantha Padmanabha | H.S Anantha Padmanabha | Market and pricing |

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.

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.


**Key Points**

- Indian sandalwood is a complex species to grow and requires a range of host species to thrive.
- TFS has vastly refined the host species used over the past ten years, improving the survival and growth rates of Indian sandalwood significantly.
- TFS has been proactive in securing land for plantation development both in the ORIA, and more recently in the Northern Territory and Queensland.

As part of its due diligence, Adviser Edge conducted a comprehensive inspection of the TFS-managed sandalwood projects located in the East Kimberley region on the 1 and 2 March 2012. This inspection provided an opportunity to view plantations across a range of age classes, both in the Ord River Irrigation Area (ORIA) and at the nearby Kingston Rest property, where TFS manages a number of institutional plantations. The two-day inspection gave Adviser Edge an opportunity to meet with the many of the key operational and management personnel, including General Manager – Forestry Operations Malcolm Baker, Head of Plantations Glenn Taylor, Head of Seedling Supply Zoe Higgins, and a number of the individual plantation managers.

Over the course of two days, Adviser Edge inspected the majority of age classes managed by TFS. In addition to this, Adviser Edge was also able to compare the plantations being managed by TFS for retail investors with those managed for institutional investors, as well as with other plantations in the ORIA which are not managed by TFS.

Adviser Edge visited the company-owned nursery at the Packsaddle property, where TFS propagates Indian sandalwood seedlings. While the majority of the sandalwood seedlings for 2012 planting are being propagated here, due to capacity constraints TFS has entered into contractual arrangements with a number of experienced nurseries to supply seedlings (predominantly host trees as they are easier to grow) in 2012. TFS has indicated that it is exploring options in relation to an expansion of the Kununurra nursery's capacity.

Adviser Edge was informed that approximately 50% of the seedlings grown this year in the nursery will have come from the company's own seed orchards. While in its infancy, TFS is looking to deliver genetic gain through the selective breeding program that is in place. At this stage it is difficult to quantify the gain that could be expected, particularly given that oil yield is as, if not more, important than volume growth. The selection of trees for the seed orchard is based on qualitative judgement on form and volume and oil sampling undertaken at a comparatively young age (less than 10 years), when the level of oil-bearing heartwood is still relatively limited. Nonetheless, Adviser Edge is pleased to see that TFS is committing the time, money and resources required to develop next generation seedlings.

Plantations established in each of 2009, 2010 and 2011 in the ORIA appeared to be in good to excellent condition, with sandalwood trees in particular exhibiting good growth and a healthy colour, with high survival rates evident across all sites. Weed control works had just commenced, which is normal due to the wet season making access to the plantations very difficult from November to February. The main focus of the weeding was to remove fast growing pumpkin vine, which has the ability to suppress both sandalwood and host trees if left unchecked.

TFS continues to refine its host species selection and planting regimes. It is evident that sandalwood trees experience shock when their short-term host, sesbania, dies off and the sandalwood tree searches for an alternate host. The planting configuration to be adopted for the 2012 plantings aims to reduce the shock by lowering the reliance of the sandalwood trees on sesbania and providing an opportunity for the trees to find an alternate long-term host earlier. This is an evidence-based approach that has a strong grounding in practical silviculture. It also reflects the fact that this is still a plantation industry in its infancy, where much is still to be learnt. TFS has shown itself to be a resourceful company that learns from its successes and failures. Adviser Edge has seen iterative improvement in operational performance over the ten years it has been inspecting plantations in the ORIA. Improved survival and growth rates are the most notable, reflecting the quality and stability of the management team and the resources placed at their disposal by a parent company that is clearly committed to delivering the best outcome possible to all investors (Including TFS through the deferred fee structure).

The final ORIA plantation inspection allowed Adviser Edge to inspect older trees on the Packsaddle orchard. Variability is greater in these older plantations, reflecting the lower knowledge base at the time they were established. Notwithstanding, Adviser Edge inspected a 2001 plantation that had strong growth and survival rates. The knowledge gained from the Packsaddle orchards has been instrumental in lifting performance in newer plantations.

In addition to the ORIA inspection, Adviser Edge also had an opportunity to visit and inspect the recently developed Kingston Rest property, which is located approximately 60km north of Kununurra. The plantations were planted in 2010 and 2011 on behalf of international wholesale investors. While there were some areas that were showing the effect of late planting or poorer soils, the vast majority of plantings were growing exceptionally well, with sandalwood growth, survival and weed control comparable to, or ahead of, the ORIA plantations. This is exemplified by the fact that the pre-wet survival rate was around 98%. The use of permanent drip irrigation, supplied by a state of the art irrigation system has ensured that the plantations sandalwood and host trees receive their full water entitlement. This drip irrigation system provides the basis for the establishment of similar systems at the new plantation sites to be established in the Northern Territory and Queensland.

TFS has placed a large emphasis on its research and development programs. Currently the R&D focus is on two key areas: the development of a growth curve, and destructive trials of aged sandalwood trees. TFS has gained collaborative support from the Forest Products Commission WA (FPC) to undertake destructive sampling of mature sandalwood trees. TFS has also instigated the ongoing measurement of trees contained in permanent sample plots located throughout the plantations, which is helping the company to develop a workable growth curve for Indian sandalwood in the future.

The overall impression gained from this inspection is that TFS continues to improve on its already high quality management standards. New plantation establishment was excellent and well in advance of peers. Survival rates continue to improve and were high across both sandalwood and host trees, and weed control across younger plantations was in line with what Adviser Edge considers to be industry best practice. Undoubtedly, TFS has become the benchmark for sandalwood silviculture and irrigation management.

***While there are a number of risks associated with the Project, investors should have confidence that TFS will manage their plantations to a very high standard, with specially developed silvicultural practices. New investors stand to benefit from the accumulated experience that TFS has gained over the last ten years, with a clear visual improvement in both survival rates and growth rates across age classes, reflecting TFS' increased knowledge and experience. Notwithstanding, TFS needs to continue towards the development of a quantitatively based yield curve for the species.***

**Region**

While it is likely that all the plantations to be established under the Project will be located in the ORIA, in the event that more than approximately 200ha is raised, it is highly likely that the surplus will be planted in the Douglas-Daly region in the northern Territory. Both of these regions are located within the Victorian Bonaparte bioregion, with similar vegetation and soil types.

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. (BOM, 2009) 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 approximately 5,000ha of plantations in the East Kimberley region (ORIA and Kingston Rest). It is currently in the process of developing and establishing new plantations in the Northern Territory (Katherine and Douglas-Daly regions) and in Queensland (Ayr).

The Douglas-Daly region is located approximately 150km south of Darwin. The region covers an area of about 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 Oolloo aquifer.

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.

***While Adviser Edge would prefer all of the Project plantations to be located within the ORIA, being in the same bioregion with similar soils and climate, it appears that the Douglas-Daly region could successfully support Indian sandalwood plantations.***

**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 made 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, which allow 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 2012 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 2012 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, Alternanthra 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 Cathormiom umbellatum (cathormiom), 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 significant 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 Cununurra Clay soils, which are free draining and with 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.

TFS has a land bank of approximately 200ha available for MIS plantings in the ORIA. In the event that plantings for the Project exceed this amount, the surplus will be located in the Douglas-Daly region.

These plantations will be established on Midway Station, which TFS purchased in January 2012. Located in the Douglas-Daly, this former cattle property has a gross area of approximately 2,910ha, of which TFS anticipates approximately 1,000ha will be suitable for the development of Indian sandalwood plantations. This 1,000ha is based on the plantation area able to be irrigated with the water available under the respective water licences held for the property.

***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 in younger trees, requiring manual labour for their removal. If left unchecked, such weeds could affect tree survival and growth rates.

***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 a new plantation site in the Northern Territory 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. With groundwater being the water source utilised in the Douglas-Daly, all plantations will be irrigated through drip irrigation.

Drip irrigation is used on sandier sites unsuitable for flood irrigation, and is also used to increase survival rates in young plantations. On sites that have been developed using drip irrigation, but are suitable for flood, TFS will revert to flood irrigation after five years in order to decrease irrigation costs and encourage root growth between rows. 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 source for the plantations in the ORIA is considered to be highly reliable.***

For plantations located at Midway in the Douglas-Daly, water will be sourced from bores that tap into the Oolloo aquifer. This aquifer is located beneath the Daly River and stretches from north-west from Katherine to the Douglas River. A draft water management plan for the aquifer has just been released, outlining rules for the sustainable use of water in terms of equitable allocation of water between the environment and human needs. While the Oolloo aquifer has historically been unregulated, this plan will enforce maximum annual allocations for all bores that draw water from it.

***Although TFS has identified 1,000ha of plantable land at Midway based on the water available through the company's licence, the new water management plan and the enforcement of maximum allocations from year to year may affect the plantations' water supply.***

***The Project should benefit from a mix of drip irrigation, which enables strong early growth and high survival rates, and flood irrigation, which is expected to encourage early root association with long-term hosts. The success to date of drip-only irrigation at the Kingston Rest property is encouraging for the plantations to be located in the Douglas-Daly.***

**Harvesting and processing**

TFS expects to harvest the majority of trees at age 14 (FY2027), although up to 20% of the plantations may be harvested at age 13. TFS will determine the exact timing of the harvesting operations.

It is expected that trees will be harvested by the removal of the entire tree from the ground using mechanical equipment to maximise the recovery of the butt and large roots, which are expected to be of high value. As harvesting is not expected for a number of years, TFS has not yet finalised its harvesting procedures, although the company is currently investigating and testing various methods.

The acquisition of Mount Romance, one of the world's largest distillers of Santalum spicatum (Australian sandalwood), has provided TFS with significant intellectual property regarding harvesting and processing. TFS has commissioned an initial scoping study into the harvesting and processing of plantation-grown Indian sandalwood, which will be led by Mount Romance General Manager Peter Wilson. Investors in the Project are likely to benefit from the expected ten years' experience that will have been derived from TFS' commercial Indian sandalwood harvests in the region by 2025.

***Adviser Edge is of the view that having Mount Romance within TFS' corporate structure increases its capacity to develop appropriate harvesting and processing infrastructure for the Indian sandalwood produced as part of the Project.***

| Market Overview | |
|---|---|
| Product type | Indian sandalwood heartwood |
| Primary use | Fragrance oil, mouth fresheners, incense, natural medicine, carvings and pharmaceuticals |
| Key target market | France, Taiwan, Hong Kong, India, USA, UK and China |
| Major Competitors | India, East Timor, Indonesia |
| Product Sales Agreements | Exclusive arrangement with ViroXis |

**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. Mount Romance has over 10 years' experience in the manufacture of Australian sandalwood oil, and supplies pure sandalwood oil to many of the major fragrance houses in the world, including Christian Dior and Estée Lauder. This experience is expected to be invaluable when TFS' Indian sandalwood plantations are ready to be harvested and its product marketed.

TFS has entered into a conditional sandalwood supply agreement with United States biotech company, ViroXis, for the supply of Indian sandalwood oil. ViroXis has been given approval to enter into commercial phase II clinical trials for the development of the botanical drug albuterpenoids for the treatment of topical viral skin diseases such as warts caused by infection from the human papillomavirus (HPV). TFS has reported that the US FDA has insisted that a future phase III trial must use Australian sourced plantation sandalwood oil. TFS, together with parties associated with ViroXis, has also established a new company, Santalis Pharmaceutical Inc. (Santalis) to explore the non-viral pharmaceutical applications of Indian sandalwood. TFS has advised that preliminary testing indicates that Indian sandalwood has a variety of pharmacological properties, including anti-inflammatory, anti-microbial, anti-fungal and anti-bacterial. This has the potential to become a significant market for Indian sandalwood oil grown and processed by TFS.

TFS also holds supply agreements with French essential oils company Albert Veille, and international soaps and cosmetic company Lush Ltd.

However, as the Project is structured in such a way that the sandalwood will be sold as logs, it is likely that TFS will be the ultimate buyer of the logs, and will then process the logs into oil either at its Mount Romance facility or at a facility in the ORIA, if TFS decides to construct a facility to meet the growing supply from that region. This poses a conflict of interest issue that TFS will need to manage to ensure that Growers receive an appropriate market 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.

### Key Points

- The sandalwood produced under the Project is intended to be sold as logs to TFS.
- It is difficult to obtain accurate information on the sandalwood industry, meaning that future prices are difficult to estimate.
- Although India is the largest sandalwood producer, native stocks and production under government control continue to decline.
- Australia is expected to become the largest sandalwood producer in the world once early managed investment scheme plantations reach maturity between 2015 and 2020.

***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.***

**Product analysis**
Indian sandalwood is a fragrant wood that is highly valued for its oil content, 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 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**
Globally, India dominates the supply of sandalwood, accounting for around 95% of global production, nearly all of which is sourced from native stands. Due to the high value of the wood, much of the Indian sandalwood harvested in India is harvested illegally, with a much smaller proportion harvested officially. 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 only 400 tonnes in 2009, in an attempt to promote sustainability. Sandalwood is now considered an endangered species in India. While it is difficult to determine, the total annual Indian harvest (legal and illegal) is estimated at around 2,000 tonnes.

Although India has traditionally dominated the global sandalwood market in terms of exports, the restricted domestic production, coupled with increasing local demand, has reduced the level of sandalwood oil and timber available for export, with the government imposing a varying annual export quota. This has also been an issue for the other significant sandalwood producer, Indonesia (2% to 3% of global production), which is tackling issues of over-exploitation with a similar approach.

As well as India and Indonesia, sandalwood also occurs naturally in Australia, with Australian sandalwood native to Western Australia (Santalum spicatum), and Queensland (Santalum lanceolatum). The sustainable harvest of these native stands (mainly Santalum spicatum) has allowed Australia to supply around 40% of world sandalwood exports. (ABARE, 2009) While Australian sandalwood is considered to be an inferior substitute for Indian sandalwood, the depressed supply out of India and Indonesia has meant that merchants have been compelled to source this species, among others, to satisfy their requirements.

The United States, the United Kingdom and Europe are considered to be the largest markets for sandalwood oil, with large fragrance and perfumery companies accounting for the majority of this volume. The United States is the biggest market for sandalwood oil outside India. Demand from Asia has increased in recent years, with China emerging as a major market for sandalwood oil and other products since sandalwood imports were legalised in 1999.

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 aromatic characteristics, it attracts a premium heartwood and final oil price. Market visibility on current pricing is difficult to ascertain due to sandalwood oil becoming more limited due to decreasing supply. However, Indian Sandalwood spot prices have consistently increased in price in excess of inflation since 1999, with the price of sandalwood oil recorded at record prices of $2,500/kg. However, prices have tempered recently, falling to around Rs80,000/kg (approximately $1,500/kg) in early 2012.

**Market outlook**
With the Indian and Indonesian governments expected to further restrict or at least maintain the annual harvest quota of native Indian sandalwood stands, it is likely that the imbalance between supply and demand currently present in the market will be exacerbated, possibly leading to further price increases. Since 1998, Indian sandalwood has been listed as vulnerable on the IUCN red list of threatened species. Although plantation development is being encouraged in these countries, a lack of resources and political issues are likely to limit private forestry development.

With the value of sandalwood oil being increasingly recognised, the number of industries that utilise sandalwood products continues to grow, boosting the level of demand for sandalwood. This, coupled with restricted supply, is cause for a relatively positive outlook.

Australia's Indian sandalwood estate will begin to be harvested around 2013, with Australia forecast to become one of the world's largest producers and exporters of Indian sandalwood heartwood and oil by 2022. It is anticipated that the 2025 heartwood harvest could be more than 12,000 tonnes of heartwood, providing a potential yield of almost 400 tonnes of sandalwood oil. Global demand is currently estimated at around 8,000 tonnes per annum. However, due to the lower oil content of plantation grown sandalwood at 15 years of age, the global demand could be as high as 13,000 tonnes per annum. (Padmanabha, 2010)

Mitigating the impact of the expected increase in global supply of Indian sandalwood are the expected continuation of Indian government export quotas, the increase in global economic growth, the development of new products that use sandalwood oil, and an increase in demand from existing users as a result of the expected increased, and more consistent, supply of sandalwood oil.

The export quotas imposed by the Indian government are also likely to be maintained in order to secure all Indian production for the local market. This will free up many lucrative export markets for the growing Indian sandalwood industry in Australia, and the fact that India's sandalwood market will probably require imports to make up the supply imbalance will also provide an opportunity.

The availability and price of substitute products will also play a role in determining market conditions into the future. As a result of demand outstripping the supply of Indian sandalwood, many buyers have sourced heartwood from other sandalwood species to fulfil their requirements. The use of synthetic substitutes could also play a role in determining future demand, although current synthetic sandalwood odourants such as isobornyl cyclohexanol and Ebanol have some inferior qualities when compared to Indian sandalwood and are used for lower value uses.

The growth of the Australian sandalwood industry has assisted in managing the supply/demand imbalance and accounts for around 40% of global sandalwood trade. However, it is not as prized as Indian sandalwood, which sells at a premium to Australian sandalwood. Recent tests comparing Indian and Australian sandalwood have indicated that the fragrance odour in soap made by replacing Indian sandalwood oil with Australian sandalwood oil is detectable.

However, the fact that native Australian sandalwood has been exported from Australia for several years will be of benefit to the domestic Indian sandalwood industry as plantations approach maturity. The product development expertise within the Australian sandalwood industry, particularly at Mount Romance for TFS, will be of great assistance in the development of value-added products and export markets.

The versatile properties of sandalwood oil are becoming increasingly known, with sandalwood oil having the potential to be a valuable constituent in the pharmaceutical industry. ViroXis cited the history of human use in natural medicines and the oil's good safety profile as benefits of the product. The drug is yet to be approved by the Food and Drug Administration (USA), but if approved and subsequently recognised as being beneficial, demand for the oil will most likely increase in the long-term.

***Based on information provided by TFS about its activities in the development of new markets for the Project's end products, particularly in the pharmaceutical market, it is likely that there will be a significant expansion in the market for Indian sandalwood oil in the long-term. However, this view needs to be tempered by the expectation of a dramatic increase in supply as TFS' plantations mature. Offsetting this impact is the fact that TFS will have substantial control of the market supply of Indian sandalwood in the future.***

| 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] | 10.89% | 10.89% | 12.35% | 12.35% |
| IRR Range[2] | 4.00%–14.45% | 4.00%–14.45% | 6.70%–15.70% | 6.70%–15.70% |
| Median Return | 9.55% | 9.55% | 11.30% | 11.30% |
| Percentage of results that are break even or better | 89.56% | 89.56% | 94.62% | 94.62% |
| Percentage of results with an IRR of 10% or better | 43.81% | 43.81% | 57.34% | 57.34% |

[1] The IRR range represents the range of results that occur within the 20th and 80th 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.

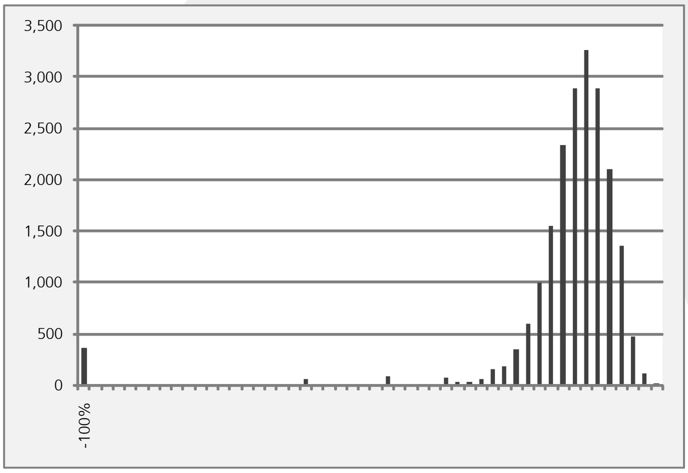
**Scenario testing**

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 on the risk/return profile of a particular investment, when compared with static investment modelling techniques.

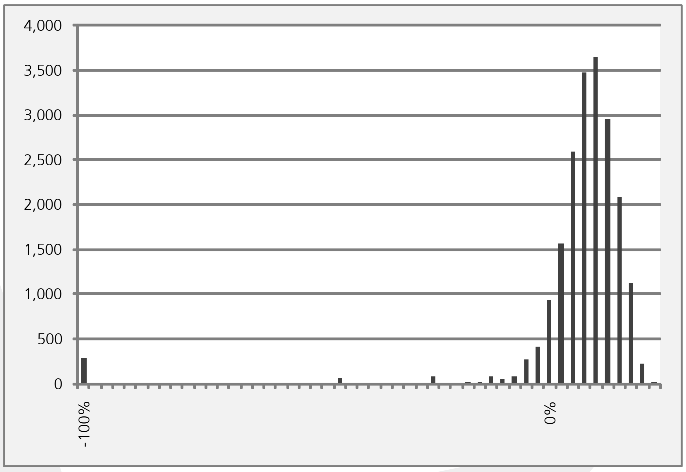
Returns modelling undertaken by Adviser Edge suggests that the annual deferred investment option provides a higher median return of 11.50% before tax when compared to the annual investment option's median return of 9.88% before tax. This is due to the higher net present value of fees paid under the annual 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 -100% to 26.5% for the annual deferred investment option, with 60% of values returns falling between 5.40% and 16.30%.

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 or a natural disaster increases the median return to 9.10% before tax for the annual investment option, and 10.80% 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.

**Pre-tax investor returns (Annual Deferred Investment Option)**



**Pre-tax investor returns (Annual Investment Option)**




**Note: The charts above include the potential impact of a natural disaster or insolvency event.**

## 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.

**Yield**

| Performance Assumptions | TFS | Adviser Edge |
|---|---|---|
| Age at harvest | 14 | 14 |
| Heartwood yield – age 14 (kg/tree) | 27.5kg | 25.5 |
| Sandalwood survival rate | 83% | 83% |
| Heartwood oil content | 3.15% | 2.50% |

***It should be noted that TFS has changed its basis for measuring heartwood content, and therefore the headline assumptions have changed. This has been done so as to align TFS with manufacturing standards. The change involves TFS measuring heartwood at the point of sale, which reflects a moisture content of approximately 25%. This is as opposed to measuring the heartwood at the point of extraction, reflecting a higher moisture content of 45% to 55%. As a result of this, the heartwood yield assumption is now lower, while the oil yield ends up being higher, at 3.7%. As such, there is no resulting loss of oil content from the original assumptions, meaning that the estimated value of the logs also remains unchanged. It simply changes the point of measurement, which is affected by moisture levels in the wood. Adviser Edge has maintained the original underlying assumptions, with all assumptions relating to measurement at the point of extraction. This is due to the fact that the measurements collected from all the relevant trials, which have been conducted on Indian sandalwood heartwood and oil yields, were taken at the point of extraction.***

TFS has indicated in the PDS that it intends to harvest the sandalwood plantations at age 14 (FY2027). However, TFS has also indicated that up to 20% of the plantations may be harvested at age 13 (FY2026).

TFS has forecast heartwood yields per tree of 25kg, 27.5kg and 30kg at ages 13, 14 and 15 respectively, at the point of extraction. Based on a forecast survival rate of 83% through until harvest, and an initial planting density of 505 sandalwood trees per hectare, this results in a forecast yield of 11,527kg/ha of heartwood, assuming that 100% of the plantations are harvested at age 14.

TFS has indicated that it may harvest a portion of the plantations (no more than 20%) at age 13. This will enable the testing of oil yields, and will also allow adaptation of management techniques prior to harvest in order to increase oil yields if required. This may include inducing stress on the sandalwood trees, which anecdotally may then promote heartwood formation and oil production. Based on TFS' harvest estimates, harvesting 20% of trees at age 13, and the remainder at age 14, would result in a yield of 11,316kg/ha of heartwood.

Yield estimates provided by TFS have been based largely on data derived from a plantation in the ORIA belonging to the Western Australian Forest Product Commission (FPC). This plantation has been used as these are the only trees of a suitable harvesting age that are available for analysis. Heartwood development has been found to occur in plantation-grown trees in the ORIA from age five onwards.

TFS in conjunction with FPC conducted a destructive harvest of 90 Indian sandalwood trees from four trial plots in the ORIA in August 2010. The trees were aged between 19 and 23 years and were selected randomly from the trial plots and had a mean average age of 21.4 years. Mean yields for these trees recorded average heartwood yields of 25.6kg per tree, calculated from volumetric measurements using specific gravity of 0.95 and a moisture content of 50% by dry timber weight. However, there was a wide variation in heartwood yields, with the smallest tree providing 3kg of heartwood and the largest tree providing 118kg of heartwood.

Mean merchantable wood per tree, which includes both heartwood and sapwood was 131kg per tree. Similar to heartwood, there was considerable variation with the largest tree producing merchantable wood of 510kg, while the smallest tree produced 23kg of merchantable wood. Most of the trees produced under 100kg of merchantable wood.

There is limited information available on comparable yields for Indian sandalwood, with most Indian sandalwood being sourced from native stands. However, it is believed that in fertile areas where growth is strong, heartwood formation is slower and oil content is lower compared to slower growing trees in lower rainfall sites (500mm to 1,000mm). Growth estimates of 1cm/year to 1.3cm/year occur in natural stands, yielding 50kg of heartwood over 30 years.

TFS anticipates that the heartwood will achieve an average sandalwood oil content of 3.15%. This estimate is based on data derived from a 2004 analysis of a 14-year-old experimental FPC plantation conducted by FPC and the Expert Forester, Kimber Environmental Services. The study found the oil yields to be highly variable, with some trees not yielding less than 0.3% and other trees yielding as high as 7.1%.

In the 2010 trial harvest, the mean oil yield recorded for the 90 trees harvested was 4.6% 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%. One of the important uncertainties between the 2010 trial harvest oil yields and those estimated for the Project is the age of the trees. The mean age of the trees harvested in the 2010 trial harvest was 21.4 years, whereas the Project trees will be 14 years at harvest. As Adviser Edge is of the understanding that oil is not meaningfully produced until the trees are eight to ten years of age, Adviser Edge expects oil yields from the 2010 trial harvest to be greater than those for the Project plantations. To this end the 2010 trial harvest incorporated the harvest of trees that were sampled in the 2004 sampling.

***While the 2010 FPC trial provides supporting data for heartwood and oil yield assumptions, the harvested trees upon which the trial was based are significantly older than the anticipated age of the trees at harvest. This may result in oil yields being significantly lower than the estimated 3.15% at age 14, with the lowest yield in the trial found to be 1.7%. However, the FPC trial does improve the likelihood of TFS achieving a merchantable oil yield***

Adviser Edge has adopted a slightly conservative heartwood yield per tree compared to TFS. Based on the results of the trial harvests in the ORIA, Adviser Edge has assumed a heartwood yield of approximately 25.5kg per tree at age 14, with a survival rate through until harvest of 83%.

***While TFS has demonstrated considerable improvement in the silviculture of Indian sandalwood, including significant improvements in sandalwood survival rates, there is still limited information available to verify heartwood yields across large plantations. Current yield estimates are based on samples of individual trees, and it is yet to be demonstrated that these yields can be achieved with the estimated stocking rates at harvest, especially when the trees are to be harvested at 14 years old, which is considered young. As a result, Adviser Edge has applied a degree of conservatism when assessing potential investor returns.***

TFS has demonstrated an ability to grow Indian sandalwood and achieve high survival rates. However, there remains a degree of uncertainty associated with forecasting heartwood oil yields, with huge variances in the results of trial harvests, and as a result Adviser Edge has adopted a conservative heartwood and oil yield for investment modelling purposes.

**Past performance**

TFS established its first Indian sandalwood plantation in 1999, and has since planted over 5,000ha. The trees planted in 1999 are forecast to be harvested in 2013, which will be TFS' first commercial Indian sandalwood harvest.

In June/July 2007, TFS harvested 17 trees from its oldest plantation, Stockroute; at this time the trees were eight years old. The trial harvest indicated that heartwood production had initiated in all of the sampled trees, with a range of between 3.52kg and 32.8kg of heartwood produced per tree, and an average of 12.85kg. Detectable traces of oil were present in 15 of the sampled trees, with two of the trees yet to develop oil. Interestingly, these two trees had some of the highest heartwood yields. Oil yields ranged from 0% to 2.84%, with an average yield of 0.68%, which was encouraging given the age of the plantations.

TFS has provided Adviser Edge with survival counts for past plantations. Survival counts are initially conducted once the trees are one year old. TFS has consistently improved survival rates since establishing its first plantations in 1999. Survival counts for early plantation years were as low as 25%, although this has improved dramatically for later plantations, with recent plantings exhibiting survival counts in excess of 90%, exemplifying the intellectual property regarding management practices now held by TFS.

In addition to this, while survival rates were low on early projects, resulting in the expectation that yields will be below initial forecasts, it is now expected that prices will exceed original forecasts, which may offset this to some extent.

***While it is difficult to fully assess the past performance of TFS due to the age of the plantations, it is clear that the company has acquired a great deal of knowledge regarding the management of Indian sandalwood plantations, which is exemplified by the substantial increase in observed survival rates since it began establishing Indian sandalwood plantations.***

**Price**

| Performance Assumption | TFS | Adviser Edge |
|---|---|---|
| Farm-gate heartwood price ($/kg) | A$40/kg | A$40.12/kg |
| Sandalwood price inflation | 2.70% | 2.90% |
| Estimated harvesting cost ($/ha) | A$16,000/ha | A$16,000/ha |
| Cost inflation | 3.52% | 2.9% |

TFS has estimated a farm-gate price of approximately A$40/kg for cleaned heartwood logs.

The market for Indian sandalwood has limited transparency, due to its size and the level of illegal trade. As a result, it is difficult to determine an accurate current price level at which large volumes of native Indian sandalwood are trading. Indian sandalwood spot prices have consistently increased in price in excess of inflation since 1999, with the price of sandalwood oil recorded as up to $2,500/kg. However, prices have tempered recently, with prices falling to around Rs80,000/kg (approximately $1,500/kg) in early 2012. It should be noted that the Independent Expert Anantha Padmanabha states in his Expert Sandalwood Marketing Report that prices in the regulated Indian market are lower than prices achieved in the international market.

***During the period until TFS begins supplying a sustainable volume of Indian sandalwood into the global market, it is likely that the market for Indian sandalwood oil will continue to remain volatile.***

It is expected that the price for plantation grown Indian sandalwood heartwood will be lower than that grown in the wild, due to an expected lower oil content. The oil content is expected to be lower for plantation grown heartwood due to the young age of the tree at harvest (14 years) compared to the average age of wild grown Indian sandalwood sold at auction (50 to 60 years). The average oil content for Indian sandalwood sold at auction in India is estimated at between 4.0% and 5.5%.

***A significant determinant of the price of the Indian sandalwood is the quantity of heartwood oil. The opaque nature and size of the sandalwood market makes it difficult to estimate prices.***

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.

As previously stated, there is limited information regarding sales prices of large volumes of Indian sandalwood oil, due to the opaque and fragmented nature of the market. In addition to this, it is unclear whether plantation-grown Indian sandalwood will sell at a discount or a premium to native oil. 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 price is lower than prices currently being reported, Adviser Edge believes that a level of conservatism needs to be applied. Based on current plantings, forecast heartwood volumes and forecast extraction rates, Adviser Edge believes that when the Project is harvested, supply from Indian sandalwood plantations in Australia may exceed the current estimated global oil supply by up to two times. While current global oil supply is expected to significantly increase by the time that the Project is harvested, it is also expected that the market for Indian sandalwood will expand with new sources of demand. This is demonstrated by the supply agreements entered into by TFS, as well as the developments in the pharmaceutical industry, a relatively new market for Indian sandalwood oil.

In addition to this, given the forecast market dominance of Australian plantation-grown Indian sandalwood, there is expected to be an inverse relationship between yield and price. If yields fall below forecasts, it is expected that the sandalwood oil price would increase commensurately.

***While there continues to be a risk to the potential supply/demand dynamics at harvest, Adviser Edge believes that it is prudent to use more conservative price assumptions when assessing potential returns from the Project.***

A base farm-gate price of A$36.11/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 2.50%. The estimated price also accounts for the relevant processing and transportation costs.

Given the limited data surrounding oil yields for plantation-grown Indian sandalwood, Adviser Edge has adopted a conservative oil yield of 2.50%. The 14-year old trees were grown under various silvicultural regimes, and were grown on supposedly poorer soils than those to be used for the Project. While it is believed that increased heartwood volumes will be achieved under the current regime, it is not known how improved growing conditions, and therefore reduced stress on the sandalwood tree, will affect oil yields. This is an area in which knowledge is expected to greatly improve in the short-term, as TFS’ early plantations mature and begin to be harvested.

Adviser Edge has assumed zero real price inflation for the sandalwood oil. While price of Indian sandalwood oil has experienced significant appreciation over the past 20 years, this sort of appreciation is not expected to be sustainable, and increased supply from plantation-grown Indian sandalwood should counter a decrease in supply from native stands.

***While the market fundamentals for Indian sandalwood appear to be strong, the Indian sandalwood market is***

***notoriously opaque and price information is significantly limited. In addition to this, the relatively small size of the market means that the Indian sandalwood price could become volatile when new supplies become available to the market. Accordingly, Adviser Edge has used a lower price assumption, which is based on a more conservative oil yield. In addition to this, a zero nominal price increase assumption has also been used. Adviser Edge has incorporated a relatively large variation in Indian sandalwood prices when determining an indicative IRR returns range.***

**Harvesting costs**

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 recapitalised balance sheet following significant capital raisings, 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, given 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 (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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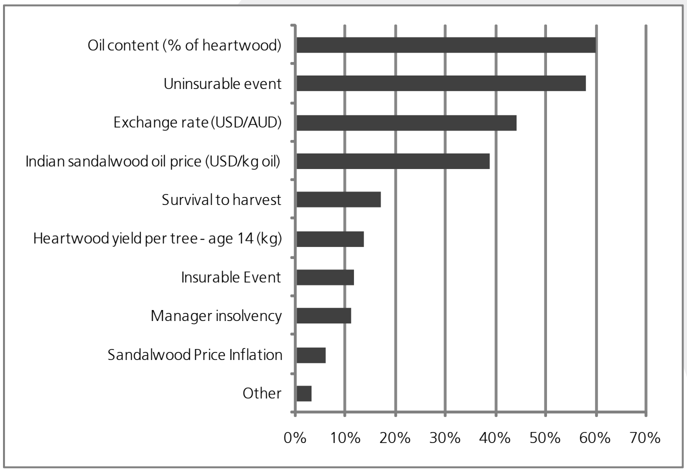
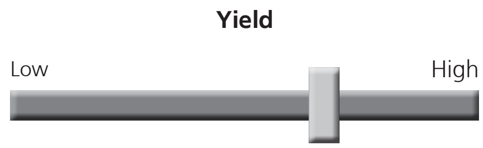
**IRR sensitivity**

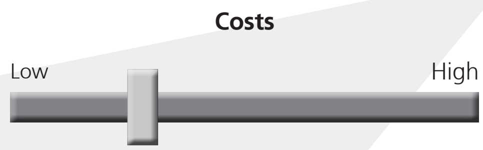



Project returns are highly sensitive to heartwood oil yields, which are expected to significantly affect the price paid for the plantation-grown Indian sandalwood. Due to the limited empirical data to support oil yields, a reasonably high standard deviation has been applied when modelling returns, which 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




Yield risk is considered to be high, due to a number of factors. The complexity of the silvicultural regime means that there is a risk surrounding survival rates. In addition to this, the Australian industry is in its infancy, and there is yet to be a commercial harvest of plantation-grown Indian sandalwood in Australia. There is a risk that the plantations will not achieve the anticipated heartwood or oil yields.


There are significant risks associated with the price estimates used to model Project returns. The opaque nature of the Indian sandalwood market makes it difficult to get an accurate understanding of current prices for wild-grown Indian sandalwood sold in large volumes. In addition, as the market is relatively shallow at present, it is difficult to determine future levels of demand.



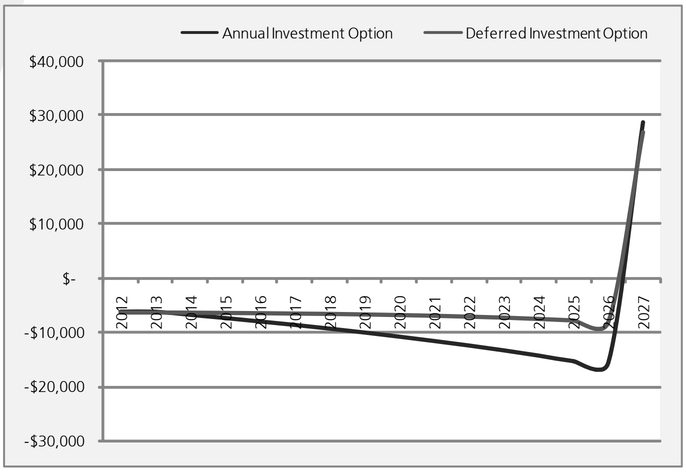

Investors in the Project are directly exposed to the costs associated with harvesting the sandalwood. While there is limited information to support the estimated cost of harvesting and extraction, given the relatively low cost compared to the high value of the commodity, the variances in harvesting costs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

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 high.

## Pre-tax Cash Flow per Unit

The TFS Sandalwood Project 2012 aims to generate investor returns through the establishment, growth and sale of Indian sandalwood heartwood. The Project has a target term of 14 years from establishment, after which time the final harvest should occur. A preliminary harvest may occur in Project year 13, at which time up to 20% of the plantation may be harvested. However, TFS intends to harvest 100% at age 14, and Adviser Edge has adopted this figure for modelling purposes. An indicative cumulative pre-tax cash flow for the different fee options is presented in the following chart. These cash flows have been calculated using the performance assumptions adopted by Adviser Edge, as previously discussed.

**Cumulative pre-tax cash flow per unit**




## Post-Tax Potential

The post-tax returns earned by an investor will depend on the investor's marginal tax rate when harvest returns are received. The post-tax IRR range provided by Adviser Edge assumes that the investor maintains the same marginal tax rate of 46.5% throughout the investment term.

However, it is likely that an investor's tax status will change over the life of the Project. A change in tax status may result from a change in circumstance for the investor, or a change in tax policy administered by the Australian government. It is important that investors are aware of how these changes may affect the Project's post-tax performance.

***Adviser Edge recommends that investors consult with qualified specialists who understand how changes to an investor's tax status may affect investment returns.***

Investors in the TFS Indian Sandalwood Project 2012 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 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 Application 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 only a small and recently established trial of Indian sandalwood planted in the Douglas-Daly region before, 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 Douglas-Daly 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 to 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.

*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 possess 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 plantation grown Indian sandalwood yield's oil, limited information remains on the yield and quality achieved in 14-year-old plantations, which is the age at which TFS anticipates harvesting the trees. As such, there is a risk that the Project plantations yield sandalwood heartwood and oil at much lower levels to 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.

*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.

*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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