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TFS Corporation (TFC)

ViroXis could be a game changer

Recommendation
Buy (unchanged)
Price
\$0.56
Target (12 months)
\$1.35 (unchanged)

Expected Return

Capital growth	142.5%
Dividend yield	8.6%
Total expected return	151.0%

Company Data & Ratios

Enterprise value	\$144.5m
Market cap	\$153.4m
Issued capital	276.5m
Free float	100%
Avg. daily vol. (52wk)	197k
12 month price range	\$0.54-1.05

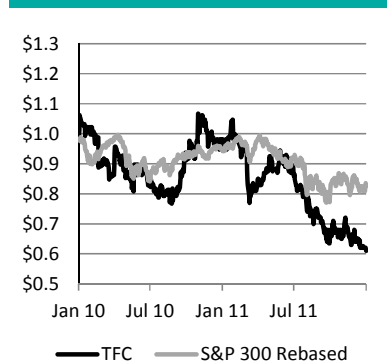
GICS sector
Food Beverage and Tobacco

Disclosure: Bell Potter Securities acted as sole underwriter of TFC's \$38m non-renounceable entitlement offer in Mar'11 and received fees for that service.

Price Performance

	(1m)	(3m)	(12m)
Price (A\$)	0.67	0.68	0.98
Absolute (%)	-8.27	-10.29	-37.90
Rel market (%)	-4.85	-13.60	-24.83

Absolute Price



SOURCE: IRESS

ViroXis update

In 2009 TFC announced an agreement with ViroXis to supply Indian Sandalwood oil for its antiviral drug Albuterpendus. ViroXis is due to commence Phase II clinical trials shortly and has advised TFS that the US FDA has insisted that a future phase III trial must use Australian sourced plantation oil. If successful ViroXis has estimated that the market for common warts could require up to 240tpa of oil, effectively absorbing about half targeted global production by 2025 at current planting rates and potentially absorbing the majority of TFC's future output.

Expanding healthcare

As part of a recent update TFC has announced the formation of JV with ViroXis to further explore the opportunities for Indian Sandalwood in the healthcare sector. TFC will take a 50% share in sister company Santalis agreeing to underwrite up to US\$1.5mpa (for 5years) in product development costs, reimbursable from future revenues generated in Santalis. The overall investment is relatively small in developing what could be a very substantial market for Indian Sandalwood and TFC in the future.

Land Program continues

In addition TFC has announced a further 1,200-1,400Ha of Sandalwood suitable properties in Katherine. Since June TFC has acquired ~2,000Ha of suitable land in line with our current capex assumptions of 3,000Ha in FY12e.

Investment View: Retain Buy rating

While not visible today the value in TFC sits in the processing business that at estate maturity will produce more than the current EV in EBITDA. The move to harvest and shift in earnings to production from estate management is the largest single catalyst in our view and developments like that with ViroXis in developing end markets for the oil are positive in this light. Buy rating retained.

Earnings Forecast

Year end June	2011	2012e	2013e	2014e
Sales (A\$m)	111.0	150.8	159.7	199.3
EBITDA (A\$m)	50.8	83.1	85.8	99.4
NPAT (Cash) (A\$m)	20.9	26.2	25.9	33.8
NPAT (reported) (A\$m)	38.9	48.2	48.7	57.4
EPS (adjusted) (cps)	8.3	9.4	9.2	12.1
EPS growth (%)	-34.7	13.5	-1.8	30.7
PER (x)	7.3	5.9	5.9	4.5
FCF Yield (%)	14.8	-15.4	3.1	-14.4
EV/Cash EBITDA (x)	4.2	2.6	2.5	2.1
Dividend (cps)	4.8	4.8	4.8	4.8
Franking (%)	100.0	100.0	100.0	100.0
Yield (%)	8.6	8.6	8.6	8.6
ROE (%)	19.0	16.0	17.4	15.6

SOURCE: BELL POTTER SECURITIES ESTIMATES

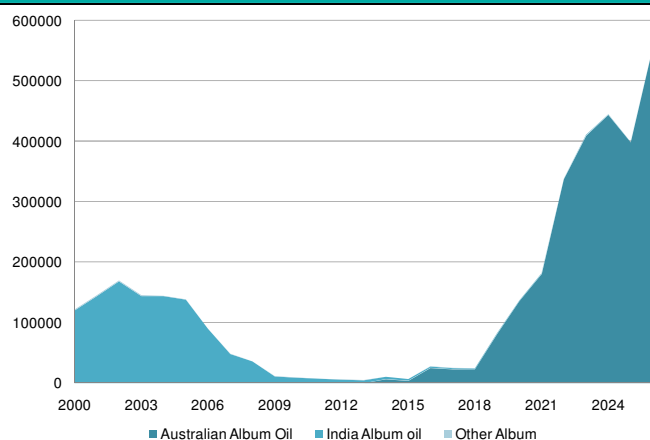
ViroXis could be a game changer

In October 2009, TFC announced a supply agreement with ViroXis to supply Indian sandalwood oil for use in the anti-viral drug Albuterpendus. At the time ViroXis had successfully completed a phase II investigator sponsored clinical trial which was a proof of concept study involving Indian Sandalwood Oil (Album) treating HPV (Human papilloma virus) warts. This positive preliminary result led ViroXis to seek approval from the US Food & Drug Administration (FDA) through an Investigational New Drug (IND) application to advance its human clinical trial programme. In April 2011, ViroXis announced that the IND application was accepted by the FDA and it had been given approval to enter into commercial phase II clinical trials that are expected to commence later this year. ViroXis has advised TFS that the US FDA has insisted that a future phase III trial must use Australian sourced plantation oil (Album).

ViroXis can take a large portion of the production pipeline

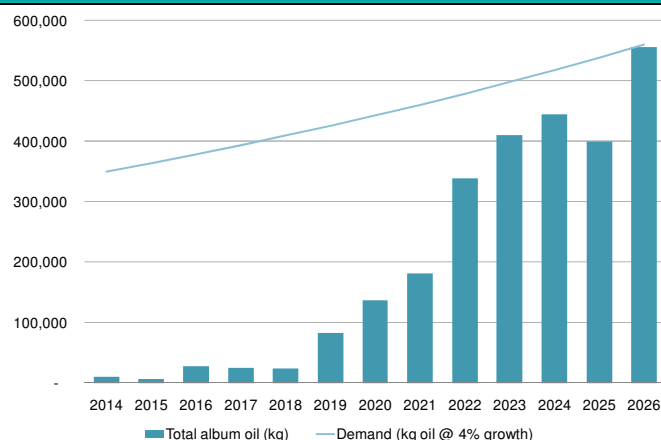
At the time we initiated coverage on TFC we highlighted that we believed the current market for Indian Sandalwood oil was ~350tpa and that we would need to see the market grow by ~4%pa to absorb what is a step change in supply emerging from Australia post 2020. Importantly this demand growth needs to occur in a market where there is no real supply. Estimates by ViroXis that the HPV common skin warts markets could absorb 240t alone is a very positive development then in our view as this would imply a market in the region of ~600t by the time TFC supply comes on stream.

Figure 1 – Projected growth in legal album supply (kg oil)



SOURCE: BELL POTTER SECURITIES

Figure 2 - Supply/demand at different growth rates (kg oil)



SOURCE: BELL POTTER SECURITIES

Importantly the price into the healthcare segment is substantially higher than current spot pricing and other recent supply deals. This suggests that the opportunity for prices to be sustained at or above current spot pricing, something we don't believe is reflected in the current share price.

Formation of JV

TFC & ViroXis have jointly funded some preliminary trials on alternative pharmaceutical related products containing sandalwood oil. After encouraging results the two companies have now agreed to formalise this development process. In particular TFS has agreed to the following terms with ViroXis and its sister company Santalis:

- TFS has reconfirmed and upgraded the sandalwood supply arrangement with ViroXis on an exclusive basis to pursue commercialisation of treatments for topical viral skin diseases such as HPV warts

- In consideration for providing Viroxis with this exclusive supply arrangement, TFS has been issued a warrant (i.e. option) to purchase approximately 10% of the currently issued shareholding in Viroxis at a fixed price that can be exercised over a term of 7 years to November 2018. Should TFS fully exercise these warrants the investment by TFS would be \$1.5m
- The key shareholders of Viroxis have created a new vehicle – Santalis– to pursue research and commercial developments solely relating to Sandalwood and targeting all possible conditions outside of viral skin diseases. Preliminary testing suggests that Santalum Album contains a variety of pharmacological properties being; anti-inflammatory, anti-microbial, anti-fungal, and anti-bacterial. Research is currently in progress to advance the validation of these properties. TFS will take a 50% interest in Santalis with no direct consideration for the equity
- In exchange, TFS will commit to a long-term exclusive Indian sandalwood (Album) supply agreement to pursue commercial developments in the Western healthcare arena
- Further, TFS has agreed to underwrite funding to Santalis for the amount of up to US\$1.5m per annum for five years for its product development costs. The amount of funding provided by TFS is reimbursable from revenues received by Santalis in the future. TFS also has the right to withdraw from its underwriting obligation on an annual basis for any reason but as a consequence would hold a reduced interest in the shares of Santalis

Background to Viroxis

In October 2009 TFS reached an agreement with ViroXis, an unlisted biotech company based in San Antonio, Tx, that potentially unlocks a strong revenue stream for TFS in pharmaceuticals.

ViroXis, whose focus is botanical drugs (ie drugs from plants rather than synthetic molecules), is exploring the use of Indian sandalwood oil in the treatment of viral infections. The company's lead compound is an 'albuterpenoid' from Indian sandalwood. The terpenoids are a large class of organic molecules found in plants known to have medicinal properties which would make them particularly useful as anti-inflammatory and anti-cancer agents¹. ViroXis has called its product an albuterpenoid because it is a mixture of terpenoids from Indian sandalwood.

ViroXis initiated a 180-patient Phase II trial of its albuterpenoid under an IND for the treatment of common warts in April 2011². Each patient will apply an albuterpenoid cream to their warts for 12 weeks and then be followed up for another 12 weeks, with the trial to measure various concentrations of the active. Phase I studies have demonstrated good safety for the cream. The trial is likely to take around 18 months to complete, with ViroXis potentially moving to Phase III in early 2013, and, subject to clinical success, being in a position to file for FDA approval in 2014.

The market for ViroXis treatment would be large. In the US 26.8% of women aged 14-59 were found in a 2003/2004 survey³ to be infected with the Human Papilloma Virus (HPV), which causes warts. This translated to around 25 million women for this age group alone. There are believed to be at least 6 million new HPV infections a year among Americans aged 15-44⁴. It is believed that at least 50% of sexually active men and women get HPV at some point in their lives, leading to 1% of sexually active adults in the US having genital

¹ See, for example, Cell Mol Life Sci. 2008 Oct;65(19):2979-99.

² See NCT01286441 at www.clinicaltrials.gov.

³ Source: JAMA. 2007;297:813-819. This study used NHANES data.

⁴ An estimated arrived at using data from the year 2000. See Perspect Sex Reprod Health. 2004 Jan-Feb;36(1):6-10.

warts at any one times. All this probably translates to a market worth several hundred million dollars in the US alone, where existing wart treatments - cryotherapy, surgery, cauterization and topical keratolytic agents – are considered unsatisfactory due to lack of efficacy, cost and high rates of recurrence.

Institutional update

TFC has also provided an update regarding approximately \$25m in sales made to an Institutional investor in 2010. Under the terms of the agreement, the investor was required to complete the transaction on or before 31 December 2011. TFS recently received notice that they would like to extend the deadline for payment of the establishment fees and land purchase agreement relating to the investment. The total amount remaining owing is approximately \$24.0m. The establishment services on the lot attributed to this institutional wholesale investor were completed by TFS prior to 30 June 2011. As such, the plantation is now in existence and being maintained.

The amount was included in the 2011 AR in Trade Debtors (\$25.0m). At the time the directors were of the view that it was highly likely that the debt would be recovered as funds are currently being raised via prospectus (that is being distributed by a large European bank). The customer has paid \$1.4m towards settling the debt and the trees have been valued at \$26.8m.

⁵ Estimates of HPV prevalence in men vary widely, but most are >20%. See J Infect Dis. 2006 Oct 15;194(8):1044-57. Epub 2006 Sep 12.

TFS Corporation

Company Description

TFS Corporation Limited (TFC) is an owner and manager of Indian Sandalwood plantations in the east Kimberly region of WA. TFC is involved in the whole operation of forestry plantations, cultivation and sale of agriculture produce, and the provision of finance.

Investment Strategy

We rate TFC as Buy. While not visible today the value in TFC sits in the processing business that at maturity will produce more than the current EV in EBITDA at the peak. Following a recent USPP and equity raising the balance sheet looks adequately funded to support the anticipated growth. The move to harvest and shift in earnings to production from estate management is the largest single catalyst in our view.

Valuation

Our target price for TFC is \$1.35ps. This is determined using an NPV for both the plantation management and oil processing businesses on established schemes only. We treat the business similar to a long duration resources play utilising an unleveraged Asset Beta of 1.2x, which when adjusted for current gearing implies a 1.5x Equity Beta. With recent debt raisings at 500bp+ we see the WACC of the business at near 13%.

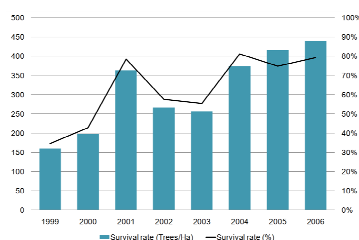
The major drivers in terms of value are (1) Sandalwood oil price with a base assumption is A\$2,500 + CPI; (2) Heartwood yield: Of 27.5kg per tree in schemes post 2004 and 20.5kg per tree pre-2004; (3) Oil yield: A yield of 3.15% for trees post-2004 and 2.9% pre-2004.

Risks

Risks facing TFC include but are not limited to:

- **Oil Yield and Heartwood mass:** Probably the largest driver of value is the oil that can be extracted from the plantations. Oil only develops in the heartwood.
- **Tree mortality rates:** Survival rates in the early products have been exceptionally disappointing and well below most PDS estimates of 90%. Since listing silviculture has improved substantially and with it so too has survival rates.
- **Oil Price:** The price of Indian Sandalwood oil has grown at 16.7%pa since 1993, as the area harvested in India and Indonesia has declined. While there is more detailed work on pricing in the Appendix of this report, spot prices today are well above the projected harvest prices in early PDS. All our valuation and earnings forecasts utilise oil prices of A\$2,400/kg.
- **Investment product sales:** The business while shifting to an institutional base is still heavily dependent on annual sales of investment offerings.
- **Risks of Nature:** Fire, Flood & Drought.

Tree mortality rates



SOURCE: COMPANY DATA

Should the impact of these factors be greater than anticipated, the stock may have difficulty achieving our target price. Likewise, if any of these factors proves to have less of an effect than we expect, the stock could materially outperform our target

TFS Corporation

as at 9 January 2012

Recommendation

Buy

Price

\$0.56

Target (12 months)

\$1.35

Table 1 - Financial summary

June year end	2008	2009	2010	2011	2012e	2013e	2014e		
Profit & Loss (A\$m)								Price	\$0.56
Sales revenue	63.5	94.9	116.5	111.0	150.8	159.7	199.3	Recommendation	Buy
... Change	40.8%	49.5%	22.8%	-4.7%	35.9%	5.9%	24.8%	Diluted issued capital (m)	276.5
EBITDA	42.0	53.0	55.8	50.8	83.1	85.8	99.4	Market cap (\$m)	153.4
Deprec. & amort.	(0.8)	(1.4)	(1.7)	(3.5)	(3.5)	(3.7)	(4.2)	Target Price (\$ps)	\$1.35
EBIT	41.2	51.6	54.0	47.3	79.5	82.1	95.3	Valuation Ratios	
Interest expense	(2.2)	(2.6)	(3.3)	(3.2)	(14.3)	(16.2)	(17.0)	Cash EPS	13.1 12.3 12.7 8.3 9.4 9.2 12.1
Pre-tax profit	39.0	49.0	50.7	44.1	65.2	65.9	78.2	Change (%)	69% -6% 3% -35% 14% -2% 31%
Tax expense	(11.4)	(14.2)	(13.6)	(5.3)	(17.1)	(17.2)	(20.9)	Reported EPS (cps)	14.6 18.4 17.7 15.4 17.3 17.4 20.5
... tax rate	29%	29%	27%	12%	26%	26%	27%	Change (%)	24% 25% -3% -13% 12% 0% 18%
Minorities	-	-	-	-	-	-	-	Reported PE (x)	4.7 3.8 3.0 3.1 3.6 3.2 3.2
Net Profit	27.6	34.8	37.1	38.9	48.2	48.7	57.4	Cash PE (x)	6.2 6.6 5.8 7.3 5.9 5.9 4.5
Abs. & extras.	-	-	4.3	(18.0)	-	-	-	EV/Cash EBITDA (x)	4.1 4.0 3.9 4.2 2.6 2.5 2.1
Reported Profit	27.6	34.8	41.4	20.8	48.2	48.7	57.4	NTA (c)	0.60 0.60 0.77 0.80 0.92 1.04 1.20
New Sales Vol. (Ha)	784	1,025	1,088	920	1,477	1,500	1,500	P/NTA (x)	0.92 0.92 0.72 0.69 0.61 0.53 0.46
Cash Revenue	56.9	78.3	97.4	91.0	123.0	130.8	169.4	Book Value (\$ps)	0.61 0.71 0.86 0.88 0.99 1.12 1.27
Cash EBITDA	35.5	35.6	41.0	34.7	55.3	56.9	69.5	Price/Book (x)	0.92 0.79 0.65 0.63 0.56 0.50 0.44
Cash NPAT	24.6	23.3	26.6	20.9	26.2	25.9	33.8	DPS (c)	4.0 4.3 4.8 4.8 4.8 4.8 4.8
Cashflow (A\$m)								Cash payout (%)	31% 35% 37% 57% 50% 51% 39%
EBITDA	42.0	53.0	55.8	50.8	83.1	85.8	99.4	Yield (%)	6.1% 7.2% 7.7% 8.6% 8.6% 8.6% 8.6%
Tax Paid	(7.9)	(6.8)	(11.2)	(5.7)	(5.3)	(11.0)	(12.7)	Franking (%)	100% 100% 100% 100% 100% 100% 100%
Net Interest Expense	1.4	(0.1)	0.3	0.8	(5.7)	(14.1)	(16.6)	Performance Ratios	
Change in Wkg Capital	(15.1)	(16.1)	(36.0)	30.0	(17.2)	(3.9)	(15.7)	EBITDA/sales (%)	64.0% 66.1% 55.9% 47.9% 45.8% 55.1% 53.7%
Release from loan book	2.9	(19.5)	(11.2)	6.9	14.2	23.3	-	EBITA/sales (%)	62.8% 64.9% 54.4% 46.4% 42.6% 52.7% 51.4%
Other	3.8	5.7	(22.8)	(42.5)	(27.8)	(28.9)	(29.9)	OCF Realisation (%)	106.7% 65.7% -88.5% 165.4% 138.6% 173.2% 64.6%
Operating Cash Flow	27.1	16.2	(25.1)	40.4	41.2	51.2	24.5	FCF Realisation (%)	10.2% 21.3% -165.3% 115.8% -72.5% 45.9% -44.1%
Capex	(19.0)	(9.2)	(19.1)	(8.5)	(51.6)	(33.2)	(33.3)	ROE (%)	32.4% 24.2% 25.8% 19.0% 16.0% 17.4% 15.6%
Div Paid (gross of DRP)	(5.6)	(7.0)	(7.9)	(9.1)	(13.2)	(13.3)	(13.3)	ROIC (%)	49.1% 46.2% 39.6% 27.5% 20.1% 30.4% 26.9%
Free Cash Flow	2.5	0.0	(52.1)	22.7	(23.6)	4.7	(22.0)	Asset turn (years)	53.73 38.72 32.02 14.43 23.49 23.04 23.95
Acquisitions	(3.1)	(11.4)	(0.3)	-	-	-	-	Capex/Deprn (x)	24.37 6.70 10.98 2.42 14.60 8.91 8.01
Disposals	0.1	-	0.9	0.5	-	-	-	Net Debt/Cash EBITDA	(0.15) 0.75 1.15 1.84 1.55 1.42 1.48
Share Issues (incl DRP)	-	-	31.5	35.8	2.1	-	-	Net debt/equity (%)	23% -7% 15% 21% -4% 5% 3%
Other	22.5	(17.6)	(1.1)	(8.5)	-	-	-	Segmental EBIT (A\$m)	
(Inc.)/dec. in net debt	22.0	(28.9)	(21.0)	50.5	(21.5)	4.7	(22.0)	Plantation Manager	37.8 40.2 36.3 31.5 65.6 70.4 79.1
Balance Sheet (A\$m)								Land Sales	- - 3.4 3.6 2.7 2.2 3.2
Cash & near cash	16.9	38.7	20.2	76.9	55.3	60.1	38.0	Interest on Loan Book	2.1 1.4 2.7 4.6 3.0 1.2 -
Receivables	38.3	50.0	86.9	74.0	100.5	106.4	125.4	SGARA	2.1 8.0 8.0 6.0 8.3 8.5 8.7
Inventories	0.8	11.4	12.0	5.3	7.2	7.6	14.5	Mount Romance	- 3.4 5.4 5.2 3.3 3.5 8.4
Other	-	0.1	0.0	22.3	22.3	22.3	22.3	EBITDA	42.0 53.0 55.8 50.8 83.1 85.8 99.4
Current assets	56.0	100.2	119.1	178.4	185.3	196.4	200.2	Non-Cash EBITDA	6.5 16.5 19.1 16.1 27.8 28.9 29.9
Fixed assets	58.5	64.5	57.6	58.1	61.2	68.2	74.8	Cash EBITDA	35.5 36.5 36.7 34.7 55.3 56.9 69.5
Intangibles	0.5	20.3	20.5	20.5	20.5	20.5	20.5	Cash EBITDA Margin (%)	62.3% 46.6% 37.7% 38.1% 44.9% 43.5% 41.0%
Biological Assets	22.0	30.9	41.5	48.0	106.2	135.7	164.8	Half Year (A\$m)	
Other	29.75	69.89	95.14	161.27	155.65	152.78	174.06	Plantation Management	1H10 2H10 1H11 2H11
Non current assets	110.7	185.6	214.8	287.9	343.5	377.1	434.1	Land Sales	3.3 33.0 2.9 28.6
Total assets	166.7	285.8	333.9	466.3	528.8	573.5	634.3	Interest on Loan Book	- 3.4 0.1 3.5
Creditors	13.1	19.3	20.8	31.2	42.4	44.9	55.1	SGARA	1.3 1.4 2.1 2.4
Borrowings	0.5	0.4	0.7	0.1	-	-	-	Mount Romance	0.1 7.8 1.2 4.8
Other	8.7	29.4	21.5	17.6	31.5	35.8	39.8	EBITDA	5.9 49.9 8.1 42.8
Current liabilities	22.4	49.1	43.1	48.8	73.9	80.7	94.9	Depreciation & Amortisation	0.8 0.9 1.6 1.9
Borrowings	11.1	65.1	66.6	140.8	140.8	140.8	140.8	EBIT	5.1 48.9 6.5 40.9
Other	19.2	36.6	28.9	34.6	37.1	39.7	42.3	Interest expense	(1.8) (1.6) (2.0) (1.2)
Non current liabilities	30.4	101.7	95.5	175.4	177.9	180.4	183.0	Pre-tax profit	3.4 47.4 4.5 39.6
Total liabilities	52.7	150.8	138.6	224.2	251.8	261.1	277.9	Tax expense	(0.3) (13.3) (1.0) (4.3)
Net assets	114.0	135.1	195.3	242.1	277.0	312.4	356.4	... tax rate	9.2% 28.1% 21.9% 10.9%
Share capital	39.7	43.0	77.7	115.7	115.7	115.7	115.7	Minorities	- - - -
Reserves	15.0	15.5	9.2	8.6	8.6	8.6	8.6	Net Profit	3.1 34.0 3.5 35.3
Retained earnings	59.3	76.6	108.4	117.8	152.7	188.1	232.2	Abs. & extras.	1.2 3.0 - (18.0)
Outside equity Interests	-	-	-	-	-	-	-	Reported Profit	4.3 37.1 3.5 17.3
Shareholders' funds	114.0	135.1	195.3	242.1	277.0	312.4	356.4		
Net Debt (Cash)	(5.2)	26.7	47.1	63.9	85.5	80.7	102.8		

SOURCE: BELL POTTER SECURITIES ESTIMATES

Recommendation structure

Buy: Expect >15% total return on a 12 month view. For stocks regarded as 'Speculative' a return of >30% is expected.

Accumulate: Expect total return between 5% and 15% on a 12 month view. For stocks regarded as 'Speculative' a return of between 5% and 30% is expected.

Hold: Expect total return between -5% and 5% on a 12 month view

Reduce: Expect total return between -15% and -5% on a 12 month view

Sell: Expect <-15% total return on a 12 month view

Speculative Investments are either start-up enterprises with nil or only prospective operations or recently commenced operations with only forecast cash flows, or companies that have commenced operations or have been in operation for some time but have only forecast cash flows and/or a stressed balance sheet.

Such investments may carry an exceptionally high level of capital risk and volatility of returns.

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