

Company Review

Ord Minnett Research

Wednesday, May 27, 2009

TFS Corporation Ltd

International institutional partnership

- TFC's recent announcement to enter into a JV arrangement with Emirates Investment Group (EIG) that relates to ~25% of TFC's annual harvest and commits EIG to annual plantings of 200+ ha pa is a milestone event for TFC
- OML had been flagging for some time that TFC was working on developing a wholesale product and sales channel to complement the MIS sales channel
- The deal secures the distribution of another 25% of oil production, in addition to the ~40% of early production already secured. This will comfort MIS investors that there are robust markets for sandalwood products. This arrangement focuses on the Middle East, North Africa and Pakistan
- Importantly, the supply of sandalwood to a new distillation plant in CY12 owned by the JVC will be in line with commercial rates, and the annual plantings will be equivalent to an MIS income stream and margin. TFC cash flows will improve further as distribution costs will be reduced
- EIG have committed to expand the client base of the JVC through its regional network to assist in developing new products for the region and to expand the planting program. The introduction of institutional investment into plantations directly, not only proves the investment fundamentals of the project but will also serve to significantly reduce reliance on the MIS channel over time. TFC is the first MIS group to achieve this and it speaks very highly of the underlying value within the group
- Another positive is the JVC will be self-funding including the capital cost of the distillation plant, beyond which there is an anticipation of achieving an ROI of 25% pa, highlighting the attractive margins emanating from sandalwood oil production and other by-products
- They say the cream rises to the top, and so it shall be with TFC as major competitors collapse under the weight of flaws in their business & funding model being exposed. In the eye of the storm, OML expects TFC to succeed through their conservative balance sheet, high margin product, strategic positioning and wise management

Key Financials

Year-end June (A\$)	FY07	FY08	FY09F	FY10F
Reported NPAT (\$m)	19.2	27.6	44.7	48.7
Reported EPS (¢)	12.0	14.9	23.8	25.5
Reported P/E (x)	8.5	6.8	4.3	4.0
Normalised EV / EBITDA (x)	7.7	5.5	4.6	4.1
Dividends (¢)	3.4	4.0	5.7	7.1
Net Yield (%)	3.3	3.9	5.6	7.0
Franking (%)	100.0	100.0	100.0	100.0
Normalised NPAT (\$m)	14.4	22.9	27.7	31.7
Normalised EPS (¢)	9.0	12.4	14.7	16.6
EPS Growth (%)	74.5	36.8	19.1	12.8
Normalised P/E (x)	11.3	8.2	6.9	6.1

Source: Iress, Company, Ord Minnett Estimates Note: all share price data as at 27/5/09

ASX \$1.02

 Recommendation
BUY

 Risk Assessment
High

Disclosure: Ord Minnett was lead manager and underwriter to a placement by TFC which was completed on 4 July 2007

Sector: Materials

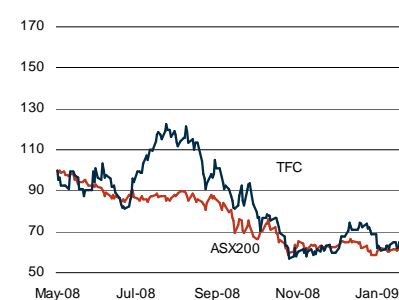
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Tropical Forestry Services Ltd

ASX Code	TFC
52 week range	\$0.67 - \$1.52
Market Cap (m)	\$201m
Shares Outstanding (m)	190.8
Av Turnover (3 month)	\$12m

Relative price performance



TFC in JV with EIG

TFC's recent announcement that it has formed a JVC with the Emirates Investments Group LLC (EIG) for the exclusive rights to sales and distribution of TFC's Sandalwood products in the Middle East, North Africa and Pakistan (the region) marks a significant milestone in the development of TFC's global footprint as well as legitimising the investment fundamentals of its Indian Sandalwood Investment Project.

The global nature of the product set derived from the raw Sandalwood commodity means that TFC must by definition evolve into a global supplier. The market is yet to truly value this leadership position that encompasses such high barriers to entry. At this point TFC is the only operator capable of being an end to end grower, processor and distributor of Indian and Australian sandalwood oil and other lucrative by-products.

This deal secures the distribution of another 25% of its oil production, in addition to the ~40% of early production secured by the Albert Vieille and Lush contracts.

OML had been indicating for some time that a new wholesale channel was going to open up for TFC and this announcement validates that view.

Key Features

- Establishment of a local JVC (with EIG retaining 51% ownership and TFC 49%) governed by a board comprising representation of each party. Each party will make an initial commitment of US\$175,000 to facilitate establishment of the JVC
- The JVC will be granted the exclusive distribution of TFC products (including Mt Romance) (MRA) in the region
- It is proposed that by the end of 2012 (FY13), the JVC will build a Santalum Album (Indian Sandalwood) distillation plant modelled on the TFC owned MRA plant in Albany, WA with a minimum 12.5 tonnes pa oil production capacity and the ability to increase capacity to 50 tonnes pa based on demand. This would result in a distillation plant in Kununurra not being required until ~2020 when OML's forecast oil production is ~70 tonnes
- TFC has committed to supply sufficient sandalwood from its Kununurra WA plantations to feed the JVC distillation plant. The supply will be in line with commercial rates and subject to a maximum of 25% of its annual harvest of plantation timber
- The JVC plans to manufacture and distribute an extended range of value added sandalwood-based products that are widely used in the region and the sub-continent utilizing TFC's sandalwood oil, provided at commercially competitive rates
- **EIG have committed to promote investment from the region into a minimum of 200 ha of new sandalwood plantations annually (from FY10), at a fee level equivalent to the MIS income stream and profit margin. It is intended that EIG will work to expand the client base of the JVC through its regional credibility and assist to develop new products for the region**
- The JVC will be largely self-funding including the capital cost of the construction of the distillation plant, beyond which a minimum ROI of 25% pa is anticipated. The benchmark minimum ROI highlights the inherent margin available from a Sandalwood plantation. Management's confidence in

indicating future returns should provide the market with comfort around management's decision to enter into this JV

EIG – a long term partner with deep pockets

- EIG is a private investment company based in Sharjah, one of the United Arab Emirates in the Persian Gulf. EIG has a wide range of investments in real estate, financial services, aviation and trading
- EIG is owned by the ruling family of Sharjah, with Sheik Tariq bin Faisal Al Quassimi as its Chair
- Given its relationship with the ruling family of Sharjah, it would appear reasonable to assume that EIG does have the connections to open up new markets that would otherwise be difficult for TFC to establish on its own
- While TFC has to give up a portion of the distilling margin for up to 25% of its annual production, this should be offset by the greater sales volume that EIG is proposing to deliver with the view to maintaining high commodity prices. This will be a key test of the success of the relationship over the long-term
- Implicit in the announcement is the prospect of further institutional investment into annual plantings from other parties, but facilitated by EIG. The objective is to reduce reliance on the retail MIS channel and for TFC to be able to operate both retail and wholesale channels in the pursuit of robust front end sales of an MIS or MIS equivalent nature
- Should EIG be able to facilitate other institutional investment into sandalwood lots, it will eliminate any doubt over the investment merits of the sandalwood project. A side benefit would be to answer critics of agricultural investment projects and demonstrate that such projects are capable of delivering appropriate returns to all stakeholders
- Developing a wholesale front end sales channel mitigates the risk currently present in the MIS sector post the collapse of TIM & GTP with the accompanying noise in the media to shut the industry down. The EIG deal and the possibility of other wholesale deals significantly reduces the risk to medium term earnings if the MIS structure is closed down. EIG's commitment to planting 200+ ha pa represents ~22% of this year's 930 ha target. OML can envisage a scenario where TFC's medium to long-term annual planting target of 1,500 ha pa is from this point, largely fulfilled from the institutional channel rather than the retail MIS channel
- It is too early to assess the earnings impact from this JV. Front end sales are exposed to regulatory risk over the next couple years, so it is unclear whether the wholesale channel is going to support growth or just substitute for the loss of the MIS channel. At the harvest end of the value chain, we will need to speak to management in greater depth to evaluate the financial impact

GTP's collapse opens the door wider for TFC

In our 20/4 note OML highlighted key issues that differentiated TFC from TIM. Now that the largest competitor has gone into receivership, it is worth reiterating these points:

- TFC has a FY09 forecast Net Debt / Equity gearing ratio of ~5% and will be net debt free even if it does not reach its sales target. OML forecasts cash at bank to be ~\$28m by June 2009 and interest cover is forecast at ~18x
- TFC operates a cash flow positive business model that does not rely on debt or next year's sales to pay for this year's expenses

- TFC's interests are aligned with growers in that TFC is exposed to investment returns via the deferred interest component of a large portion of MIS investors own investments
- TFC has invested in sandalwood plantations in its own right and currently owns ~250 ha. TFC plant ~50 ha annually on its own balance sheet which results in a meaningful exposure over time. TIM & GTP never did this! A significant portion of the early harvests are in fact TFC's own trees
- TFC no longer operates an internal loan book that generates low returns. The external finance facility for growers via CBA enables TFC to receive cash sales and operating cash flows turned around in FY08 as a result
- The lack of MIS product available this year due to TIM & GTP being out of the market and some unlisted operators means that ~50% of the competition no longer exists. TFC should have an easier time of achieving its target sales of 930ha or ~\$61m in MIS sales. Assisting this goal is the significant expansion in the distribution base through new dealer groups placing TFC's project on their approved product list. This recognises the high quality and high investment return project, which should deliver returns in the order of ~15% pa after tax ungeared
- It is even possible that there may be a shortage of MIS product available this year which would place TFC's product in even greater demand. It is worth noting that MIS products remain one of the only tax advantaged investments and the GFC may have reduced investor sentiment for such alternatives as; negative gearing, margin lending and superannuation contributions

Will GTP's collapse create a regulatory backlash?

Since TIM and GTP collapsed there has been a lot of noise in the media calling for the end to the MIS financing structure. While potential losses and pain from these collapses is to date unclear, the expectation of severe losses has got the "dogs barking".

What has been forgotten in all the noise is that it is not the MIS model as such that has failed but rather the quite conventional issue of normal business risk, approaches to funding and the pursuit of growth for its own sake. OML does not see the MIS model as causing any particular concern.

Even the issue of commissions to financial advisers is often misconstrued due to vested interests. It was recently highlighted that given the nature of trail fees and long-term growth expectations in financial markets, a standard managed fund would probably pay more in fees to a financial adviser than an MIS promoter if compared over a similar time frame and taking into account the long duration of typical agricultural projects. No one is really suggesting the scrapping of the Managed Fund industry because distribution of product involves fees to advisers. Fee structures differ because of the underlying differences in product structures and these ultimately need to be left to market forces.

The one improvement that may be worthwhile considering is greater prudence in the capital structure of the relevant Responsible Entity and Corporate Group. This would ensure greater protection for existing growers' interests.

Contrary to the expectation of an aggressive government response to the collapse of TIM & GTP, the Federal Agriculture Minister made some encouraging comments last week about the need to distinguish the MIS structure from the particular business models of some companies. While the chorus of dissenters will be quite loud over the near term, these initial comments from the government do not sound all that ominous and may indicate a willingness to take a more rational approach to understanding the problems experienced by some of TFC's competitors.

Financial Summary

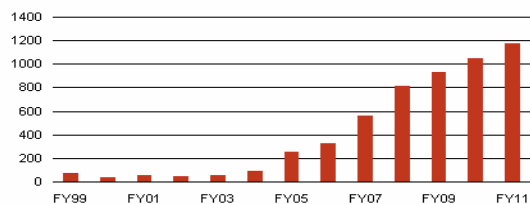
TFS Corporation Ltd

Profit & Loss Statement (A\$m)	FY07A	FY08A	FY09F	FY10F	FY11F
Ha Sold	559	814	930	1,051	1,177
Operating Revenue	38.3	61.7	80.6	90.9	101.9
Operating Costs	16.1	26.2	37.2	42.4	48.5
EBITDA	22.2	35.5	43.3	48.5	53.4
Depreciation & Amortisation	0.5	0.8	1.2	1.5	2.2
EBITA	21.7	34.7	42.1	47.0	51.2
Amortisation of Intangibles	0.0	0.0	0.0	0.0	0.0
EBIT	21.7	34.7	42.1	47.0	51.2
Interest Expense	-1.4	-2.4	-2.4	-2.1	-1.5
SGARA / Deferred Fees	6.8	6.7	24.3	24.3	24.3
Share of Associates	0.0	0.0	0.0	0.0	0.0
Reported Pre-Tax Profit	26.9	39.0	63.9	69.6	74.4
Tax Expense	7.7	11.4	19.2	20.9	22.3
Minority Interests	0.0	0.0	0.0	0.0	0.0
Reported NPAT	19.2	27.6	44.7	48.7	52.1
Significant Items (After Tax)	0.0	0.0	0.0	0.0	0.0
NPAT (Pre-Non Cash Items)	14.4	22.9	27.7	31.7	35.1
EBITDA Margin	58.0%	57.5%	53.8%	53.4%	52.4%
Effective tax Rate	29%	29%	30%	30%	30%
EPS (Cash) (¢)	9.0	12.4	14.7	16.6	18.4
EPS (Reported) (¢)	12.0	14.9	23.8	25.5	27.3
DPS (cps)	3.4	4.0	5.7	7.1	8.6
Yield	3.3%	3.9%	5.6%	7.0%	8.5%
Payout Ratio	38%	32%	39%	43%	47%
Franking	100%	100%	100%	100%	100%

Cash Flow Statement (A\$m)	FY07A	FY08A	FY09F	FY10F	FY11F
EBITDA	22.2	35.5	43.3	48.5	53.4
Change in Working Capital	-12.8	-4.7	-3.2	-3.6	5.8
Net Interest (paid)/received	-0.3	0.9	-2.5	-1.7	-1.1
Tax Paid	-3.0	-7.9	-11.9	-13.6	-15.0
Other Operating Items	3.6	-3.3	0.0	0.0	0.0
Operating Cash Flow	2.5	27.1	25.7	29.6	43.0
Asset Sale Proceeds	0.0	0.1	0.0	0.0	0.0
Net Acquisitions	0.0	0.0	-28.6	0.0	0.0
Capex	-8.1	-19.0	-4.0	-5.4	-5.9
Other investing items	0.0	-3.1	5.0	0.0	0.0
Investing Cash Flow	-8.0	-22.0	-27.6	-5.4	-5.9
Inc/(Dec) in Equity	0.0	19.8	0.0	0.0	0.0
Inc/(Dec) in Borrowings	14.7	-11.2	22.8	0.0	0.0
Dividends Paid	-3.1	-5.6	-10.8	-13.6	-16.5
Other Financing Items	0.0	0.0	0.0	0.0	0.0
Financing Cash Flow	11.5	3.0	11.9	-13.7	-16.5
Net Inc/(Dec) in Cash	6.0	8.1	10.1	10.5	20.6

Balance Sheet (A\$m)	FY07A	FY08A	FY09F	FY10F	FY11F
Cash	9.4	16.9	28.4	39.0	59.5
Inventories	1.0	0.8	4.9	1.0	1.2
Receivables	29.1	35.2	33.9	36.3	40.8
Other Current Assets	1.5	1.0	-4.0	-4.0	-4.0
PP & E	37.3	58.5	67.0	70.9	74.6
Intangibles	0.0	0.5	13.9	13.9	13.9
Other Non Current Assets	44.9	53.7	48.5	63.5	63.2
Total Assets	123.2	166.7	192.7	220.7	249.3
Short term Debt	1.0	0.5	0.5	0.5	0.5
Other Current Liabilities	28.3	21.8	13.8	14.3	15.0
Long term Debt	22.0	11.1	33.9	33.9	33.9
Other Non Current Liabilities	12.3	18.6	25.7	32.8	39.8
Non Current Liabilities	34.8	30.4	60.2	67.2	74.2
Total Liabilities	64.1	52.7	74.5	82.1	89.8
Total Equity	59.1	114.0	115.9	134.0	152.6
Total Liability & Shareholder Equity	123.2	166.7	190.4	216.1	242.4
Net Debt	13.6	-5.5	6.5	-3.8	-25.1

Ha Sold



Source: Ord Minnett Estimates, Company Data.

Profitability Ratios	FY07A	FY08A	FY09F	FY10F	FY11F
Revenue Growth	68.5%	61.2%	30.5%	12.8%	12.1%
EBITDA Margin	58.0%	57.5%	53.8%	53.4%	52.4%
EBITDA Growth	80.5%	60.0%	22.0%	11.9%	10.1%
EBITA Margin	56.6%	56.2%	52.3%	51.7%	50.3%
EBITA Growth	81.1%	60.1%	21.3%	11.6%	9.0%
EBIT Margin	56.6%	56.2%	52.3%	51.7%	50.3%
EBIT Growth	81.1%	60.1%	21.3%	11.6%	9.0%
Net Profit Margin	37.6%	37.1%	34.4%	34.9%	34.4%
Net Profit Growth	75.9%	58.7%	21.2%	14.4%	10.6%

DuPont Analysis	FY07A	FY08A	FY09F	FY10F	FY11F
EBIT Margin	56.6%	56.2%	52.3%	51.7%	50.3%
x Asset Turnover	0.31	0.37	0.42	0.41	0.41
x Interest Burden	1.24	1.12	1.52	1.48	1.45
x Tax Burden	0.54	0.59	0.43	0.46	0.47
= Return on Assets	11.7%	13.7%	14.4%	14.4%	14.1%
x Leverage	2.1	1.5	1.7	1.6	1.6
= Return on Equity	24.4%	20.1%	23.9%	23.7%	23.0%

Per Share Ratios (A\$ cps)	FY07A	FY08A	FY09F	FY10F	FY11F
Normalised EPS (Cash)	9.0	12.4	14.7	16.6	18.4
EPS Growth	74.5%	36.8%	19.1%	12.8%	10.6%
Dividend Per Share	3.4	4.0	5.7	7.1	8.6
Cash Flow Per Share	1.6	15.6	13.7	15.5	22.5
NTA per share	36.5	61.2	54.6	65.3	76.2

Valuation Ratios (x)	FY07A	FY08A	FY09F	FY10F	FY11F
Reported PE Multiple	8.5	6.8	4.3	4.0	3.7
Normalised PE Multiple	11.3	8.2	6.9	6.1	5.6
Price To Book Value	2.8	1.7	1.9	1.6	1.3
Price To Cash Flow	64.9	6.5	7.5	6.6	4.5
EV / EBITDA Multiple	7.7	5.5	4.6	4.1	3.7
EV / EBITA Multiple	7.6	4.8	3.9	3.5	3.2
EV / EBIT Multiple	7.6	4.8	3.9	3.5	3.2

Leverage	FY07A	FY08A	FY09F	FY10F	FY11F
Net Debt / Book Equity	23.0%	-4.8%	5.6%	-2.9%	-16.5%
Net Debt / Total Assets	11.0%	-3.3%	3.3%	-1.7%	-10.1%
Net Debt / (Net Debt + Mkt. Cap)	8.2%	-3.3%	3.9%	-2.3%	-15.2%
Interest Cover (x)	15.0	14.5	17.8	22.7	33.9

Substantial Shareholders	m	Current (%)
Domenica Nominees Pty Ltd	38.78	24.4
Steynton Nominees Pty Ltd	14.11	8.93
BDK Administration Services Pty Ltd	8.44	5.34
Nora Atkinson	5.99	3.79
Ronald Eacott	4.60	2.91
Anna Coxon	4.00	2.53
Julius Matthys	3.08	1.95

Valuation

Risk Free Rate		3.0%
Equity Risk Premium		8.8%
Equity Beta		1.6
Cost of Equity		17.5%
D / EV		0.0%
WACC (%)		17.5%
Terminal Growth		2.0%
Number of shares (m)		190.9
	A\$m	A\$
Operational NPV (20 year Forecast)	388.5	2.04
Terminal Value	153.5	0.80
Net Debt	6.5	0.03
Franking Credits Value (50%)	0.0	0.00
Group NPV	535.5	2.81
Current Share Price		1.02
Share Price Prem/(Disc) to NPV		175.0%

Sensitivity Analysis

		WACC				
		15.5%	16.5%	17.5%	18.5%	19.5%
Terminal Growth	1.0%	\$3.53	\$3.11	\$2.75	\$2.44	\$2.18
	1.5%	\$3.57	\$3.14	\$2.78	\$2.47	\$2.20
	2.0%	\$3.61	\$3.17	\$2.81	\$2.49	\$2.22
	2.5%	\$3.65	\$3.21	\$2.84	\$2.52	\$2.24
	3.0%	\$3.70	\$3.25	\$2.87	\$2.54	\$2.26
		β				
		1.48	1.56	1.64	1.73	1.81
Equity Risk Premium	7.8%	\$4.39	\$3.95	\$3.57	\$3.24	\$2.95
	8.3%	\$3.89	\$3.50	\$3.16	\$2.86	\$2.60
	8.8%	\$3.47	\$3.11	\$2.81	\$2.54	\$2.31
	9.3%	\$3.10	\$2.78	\$2.51	\$2.27	\$2.06
	9.8%	\$2.79	\$2.50	\$2.25	\$2.04	\$1.85

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Guide to Ord Minnett Recommendations

BUY	The stock's total return (nominal dividend yield plus capital appreciation) is expected to exceed 15% over 12 months.
ACCUMULATE	The stock's total return is expected to be between 5% and 15%. Investors may add to existing holdings, or initiate holdings on share price weakness.
HOLD	The stock is fairly priced, and its total return is expected to be between 0% and 5%.
LIGHTEN	The stock's total return is expected to be less than 0% and possibly down 15%. Investors should consider selling into share price strength.
SELL	The stock's total return is expected to lose 15% or more.
RISK ASSESSMENT	Classified as High, Medium or Low, denotes the relative assessment of an individual stock's risk based on an appraisal of its disclosed financial information, volatility, nature of its operations and other relevant quantitative and qualitative criteria.

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