

Hello

Spring has arrived and with the longer daylight hours hopefully summer is just around the corner. We'd like to say thank you to all who voted online to approve the audited accounts. The online voting is proving popular with partners as it only takes a few moments to complete.

It was pleasing to see New Zealand has ratified the Paris Agreement which has resulted from the UN Climate Change Conference. On October the 5th the threshold of 55 countries accounting for 55% of world emissions was passed, this means the Paris Agreement on Climate Change came into effect on November the 4th.

The key difference to previous agreements is the world's two largest emitters, the USA and China are signatories. New Zealand also signed, thus joining others at COP22 in Morocco this month.

Managed Investment Scheme - We're Licensed!

As you are aware we are required to be licensed by the Financial Market Authority (FMA) to continue managing the forest partnerships. We are very happy to report that we were the first forestry managers to get a license. It has been a huge effort by our office over the last 14 months to achieve the licensed status. The additional layers of compliance monitoring and reporting appear slightly heavy handed for our partnerships, especially when you consider all and any expenditure is pre approved by the partners in the annual budget - a point we pushed strongly with the FMA. However, the law is the law and we are incorporating the new requirements into the daily operations of our business.

We have pushed for exemptions where available and completed as much of the work as possible in house in an effort to keep cost to forest owners to a minimum.



Deed of Participation Update

As advised the original Deed of Participation (DOP) requires updating to comply with the Financial Markets Conduct Act (FMCA). Our lawyers, Kensington Swan, have been working on this in conjunction with the Statutory Supervisor.

We have only made changes as required to comply with the new FMCA - the rest of the DOP remains as it was originally. We will call a meeting to adopt the updated DOP with online voting as per the recent adoption of audited accounts.

AML Partner IDs

The Anti-Money Laundering and Countering Financing of Terrorism Act 2009 was brought into full force in June 2013, we need to ensure we are taking appropriate measures to be compliant with all the obligations within the AML/CFT Act. The office team are continuing to work their way through the partnerships gathering personal IDs. **It is important that you supply the required information and it is VERIFIED.** Non compliant IDs will be returned.

Carbon Markets

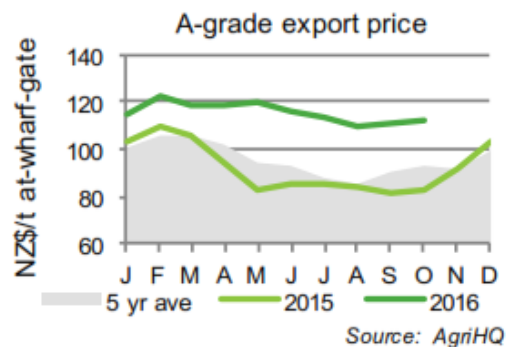
Spot NZUs are currently \$18.80 per tonne. The market continues to consolidate at present levels and sits near its 5 year high.

"It's only a matter of time in our view that \$19 will trade as large sellers remain absent and demand is expected to increase over the next two quarters as buyers finalise their 2016 requirements and annual demand increases from Q1 as the one for two unwinds from January next year"
says Nigel Brunel, OM Financial Limited.

Log Market Update

As Agri HQ stated *"It would be fair to say the log markets as a whole are enjoying a positive period, and it looks set to stay that way for the remainder of the year."*

Demand from the housing construction sector is the driving force behind the current state of the domestic market, and unless there's a significant reversal in new housing projects, structural logs should continue to be met with good prices. Pruned logs are the only grades which are showing any



signs of softness, a product of increased supply, as volumes move away from the weaker export market. It appears as though the export vs. domestic supply has come to a balanced level in recent weeks, which should prevent significant downward movement for the short-term. Export markets are in a similarly stable position for now.

Will and Steve are recently back from a trip to Korea to build knowledge of the log market there. See Will's separate report.

Harvesting

Our first forest Waikare, a 441 ha (NSA) forest, near Wanganui has now been harvesting for 20 months. It is pleasing that net returns per ha are tracking 25% above those in the harvest proposal presented to partners prior to harvest, which reflects the recent markets.

Roading work has started at the other Wanganui forest Maxwell and is progressing well with clear-fell commencing earlier in November. Road lining, Harvest planning and pre-harvest work is underway at Glenview, Tangoio, Eskdale, Bayview, Kaheka 1 and 2, and Waipapa. Full details of progress are in the Forest Managers reports for those forests.



First Logs from Maxwell Forest

Power Corridors

As described in the FMNZ report, this is work in progress. In essence, power line companies are trying to charge us for tree damage to lines, even when the trees are planted outside the designated power line corridor. They pay us no rent for the area we cannot plant and we feel they have no rights for areas that are not legislated as non plantable areas.

Napier - Wairoa rail line to reopen

The Wairoa to Napier rail line is back on track following a commercial agreement between KiwiRail and Napier Port. A dedicated log service will run from Wairoa to Napier Port from the end of next year subject to Napier Port approving KiwiRail's updated forecast cost for restoring the line to service.

Part of the operational arrangements is a log hub in Wairoa to store logs as they await transport to the port - great news for all of our forests in the Wairoa region.

Insurance

We recently completed negotiations with our brokers and insurers for our Forest Insurance for the year beginning October 1st 2016.

This year has seen the first significant increase in premium cost for many years. Our total premium cost has risen by around 38% from \$889,000 to \$1,222,000.

The reasons for this are:

- The value of our forest estate has risen by 27% in one year to \$497 million. This is due to both growth in the volume of the estate and the fact that New Zealand registered forest consultants have changed their discount rate used from 7% to 6.5%, this is based on sale price of forests in recent years.
- The average insurance premium across all of New Zealand has risen by 7%, this is due to both firming in the world insurance market and New Zealand's overall claims history in the past year or two. There have also been a couple of quite big forest fires in the South Island.
- As well, there is a risk rating for various regions and almost all of our forests are in a region that is rated at a high risk rating for wind.

The initial quote we received had an additional 7% higher rating for our forests premium over and above the New Zealand average. However, after firm negotiations we were able to get our additional rating reduced to about 1%.

Our insurance cover is for \$50 million of wind damage (maximum \$40 million in any one event). We hold the majority of wind cover in New Zealand and our insurance sub-committee, our investors and myself are comfortable with that as we have had claims of between \$1 million and \$4 million in the past. There are also a range of other benefits in the cover, two of the most useful, in the event of a claim, are fire fighting costs of \$2.5 million (helicopters are expensive), and claims preparation expenses of \$500,000.

The insurance premium is by far the biggest part of your annual expenses. As we approach harvest and with increased forest value the risk of significant claims from windthrow is increased and the feedback we get from investors is that they are satisfied with our conservative approach to insurance but of course no one is very happy with the new increased rate.

Given the above, this year's cost of insurance will be higher than in each forest partnership individual budgets. In most cases it will still be covered by the individual partnerships share of the Insurance fund.

Secondary Sales

Uptake within partnerships through the pre-emptive rights phase has been positive which has seen fewer opportunities going to the open secondary market. Any securities that have made the secondary market have been taken up by investors from other partnerships or new investors, many from overseas - particularly Europe.



Carlsberg Forest - to be planted 2017 - Note Ridgemount Forest in the background

New Forests

Interest from European families continues to be strong with the challenge being finding suitable properties. We continue to actively monitor the market for forest properties.

New Office Staff

We welcome back Amanda to our Waverley Office. Amanda was with us 12 years ago, before she and her husband moved away dairy farming. They have recently moved back to the area. Amanda will be helping in the administration office with the increased compliance monitoring and reporting requirements on the partnerships.

Please keep an eye out for the online voting to adopt the new DOPs. A prompt online vote would be appreciated.

Enjoy the summer months, and remember you are welcome to visit your forest anytime - you just need to confirm with Forest Management when you would like to visit.

Regards

Roger

KAHEKA 2 FOREST PARTNERSHIP

Forest Managers Report



October 2016

The drifts of yellow pine pollen are over for the season and we are well into what has turned out to be a very warm but wet spring. These are ideal conditions for the spring growth flush which is now very evident throughout the forest.

Forest health is generally excellent with foliage a uniform healthy green. It is pleasing to see there is little evidence of the spread of red needle cast (RNC) in the forest at present.

Apart from some fallen branch debris, a couple of slumps and some minor water damage, the tracks remain in reasonable condition. Given the impending harvest operation, we have not allowed for any tracking maintenance in the budget this financial year.

The Lidar imagery has been completed and the data is now available to be incorporated into our mapping files in preparation for the harvest planning. The conceptual harvest plan has been drafted and will be refined over the next few weeks in preparation for the commencement of the road lining. This will commence later this year.

The measurement for the pre harvest inventory has just got underway and should be completed by the end of the month.

Now that the possum control is no longer the responsibility of the Animal Health Board contractors, earlier in the year the possum poisoning maintenance work was attended to. Most of the bait used in this operation is Feratox, an encapsulated cyanide. It is placed in small paper bags and stapled to the trees in places where the possums run. The benefit of Feratox is that the bait lasts for some time.

This year we have also commenced using Pest Off to kill rats which have been taking the possum baits but do not kill the rats. Pest Off is an anti-coagulant toxin called brodifacoum which is highly palatable to rats and rodents. This is fed via bait stations made up from old plastic bottles. The baits last for some time and are particularly useful in some of the harder to access areas as they do not need to be visited often.

Carbon Trading

Over the past months, the price of NZUs has moved up to \$18.80, this is from \$9.65 as at the end of February. The major movement in price was initiated by the announcement from the government of the phasing out of the two for one subsidy in May.

This financial year up to the end of August, Kaheka 2 Forest has sold 250 units @ \$15.15 and 1050 units @ \$17.65 to

fund operating expenses. By selling smaller tranches of NZUs more often we are able to take advantage of rising NZU values.

Kaheka 2 has 28,134 liability free NZUs remaining as at August 31st.

Emissions Trading Scheme (ETS)

Climate Change Minister Paula Bennett recently announced that New Zealand has ratified the Paris Agreement, thereby guaranteeing New Zealand a seat at the decision making table at Marrakech in November. She noted "the big challenge now is to develop an effective plan for meeting our target of reducing our emissions by 30% below 2005 levels by 2030".



New Zealand's greenhouse gas emissions are forecast to double between 1990 and 2030 which means we will be short of our Paris Agreement pledge by 143 million tonnes or 96% above our 1990 levels. Assuming a carbon price of say \$20 and most commentators anticipate it will be higher, this leaves New Zealand with a significant liability at around \$2.8 billion.

Our increase in emissions is mainly due to land use, land use change and the forestry sector. With limited abatement opportunities currently available to reduce emissions from agriculture and considering New Zealand already has a high percentage of renewable electricity generation, the most significant emissions reductions are likely to come from transport and the industrial use of energy.

Both the economy and the population are forecast to remain in steady growth mode over the next ten to fifteen years. The challenge will be how to continue to grow the

New Zealand economy while at the same time cutting emissions to meet international obligations.

The government has also provided summaries of feedback received so far on the Stage 2 ETS issues which include managing unit supply, auctioning and international linkages. The key themes that have emerged are:

- The need for regulatory or policy stability around the ETS – this was by far the strongest theme expressed across all sectors
- The need for a long term plan to demonstrate how the NZ ETS will enable New Zealand to meet their emissions targets
- Forestry concern that a stable NZU price which incentivises forestry investment is required along with a stable ETS

The Ministry for the Environment are currently developing policy proposals on matters such as:

- Whether price stability mechanisms are required such as a price ceiling or floor
- Whether to sell some NZUs by auction
- When and how the New Zealand ETS should re-open to international units
- What conditions would warrant the reduction of free allocation allowances in future given that the government presently plans to keep current rates in place until 2020

Napier – Wairoa Rail Update

Although the local body elections have been and gone, the Napier – Wairoa rail line is still not operational. It has been confirmed however, KiwiRail and Napier Port have reached a commercial agreement whereby the port company will run a dedicated log service from Wairoa to the port from late 2017. The last remaining proviso depends upon the port company approving KiwiRail's costing for restoring the line to service.

The service will initially run on the weekends from the Wairoa log hub to Napier port. Port CEO, Garth Cowie noted "the East Coast region was expecting a major increase in log exports from late next year, with significant volumes forecast to come through both Eastland Port in Gisborne and Napier Port. The increasing long term log volumes from Wairoa will stretch the capacity and infrastructure of both road and rail in the whole East Coast region and it's vital we have the capability within the wider region to transport these in a reliable, efficient and environmentally friendly manner. The reopening of the rail link will enhance transport options for our log exporters". The opening of the rail link will give forest owners another transport option which they will support, provided the charges for using the hub are contained. The Waingawa rail hub in Masterton is a good example. FMNZ had been using the hub to ship logs to CentrePort in Wellington and saving up to \$1.50/tonne over road freight costs. The port company took over the operation of the rail hub and the first thing they did was increase the charges which cancelled out the savings created by using the hub.



Fire and Emergency New Zealand (Fenz)

We recently attended a seminar on the establishment of Fire and Emergency New Zealand (Fenz), an amalgamation of the New Zealand Fire Service, the National Rural Fire Authority, 12 enlarged rural fire districts and 26 territorial authority rural fire authorities. The intention is to set up a single integrated organisation from 1 July 2017 with the aim of building a modern nationwide service from the present separate urban, rural, volunteer and paid firefighting forces.

This raises several questions on the effect this amalgamation will have on the existing forestry fire fighting brigades such as Bay Forests, Eastland etc. It seems there is a lot of work to be done before clarity can be provided around the role of these entities in the new Fenz organisation. There is also a great deal of uncertainty around what will be funded by Fenz and what the forest owners will need to fund to continue to maintain adequate fire protection in our forests.

The amalgamation will be a multi-year project. In order to create one unified organisation, there is still a huge amount of consultation and discussion required at a local and national level. It is the intention to establish local committees in each area to link Fenz with the various community and industry groups it needs to serve and protect.

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Forest Manager

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Korea Visit with YSI Log Exporters

I have just returned from a visit to South Korea with Steve Bell, on a log sales trip for the last 4 days. This was a timely visit, as we begin the road lining and harvest of our partnership forests.

We were hosted in Seoul and Incheon by YSI Managing Director Mr. K. Kim and General Manager David Moon. YSI is a New Zealand based company, established by Mr. Kim in 1998 exporting Radiata Pine into South Korea.

Mr. Kim, pictured right, has been in the timber trading industry for over 40 years now, starting in the Hyundai Timber division in Korea where he met and developed relationships with a majority of the long-standing Korean Sawmills. YSI was the first company to export New Zealand logs into Korea. It became very evident to both Steve and myself that selling into an established market such as Korea relies heavily on relationships - more on this later.



Mr Kim (front left) and David Moon (middle left) host us with their clients in South Korea

The Korean Log Market - Some Background.

The Korean market consumes between 8-9 million cubic meters (m3) of logs (not timber) per annum. Between 45 and 50% of this volume is imported with the rest sourced locally.

New Zealand supplies between 2.3 and 2.6 million m3 of logs per annum. This makes South Korea the second largest market for our logs (behind China whose annual imports are around 11 million m3). The Korean log market is described as well established. That is most of the importers are end users rather than traders, hence there is very little volatility/speculation in annual log consumption.

The logs are mainly used for construction in temporary form work for concrete. It is also used in packaging and pallets and the remainder for MDF board.



Steve Bell inspecting Radiata from New Zealand

Site Visits

On the first day of mill visits, we went to medium sized sawmills with monthly consumption between 3-12,000 M3 of logs. Fumigation of the logs happens in the yard at the mill (All other countries require fumigation to be done on the ship before leaving New Zealand). The processing is all done using various forms of automation. The sorting of the boards coming out of the bandsaw is still a manual process. The level of health and safety varies from mill to mill. Only some staff choose to wear hearing protection. There is no hi-vis or hard hats, and the machines have very little in the way of safety barriers. When asked about lost time incidents, they said there were very few - One mill recalled only 1 broken limb in 20 years!

One of the mills, Foresco, has developed a process where they make colored MDF - one of only 3 mills in the world with this capability. The fiber board is used for decorative purposes only. Interestingly, all the mills that saw logs, but do not have facilities to make MDF or use the offcuts, package and send all the offtakes to mills like Foresco that can use them.



Foresco Colored MDF- It is very difficult to tell the difference between sawn wood and this MDF product.

On the second day, we visited a number of other sawmills including Sunchang Corporation - the largest sawmill in Korea. Sunchang Corporation saw between 50- 60,000 m3 of timber per month in one location - this is a 23-hectare sawmill! They make lumber, plywood, and MDF.

Sunchang already own forests in New Zealand - 4000ha in Marlborough which they are actively harvesting and exporting through YSI. Their sawmill is based in Incheon alongside the port. The logs are offloaded at one of the 75 berths at the port and then barged across the port inlet 2km to their mill. This is more cost effective than loading them on trucks for the 20km trip around the perimeter of the port.



Sunchang Corporation - the mill occupies 23 hectares and processes 50-60,000 cubic meters per month

The tide in Incheon moves a massive 10 meters and meant they can only reach the barges to offload the logs when the tide is higher than 6.5 meters. The rise and fall of the tide was very impressive.



Grade Mix and Korean Pine.

The demand for New Zealand Radiata is strong. Korean Pine does not grow merchantable saw logs (Korean pine pic) so it is only used in MDF. They, therefore, require other timber sources for use in their construction and packaging industries. Unfortunately, because it is only used in construction and packaging there is not a lot of demand for our higher grade logs. They are predominantly after A and K grades to meet their requirements.

When we asked about timber use in buildings (like we do here in New Zealand) they commented that the perception of New Zealand Radiata is that it is a lower grade log. All building over there is predominantly done with Hemlock from North America. The structural properties of these 2 logs are similar, it is just a matter of educating the Korean market of this. Perhaps some more of our national harvest levy could be directed this way?



Will beside a load of Korean pine for chipping. Note the logs are stacked across the truck - less tha 2.4m long.

Relationships

I think the thing that became clear to Steve and myself is how much the Korean log market relies on relationships. All of the end users have been in the game a long time, they value honesty and integrity very highly. It was evident that the relationships Mr. Kim and David had with all the operations we visited was very well respected. They are all very interested in growing relationships in the New Zealand market.

We thank David and Mr. Kim for their most generous hospitality and look forward to a successful relationship for our forest partnerships moving forward.

Regards,

Will Dickie

