

# INTERIM REVIEW

THE SIX MONTHS ENDED 31 DECEMBER 2014

(released 20 February 2015)



*There are statements in this Review that are “forward looking statements.” As these forward-looking statements are predictive in nature, they are subject to a number of risks and uncertainties relating to Rubicon, and our Tenon and ArborGen investments, some of which are beyond our control. As a result of the foregoing, actual results and conditions may differ materially from those expressed or implied by such statements. Tenon’s risks and uncertainties include - that its operations and results are significantly influenced by the level of activity in the various sectors of the economies in which it competes, particularly in North America. Fluctuations in industrial output, foreign exchange changes, commercial and residential construction activity, capital availability, housing turnover and pricing, levels of repair and remodelling and additions to existing homes, new housing starts, relative exchange rates, interest rates, and profitability of customers, can have a substantial impact on Tenon’s results of operations and financial condition. ArborGen’s risks and uncertainties include (in addition to those of Tenon) - the global markets and geographies in which it operates, intellectual property protection, regulatory approvals, public and customer acceptance of genetically engineered products, customer adoption of advanced seedling products, the success of ArborGen’s research and development activities, weather conditions and biological matters. As a result of the foregoing, actual results and conclusions may differ materially from those expressed or implied by such statements.*

## Rubicon Interim Review – Fiscal 2015

This document is the Interim Review of operations for the six months to 31 December 2014 – i.e. the first half of Rubicon’s 2015 fiscal year. It addresses in summary form the highlights for the period in each of the Company’s major business activities – i.e. ArborGen and Tenon.

*Our Annual Review for 2014 is available on our website – [www.rubicon-nz.com](http://www.rubicon-nz.com). In addition to our shareholder reports, from time to time we make announcements to the New Zealand Exchange. These can be viewed either on the NZX website or on Rubicon’s own website, where a history of our market releases is maintained.*

*Rubicon’s functional currency is the US dollar, and accordingly, unless otherwise stated, all references to dollars in this Review are references to US dollars.*



### About Tenon

Tenon is a wood-products processing, marketing and distribution business, focusing on high-value markets in North America. Tenon has strong supplier relationships with the independent pro-dealer (i.e. new housing) segment, and channels into the world’s largest (DIY) home improvement centre stores. As well as providing a channel to market for product made at Tenon’s large clear-wood remanufacturing facility in Taupo (NZ), its distribution business sources significant quantities of finished product from other international suppliers for sale into North America. Tenon ships over 8,000 40’ containers annually, through an internal logistics system that sources specialised product from China, Chile, Brazil, United States, Canada, and New Zealand. In addition to Tenon’s Taupo operation selling product into the North American market, it also has an export presence into Europe, China and Australia. For more information please visit [www.tenon.co.nz](http://www.tenon.co.nz).



### About ArborGen

ArborGen is revolutionising productivity in commercial forestry. ArborGen is the largest global supplier of seedling products and a leading provider of improved technologies to the commercial forest industry. Through innovations in conventional breeding, improved genetics and emerging biotechnology advances, ArborGen is developing high-value seedling products that significantly improve the economic returns and productivity of a given acre of land. These products enable ArborGen’s customers to grow trees that yield more wood per acre with greater consistency and quality in a shorter period of time. ArborGen’s work is improving the sustainability of working forests while helping to meet the world’s growing need for wood, fibre and energy. For more information, please visit [www.arborgen.com](http://www.arborgen.com).

## Six Months' Highlights – 31 December 2014



- **US economy continues on recovery path**
  - 11 successive months of job creation > 200,000 per month
  - 1 million jobs created in the 3 months to January
- **US housing industry data shows growth that is now underway**
  - Calendar '14 housing starts of 1.0 million, up 9% on the previous year
  - Builder's confidence index reported 6 successive months >50 (indicating future expansion)
  - Existing home sales (annualised) of 5.0 million recorded in December
  - Case-Shiller 20-city home price index 29% up on 2012 low, and up 4% y-o-y (November)
- **US new home construction is forecast to grow strongly<sup>1</sup> over the next 2-3 years**
  - Industry forecasts ≈ 1.18 million housing starts in calendar 2015, up 18% on 2014
  - Tenon has increased its exposure to the new home construction market
    - Projected to be ≈ 55% of US distribution revenues in FY'15
    - ... up from c35% at the same point in previous cycle
- **Revenue of \$209 million, up \$12 million on the corresponding prior period ("cpp")**  
(i.e. for the six months to December 2013)
- **Net profit after tax of \$2 million, compared with a breakeven result for the cpp**
- **EBITDA<sup>2</sup> of \$6 million was up 20% on the cpp, and included -**
  - Average effective NZ\$:US\$ rate of 84 cents (cpp, 79 cents)
  - ≈ \$1.5 million in retail store major line reset activity expensed
  - ... partially offset by a gain of \$0.4 million on the sale of a residual forest asset
- **Earnings expected to improve further<sup>1</sup>, as -**
  - US macro-economic and housing market conditions continue to improve
  - The effect of the lower NZ\$:US\$ FX rate begins to flow through
  - Business re-engineering projects in US operations positively impact performance
  - Organic growth (regional and product expansion) is executed
- **Taupo site (NZ) capital projects are underway**
  - Two manufacturing projects, with total capital investment of \$6-7 million
  - Expected cash payback of < 2.5 years
  - Anticipated first project will be completed and operational in Q4 of calendar 2015
- **Closing debt (net of cash) of \$49 million (cpp \$53 million)**
  - \$6 million of cash generated from operating activities
  - \$3 million invested in capital replacement and expansion (e.g. Taupo capital projects)
  - \$7.5 million collateral 'reserve' released (January'15) by banking syndicate
- **Share price increased 22% over the six-month period (from NZ\$1.52 to NZ\$1.85 per share)**
  - Compares with NZX50, ASX and Dow Jones indices up 8%, 1%, and 6% respectively
  - Future upside remains - Edison Research valued Tenon at mid-point of > NZ\$2.50+ per share<sup>3</sup>
  - Share buyback program in place
  - Dividend policy under active review – intention to announce dividend during fiscal'16 year<sup>1</sup>

<sup>1</sup> Please refer also to pages 11-13 of this Interim Review.

<sup>2</sup> EBITDA (i.e. Earnings before Interest, Taxation, Depreciation and Amortisation) is a non-GAAP earnings figure that equity analysts tend to focus on for comparable company performance analysis, because that number removes distortions caused by the difference in asset ages, depreciation policies, and debt : equity structures. EBITDA is calculated as Net Profit/Loss after Taxation of \$2 million (2013 \$nil), less income tax benefit of \$nil million (2013 \$nil), plus financing costs of \$2 million (2013 \$3 million), plus depreciation and amortisations of \$2 million (2013 \$2 million). These numbers have been extracted from our 31 December 2014 Interim Financial Statements – please refer to Note 6 to those statements.

<sup>3</sup> September 2014 report, adjusted for subsequent change in NZ\$:US\$ FX rate from 82 cents when the report was released to 75 cents today.

## Operations and Finance

Tenon's financial performance continued its momentum in the six months, in line both with market expectations and the recovery in the US housing market now taking place. In this latter respect, a quick review of recent US industry data shows this succinctly –

- Housing starts for calendar'14 were 1.0 million, up 9% on the previous calendar year. Total starts in the six months to December'14 were up 11% on the cpp. The single-family home component of this figure at 0.7 million was at its highest in seven years.
- Permits issued for new home construction, at 1.0 million (annualised) in December, were up 6% on the June'14 figure. Again, the single-family home component of the total permit issuance was at a six-year high, and the home builder confidence index recorded greater than a 50 reading (indicating future expansion) for the entire six month period.
- December (annualised) existing home sales of 5.0 million, were up on the cpp figure of 4.9 million.
- The Case-Shiller 20-city composite home price index increased 4.3% year-on-year (November), and is now 29% higher than the 2012 low.
- Existing home inventory ended the year at 4.4 months of supply, down 20% on the 5.5 months level prevailing at June '14. New home inventory, at 5.5 months of supply was also down, by 5% on the 5.8 months reported at June '14.

As these data points indicate, over the past 12 months US new home construction has now begun to lift to a new level, and this improvement in industry activity levels is beginning to flow through into Tenon's financial performance.

For the period under review, Tenon's **Revenue** was up \$12 million compared with the cpp. Gains were made in all the pro-dealer regions Tenon services, and these customers in turn supply the new home construction market. Retail activity (measured by same store comps), which typically lags new home construction, was flat in volume terms during the period, to some extent due to the extensive 700 store resets that we are undertaking. These resets, which began in June '14 and are expected to be completed this October, are major in nature and involve a complete 'revamp' of the layout and physical structure supporting the commodity and decorative moulding aisles we service in the stores. Although store sales are impacted as we undertake the reset activity, once completed we would expect strong year-on-year same store comps to prevail. Revenue from Australian activities lifted by \$2 million, as we began servicing 50 Masters stores.

**Net profit after tax** of \$2 million was recorded for the six months, up on the breakeven result in the cpp. **Gross profit of \$49 million** was up on the \$45 million recorded in the immediately preceding six-months to June '14, as margin percentage expanded in the period, despite the unfavourable FX conditions experienced (see below). **EBITDA<sup>2</sup>** at \$6 million, was up 20% on the cpp. This increase was recorded despite the expensing of \$1.5 million in store reset activity in the period, which was partially offset by a \$0.4 million gain recorded on the sale of a minor residual retained forest. The improved EBITDA result did not include any benefit of the recent weakening in the NZ dollar, as that occurred late in the period and FX cover taken earlier under Tenon's hedging policy had not run off. In fact, the average effective NZ\$:US\$ FX rate for the period was 84 cents, which was some five cents worse than was experienced in the cpp.

Tenon used some of the **\$6 million of cash generated from operating activities** (cpp, \$1 million) to initiate its previously announced **capital investment** plans, investing \$3 million in the period, primarily on the key optimisation projects at Taupo. The first of these projects is designed to maximise the amount of clearwood that can be recovered from a given log. This improved recovery will allow the Taupo site to increase the volume of high value products that it can produce from the same volume of log into the sawmill. The optimisation equipment is expected to be installed and operational in Q4 of calendar'15, and the overall \$5 million project is targeted to have a capital payback of less than 2.5 years.

Tenon's **debt balance (net of cash) reduced to \$49 million** (cpp, \$53 million) across the period, and financing costs declined y-o-y as a result.

Tenon's recent financial performance has exceeded that projected when it entered its new Bank Facility in September'13, such that by the end of December it was able to generate **four successive quarters of fixed charge coverage (FCCR) in excess of 1.5 times** (refer note 5 to our 31 December 2014 Interim Financial Statements for explanation of the FCCR). The practical effect of this is that the \$7.5 million 'block' reserve that the banking syndicate had previously held against Tenon's borrowing collateral has now been released under the terms of the facility agreement, and is available for collateralised borrowing under the revolver facility. This is just another indication of the financial results that Tenon is now beginning to produce.

Tenon announced at its Annual Shareholders' Meeting (ASM), that it had implemented a complete operational review of its North American manufacturing and distribution operations. This is a fundamental 'nuts and bolts' review, with the goals being to –

- Identify new opportunities for growth; and
- Improve profitability in its existing activities, whilst at the same time improving the service level it provide to its key customers.

By way of flavour of what is being undertaken, is the installation of an advanced product procurement system, which combines sophisticated demand-based forecasting with an automated inventory replenishment system. Logistics management is a core Tenon capability – it must be, as Tenon is required to ship more than 8,000 40' containers from around the world (e.g. New Zealand, Chile, Brazil, Mexico) to its North American warehouses, for subsequent delivery to its US national home centre customers (i.e. retail / DIY) who have extremely demanding on-time fulfillment criteria, and to its pro-dealer customers who have similarly demanding short lead time delivery requirements. The growth in the size (volume and product) and complexity of Tenon's distribution operations has made this logistics competency even more critical than it has been in the past. From product order through to manufacture and delivery can be a 3-4 month lead time, so demand forecasting and inventory management is a fundamental capability in ensuring Tenon can deliver its customer needs more than a quarter forward, based only on known demand and market conditions today. The new system being put in place is designed to ensure Tenon can do just that, and once operational it should allow it to optimise inventory levels (by product sku), lower operating costs, and increase sales. We will report more fully on this and Tenon's other projects at the time of our Annual Result.

## □ Production and sales

### □ ArborGen world-wide, targeting to -

- Lift total volumes by 10% y-o-y
- ≈ 20% in advanced genetics sales (in the US), on higher target loblolly volumes
- Increase revenue ≈ 15-20% y-o-y

### □ United States

*ArborGen's core market today is the US. The US crop-growing season is typically from April–December, with the sales season occurring primarily in the January-March period each year. Accordingly, Rubicon's Interim Reviews do not cover the US sales season, which means recorded sales revenue and unit data are not reported on in respect of the US operations. The US discussion below reflects this seasonality.*

- Targeting a 10%+ volume increase y-o-y
- 270+ million seedlings currently in production, for harvesting and delivery to customers predominantly in the first quarter of calendar '15 (i.e. fiscal'15)
- ≈ 20% of loblolly production in advanced genetics, on higher fiscal'15 target volumes
- Continued recovery in the US housing market (also refer Tenon discussion), which will -
  - Lift forest harvesting and, in turn forest replanting levels
  - Encourage planting of higher quality genetics
  - Assist in goal of 'locking in' customers with long-term contracts
    - Target is to have equivalent of ≈ 30% of 2015 loblolly volumes under term contracts
- 'Blended traditional + biotech' production techniques being implemented, to -
  - Increase the supply of advanced genetics
  - Lower future cost of production

### □ Australasia

*The New Zealand crop-growing season is typically from October-June, with the sales season occurring primarily in the July-September period each year. The Australian planting sales season is similar, albeit slightly longer than in New Zealand. Accordingly, Rubicon's Interim Reviews do cover the Australasian sales season. The Australasia discussion below reflects that operational seasonality.*

- Unit sales increased to 21 million seedlings, up 13% on the cpp
- Revenue was up 18% on the cpp
- NZ revenue for advanced genetics pine sales ≈ 85% of total NZ pine revenue<sup>5</sup>
- Total NZ-domestic sales now represent 37% of the New Zealand market

### □ Brazil

*Eucalyptus in Brazil is planted and harvested almost all year around. Accordingly, this Review addresses the Brazil performance for six months of the year.*

- Current season's eucalyptus production targets on plan
  - Targeted to sell 5-10 million seedlings in the first 24 months of operation
  - Target on track to be met by the completion of the current fiscal year
  - Current year order book is sold out
- 'Follow-on' loblolly pine strategy is in place

## □ **On track to meet EBITDA<sup>4</sup> positive 'run-rate' objective<sup>6</sup>**

## □ **Introduction of genomics into the product development / technology platform**

## □ **China 'step-out' under active review**

## □ **Focus remains on critical commercial milestones for ArborGen financing / liquidity event**

<sup>4</sup> EBITDA (i.e. Earnings before Interest, Taxation, Depreciation and Amortisation) is a non-GAAP earnings figure that equity analysts tend to focus on for comparable company performance analysis, because that number removes distortions caused by the difference in asset ages, depreciation policies, and debt: equity structures.

<sup>5</sup> Excludes contract grown revenue

<sup>6</sup> Please also note the related discussion on this objective on page 13

## ARBORGEN

### Production, sales and customers

In 2014 ArborGen met all its production and sales goals. It produced 265 million seedlings globally, and in its core market in the US it increased its advanced genetics proportion of loblolly pine sales by 55% y-o-y, and its average selling price by 15% y-o-y. The proportion of its loblolly sales in advanced genetics has increased from 8% of all loblolly pine sales in 2012, to over 20% last year.

For this current season (2015), the immediate objectives have been targeted at –

- Increasing total seedling production volumes by 10%
- Increasing total Revenue by 15-20%
- Establishing long-term US customer contracts ≈ 30% of current year loblolly volumes

As the crop-growing season in ArborGen's core market of the US is typically from April–December, and the sales season is primarily the January–March period each year, our Interim Reviews to shareholders for the six months to December are unable to give commentary on actual production and sales out-turns for the fiscal '15 year. However, on the basis of what we know today, and on the basis of the 21 million seedling sales that have already been recorded in the Australasian sales season this year, ArborGen believes it is on track to meet the 2015 season's goals outlined above. Having said that, weather conditions are an important consideration in end-of-season planting requirements and activity, so the realities of the remaining US winter months will likely determine the final outcome.

As previously discussed, ArborGen is currently putting in place a blended 'traditional + biotech' production technique to overcome the shortage of supply (relative to demand) in its advanced genetics that has emerged in the short-term. This is progressing to plan. However, as it involves a traditional biological growth cycle, this process will not boost supply for several seasons (this current season included), so the objective for this 2015 year is to maintain the existing ≈ 20% advanced genetics proportion of loblolly pine sales in the US, but on the higher volumes noted above.

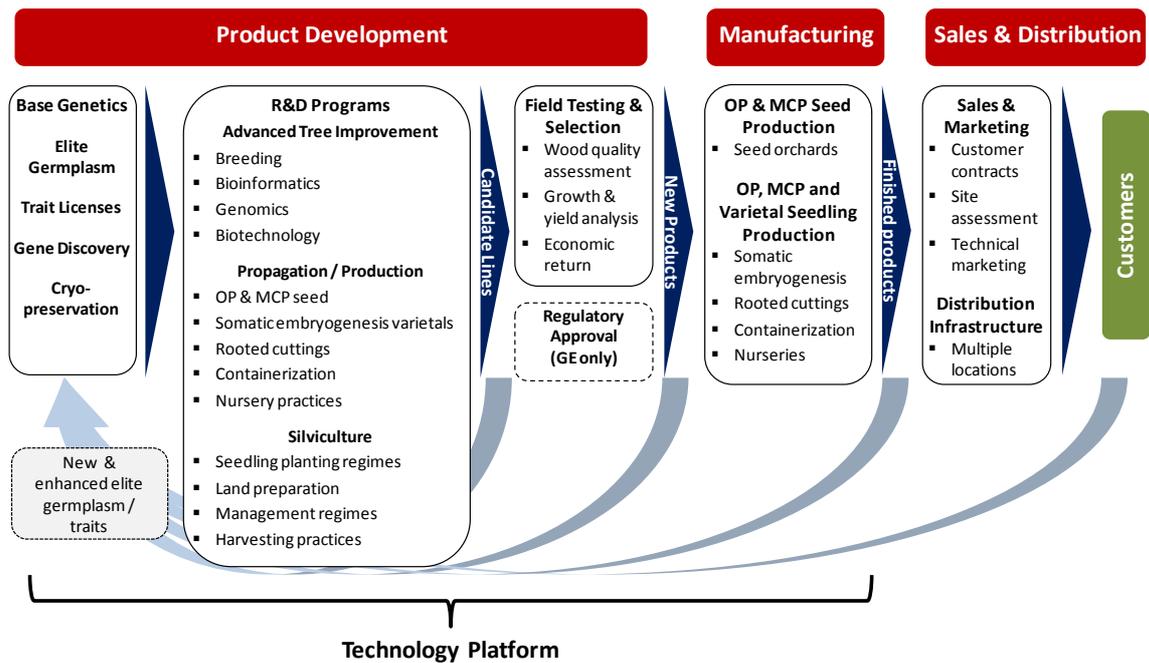
In Brazil, the initial target was to sell 5-10 million eucalyptus varieties in the first 24 months of operation. ArborGen believes this goal will have been met this fiscal year.

While ArborGen's commercial operating business in the US, Australasia and Brazil are already profitable in the aggregate today, (inclusive of research and development on future products and corporate costs) ArborGen as a whole is not. The sales and operational objectives outlined above are consistent with ArborGen's internal stretch goal of achieving a positive EBITDA<sup>4,5</sup> 'run-rate' at the end of calendar'15, inclusive of the expensing of research and development expenditure. Achieving this will require industry harvesting and replanting levels to increase, in line with a recovering US housing market and consistent with ArborGen's internal plans, ArborGen to meet its initial production plan in Brazil, and no major additional science projects being initiated in the immediate term. While weather and other 'uncontrollables' always have the ability to put short-term earnings targets like this off course, ArborGen is still firmly focused on achieving this fundamental earnings run-rate objective.

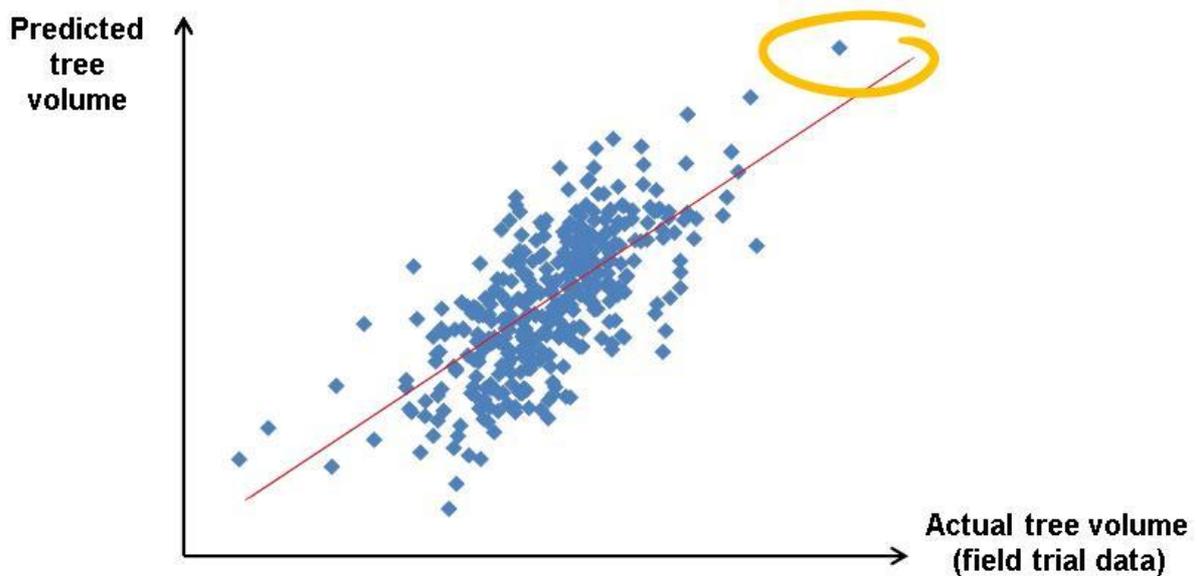
## Product development – the use of genomics in the technology platform

ArborGen’s technology platform is a critical component of its integrated business model and is at the core of the company’s continued success. ArborGen believes it has the broadest portfolio of intellectual property in the industry as well as the largest and most diverse repositories of germplasm, encompassing more than 40 commercial tree species and hybrids. ArborGen also operates an extensive field trial system and it is currently conducting over 900 field trials containing over 1 million trees.

### ArborGen’s Integrated Business Model



While the product development program continues to bring a portfolio of next generation products to market, ArborGen is also focusing on new technology that will help bring higher value products to market more quickly. One of the most innovative areas is the application of advanced genomics in its product development process that we have mentioned previously. The intention is to use genomics technology in combination with ArborGen’s bioinformatics platform and extensive genetic library, to ultimately select genetic crosses without the need for many years of trials in the field to determine the best performers. To test the power of this genomics technology this past year, ArborGen took the known outcomes from its existing trial data of more than 350 loblolly pine varieties and compared those with what the combined genomics and bioinformatics model predicted would occur. The model output not only showed a very strong correlation between predicted and actual outcomes, but it also precisely determined which would be the top performer. This is an exciting development tool for ArborGen, with huge potential.



### Geographic expansion

ArborGen's immediate geographic expansion efforts are focusing on Brazil, where success with eucalyptus (i.e. the proving out of the initial position by meeting production, sales and pricing targets, and then scaling up) will see ArborGen expand into pine products. The initial eucalyptus outcomes are outlined above (refer *Production and sales*), and are substantively on track. Commercial negotiations and positioning around an initial pine position are also well advanced, and although behind on the initial timeline set, are also fundamentally on track for an announcement this year. In this respect, the necessary pine development work has been underway for some time - e.g. ArborGen has already established MCP trials on customers' lands, matching its elite US genetics to similar growing conditions in Brazil, while the CellFor acquisition brought into the varietal portfolio a well established testing program in Brazil.

China remains under review as a geographic step-out opportunity for ArborGen. China represents a massive annual planting market opportunity for both loblolly and eucalyptus, and it has a need for advanced genetics to lift performance above the low commodity seedling genetic base that prevails today. To advance its due diligence, ArborGen has been in discussions with large end-users and provincial governments in selected provinces in China, to determine whether a low-risk, low-capital entry point to the China opportunity can be created. In this respect, ArborGen needs to be realistic about the resource (people and dollars) involved in order to be successful there, and the risk to growth of the core business from diverting capability away from existing markets. The ArborGen Board will ultimately weigh this all up and make the decision as to how best to address the China opportunity, whilst still ensuring success in its existing markets (including growth in Brazil).

## FINANCIAL

*As Rubicon's functional currency is the US dollar, our financial statements generally refer to US dollars unless otherwise stated. All numbers are rounded to the nearest million. As Rubicon has majority ownership (59.5%) of Tenon, NZ International Reporting Standards (IFRS) require Tenon's Income, Cash Flows and Balance Sheet financial statements to be consolidated into Rubicon's statements. This is the basis upon which our financial statements are presented in this Review.*

For the six-month period we recorded a 'break-even' net earnings result, a notable improvement on the cpp loss of \$2 million. As noted in the Tenon section of this Review, this result included the expensing of \$1.5 million in retail store major product line reset activity, partially offset by a \$0.4m gain from the sale of a minor residual forest interest. Operating earnings before financing expense improved to a profit of \$3 million (cpp \$2 million), as Tenon's results lifted further as cyclical recovery in the US housing market continued (refer *Tenon* section above). This was also reflected in our EBITDA<sup>7</sup> result, which improved to a \$5 million profit (cpp \$4 million), inclusive of ArborGen research and corporate development costs expensed.

As Rubicon owns only 31.67% of ArborGen, ArborGen is treated as an associate and its debt is not consolidated into Rubicon's balance sheet, however Tenon's debt is consolidated into Rubicon's statements as we own 59.5% of Tenon. ArborGen and Tenon's debt are non-recourse to Rubicon Limited. At 31 December 2014, Rubicon's consolidated bank debt (net of cash) was \$64 million (cpp \$70 million), of which Tenon's debt was \$49 million (cpp \$53 million), and Rubicon Limited's own debt was \$15 million (cpp \$17 million).

Tenon only recently put in place a new \$70 million syndicated debt facility, which does not fall due until September'18. ArborGen's existing two-year bank facility expires in August'15, and the company is already in negotiations to extend the facility. As at the time of writing, the partner capital requirements for the next fiscal year for ArborGen have not yet been set. Once these are known, Rubicon's needs will then also be able to be determined, and our own wider funding position addressed (Rubicon's existing \$20 million bank facility expires in July'15). We will inform shareholders of the outcome once it is known.

<sup>7</sup> EBITDA (i.e. Earnings before Interest, Taxation, Depreciation and Amortisation) is a non-GAAP earnings figure that equity analysts tend to focus on for comparable company performance analysis, because that number removes distortions caused by the difference in asset ages, depreciation policies, and debt:equity structures. EBITDA is calculated as Net Profit/Loss after Taxation of \$nil (Dec 2013 -\$2 million loss), less income tax benefit of \$nil (Dec 2013 \$nil), plus financing expense of \$3 million (Dec 2013 \$4 million), plus depreciation and amortisation of \$2 million (Dec 2013 \$2 million). Please also refer to Note 11 of our 31 December 2014 Financial Statements.

## Governance

We held our last ASM in Wellington on the 5<sup>th</sup> of December 2014. The formal presentation materials for the day are available on our website at [www.rubicon-nz.com](http://www.rubicon-nz.com). More than 83% of the Company's issued shares were voted at the meeting, and all resolutions were passed - each with a majority in excess of 96%. Tenon's ASM was held on the day prior, with over 84% of the Company's issued shares voted at the meeting, and again with each resolution passed with a majority in excess of 99%. These excellent voting statistics are a reflection not only of the consolidated share registers of the two companies, but also of the agreed future direction of these two companies.

Tenon's share price performance has been strong over the six-month period, increasing 22%, compared with returns on the Dow Jones, ASX50 and NZX50 of 6%, 1% and 8% respectively recorded over the same period. We would naturally have expected the Tenon share price increment to flow through into Rubicon's share price, but that has not been the case. Indeed, Rubicon's share price declined across the period, which by deduction implies a fall in ArborGen's implied (i.e. 'look-through') value in our share price. Our view is that this just does not reflect the reality of the progress that ArborGen has made in its commercialisation goals over the past 12 months *(please refer ArborGen Summary Highlights in this Review and in our 2014 Annual Review to shareholders)*, and given Rubicon holds the strategic control stake in Tenon and our investment should therefore carry some additional control 'premium' value to us, the Rubicon share price performance is even more disappointing. We have discussed the reasons before – particularly the illiquidity of the Rubicon share register, and the 'waiting for events' to prove value dilemma – however it is ultimately our responsibility to ensure the market understands and values the investments we have and the progress that has been made. So, we either need to build momentum in the share price, or address our investments to prove out their value. This is a current focus of the Board.

Tenon announced yesterday that it anticipated it would be announcing the introduction of dividends during its fiscal '16 year, subject to a favourable macro-environment for the company. This obviously means that Rubicon, as Tenon's 59.5% shareholder, will receive a future cash income stream from Tenon upon such policy introduction. We support Tenon's decision in this regard, and believe it will be a strong positive for Tenon's share price, as it will overlay a dividend yield on top of what is already an excellent growth story.

## Outlook

### Tenon

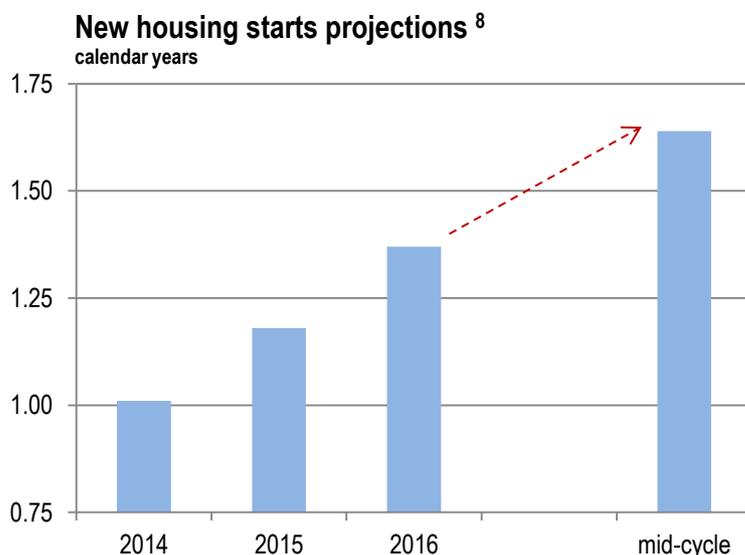
Macro conditions for Tenon are now clearly improving.

The US economy is now entering a cyclical upswing, after six years of moribund performance post the global financial crisis. By way of example, last month the US posted its eleventh straight month of 200,000+ job creations – the longest successive ‘run’ of such a figure for almost two decades – and in the three months to January the economy created one million new jobs.

While the strengthening economy will ultimately see interest rates rise in the US, the pace of those increases is expected to be gradual, as is their impact on housing activity. What this will do however, is see the US dollar strengthen, and in the absence of the Reserve Bank of New Zealand lifting domestic interest rates, then the NZ\$:US\$ FX rate should fall, which would be a strong positive to Tenon’s future earnings and cash flow. In the immediate term, Tenon is ‘hedged’ through to the end of March’15, at an average rate for Q3 of 76 cents. Tenon is currently unhedged beyond this period, so it will enjoy any falls in the cross rate that occur in respect of Q4 and onwards into fiscal’16.

The second half will see Tenon complete much of its required retail store reset activity, and also see the conclusion of some of the key business re-engineering projects underway in its US distribution operations. Each of these will require costs to be incurred in the second half of the year, but these should be more than offset by the rewards that will flow in fiscal’16.

Tenon will continue its organic growth initiatives. These are focused on broadening the range of products it supplies into its national home centre customers (i.e. retail / DIY), and on expanding the geographic reach of its pro-dealer activities. This latter growth will ultimately see Tenon’s presence in the pro-dealer market (i.e. new home construction) increase in percentage terms relative to its retail activities. By the end of fiscal’15, Tenon believes this weighting will have increased to almost 55% of its total distribution activities, from 50% last year, and approximately 35% at the beginning of the previous cycle. As we believe new home construction will likely expand strongly (refer chart below) and earlier than will DIY / retail, this is the right balance for Tenon at this point in the cycle. Having said that, Tenon will continue to actively seek growth in both markets, and we will be reporting more on this with our Annual Result later in the year.



While there are always some unknowns that can affect earning projections<sup>9</sup> – the impact of rising interest rates in the US, the path of future log costs, the current labour issue at US West Coast ports, and the FX rate are good examples for Tenon in the immediate outlook. However, absent any adverse surprises with these, Tenon expects its earnings path to continue to improve in the second half of the fiscal year.

Looking further ahead, the completion of its business re-engineering efforts, the installation of the optimisation capital equipment at Taupo, the weaker NZ\$:US\$ FX rate, and success with its organic growth initiatives, should cumulatively set Tenon up for a strong fiscal '16 year assuming macro conditions are supportive.

### **ArborGen**

The immediate and short-term environment for ArborGen's production and sales will be dependent upon the same key factor underlining Tenon's outlook – i.e. the rate of recovery in the US housing market. ArborGen's US seedling volumes are dependent upon the underlying demand for wood in the economy, whether it be for new home construction, remodelling and renovation, or energy (e.g. pellets) – as wood demand drives harvesting, and, in turn, replanting. As the new housing chart (previous page) shows, the outlook for new home construction in the US is positive, and this should (with a lag) flow directly through to seedling demand to meet higher replanting levels post harvesting. Improvement in remodelling and renovation activity would be additive to the demand profile.

ArborGen's 2015 production, sales, and customer objectives are clear – i.e. to increase total seedling production volumes by 10% y-o-y, increase total Revenue by 15-20% y-o-y, and establish long-term US customer contracts equivalent to ≈ 30% of current year loblolly sales volumes. As at the date of writing, ArborGen remained on track to meet each of these, and their achievement will be a good indicator of ArborGen's ability to meet its fundamental EBITDA positive 'run rate' goal. And while these short-term earnings goals are important, they are not being progressed at the expense of the future growth and development of the business. The inclusion of genomics science into the technology platform is a good example of this, and if more value can be generated from greater expenditure on science and product development of this type, then that will be done, rather than compromise the value upside solely in order to meet a short-term EBITDA goal. To this point, the product development pipeline continues to be refined, and trials of next generation genetics are proving out the gains that can be delivered. In our next Review we will present some field trial data (>15 year) that proves out the gains that can be delivered from the adoption of MCP genetics.

ArborGen is entering a period of growth – both expansionary (e.g. the Brazil step-out) and organic (e.g. working capital growth as the US market recovers). The funding for these should ideally be met out of capital raised in an external ArborGen financing event – i.e. an event that achieves both capital and liquidity objectives. ArborGen continues to actively advance to this fundamental financing objective.

<sup>8</sup> Projections represent averages taken from the following data sources for the respective years -  
2015 – Fannie Mae, Freddie Mac, National Association of Home Builders, Mortgage Bankers Association, National Association for Business Economics, National Association of Realtors, Forest Economic Advisors, Forisk Consulting, Joint Center for Housing Studies of Harvard University  
2016 – Fannie Mae, Freddie Mac, National Association of Home Builders, Forest Economic Advisors

*Mid-cycle* – Forest Economic Advisors, Forisk Consulting, Joint Center for Housing Studies of Harvard University, Tenon  
<sup>9</sup> Please also refer to Note 5 Key Financial, Commercial and Environmental Risks in our 2014 Statutory Report

Finally, we would like to thank all of our stakeholders for their continued support. As always, it is very much appreciated.

Sincerely,

Steve Kasnet (Chairman)

Luke Moriarty (Chief Executive)

20 February, 2015