

RAM

SECTOR REPORT Tea Industry

The Green Gold of Ceylon

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RAM Ratings (Lanka) Ltd
(Wholly owned by RAM Holdings Berhad)

No 9, Arthur's Place
Colombo 4
Sri Lanka

T +94 112 553089
F +94 112 553090
E ram@ram.com.lk
www.ram.com.my

RAM

Company Contact:

Adrian Perera
MBA, FCMA (UK), FCCA, FCMA, MCPM, AIB
Chief Executive Officer
(94) 11 2596099
adrian@ram.com.lk

Analyst Contact:

Prashani Illangasekera
MSc, BA
Senior Analyst
(94) 11 2503551
prashani@ram.com.lk

Khailash Weeralingam
ACMA (UK), BSc
Senior Analyst
(94) 11 2553089
khailash@ram.com.lk

Website: www.ram.com.lk

Summary

Sri Lanka's plantation exports, particularly tea, have played a vital role in the country's economic and social development. The growth of plantations during the British colonial era had necessitated advances in the country's infrastructure and financial sector, thereby providing an impetus for the development of the road/railway networks and banking systems. Almost 150 years later, the plantation industry has remained an integral component of the country's socio-economic make-up. Tea is a significant contributor to Sri Lanka's export earnings; this segment is also among the largest employers in the country.

Since the early days, Sri Lankan tea has been considered among the best in the world; this has enabled it to command higher prices than its global peers. As such, Sri Lanka has retained its status as one of the world's top 2 tea exporters, albeit having relinquished its position as the largest global exporter of tea (currently Kenya) in 2007. Although historically catering to the European region, demand for Sri Lankan tea has in more recent times largely stemmed from the Commonwealth of Independent States ("CIS") and the Middle East.

While still considered a producer of superior-quality tea, it is evident that Sri Lanka's competitive position in the global tea arena has been slipping. Heightened competitive pressures in the global market, coupled with several internal supply issues, have eroded the country's competitiveness. For instance, Sri Lanka's cost of production remains among the highest in the world, a result of lower labour productivity and relatively inferior yields. Inadequate focus on replanting and fertilising due to financial constraints has dampened yields in comparison to its global peers. Meanwhile, continued focus on orthodox and bulk tea could further affect the country's competitive position as global consumption patterns increasingly tilt towards more convenient forms of this beverage.

To ensure the continuity of Sri Lanka as a dominant force in the global tea market, it is crucial that productivity-enhancing measures be implemented on a national scale. On a related note, most plantation companies generally face financial constraints due to the reluctance of banks to provide loans to this relatively volatile sector. Given the current buoyancy of the equity market, however, it is opportune for such companies to start tapping the stock market. On a more macro level, it is evident that a cohesive policy to promote the production of value-added forms of tea is essential - to arrest the trend of declining competitiveness. In this regard, Sri Lanka could consider the partial liberalisation of tea imports to enable multi-origin blending while balancing the impact such a move would have on the domestic industry.

History of the Tea Sector

The ambitious British colonists had radically altered the course of Sri Lanka's socio-economic development by nurturing the plantation sector. Following the experimentation of a variety of plantation crops in the mid-1830s, coffee had emerged as the country's winning crop, acting as a growth catalyst for plantation agriculture. The abolishment of slavery in the West Indies had diminished global coffee supply, thereby providing further impetus for Sri Lanka to bridge the shortfall. Concurrent with the expanding cultivation of coffee, the requisite rail and road networks, banking systems and administrative procedures had been put in place, thereby instigating the development of the country's infrastructure.

For nearly 20 years, coffee had been Sri Lanka's principal crop whereas tea cultivation had remained a minor activity. However, a fatal leaf disease had spread rapidly through the coffee plantations in 1869, completely decimating the entire industry. Tea had subsequently surfaced as a crop with high growth potential; the entire local economy had thus shifted its focus on to the new crop.

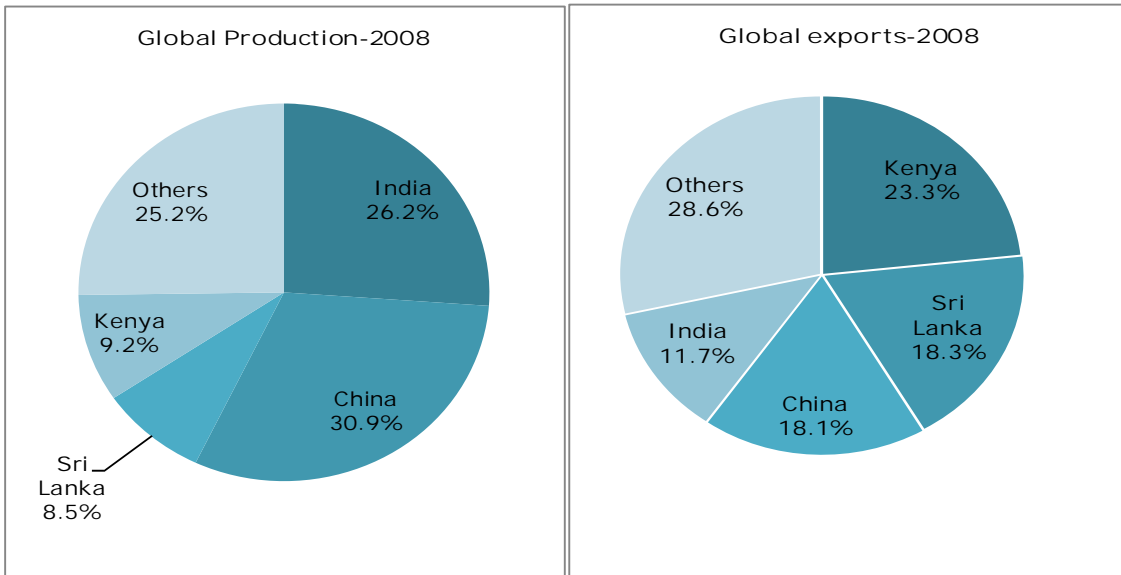
The immense popularity of Sri Lankan tea in the world market had resulted in the industry's rapid growth, along with the establishment of large-scale tea plantations. Towards the latter part of the 19th century, the rubber industry had also gained prominence as an additional source of export earnings.

After Sri Lanka gained independence from the British in 1948, several British estate owners had exited the industry in anticipation of nationalisation. In the early 1970s, the government nationalised foreign-owned plantations, thereby centralising their management. However, bureaucracy and increasing inefficiency amid the growing political bargaining power of plantation workers had deteriorated the companies' post-nationalisation performance. In view of this, the government initiated the privatisation of the sector in 1992; after a change in administration in 1995, tea plantations became fully privatised.

Global Fundamentals

Global tea production is primarily concentrated in 4 countries - India, China, Kenya and Sri Lanka, which together accounted for nearly 75% of the world's output in 2008 (refer to Chart 1). Although India and China are still the largest tea producers, these 2 nations' considerable domestic consumption has rendered Kenya and Sri Lanka the largest global exporters of this commodity. While Sri Lanka has historically dominated exports, it relinquished this position to Kenya in 2007. Since then, Kenyan production has been growing robustly, driven by its expanding hectareage and improving production skills.

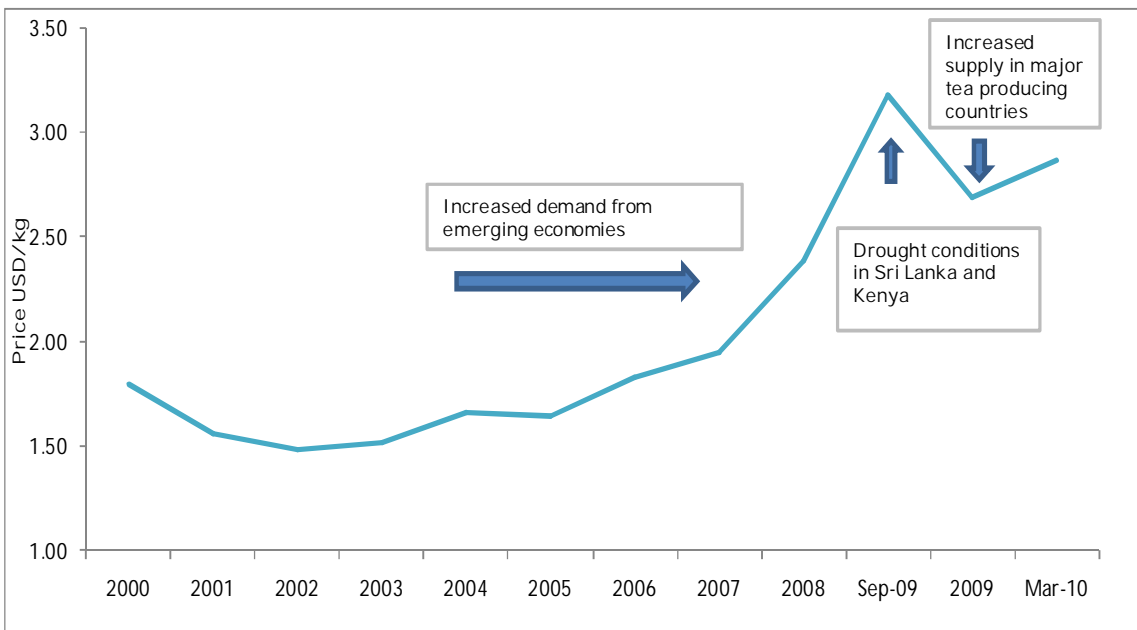
Chart 1: Global tea production and exports by geographical location



Source: Sri Lanka Tea Board

On a separate note, global supply has consistently outstripped demand, although the gap has narrowed in recent years. Moreover, prices have been trending upwards in reaction to supply constraints amid civil unrest in Kenya, labour disputes in Sri Lanka and droughts in major tea-producing countries. Meanwhile, stronger demand from emerging economies has also pushed up prices (refer to Chart 2). However, this has brought about concerns that tea producers may overreact to the sudden surges in demand, thereby creating the threat of excessive supply.

Chart 2: Global price trends



Source: FAO Composite Price Index

In general, preference for tea varies substantially, depending on the origin and quality of the leaves. For instance, Middle Eastern and CIS countries opt for orthodox, low-grown, strongly flavoured tea produced primarily in Sri Lanka. Elsewhere, consumers in the United Kingdom ("UK"), Pakistan and Egypt prefer finely ground, low-quality, crush-tear-curl ("CTC") tea that is mainly used in tea bags. Meanwhile, the American region prefers light-liquoring, low-priced teas.

Importance to the Domestic Economy

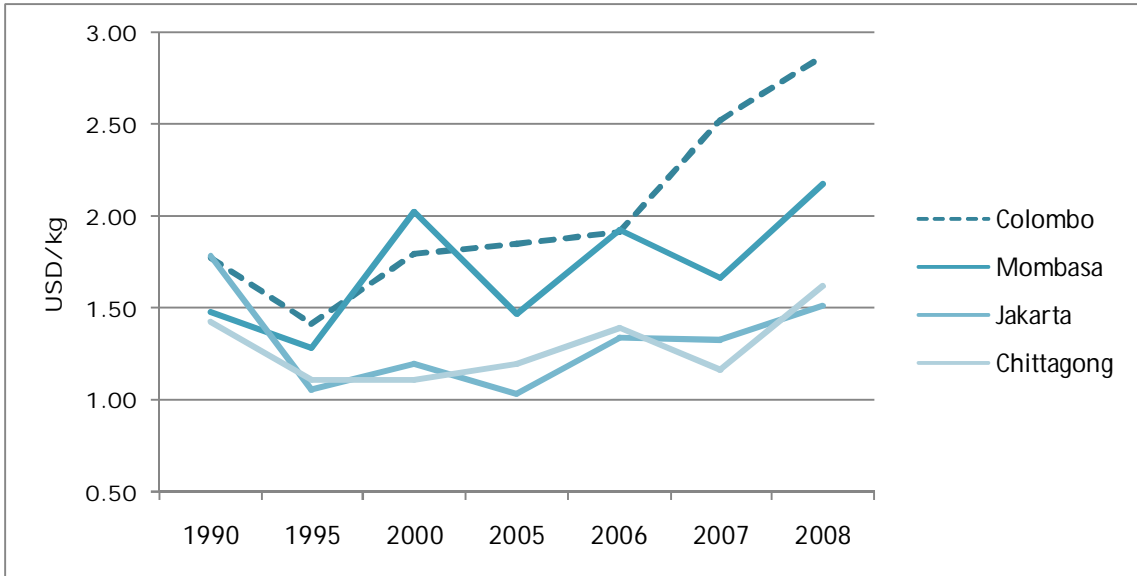
Although predominantly an agriculture-based economy during the British colonial era, the tea industry's contribution to Sri Lanka's GDP has been declining along with the expansion of the country's industrial and services sectors. Nevertheless, the tea industry remains a vital component of Sri Lanka's exports, generating approximately USD1.18 billion of income in 2009, surpassed only by garments. Meanwhile, the agriculture sector stayed among the largest employers; with nearly 2.5 million employees, this sector accounted for more than 30% of the country's employed population. The plantation industry is therefore undoubtedly still an integral part of the island's socio-economic make-up.

Sri Lankan Tea

Sri Lanka produces tea cultivated in a variety of elevations, with the bulk being low-grown tea. This is cultivated in elevations ranging from sea level to 600 meters, and essentially has a stronger flavour and colour, as preferred by the CIS (particularly Russian) markets. As such, higher income levels and the resultant rise in demand from these countries have pushed up the prices of low-grown tea in recent times. Meanwhile, high-grown tea is cultivated in altitudes of over 1,200 meters and is generally regarded as being of superior quality, with a unique taste and aroma.

Sri Lankan tea has traditionally ranked among the world's prime-quality teas due to its strong flavour and aroma. As such, prices at Colombo tea auctions have consistently been higher than those in other major auctions in the world (refer to Chart 3).

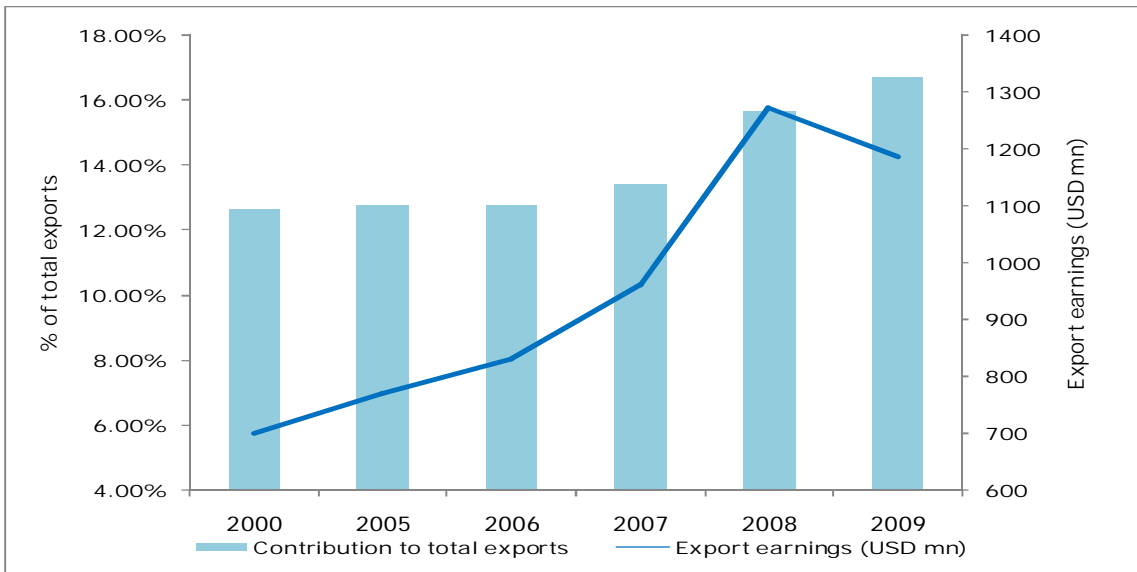
Chart 3: Price performance of Colombo tea auctions vs major auctions



Source: Sri Lanka Tea Board, Central Bank annual reports

The tea industry remains a vital contributor to the country's exports, accounting for nearly 16% of its total exports in 2009 (refer to Chart 4). Export earnings of USD1.18 billion from tea were sufficient to cover nearly 95% of the country's food imports. Export revenue from tea has been rising at a compound annual growth rate ("CAGR") of nearly 12% since 2000, supported by strong demand for Ceylon tea that has resulted in robust prices. However, earnings dipped in 2009 following drought conditions that had affected supply in the first quarter of the year.

Chart 4: Tea sector's export performance



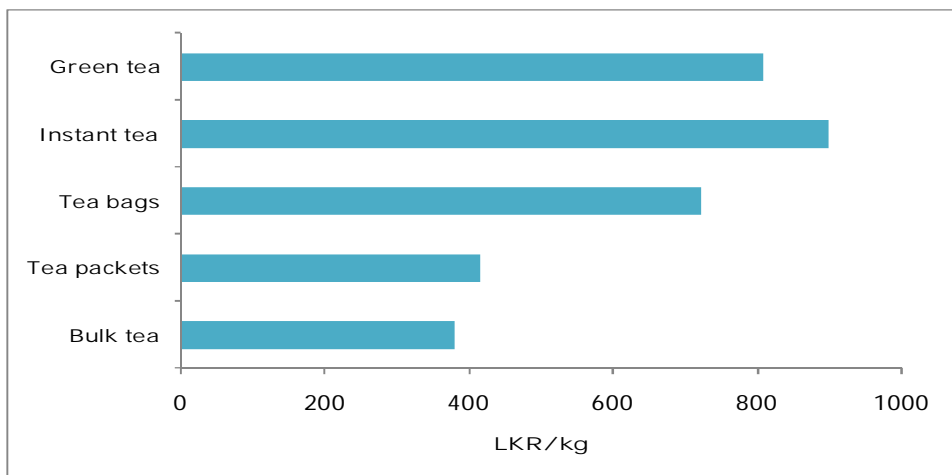
Source: Central Bank of Sri Lanka

Historically, Sri Lanka's main export destination for tea had been Europe, including the UK. Given the increased use of tea bags there, however, Sri Lankan bulk tea exports have now tilted towards the Middle East. As such, this is currently the

largest export destination, accounting for nearly 47% of Sri Lanka's tea exports in 2009 - mainly Iran, Syria and the United Arab Emirates. Meanwhile, the largest individual importer of Sri Lankan tea is Russia, which took up almost 15% of such exports last year.

With regard to export categories, Sri Lanka has always focused on bulk tea. Although there has been a shift in European demand to value-added tea, Sri Lankan exports are still dominated by bulk sales, which constitute over 50% of its total exports. Meanwhile, we note that value-added forms of tea enjoy close to 250% price premiums compared to bulk tea, thereby commanding much broader profit margins (refer to Chart 5).

Chart 5: Prices of various forms of tea exports



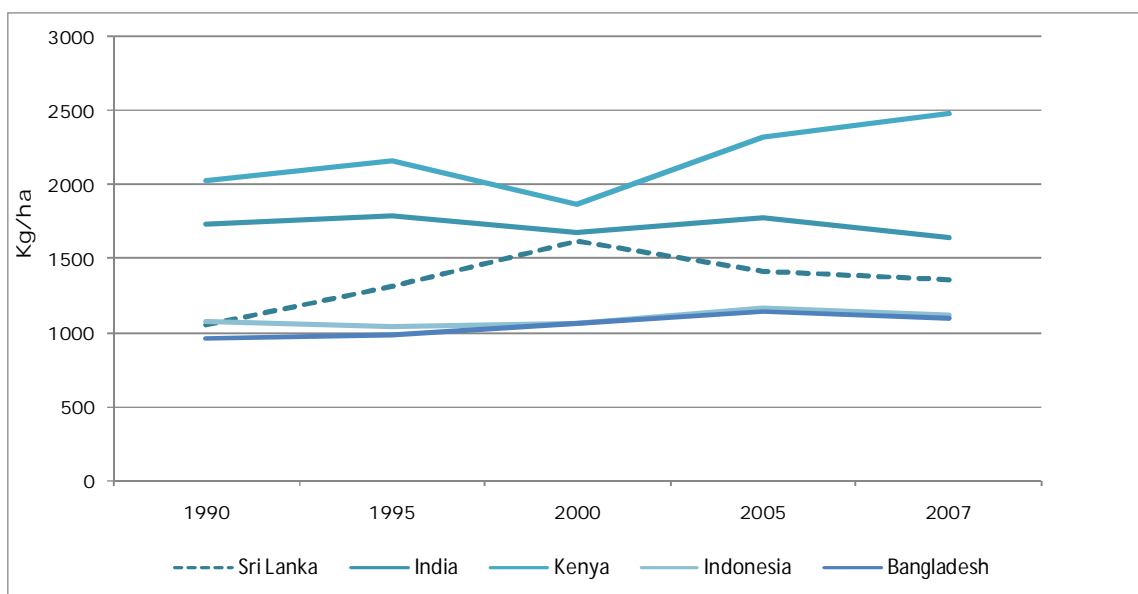
Source: Sri Lanka Tea Board

Issues and Challenges in the Tea Industry

- *Comparatively low yields*

Globally, tea-producing countries have been recording variable yields. We note that yields usually depend on a range of factors, including weather conditions, labour productivity, the fertility and topography of the land, the quality of seedlings, and technology. It is evident that Sri Lankan yields have been lower than those of competing countries (refer to Chart 6). Whereas Kenya enjoys average yields of over 2,000 kg/ha and India records close to 1,800 kg/ha, Sri Lanka's yield has remained low at around 1,400 kg/ha. As indicated by Chart 6, yields in Sri Lanka have been declining in the last few years. On a related note, it is clear that the yields of smallholdings are higher than those of regional plantation companies ("RPCs") owing to better labour productivity.

Chart 6: Yield comparison



Source: Sri Lanka Tea Board

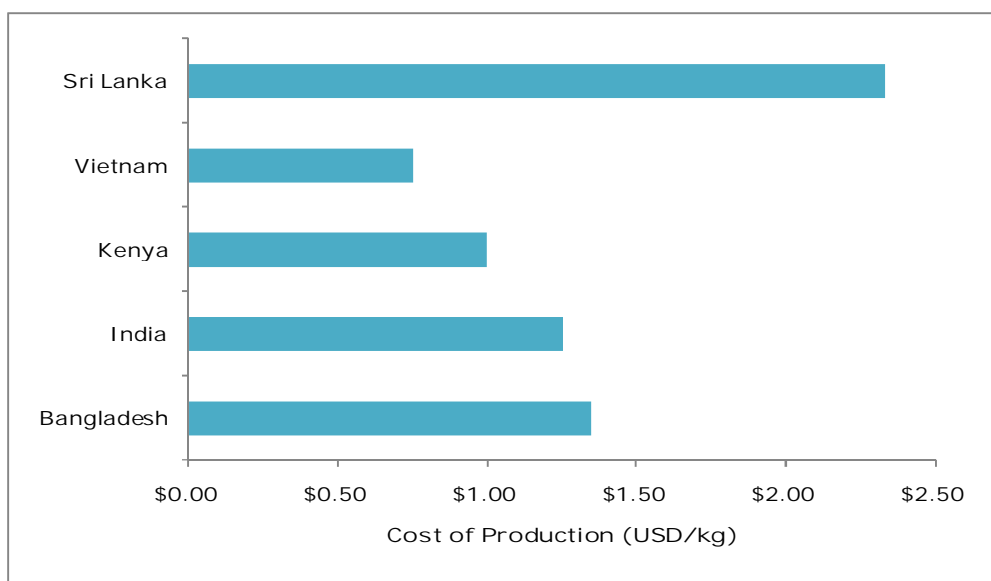
There are several reasons for the low-yield scenario; factors that have influenced labour productivity include chronic absenteeism and lack of workforce continuity. Aspirations for a higher standard of living, coupled with low levels of social recognition for plantation workers, have encouraged younger generations from such families to seek employment elsewhere.

On a separate note, low incidences of replanting and in-filling have also crimped yields in Sri Lanka. Replanting involves uprooting old bushes, rehabilitating soil, planting and maintenance until maturity. According to the Sri Lanka Tea Board ("SLTB"), a replanting rate of nearly 3% is essential to obtain a sustainable improvement in yields. Currently, replanting stands at only 0.5%; the rate has been relatively low due to the hefty capital outlay associated with the exercise. That said, the Ministry of Plantation Industries recently announced its intention of making it mandatory to achieve a certain level of replanting and infilling; the government has also indicated that provisions of concessionary loans will be considered to finance the replanting schemes. These developments are viewed positively. Meanwhile, it is evident that over 50% of the tea plantations in Sri Lanka are over 100 years old, thereby rendering the land less productive; the economic age of a tea bush is on average estimated at 100 years. The use of low-yielding seeds and inadequate fertilising have also contributed to sub-par yields.

- *High cost of production*

On average, the cost of production ("COP") for Sri Lanka's tea sector approximates USD 2.33/kg - among the highest in the world (refer to Chart 7). This has affected the country's competitive position in the global arena. The primary determinants of COP in the tea sector include labour productivity. In this regard, it is clear that the wage bills of most estates are inflated, mainly in view of the low productivity levels of their labour force. For instance, wages make up approximately 60% of the COP in Sri Lanka while they only come up to 40%-50% in India and Kenya.

Chart 7: Comparison of production costs

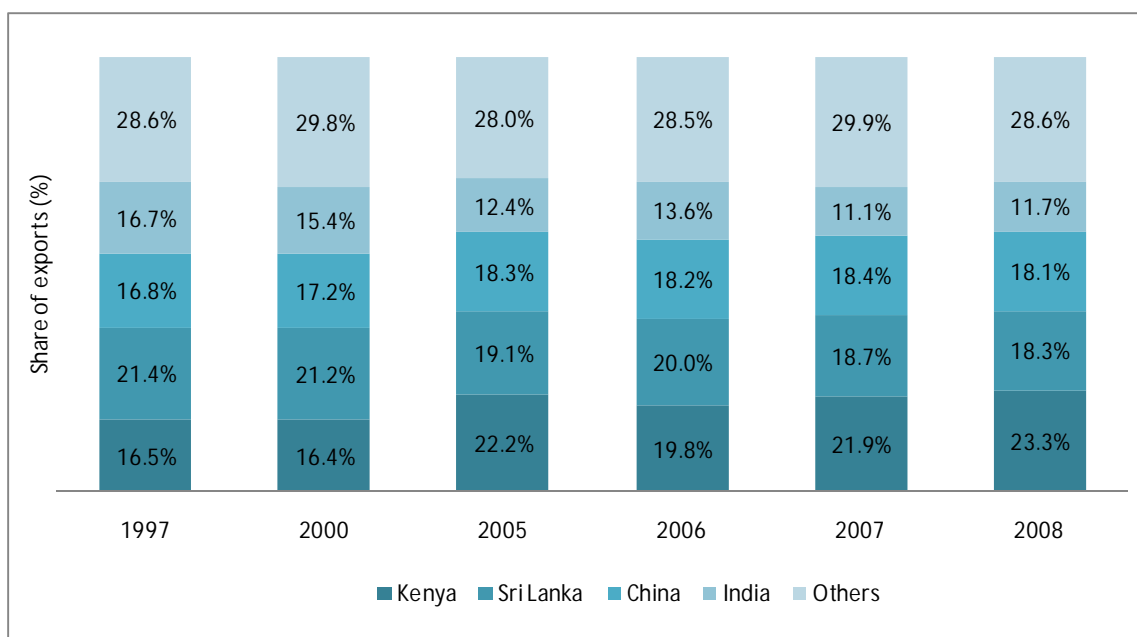


The wages of the country's plantation industry are determined every 2 years, through a collective agreement between the sector's trade unions and the Employers Federation Council (or EFC), which represents the plantation companies. Given the power wielded by the trade unions, minimum wage rates have increased significantly over the last decade, exerting a heavy impact on total COP. The minimum wage for plantation workers has been elevated from just LKR60 in 1992 to the present LKR405. Moreover, energy costs have also risen at a CAGR of approximately 11% over the last decade, accounting for almost 13% of the tea sector's total COP.

- *Declining competitiveness*

Despite the superior quality of its tea, Sri Lanka's competitiveness in the global arena has been slipping in the last few years; this has been largely due to heightened competitive pressures and the country's continued focus on bulk tea. Once the largest tea exporter, Sri Lanka has now relinquished its position to Kenya and is closely followed by China (refer to Chart 8). Kenyan tea production has expanded robustly, driven by the expansion of its cultivated land (from 120,400 ha in 2000 to 157,700 ha in 2008) and better production skills. However, it should be noted that Kenya primarily competes against Sri Lankan high-grown varieties; competition in the low-grown segment stems from India and Vietnam.

Chart 8: Share of global tea exports



Source: Sri Lanka Tea Board

Changing global demand patterns have threatened Sri Lanka's competitive position because of its continued focus on orthodox tea, which is manufactured via the traditional method of gradually rolling the leaves into smaller particles. In this regard, the country has failed to exploit opportunities such as rising demand for value-added tea. For instance, as European markets have been turning to tea bags, Sri Lanka has gradually lost its footing in Europe to CTC producers such as Kenya. This is primarily due to the financial constraints of most plantation companies, as production of value-added tea would require substantial capital outlay. Similarly, Sri Lanka's high COP has also affected its competitive position. In this regard, Egypt and Pakistan – traditional importers of Sri Lankan tea - have already switched to cheaper exporters such as Vietnam.

- *Inability to engage in multi-origin blending*

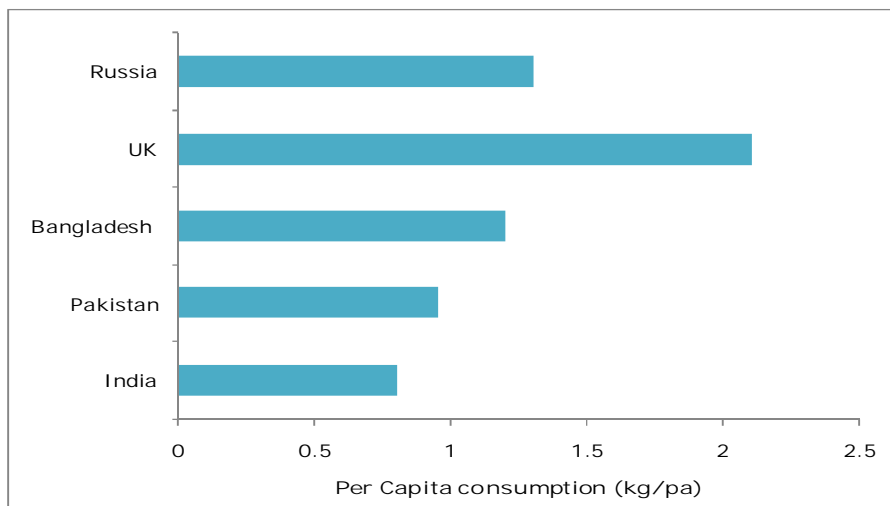
In recent times, there has been much controversy over Sri Lanka's import restrictions on tea. The current regulations only allow imports of specialist tea such as green tea; these restrictions have prevented the country from developing as an international tea hub due to its inability to undertake multi-origin blending. Tea exporters are now lobbying for the relaxation of these import restrictions, as multi-origin blending and the re-exporting of such value-added tea would be significant generators of foreign exchange. On the other hand, certain industry experts argue that permitting free imports of tea would reduce demand for Ceylon tea, thereby threatening the livelihood of the parties involved. These experts argue that the focus should be on promoting Ceylon tea as a brand in its own right, rather than relying on major international tea brands. In this regard, we believe that it is crucial to formulate a cohesive strategy that will allow a certain level of liberalisation vis-a-vis imports, rather than permitting the import of all types of tea, in order to minimise its impact on the domestic industry. We note that major brands have already exited the country in search of additional value; the potential in this sphere has been exploited by countries such as Dubai, Russia and the Ukraine.

Performance Drivers

- *Strong buying interest from Russia and the Middle East*

Russia is the world's largest tea importer; it is also Sri Lanka's largest individual buyer of tea, accounting for nearly 16% of the latter's export volumes in 2009. Russia's per capita consumption of tea ranks among the highest in the world (refer to Chart 9). The use of bulk tea in that country has been growing at a healthy pace in recent years, underscored by higher import tariffs on packaged tea as opposed to bulk tea. Consequently, most major global players have established operations in the region. Prospectively, the Food and Agriculture Organisation ("FAO") projects tea imports into Russia to increase 3% annually; Sri Lanka is well poised to benefit from this growth. Meanwhile, the Middle East is Sri Lanka's largest export destination as a region; demand has been expanding robustly on the back of strong oil prices.

Chart 9: Per capita consumption of tea (2007)

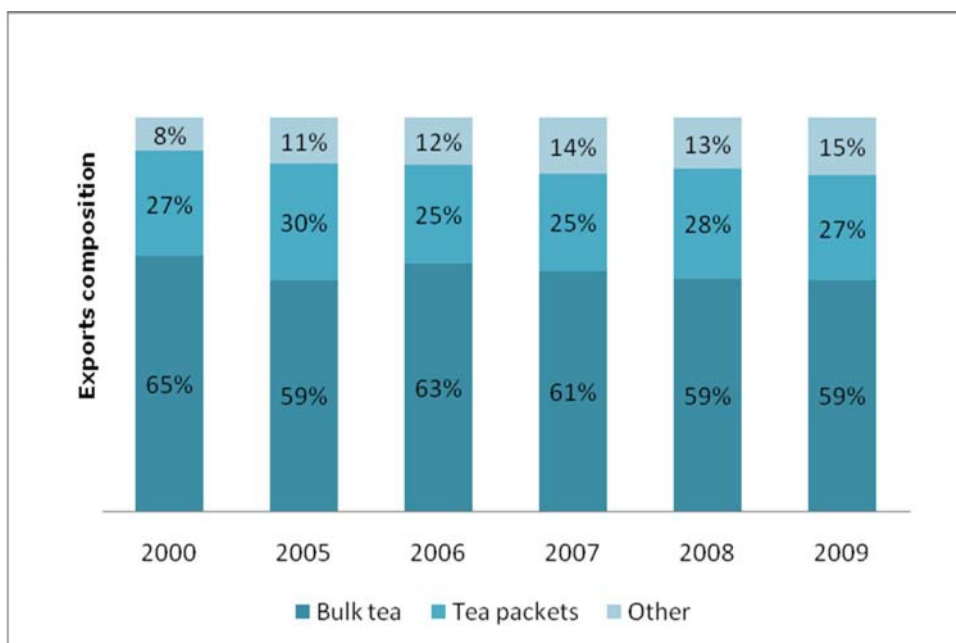


Source: Aginsky Consulting Group

- *Changing consumption patterns*

As mentioned earlier, Sri Lanka has remained focused on orthodox tea, which accounted for almost 95% of its tea production in 2010; the remainder comprised CTC tea, which is used to fill tea bags. Moreover, Sri Lanka has principally been an exporter of bulk tea (refer to Chart 10). However, there has been a gradual shift in consumption patterns, with several countries switching to the use of more convenient forms of the beverage, such as tea bags. For instance, demand from the UK has changed from bulk tea to tea bags, thereby enabling Kenya (which mainly produces CTC tea that is suitable for bagging) to capitalise on this. As such, shifts in consumption patterns may become a threat to Sri Lanka if the country continues to focus on bulk tea.

Chart 10: Sri Lanka exports - by category



Source: Sri Lanka Tea Board

- *Supply-side factors*

As highlighted before, the COP for Sri Lankan tea is rather high while yields are lower than those of its competitors. This is chiefly due to inadequate investment in field development, such as re-planting and in-filling efforts, as well as lower levels of labour productivity. Overall, regional plantation companies and smallholders are challenged by financial constraints as they do not have access to viable funding options. Given the intensifying competition in the global arena, the inability to reduce costs and improve yields may cause Sri Lanka to lose out to its more cost-efficient competitors.

Outlook on the Tea Industry

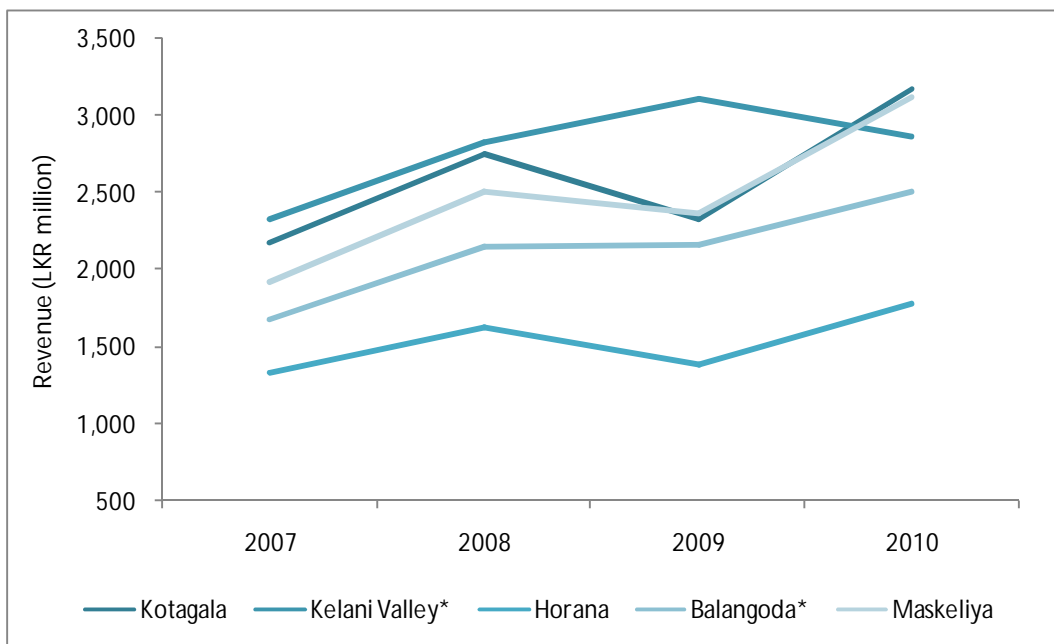
The FAO projects world production of black tea to increase by around 1.7% per annum until 2014, supported by healthier yields. Growth is primarily expected to emanate from the African region, underpinned by tea bushes reaching optimum production age and the maximisation of smallholders' skills. As such, Kenya's production is estimated to expand 2.4% whereas Sri Lanka's growth is anticipated to reach 1.9% per annum. Meanwhile, consumption is expected to be driven by imports into the CIS region, along with domestic consumption in China and India. All in all, the FAO predicts that the fundamental oversupply in the world market is likely to remain while prices are likely to remain depressed.

Performance of tea-sector operators

Sri Lanka's tea cultivation can be primarily classified as smallholdings (less than 20 acres/8.09 hectares) and estates (above 20 acres). Although smallholdings accounted for roughly 59% of the total land area in 2008, they contributed almost 70% of the country's total production. This can be primarily attributed to better productivity levels in smallholdings, as reflected by their higher yields. The estate/formal sector is represented by 23 regional RPCs, which make up the remaining 30% of overall production. Hence it is evident that the industry is largely fragmented.

Plantation operators are inherently exposed to a multitude of risks due to the very nature of the industry. On the supply side, the companies' performances are vulnerable to cost pressures, particularly wages, rising energy costs and varying fertiliser prices, which are beyond their control. Moreover, demand conditions are broadly linked to global economic fundamentals. In light of this, most plantation companies are susceptible to volatile revenue performance (refer to Chart 11).

Chart 11: Trends in plantation industry's revenue

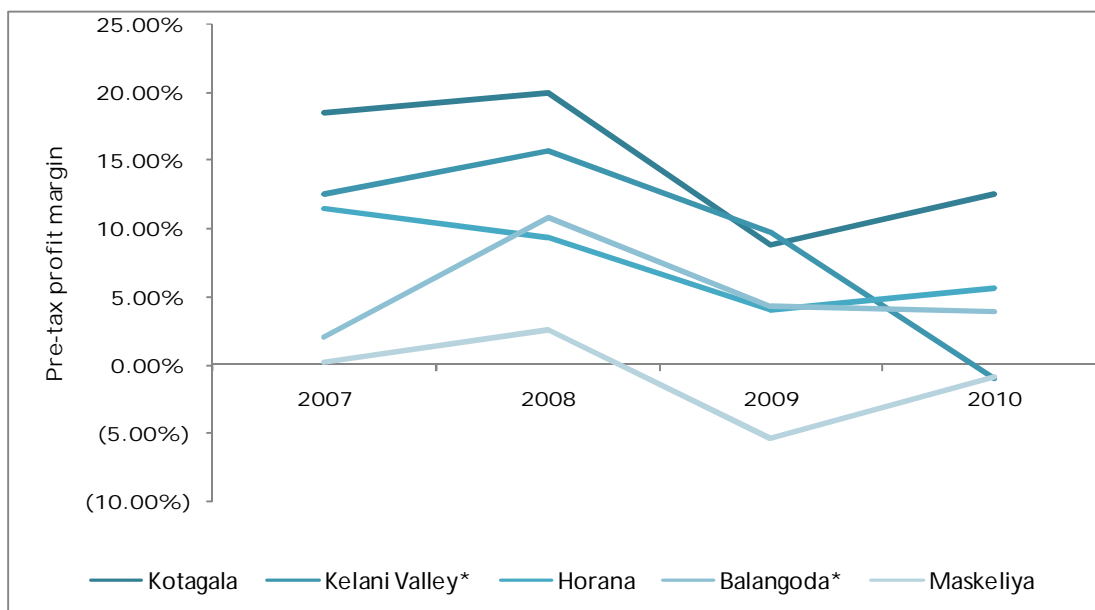


Source: Company annual reports

* Financial year-end = 31 December

Meanwhile, profit margins are variable across the industry, primarily due to diverse crop mixes, differences in production yields and varying cost structures (refer to Chart 12). In this regard, industry players with a well-diversified crop mix have generally displayed some level of resilience against economic vagaries. All said, investments in labour and field productivity are crucial in order to demonstrate a sustainable improvement in performance; however, the ability of plantation sector operators to engage in such measures is hampered by financial constraints. High gearing levels and the resultant hefty debt-servicing obligations have hampered the profitability of several plantation companies, rendering it difficult for them to access funding. Going forward, we believe that tapping the equity market would be a viable option given the current buoyancy of the local bourse.

Chart 12: Trends in plantation sector's profitability



Source: Company annual reports
 *Financial year-end = 31 December

Table 1: Crop mix – latest available data

Regional Plantation Company	Tea	Rubber	Other
Kotagala	71%	29%	
Kelani Valley	72%	28%	1%
Balangoda	87%	13%	
Horana	76%	24%	
Maskeliya	100%		

Source: Company annual reports

Conclusion

Although still regarded as a producer of superior-quality tea, Sri Lanka is gradually losing its footing in the global tea industry. Intense competition from rivals has adversely affected the nation's competitive position; this has been exacerbated by the higher production costs of Sri Lankan tea and poor yields. Meanwhile, the country's continued focus on orthodox tea as opposed to value-added tea could further erode its market share amid global consumers' rapidly changing preferences.

Under the circumstances, a cohesive policy to promote the production of value-added tea through multi-origin blending is required. In this regard, partial liberalisation of imports should be considered while protecting the domestic industry. Concurrently, lifting yields via adequate investments in re-planting, in-filling and fertilising as well as the use of high-yielding seeds are necessary to optimise local productivity levels.

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RAM Ratings (Lanka) Ltd
No. 9, Arthur's Place
Colombo 4
Sri Lanka
Tel: +94 112 553089 Fax: +94 112 553090
E-mail: ram@ram.com.lk Website: www.ram.com.lk

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