ICRA LANKA

Insights

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Sri Lanka plantations at a fork in the road, thrive or survive?

Key Takeaways

- Plantation sector has been facing headwinds in the past few decades. Declining production levels, shrinking market share, and meagre profitability pose a major threat to the long-term viability of the industry.

- Poor performance of the industry with respect to its peers is a culmination of intricately intertwined set of problems. Low yielding crops, labor issues, government policy changes, price volatility, and vagaries of weather are among the top problems to the industry.

- When it comes to profitability, the industry is characterized by volatile revenue growth and high degree of variability in profitability. Only a handful of RPCs managed to remain highly profitable while at least 25% of the companies were consistently making losses in the last decade. From CY2015 to CY2020, with the exception of CY2017, around 50% of the RPCs were making losses.

- Majority of the RPCs neither produce sufficient internal generation nor receive adequate capital infusions from the parent companies to finance these investments and as it stands, due to relatively moderate leverage among many RPCs, borrowing is also not a viable long-term option.

Introduction

Plantation industry is one of the oldest industries in Sri Lanka and plays a pivotal role in bringing foreign exchange earnings to the country. Once a flourishing industry, is now facing a decisive period ahead regarding its long-term viability as it demands a great deal of capital expenditure in the next five to ten years. In this report we assessed the ability of the Regional Plantation Companies (RPCs) to finance these expenditures via (1) internal generation, (2) capital infusion, or (3) borrowing. Our findings indicate that majority of the RPCs neither produce sufficient internal generation nor receive adequate capital infusions from the parent companies to finance these investments and as it stands, due to relatively moderate leverage among many RPCs, borrowing is also not a viable long-term option.

Assessment of the long-term viability

Plantation sector has been facing headwinds in the past few decades. Declining production levels, shrinking market share, and meagre profitability pose a major threat to the long-term viability of the industry.

Figure 1: Tea production of main tea producing countries ('000 tonnes)

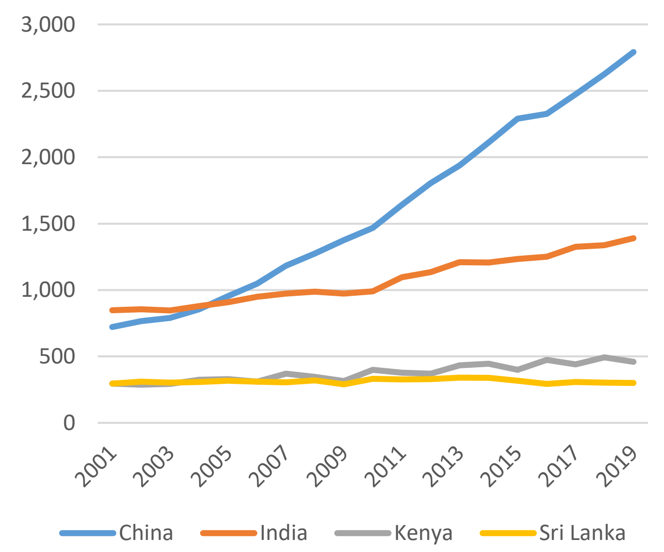
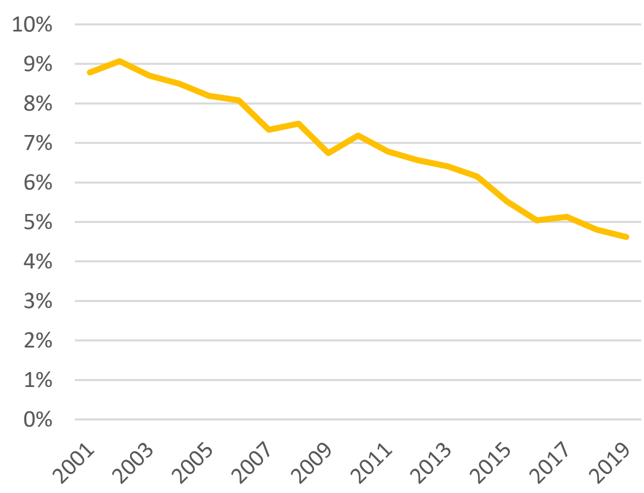


Figure 2: Sri Lanka's world market share of tea (by volume)

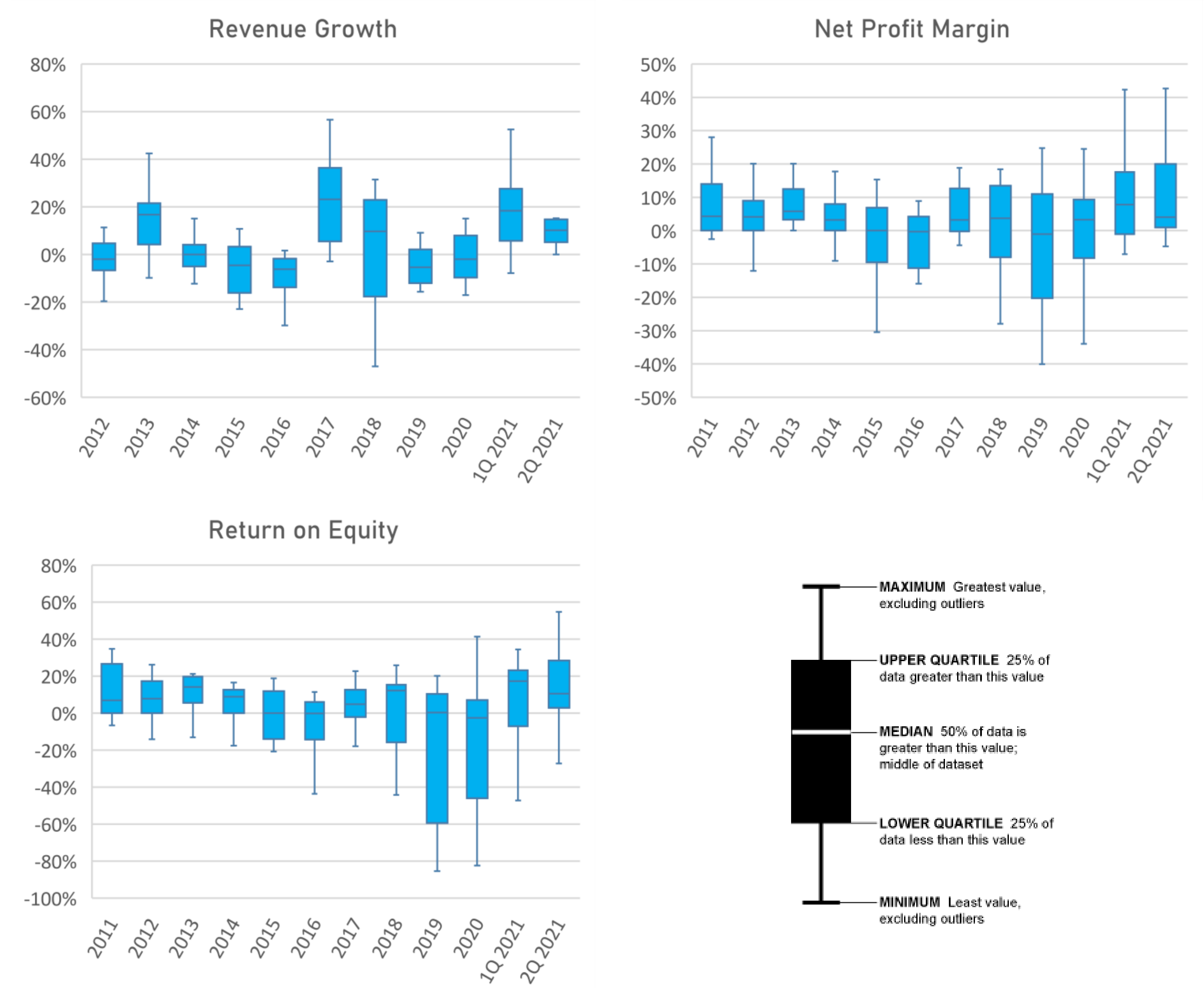


Source: FAO Statistics

In the past two decades, tea production by Sri Lanka's main competitors; China, India and Kenya, grew roughly at around 8%, 3% and 2% respectively on CAGR basis while the same for Sri Lanka remained more-or-less flat. In fact, Sri Lanka's total tea production slumped in 2020 for third consecutive year since 2017.

Sri Lanka ranks fourth on the tea production in terms of the volume. The nation's global market share continues to fall amid stiff competition among the major tea producing countries. In the decade starting from 1960, before the industry was nationalized, Sri Lanka held a market share of over 20% which has now declined to an alarming 5% [1].

Figure 3: Profitability indicators of the listed RPCs



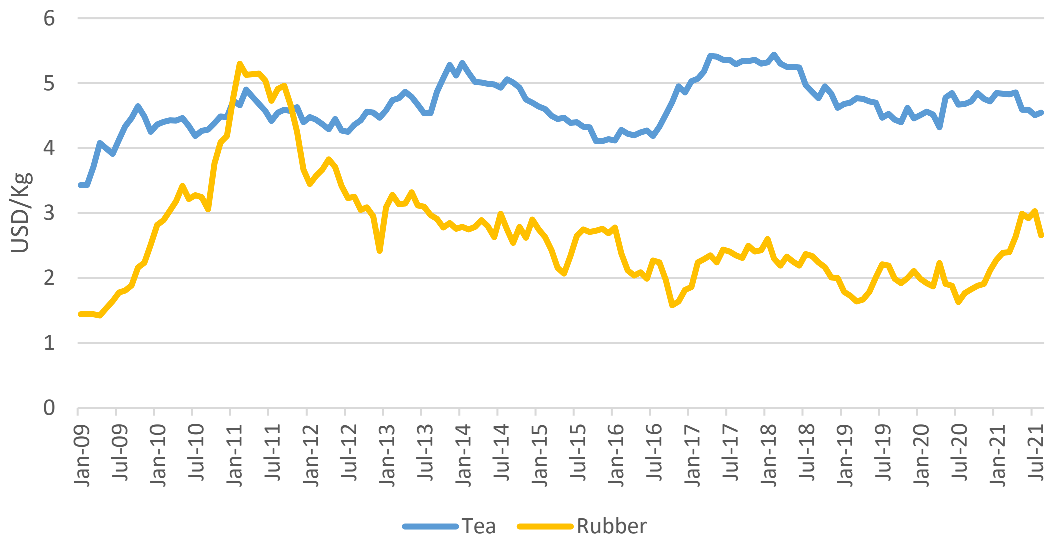
Notes: calendar year performance, group level figures, above charts are without the outlier figures

Sources: RPC annual reports, ICRA Lanka Research

When it comes to profitability, the industry is characterized by volatile revenue growth and high degree of variability in profitability. Only a handful of RPCs managed to remain highly profitable while at least 25% of the companies were consistently making losses in the last decade. From CY2015 to CY2020, with the exception of CY2017, around 50% of the RPCs were making losses. Losses in CY2019 and CY2020 were substantial as seen from the augmented negative ROEs (as high as 80% among some RPCs). An overarching trend that can be observed within the industry is that median net profit margin for the last decade was around 3-to-4 percent for most years. However, profitability saw a notable increase in 2021CY as rising global demand for tea together with supply disruptions from countries like India and China caused prices of tea and rubber to peak.

Untangling the issue

Figure 4: Price of tea and rubber



Source: CBSL

Poor performance of the industry with respect to its peers is a culmination of intricately intertwined set of problems. A closer examination allows one to narrow this down to five broad issues. Firstly, prices of tea and rubber, two key crops of the RPCs, are highly volatile, being commodities. Secondly, crop yields are sensitive to vagaries of weather and climatic conditions and adverse weather conditions could lead to revenue losses. Third, lower crop yields generated due to failure to invest in replanting as there is a dominance of older tea bushes[1]. Fourth is the scarcity of labour which has a substantial impact on the productivity[2]. Fifth is haphazard policy changes by the government, often without any scientific basis, which has caused serious damage to the sector and the profitability of RPCs[3].

[1] Studies show that yield per hectare of Sri Lanka is less than 72% of the yield per hectare of India [3]. Generally, a healthy yield can be obtained from a tea bush up to 50-60 years, yet in Sri Lanka majority of the bushes are over 80-100 years old [4].

[2] A major portion of the estates function under severe labour scarcity (Labour availability less than 50% of the requirement) and up country, mid country and low country have reported labour declining rates of 3%, 5% and 4% respectively [5].

[3] The industry has been a victim of changes of policies of the government from 1960s ever since the government nationalized all the plantation companies. Some of the recent changes that affected the profitability of the RPCs are Glyphosate ban (2015), daily wage hike (2021), Oil Palm ban (2021). Some claim the most recent move by the government to ban chemical fertilizer may have caused tea yields to decline by over 40% [6]. However, the ban has now been relaxed by the government.

The way forward

In this context, some RPCs have adopted some strategies in an attempt to improve their profitability and long-term viability. Broadly these strategies can be recognized as replanting, factory upgrade, mechanization, and diversification.

Replanting refers to the process of replanting old plants with newer, vegetatively propagated, more weather resistant varieties. This would generate higher yields, thereby higher revenues.

Factory renovations and plant upgrades are also considered mandatory to ensure capacity expansions, quality improvements and increased efficiency. In addition, mechanization of field and factory operations to minimize dependency on labour will mitigate the risk of escalating cost of production.

Some RPCs have already embarked on diversification to curtail the risks associated with volatility in prices. The plantation companies are looking at expanding their product portfolio with relatively less labour-intensive crops that offer better price stability, such as Cinnamon, Pepper etc. RPCs are also taking measures to improve their non-core income generation and have incorporated leisure, tourism and renewable energy into the sector. Promoting eco, natural and tea tourism and the establishment of theme parks are some initiatives RPCs have taken thus far. Renewable energy, first adapted to promote low-impact operations and manage costs in the long run, is now being expanded and considered a potential income generating source as investments are being made especially in hydro and solar energy.

The above-mentioned strategies require consistent stream of annual investments by companies for next 5 to 10 years. For instance, it has been estimated that the cost of replanting alone would cost about LKR 1.5 Mn per hectare [2]. During the latest budget speech, the Minister of Finance made several remarks on the need to make these investments. However, it is not clear what sort of support the industry is going to receive from the government in this regard.

How can the RPCs finance these costs?

Three modes are available for RPCs to finance these investments; profits generated internally, capital infusion, or borrowing.

Figure 5: Aggregate internal generation against aggregate capital expenditure by the RPCs (LKR Mn)

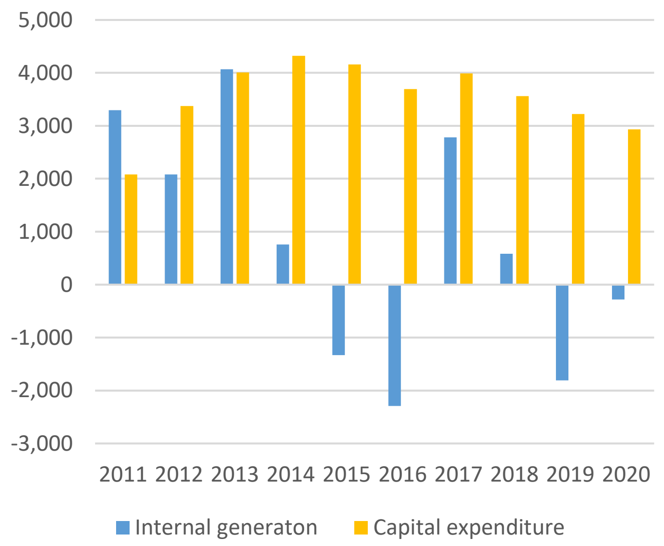
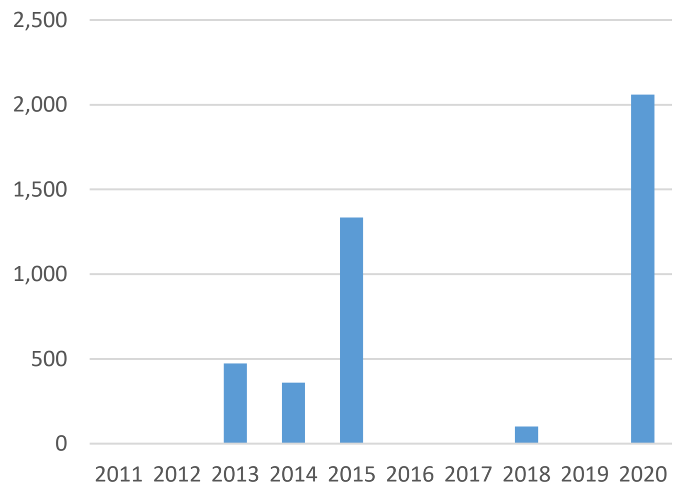


Figure 6: Aggregate capital infusion of the RPCs (LKR Mn)



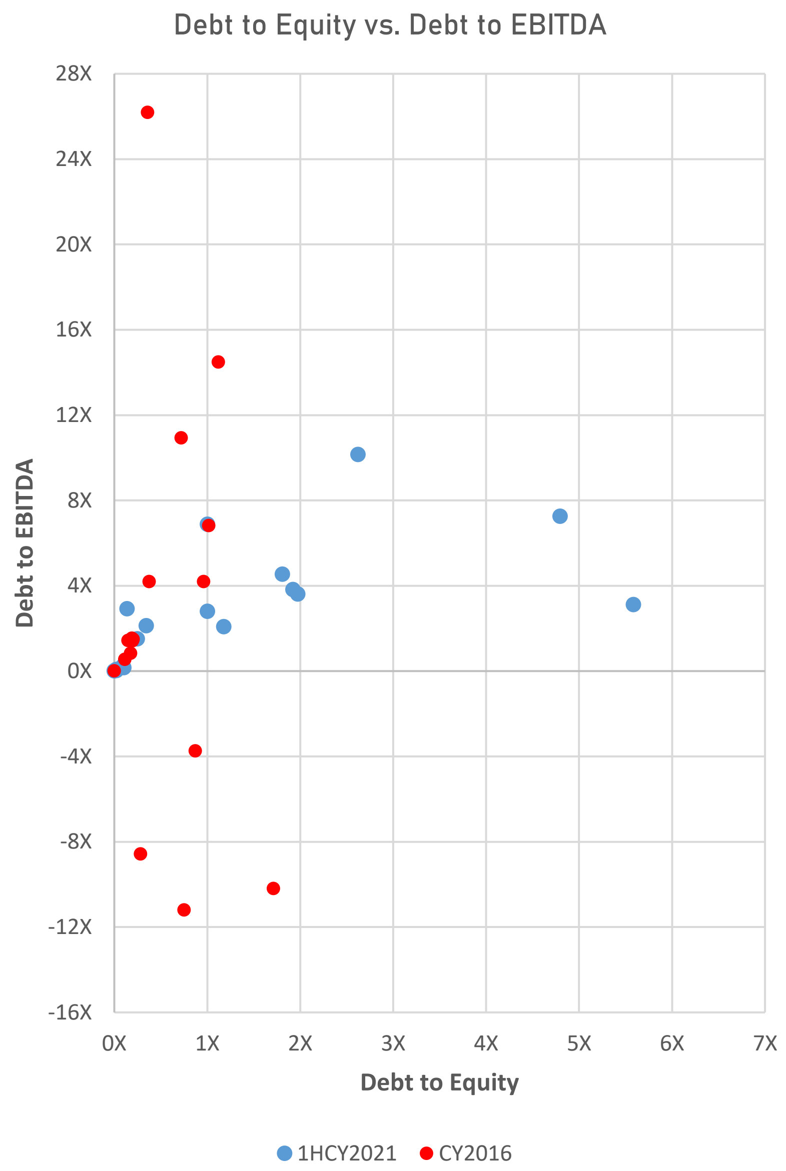
Notes: group level figures, capital infusion is change in stated capital

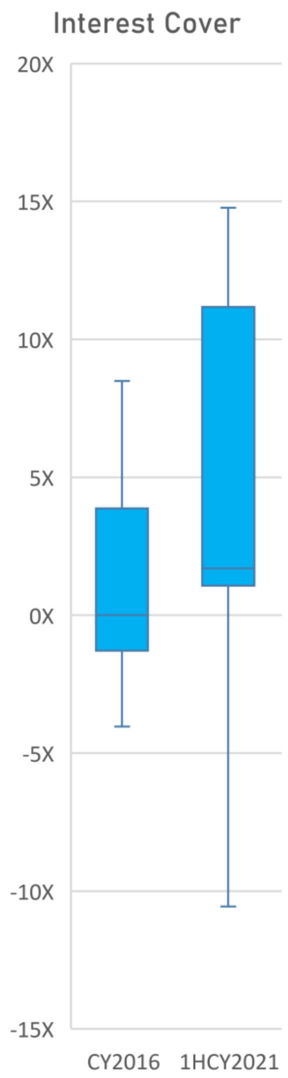
Sources: RPC annual reports, ICRA Lanka Research

In the last 10-year period, the industry's annual aggregate capital expenditure peaked to LKR 4.3 Bn in 2014 before gradually declining to about LKR 3 Bn by 2020. During this reference period, aggregate retained profits, except in two instances, have always remained below the capital expenditure indicating that the RPCs have funded the said investments through other means. Given the volatility in net profits and weaknesses in profitability among a large number of the RPCs, there is very limited ability for the RPCs to utilize internal generation to fund investments.

The aggregate annual capital infusion level is nil for most years and highly irregular over the past decade. In addition, the capital infusion among the RPCs remained highly asymmetric, meaning that only a smaller proportion of the RPCs in fact have received capital infusion from the respective parents to drive investments. Therefore, parent companies of the majority of the RPCs either do not possess or are unwilling to inject capital to their respective RPCs to fund capital expenditure.

Figure 7: Debt affordability among the listed RPCs





Notes: Each dot represents an individual RPC, group level figures, above charts are without the outlier figures

Sources: Company annual reports, ICRA Lanka Research

Borrowing is the third option available for RPCs to finance the capital investments. To assess the debt-affordability among the RPCs, we looked at how the relevant ratios have changed from the industry's worst year in terms of financial performance in the last decade (i.e., CY2016) to the latest figures (i.e.,1H CY2021). There is a clear shift from CY2016 to CY1H2021 indicating improved debt-affordability. The gearing levels have increased in CY2021 relative to CY2016 indicating greater access to debt financing with improved performance. More importantly, leverage (debt/EBITDA) also has improved significantly, even though three companies are on the higher side. However, the volatility of the earnings and cash-flows remain the bigger challenge in accessing debt, as it affects the consistent/stable debt servicing ability of the RPCs.

Conclusion

The sector faces price volatilities, vagaries of weather, dwindling crop yields, labour shortages, and the challenge of arbitrary and inconsistent government policy changes often without any scientific basis. Facing up to these challenges are daunting. In addition, the long-term viability of the plantation industry hinges on the need to make investments in upgrading assets, acquiring technology, and changing business models. Required investments in this regard are substantial and have relatively a longer gestation period. Regrettably, as it stands, only few RPCs have the ability and the financial strength to commit to a credible plan to transition out from the current state of affairs.

Abbreviations

CAGR	Compound Annual Growth Rate
CBSL	Central Bank of Sri Lanka
EBITDA	Earnings before Interest, Taxes, Depreciation, and Amortisation
RPC	Regional Plantation Company

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