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Indian Bulk Tea Industry

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Rising cost pressure, inadequate increase in realisations to negatively impact profitability of bulk tea players in FY2019



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CONTENTS

1. Executive Summary	03
2. Outlook	07
3. Industry Trends	10
Tea Production Trends	11
Tea Exports Trends	15
Tea Prices Trends	18
4. Trend in Aggregate Performance	22
5. Peer Comparison	25
6. ICRA Ratings On Bulk Tea Industry	27
7. Annexures	30
8. Company Section	33
McLeod Russel India Limited	34
Goodricke Group Limited	37
Rossell India Limited	40
Jayshree Tea & Industries Limited	43
Warren Tea Limited	46
Harrisons Malayalam Limited	49
Dhunseri Tea & Industries Limited	52



Executive Summary

HIGHLIGHTS



- Aggregate tea production across major tea-growing nations witnessed a marginal increase during CY2018, on the back of significant increase in Kenyan production, while Indian and Sri Lankan production remained marginally low.
- There was pressure on prices at the Kenyan and Sri Lankan auction centres during CY2018; Modest increase in domestic auction average during CY2018 was driven largely by firming up of plain category of teas. As per ICRA estimates, for the full fiscal FY2019, the overall NI auction prices are likely to be around Rs 9/kg higher over the previous fiscal.
- In CY2018 Indian export volumes remained largely stagnant while export realisations in US\$ terms were muted on the back of higher volumes from Kenya; however, clarity on export to Iran is likely to support volume and realisation, going forward.
- The operating margins of bulk tea players have already witnessed pressures over the last few years on account of increased cost pressures, with the increase in realisations, not adequately compensating for the increase in wage costs. In the current financial year (FY2019), the significant increase in cash wages for both Assam and West Bengal tea estate workers is likely to further dent the operating margins of the organised tea players. ICRA expects around 300bps contraction in operating profitability during FY2019.

OVERVIEW

Profit margins for bulk tea players are set to be negatively impacted during FY2019, particularly for the North Indian (NI) producers, driven mainly by a modest increase in realisation, not adequately compensating for the significant increase in labour expenses, post announcement of the interim wage rate hike in July 2018. ICRA notes that the initial uptrend in NI auction prices, was not maintained during the months of August to November 2018, thus hampering the overall auction price trend for the current fiscal. While, after the decline in NI production by around 20mkg in December 2018, coupled with improved performance of orthodox teas, the NI auction prices firmed up in recent months, the impact of such a movement on cumulative average prices for the entire FY2019 is going to be limited. This is owing to lower volumes in Q4 and ICRA estimates the overall NI auction prices to be around Rs 9/kg higher over the previous fiscal. However, this increase in prices is not expected across all the categories of tea – while the prices of plainer category of teas, at the lower end of the market, is expected to increase considerably, the medium-to-good category teas, at the middle level of the market, are expected to witness only a marginal increase. Such a trend is already visible - the auction prices of Assam teas, considered to be of high quality, witnessed an increase of only Rs 2.8/kg during 10M FY2019, whereas the average auction prices of teas produced in the Dooars and Terai regions are up by ~ Rs. 11/Kg. South Indian tea prices, which started off at a significant discount to previous year's prices, recovered to almost previous year levels of Rs. 101/kg during CY2018 on a cumulative basis. ICRA further notes that the Kenyan production, after a significant crop increase in CY2018, was further up in the month of January 2019. Thus, the supply-side dynamics in the international market in the current year, would remain crucial in determining the trajectory of international auction prices, which is likely to have a bearing on the domestic auction prices.

Global tea availability increased during CY2018 on the back of increased crop in Kenya, despite India, Sri Lanka recording a marginal deficit in production

India is the single largest producer of black tea in the world, accounting for around 43% of the total black tea production globally, followed by Kenya (16%) and Sri Lanka (10%). Over the past few years, however, Indian tea production has remained relatively stable, leading to movements in global tea production being primarily driven by variations in Kenyan and Sri Lankan crop levels. During CY2018, the aggregate tea production from the three countries, increased by 37.5 mkg (YoY increase of around 1.8%) primarily on account of a 12% growth in Kenyan tea production. The Sri Lankan production, however, declined by around 2%, owing to unfavourable weather conditions. India recorded a nominal de-growth of 1% in crop levels during CY2018 to touch 1312 mkg, primarily driven by the decline in South Indian (SI) production, coupled with a ~20 mkg decline in North Indian (NI) crop level during December 2018 owing to early closure of the tea season. CY2019 has started on a positive note, with aggregate tea production increasing by 3%, primarily driven by the 19% increase in Kenyan production. India, however, recorded a 21% decline in production during the month. However, ICRA notes that domestic cropping trends in January are not indicative of the full-year pattern, since the full-year trend will primarily be determined by cropping levels in North India during the peak tea producing months of June to October.

In CY2018 Indian export volumes remained largely stagnant and realisations muted on the back of higher volumes from Kenya

India exports only around 20% of the black tea produced domestically. Nonetheless, exports play a vital role in maintaining the overall demand-supply balance in the domestic market. During CY2018, aggregate export volume from India remained largely stagnant at ~249mkg. While the NI export volumes (150 mkg during CY2018) declined by 5%, the SI export volumes increased by around 5% to reach 99 mkg for the year. The surplus in Kenyan production, tightening norms on pesticides by the US (comprising ~4% of total export volume) coupled with

uncertainties on exports to Iran, given the impending sanctions, which is a primary market for high quality orthodox teas, impacted North Indian tea exports in CY2018. However, subsequent clarity on exports to Iran, with India getting a conditional waiver from the US sanctions, along with the favourable payment mechanism, is expected to support Indian export volumes to Iran in the new tea season. The realisation of the orthodox variety of tea has already started moving up from December 2018. Cumulative Indian export realisations increased by 4.1% to Rs. 206/kg from Rs 198/kg in the previous calendar year. However, in dollar terms the export prices continued to remain muted, primarily owing to an increase in export volumes of 14% and lower realisation of Kenyan teas, India's main competitor for CTC teas in the international market. Sri Lankan export market performance was also impacted owing to considerable decline in realisation, primarily on account of lower demand from Iran, given the impending sanctions. Going forward, India's ability to maintain adequate export volumes at remunerative prices, despite fluctuations in global supply, would be critical to the overall financial performance of the domestic tea industry.

Modest increase in domestic auction average during CY2018 owing to poor performance of premium quality teas; prices at international auction centres also under pressure

Average auction prices (in US\$ terms) in the major centres of Kenya and Sri Lanka witnessed a YoY decline of 13% and 12% respectively, during CY2018. The significant increase in production negatively impacted auction prices in Kenya, which led to prices reaching a two-year low. Sri Lankan weekly auction prices also continued the downtrend witnessed over the past few months. All-India cumulative auction prices increased by only 4.1% on a YoY basis during CY2018, largely driven by a modest increase in North Indian prices. While the price improvement of teas produced in the Dooars/Terai (majorly medium/low quality) remained considerable (~Rs 11/kg), the poor performance of teas produced in Assam (comprising 60% of total NI auction volume), which increased by only Rs 2/kg, hampered the overall NI price trend during CY2018. Although recent weekly auction prices remained firm, with North Indian Assam prices up by ~Rs. 6/kg and Dooars prices up were by ~Rs. 9/kg during January 2019, the impact of such a movement on cumulative average prices for the entire FY2019 is going to be limited, given that the auction volume during Q4 comprises only 20% of the annual auction volume. As per ICRA estimates, for the full fiscal FY2019, the overall NI auction prices are likely to be around Rs 9/kg higher over the previous fiscal. South Indian tea prices, which started off at a significant discount to previous year's prices, recovered to almost previous year levels of Rs. 101/kg during CY2018 on a cumulative basis on account of the decline in SI production. Going forward, ICRA notes that the supply-side dynamics, particularly in Kenya and Sri Lanka, together with the currency movements, would remain crucial in determining the trajectory of international auction prices, which in turn would also influence domestic prices to an extent.

Profit margins and debt-coverage indicators for established bulk tea players likely to be adversely impacted during FY2019

During 9M FY2019, the financial profile of organised bulk tea players has weakened with operating margins contracting by over 300 bps, thus adversely impacting the debt-coverage indicators of the entities. ICRA had earlier highlighted that tea realisations would need to increase by more than 15% (around Rs. 20/kg) to offset the sharp increase in wage rates, ceteris paribus, in the current year, however, the North Indian auction realisation for 9M FY2019 has increased by only 4.4% (around Rs 7/kg), which adversely affected the margins of all the bulk tea companies, given that the production volume was almost flat during the aforementioned period. The operating margins of bulk tea players have already witnessed pressures over the last few years on account of increased cost pressures, with the increase in realisations not adequately compensating for the increase in wage costs. In the current financial year (FY2019), the significant increase in cash wages for both Assam and West Bengal tea estates workers is likely to further dent the operating margins of the organised tea players. ICRA expects around 300 bps contraction in operating profitability during FY2019.

ABOUT ICRA

ICRA Limited (formerly Investment Information and Credit Rating Agency of India Limited) was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

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