



Weekender

Your Think Tank for Investment Management

Jan 8th, 2007

Tea industry – Time to sip more!

India is the largest producer and consumer of tea in the world accounting for 28% of the global production of 3200 million kg (mkg) and 23% of the global consumption. It has retained its leadership position from past 150 years.

Major producing countries with their production figures and shares: FY2005

Countries	Production (mkg)	% to total	Exports (mkg)	% to total
World	3200	100	--	100
India	928	29%	192	12%
China	750	23.4%	286	18%
Sri Lanka	315	9.8%	299	19%
Kenya	325	10.2%	350	22%
Vietnam	100	3.1%	88	6%

Nature

Tea is a seasonal commodity and its production depends on the climatic conditions and varies from month to month. The North-Indian climate being more favorable for high quality tea, accounts for the major production (more than 77%) of tea in India. South-India, on the other hand, produces more amount of low quality tea.

Types of tea companies

Tea players can be broadly classified into three categories: planters, planters-cum-traders (i.e. integrated players) and non-integrated players

Planters are basically tea growers who primarily sell their produce at auctions and export tea.

Planters-cum-traders often called integrated players are tea growers who also have presence in the packaged tea segment. The Integrated tea players stand to gain compared to other types of tea players by insulating themselves from the fluctuations in auction prices. They are involved in plantation, manufacturing, processing, blending, marketing and sale of tea in the domestic retail or export markets.

Non-integrated players do not own any plantations and are not involved in estate operations but purchase tea at auctions and then blend, pack and market tea under their own brands.

Besides the above three types, there are two other types of entities: the Green Leaf Growers (GLG) and Bought Leaf Factories. The former undertakes plantation activities and sell green leaf to the latter and also to larger Tea Marketing Companies.

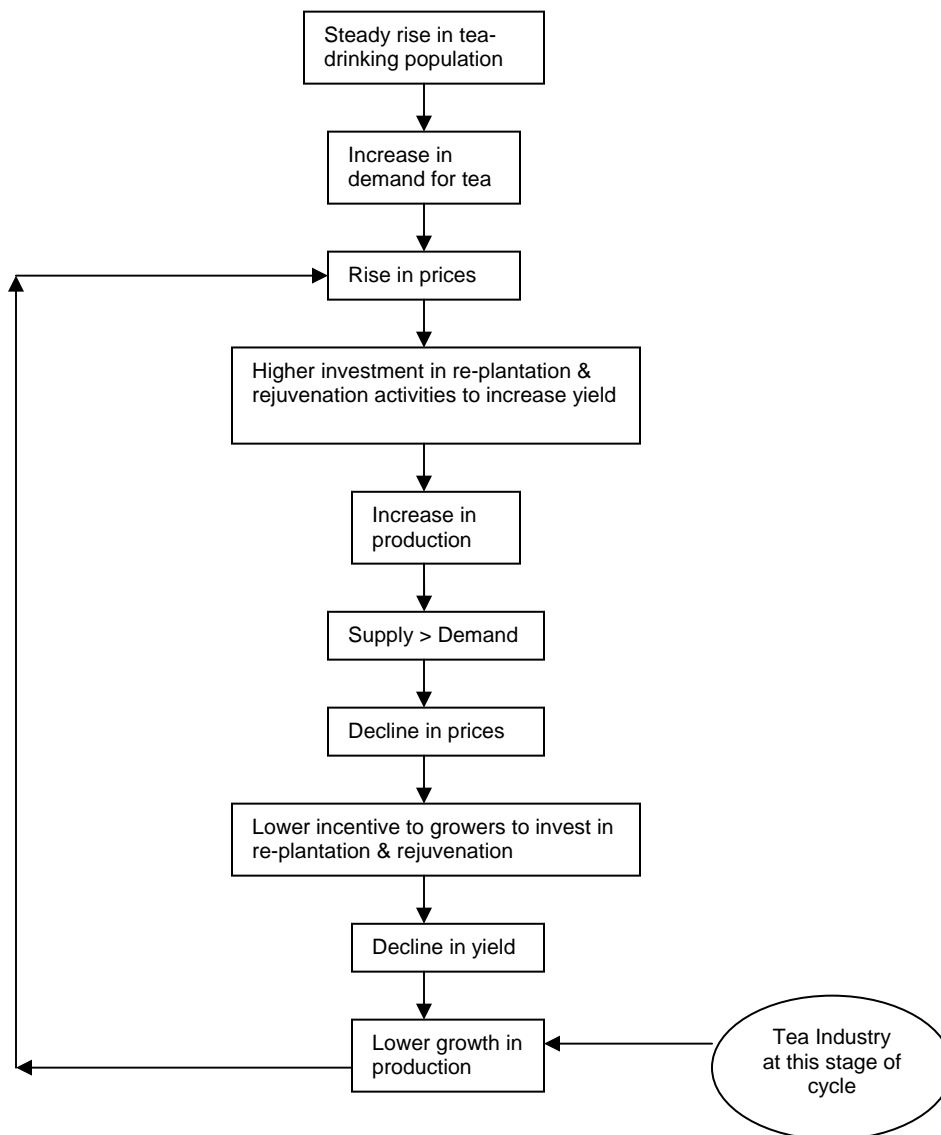
Tea season and cycle: Tea is produced throughout the year but June-October is peak



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season for North Indian teas and April-September for South Indian tea due to difference in climatic conditions. Production and yield of tea are dependent on climatic conditions, availability of land and yield of the crop, which in turn depends on the age profile of tea bushes. Productivity of tea bushes is the highest between 15 years and 35 years and starts declining after 50 years of its plantation. In order to retain its productivity, regular re-plantation and rejuvenation activities should be undertaken. Structural problems like low labour productivity, high labour cost, declining yields, and depressed prices have resulted in a slow down in the addition of area under tea plantation and also reduced the necessary investment in re-plantation and rejuvenation activities.

Tea industry thus follows a cyclical pattern of around 5-6 years. Cyclical nature of the industry is explained through the following flowchart:



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Demand-Supply Mismatch

Particulars	2002	2003	2004	2005E	2006P	2007P	2008P
Opening Stock	305	298	304	238	199	150	98
Production	883	907	870	920	930	945	960
Imports	22	9	23	13	13	20	35
Exports	201	174	198	185	180	180	174
Net exports	179	165	175	172	167	160	139
Domestic Consumption	711	736	761	787	812	837	862
Closing Stock	298	304	238	199	150	98	57

Source: CRIS INFAC P=Projected

As evident from the above chart, we are currently at the threshold of a widening demand – supply gap. A glut of production up to CY2001 resulted in mounting stock levels and hence a decline in prices. This slowed down the addition of hectareage under tea as well the replantation and rejuvenation activities resulting in an increase in the proportion of low-productive tea bushes, which in turn led to a decline in the yield. On the other hand, as per the statistics of Tea Board of India, domestic demand for tea has been growing at the rate of 20-25 mkg p.a., which is higher than the rate of growth in production (estimated to be in the range of 10-15 mkg). This would tighten the demand-supply situation.

Demand vs. Supply (in mn kg)

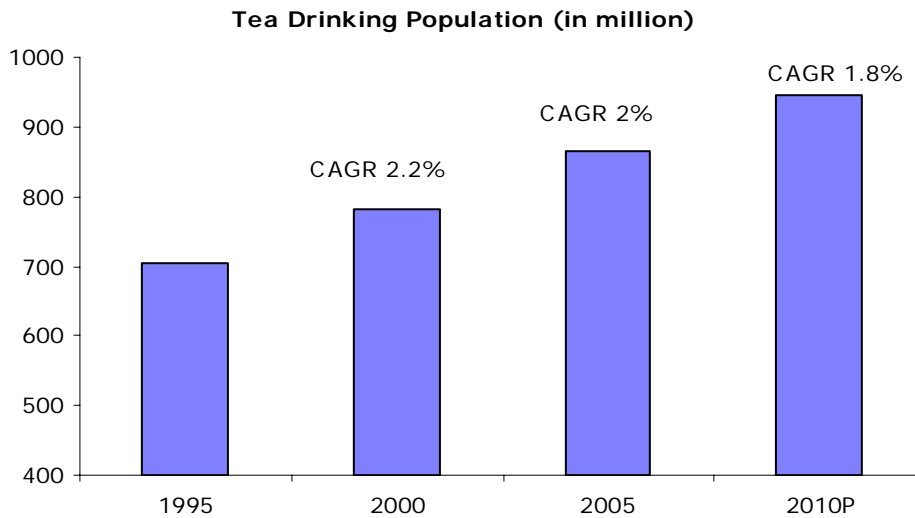


Source: CRIS INFAC P=Projected

Increase in tea-drinking population and per capital consumption of tea Demand for tea is derived from the growth in tea-drinking population and changes in per capita consumption of tea. As estimated, the tea-drinking population would increase at a CAGR of 1.8% between 2005 and 2010. Also, as per industry sources, the boom in the ITES (BPO services) in India, would add around four million people. This would further accelerate the demand for tea. Thus, the per capital consumption of tea is expected to rise at a CAGR of 1.3% during 2005-2010 period.

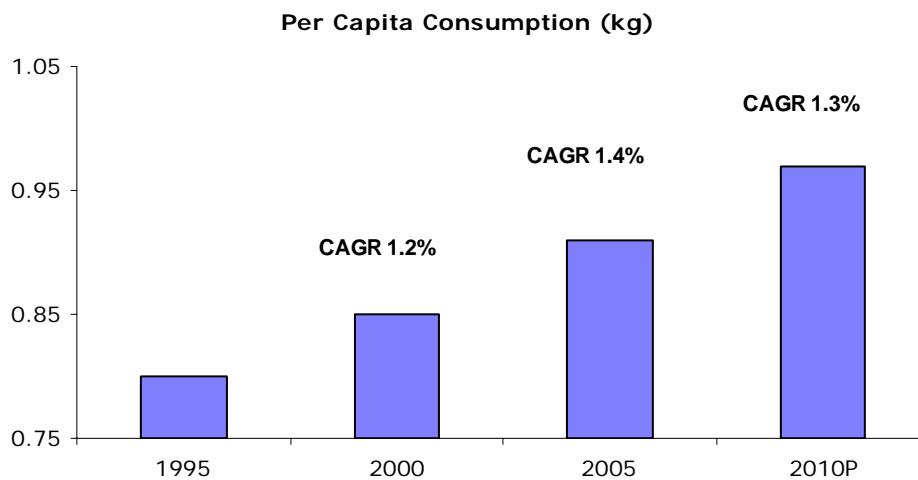


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Source: CRIS INFAC P=Projected

Taking into consideration the growth in tea drinking population and the 2005 level of per capita consumption of tea, demand for tea is expected to grow at a CAGR of 3.1% during 2006-2010.



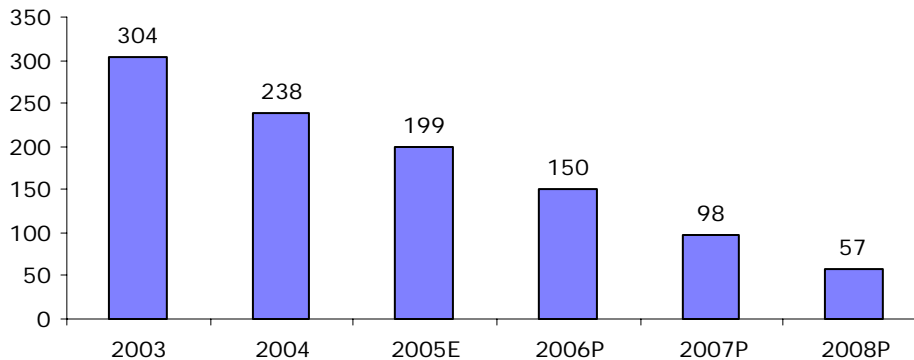
Source: CRIS INFAC P=Projected

Depleting Closing Stock Levels to push up prices

With a limited incremental growth in production and rising demand for consumption and exports, the domestic stock level is expected to decline sharply over next few years as evident from the following graph. Thus, the demand-supply mismatch leading to depleting stock levels would lead to an increase in the tea auction prices over the next few years. As per industry estimates the auction prices are expected to increase by 5-10% till 2008.

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Closing Stock of Tea (in mkg)



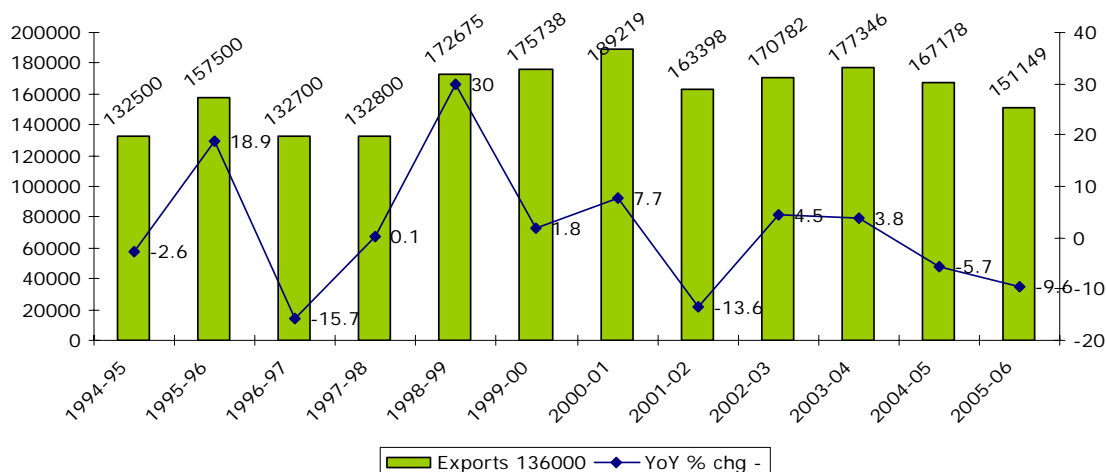
Source: CRIS INFAC P=Projected

Exports – Besides the domestic demand, increase in exports is also a major growth driver and would affect the future prospects of the Indian tea industry. Indian tea companies would benefit immensely from exports of Indian tea – packaged as well as loose – in the short as well as in the long run. As per industry estimates, the current drought situation in the major tea exporting country, Kenya, would decline its production by 16% or 50mn kg in the year 2006. Kenya majorly being a CTC exporter would provide India to grab Kenya's market share to a certain extent. For example, Pakistan a CTC consuming country, imports around 60% of its tea requirement from Kenya while only 4-5% from India. As per industry sources, tea exports to Pakistan have increased from 4mn kg in 2004 to 10mn kg in 2005 and is expected to touch 20mn kg in 2006. This, coupled with improving political relations between the two countries, geographical proximity and category of production, provides immense potential for Indian tea exporters. Besides Pakistan, the Tea Board of India is also eyeing Egypt, which is also a lucrative market for CTC tea. Long term prospects of the industry also looks promising due to the demand-supply mismatch as explained in the earlier paragraphs.

Trends in exports: Exports from India have grown at a 12-year CAGR of 0.88%. Decline in exports was due to increasing domestic demand.



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Bent towards branded products – Rising consumerism has resulted in consumers moving away from unbranded to branded products. The media too has played an important role in creating brand awareness, which has perked up growth of branded products. With globalization and growing popularity of high-quality Indian brands, the international consumers have also started to check out Indian brands. We believe branded tea players like HLL, Tata Tea commanding strong pricing power would also benefit from an upturn in the demand for branded and value-added teas.

Government/Tea authority Initiatives

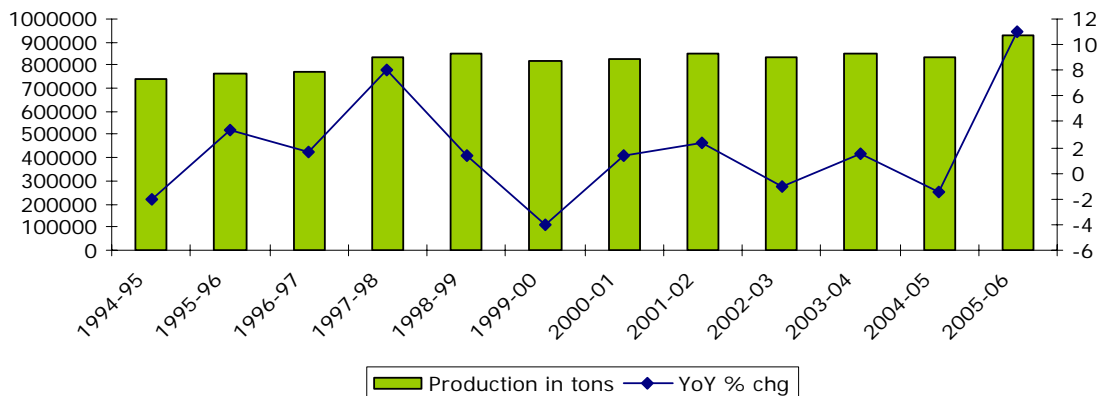
In order to improve the state of Indian tea industry, correct the demand-supply mismatch and to increase the production, Government of India is taking active steps to increase productivity of the existing tea bushes. It has announced Rs4700 crore Special Tea Fund in Budget 2006-07, which is aimed to encourage estates owners to carry out rejuvenation and re-plantation activities in the age-old tea gardens over a period of 15 years with government subsidy. The Special Tea Fund is formed with 30% government subsidy, 50% loans from lending institutions and 20% contribution by the tea-growing companies. This would bring in approx.2% of the eligible land been brought under the pruning activity every year. However, this is not expected to result in an immediate increase in the production.

Factors influencing tea prices

Short term	Middle term	Long term
Climatic conditions	Acreage in major producing nations	Demographic changes in major consuming nations
Economic downturn in any major consuming nation	Emergence of new producing nations like East African region	Changes in tea-drinker's preferences over time
	Yield and age of bushes	Emergence of other substitute beverages
	Re-plantation efforts undertaken by major producers	
	Orthodox to CTC Mix	

Source: CRIS INFAC

Trends in production: Domestic production has remained almost flat with 12-year CAGR of 1.78%

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Current (CY2006) tea scenario:

India - Cumulative tea production during Jan-Sept2006 has increased by 3.5% to 704.3mn kg. This was contributed by 5.8% increase in North Indian tea to 539mn kg and 3.4% decline in South Indian tea to 165.3mn kg.

Kenya - Cumulative tea production during Jan-Aug2006 has declined by 19.6% to 134.1mn kg. However, in August'06, production was higher by 6.5% yoy due to favourable weather conditions.

Sri Lanka - Cumulative tea production during Jan-Sept2006 has declined by 1.2% to 238.1mn kg. However, in September'06, production was higher by 15.4% yoy due to favourable weather conditions.

Outlook for the sector

Production is expected to grow at a slower pace due to:

- No substantial addition in plantation area due to lower auction prices for these years;
- Lower yield due to absence of re-plantation and rejuvenation activities;
- Recent initiatives of government to undertake ~2% of plantation area for re-plantation and rejuvenation activities, which would restrict immediate growth in production though would benefit after atleast 5 years when the first trench of re-planted land starts yielding results.

Consumption is expected to grow at 3.1% CAGR over 2006E-2010P due to:

- Increase in tea consuming population (expected to grow at 1.8%); and
- Increase per capita consumption of tea (expected to grow at 1.3%)
- PCC is also expected to increase due to various initiatives taken by the Tea Board of India to popularize tea drinking as also rising demand for flavoured and speciality tea due to increase in disposable income.

Benefits to Indian tea industry

- **The recovery phase** of cyclical tea industry would benefit the **integrated** tea players and branded tea players with significant pricing power like Tata Tea.
- **Demand-supply mismatch** resulting from limited production growth and steadily rising demand would trigger the rise in tea prices over 2006-2008.
- Kenyan drought condition and **improving bilateral relations** with neighbouring countries would open new international markets, like Pakistan and provide a thrust to Indian tea exports.



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Conclusion

A slow-down in the global tea production coupled with a steady increase in the tea-drinking population and per capita consumption of tea, would lead to a demand-supply mismatch and hence, an increase in tea auction prices. We believe that integrated tea manufacturers would be best placed to benefit from this situation. India being the largest producer of tea in the world is best placed to benefit from this mismatch due to its strong position in production and exports. It would also benefit from various initiatives taken by the Indian government to boost productivity through rejuvenation & re-plantation activities and by tea associations to boost consumption through promotion of tea drinking benefits. The domestic demand would also get a boost through initiatives by major branded companies like Tata Tea, who are promoting value-added teas like fruit & herbal teas, speciality teas, etc. Thus, the domestic and global scenario looks positive for the Indian Tea industry.

Top-pick from Tea Industry: Tata Tea

Based on the bright prospects of Indian tea industry we have selected Tata Tea as our best pick in the sector. Tata Tea with its long standing and convergence from an auction tea player to a branded tea and other beverages company holds immense potential going forward. We believe, Tata Tea to be a multi-bagger in the long term due to its emergence as a complete beverage company on a global scale.

Company Background:

Tata Tea Ltd is the second largest branded tea player in India and largest integrated tea company in Asia. The company has however, restructured its operations to become a global complete beverages company from a tea manufacturer due to various problems faced by the tea industry in the past. It has divested its South Indian tea estates into a separate company owned by the workers with ~20% stake. A similar move is devised for North Indian Plantations also with effect from 1st April 2007. Thus, the company would now focus on branded beverages only.

Transition from tea company to complete Beverages Company:

To cushion itself from the declining demand for black tea in the global markets, Tata Tea acquired 100% stake in US-based Eight O'clock Coffee through its 50.67% subsidiary Tata Coffee Ltd. It has also acquired strategic stakes in fast-growing speciality tea companies like Good Earth, Jemca, and Joekels. The company has further spread its wings by acquiring 30% stake in Energy Brands Inc., a US-based company operating in the fastest growing segment of the beverage industry – enhanced water.

Tata Tea had a complete makeover with the EBI acquisition as it has transformed the company into a global beverage company from a tea player and placed it at par with global giants like Coke and Pepsi. Burgeoning demand for health-based foods and drinks coupled with Tetley's strong world-wide distribution network offers EBI a ready-made platform to spread its operations beyond East Coast of America, its home-turf. Thus, the EBI acquisition is a win-win situation for both the parties as EBI gets the much needed funds and wide-spread distribution network to expand its operations while Tata Tea gets an easy entry into the world's fastest growing health beverages segment. Though five acquisitions in a row have put some financial strain on the company's balance sheet in the medium term, we believe the acquisitions to be significantly earnings accretive in the long run generating tremendous value for its shareholders.



Relative Valuation (based on FY2006 financials)

Company	Tata Tea	HLL	McLeod Russel
CMP (Rs)	723	213	95
EV (Rs crore)	5741.1	46584.4	1491.1
EV/Sales (x)	1.8	4.0	2.9
EV/EBIDT (x)	11.0	33.1	59.6
EBITDA (Incl oth inc) (%)	19.3	14.9	12.3
NPM (%)	9.3	10.8	1.4
EPS	53.0	5.9	0.8
CEPS	66.4	6.5	-0.3
EBIDTA (Excl OI) (%)	16.3	11.8	4.5
NPM (%)	9.3	10.8	1.4
MCap	4064.7	46885.6	935.0
P/E (x)	13.7	36.3	121.4
Cash P/E (x)	10.9	32.8	-314.8

Tata Tea with tremendous potential to grow its topline from multi-sources and bottomline through strong pricing power is valued at a steep discount compared to other players in the FMCG space. We believe in the company's business strategy and are bullish on its performance going forward and hence strongly recommend long term investors to **BUY** the stock.

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