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**COMMON PRE-SEEN
(KC1 TO KC4)**

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Investment Opportunity in the Sugar Industry

Background

Alpha (Pvt) Ltd is jointly owned by the Fernando brothers, Mahen and Ajith. They both own 50% of the company.

Ajith pursued his undergraduate studies at the University of Colombo, is a freelance consultant. Mahen is a chartered accountant who was based in Brazil working for a leading sugar manufacturing company. After nearly 20 years in the sugarcane industry Mahen has decided to leave his job and purchase a company that manufactures sugar in Sri Lanka. He believes that with his vast knowledge and industry experience he could run a sugarcane company successfully. Mahen was able to gather information related to the sugar industry in Sri Lanka. (Refer Annexure 1)

The annual sugar consumption in Sri Lanka is approximately 559,820 metric tons (MT). The local annual sugar production is only approximately 55,982 MT. This amounts to about 10% of the total consumption. In view of this there is a huge potential if sugar production can be increased to obtain self-sufficiency in the industry.

Ceylon Sugar (Pvt) Ltd

Ceylon Sugar (Pvt) Ltd is a company involved in the growing and milling of sugar. It is currently owned by the government and Beta (Pvt) Ltd. The current shareholding of Ceylon Sugar is given below.

Shareholders	No of shares (million)	Percentage holding
Government of Sri Lanka	51	51%
Beta (Pvt) Ltd	49	49%

Beta wishes to sell its stake and the government has agreed to this. The extent of the sugar plantation is 10,000 ha. 4,000 ha have been leased to Ceylon Sugar by the government on a 50-year lease and it is occupied by the factory and other buildings (the factory is located in the Sudu Oya region and sugarcane is grown in approx. 3,000 ha of this land). The balance 6,000 ha of the plantation is used by farmers who have been allocated 2 ha each on a lease to grow sugarcane. The farmers supply sugarcane to the factory at a fixed rate per ton of sugar.

Loan facilities have been extended to the farmers to assist them in growing sugarcane. Sugar is the main product that is sold by Ceylon Sugar. The installed capacity of the factory is 40,000 MT of sugar per year. However, the current utilisation is only about 45% of the installed capacity. Therefore, there is capacity available to increase production.

Board of directors of Ceylon Sugar (Pvt) Ltd

Mr. A. Perera	Chairman
Mrs. B. Fernando	Chief Executive Officer
Mr. T. Sally	Non-executive director
Mr. S. Ferdinands	Non-executive director
Mr. R. Pillay	Executive director
Mr. R. Perera	Executive director
Mr. V. Fernando	Executive director

Mrs. B. Fernando and Mr. T. Sally have served on the board since 2011 and 2006 respectively.

Governance issues

Since Ceylon Sugar is a government owned enterprise, its governance systems are not as strong as those in listed companies. This may be due to competing owners and stakeholders (government and private) and a lack of clear objectives. In contrast, in public listed companies the sole objective is shareholder wealth maximisation.

Directors appointed by the government are likely to follow political imperatives in order to meet the needs of the electorate. In certain cases, such objectives may be traded off for commercial objectives.

Salaries offered by Ceylon Sugar are also generally lower than those offered in the private sector. The lack of performance-based contracts might also adversely affect the results of the company.

Following an informal review of the governance structure it seems that this company has a dysfunctional board, careless expansion strategies and a lack of risk management strategies. Board members have failed to exercise proper business judgment in pursuing expansion strategies to reduce costs of production and increase revenue.

Ensuring that this company has a qualified board is a critical issue that needs to be addressed in order to have proper oversight over the company. The nomination process of the board members could also be flawed.

Another problem that impacts the company's board lies in the conflict of interest. Excessive ministerial intervention may impair the ability of the board to make sound decisions. The company also does not have an independent internal audit function.

Financial information of Ceylon Sugar (Pvt) Ltd (Refer annexure 2-5)

Property, plant and equipment (PPE) – Extract of key items

As at 31 March 2016	Cost (Rs. million)	NBV (Rs. million)
Buildings	40.05	30.00
Harvesting equipment	55.00	9.00
Factory plant and machinery	950.09	565.09
Water tanks	48.00	25.00

The factory plant and machinery were installed many years ago. They are now technologically obsolete and require urgent replacement if production is to be increased. The factory buildings also require refurbishment. The water tanks were constructed in FY 2015/16.

Inventories

As at 31 March	2016 (Rs. million)	2015 (Rs. million)
Molasses	355	38
Sugar	45	40
Sugarcane	40	35
Others	10	32
Total	450	145

The molasses could be used for ethanol production in the future.

Borrowings

The bank loans under interest bearing liabilities were initially from leading state banks. Corporate guarantees have been issued by Beta for the two loans taken from state banks. An interest rate of 12% was charged for FY 2014/15.

However, the interest rates charged by the banks for FY 2015/16 increased up to 14% and additional loans of over Rs. 1 billion were taken in the FY 2015/16. These loans have been taken to settle past due loans as well as loans taken from related parties. The new loans taken were from private banks at an interest rate of around 14%, to be settled in over 5 years. The related party loans were taken at a very high interest rate of 22%. A few leases were also taken to purchase vehicles and cane harvesters.

Ceylon sugar is highly geared and its borrowings have been increased. The overdraft balance has also increased indicating that the company is facing liquidity issues.

	Rs. million		
As at 31 March	2016	2015	2014
Loans	4,428	3,025	3,135
Bank Overdrafts	288	275	130
Loans due to related parties	375	1,251	925
Leases	41	63	63
	5,132	4,614	4,253

The overdraft position of Ceylon Sugar has worsened and it is headed for severe working capital issues. It is also indicative that the company may not be able to incur capital expenditure to upgrade its PPE.

The internal auditors have identified that there are certain expenses (in the payable balances) that have remained unpaid for more than 2 years due to the financial difficulties of the company.

Revenue

Ceylon Sugar (Pvt) Ltd sells its sugar to three main customers:

- Siri Distributors (Pvt) Ltd
- Agro Sugar (Pvt) Ltd
- Vajira Sugar (Pvt) Ltd

Siri Distributors buys nearly 50% of the sugar output of the company. Ceylon Sugar does not export sugar. The sugar price in Sri Lanka is based on various factors and it is controlled by the government. The duty on imported sugar (currently Rs. 30 per/kg), the world market prices and interest rates on loans offered to farmers have an impact on the sugar price.

External market forces result in volatility of the price of imported sugar.

According to the following table it can be seen that although sugar sold has increased from 15,770 MT in FY 2013/14 to 25,350 MT in 2014/15, a decrease of 28% is seen in FY 2015/16.

The cost of sales (COS) per MT has also increased year-on-year in the last 3 years despite the fluctuations in the quantity of sugar sold.

	2015/16	2014/15	2013/14
Cost of sales (Rs. million)	1,600	1,583	814
Sugar sold (MT)	18,250	25,350	15,770
Cost of sales per MT (Rs.)	87,671	62,446	51,617
Total cane harvested by the company (MT)	120,142	250,582	151,878
Cost per MT of cane (Rs.)	4,545	4,000	3,571

Financing strategy

As Ceylon sugar is facing liquidity issues and has nearly Rs. 5.1 billion borrowings, it does not appear to be a good acquisition. However Mahen is confident that if capacity and production can be increased with additional investment, the company could be turned around as there is a large domestic market for sugar.

Mahen and Ajith prefer a dual-path approach of both bank lending and capital market alternatives. Mahen has spoken to a few of his banking colleagues to obtain loans at lower interest rates. The possibility of converting some of the permanent overdrafts to term loans will also be considered.

As sugar has been earmarked by development banks as an industry that has huge potential, provided that the companies have a good management team and governance processes in place, the banks will positively consider a request for long-term debt financing to fund the acquisition based on the projected cash flows.

Annexure 1

Sugarcane process

Sugar is produced in more than 100 countries. Sugarcane is a tall plant that is similar to bamboo, which grows in tropical climates. Sugarcane needs strong sunlight, fertile soil, at least 1.5 mm of rainfall each year and access to irrigation. Sugar is made from the sugarcane plant through a natural process called photosynthesis.

Sugarcane is grown by replanting part of a mature cane stalk. Machines called cane harvesters cut the cane stalks off the plant at its base. To minimise sugarcane deterioration and juice evaporation, sugarcane must be transported to a sugar mill within 16 hours of being harvested.

Sugar mills crush cane to extract and separate the sucrose (sugar) from the water, impurities and plant fibre contained in the billets. The cane material is then crushed as it is fed through a series of mills. The juice is pumped away for processing into raw sugar. It is cleaned to remove impurities and thickened into a syrup by boiling off excess water. It is then seeded with tiny sugar crystals in a vacuum pan and boiled until sugar crystals have formed and grown.

Sugar industry in Sri Lanka

Sugar production increased in 2015 supported by favourable rainfall, increased extent cultivated and the higher purchase price of sugarcane. Sugar production increased by 7.0 per cent to 55,982 MT in 2015, although the performance of sugar production factories varied. The output at Pelwatte sugar factory, which accounts for half of the total domestic sugar production, increased by 53.7 per cent to 27,612 MT in 2015 while the production at Sevenagala, Sudu Oya and Gal Oya sugar factories declined. The Kantale sugar factory engaged in sugarcane cultivation with a view to recommencing its manufacturing operations in the near future.

Meanwhile, the Sugar Recovery Rate, which partly reflects productivity, declined to 7.5 per cent in 2015 from 8.0 per cent in the previous year. It is estimated that the overall domestic sugar production in 2015 was sufficient to meet around 10 per cent of the total sugar requirement of the country. The increased demand along with low sugar prices in the global market, led to an increase in sugar imports by 20.1 per cent to 623,971 MT in 2015.

Considering the potential for expansion of the sugar industry and the substantial amount of foreign exchange incurred in importing sugar, it is essential to revitalise the sugar industry with the use of improved varieties, better management practices and modern technology while undertaking measures to reduce the cost of production which is currently estimated above the retail price of sugar.

(Source: Modified extract from the CBSL Annual Report 2015)

Challenges in the sugar industry

The Sri Lankan economy is significantly based on agriculture. Although its contribution to the overall GDP is on the decline, there is a substantial amount of labour deployed in agriculture-based manufacturing. Apart from tea, rubber and coconut, sugar is also manufactured in Sri Lanka despite many challenges. In the dry zones of Sri Lanka there is land that could be made use of for sugarcane cultivation. The sugar industry also provides jobs for people living in these areas.

There are many challenges faced by this industry. These include the high cost of production, use of expensive plant and machinery and labour shortages. Research and development is also not up to standard. Electricity is a by-product in the sugar manufacturing process. However in Sri Lanka this is not the case due to the use of obsolete technology and high capital costs. Sugar manufacturers use furnace oil or diesel generators to supplement the shortages, which increase the cost of production. The cost of production must be minimised for the long-term sustainability of the sugar industry in Sri Lanka.

Annexure 2

Ceylon Sugar (Pvt) Ltd

Statement of comprehensive income

For the year ended 31 March	2016	2015	2014
	Rs. million	Rs. million	Rs. million
Revenue	2,800	2,361	1,252
Cost of sales	<u>(1,600)</u>	<u>(1,583)</u>	<u>(814)</u>
Gross profit	1,200	778	438
Other income	81	125	68
Interest income	-	1	2
Administrative expenses	<u>(470)</u>	<u>(580)</u>	<u>(570)</u>
Profit/(loss) before finance cost and tax	811	324	(62)
Finance cost	<u>(545)</u>	<u>(646)</u>	<u>(612)</u>
Profit/(loss) before taxation	266	(322)	(674)
Income tax expense	<u>(27)</u>	<u>(5)</u>	<u>(3)</u>
Profit/(loss) for the year	<u>239</u>	<u>(327)</u>	<u>(677)</u>
Actuarial gain/(loss) on retirement benefit obligation	-	(4)	(1)
Total comprehensive income for the year	239	(331)	(678)

	2015/16	2014/15	2013/14
Number of shares (in millions)	100	100	100
EPS (Rs.)	2.39	-3.31	-6.78

Annexure 3

Ceylon Sugar (Pvt) Ltd

Statement of financial position

As at 31 March	2016	2015	2014
	Rs. million	Rs. million	Rs. million
Assets			
Non - current assets			
Property, plant and equipment	980	1,010	1,130
Infrastructure improvements	77	97	100
Right to use land	329	340	350
Capital work in progress	165	60	5
AFS investment in Candy PLC (15%)	30	-	-
Loans given to farmers - amount fall due after one year	<u>210</u>	<u>97</u>	<u>91</u>
Total non - current assets	<u>1,791</u>	<u>1,604</u>	<u>1,676</u>
Current assets			
Biological assets at fair value	35	19	17
Inventories	450	145	95
Loans given to farmers - amount fall due within one year	239	150	225
Trade and other receivables	571	396	285
Amounts due from related parties	3	2	9
Income tax receivable	6	1	2
Cash and cash equivalents	<u>2</u>	<u>2</u>	<u>2</u>
Total current assets	<u>1,306</u>	<u>715</u>	<u>635</u>
Total assets	<u>3,097</u>	<u>2,319</u>	<u>2,311</u>
Equity and liabilities			
Equity			
Stated capital	1,000	1,000	1,000
Retained earnings	<u>(3,127)</u>	<u>(3,366)</u>	<u>(3,035)</u>
Total equity	<u>(2,127)</u>	<u>(2,366)</u>	<u>(2,035)</u>
Non - current liabilities			
Interest bearing liabilities	1,461	547	900
Retirement benefit obligations	30	27	20
Finance lease obligations	<u>25</u>	<u>32</u>	<u>43</u>
Total non - current liabilities	<u>1,516</u>	<u>606</u>	<u>963</u>

Current liabilities			
Trade and other payables	62	42	73
Amounts due to related parties	375	1,251	925
Interest bearing liabilities	2,967	2,478	2,235
Finance lease obligations	16	31	20
Income tax payable	-	2	-
Bank overdrafts	<u>288</u>	<u>275</u>	<u>130</u>
Total current liabilities	<u>3,708</u>	<u>4,079</u>	<u>3,383</u>
Total equity and liabilities	<u>3,097</u>	<u>2,319</u>	<u>2,311</u>

Annexure 4- Key ratios of Ceylon Sugar (Pvt) Ltd

	2015/16	2014/15	2013/14
Solvency			
Debt ratio - (Total debt/Total assets)	168%	201%	187%
Gearing ratio - (Interest bearing debt/(Equity + Interest bearing debt)	171%	205%	192%
Interest cover - (PBIT/Finance cost)	1.49	0.5	Negative
Liquidity and efficiency			
Current ratio - (CA/CL)	0.35	0.18	0.19
Quick ratio - [(CA - Inventory)/CL]	0.23	0.14	0.16
Accounts receivable collection period (days) (Trade receivables/Revenue * 365)	74	61	83
Inventory turnover period (days) (Inventory/Cost of sales * 365)	103	33	43
Accounts payable payment period (days) (Trade payables/Cost of sales * 365)	14	10	33
Profitability			
ROCE (PBIT/Capital employed) (Capital employed= Total assets - Current liabilities)	-133%	-18%	Loss
Gross profit margin	43%	33%	35%
Net profit margin	9%	-14%	-54%

Annexure 5

Ceylon Sugar (Pvt) Ltd

Projected statement of comprehensive income

For the year ended 31 March	2016/17	2017/18	2018/19	2019/20	2020/21
	Rs. million	Rs. million	Rs. million	Rs. million	Rs. million
Revenue	3,641	4,369	5,679	6,815	8,860
Cost of sales	(2,548)	(3,058)	(3,976)	(4,771)	(6,202)
Gross profit	1,093	1,311	1,703	2,044	2,658
Gross profit margin (%)	30	30	30	30	30
Other income	197	236	307	368	478
Interest income	-	-	-	-	-
Administrative expenses	(550)	(556)	(557)	(601)	(613)
Profit/(loss) before finance cost and tax	740	991	1,453	1,811	2,523
Finance cost	(413)	(416)	(413)	(430)	(431)
Profit/(loss) before taxation	327	575	1,040	1,381	2,092
Income tax expense	(40)	(79)	(125)	(166)	(4)
Profit/(loss) for the year	287	496	915	1,215	2,088
Actuarial gain/(loss) on retirement benefit obligation	-	-	-	-	-
Total comprehensive income for the year	287	496	915	1,215	2,088

Number of shares	100,000,000	100,000,000	100,000,000	100,000,000	100,000,000
EPS (Rs.)	2.87	4.96	9.15	12.15	20.88