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THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

COMMON PRE-SEEN

(KC1 TO KC4)

DECEMBER 2019

Upcountry Estates (Pvt) Ltd

1. Introduction

Jerad De Silva, an experienced senior planter, began his career in planting 30 years ago. His father, Nicholas De Silva, was also a planter. Jerad grew up in plantations and moved around the country when his father was transferred for work to many different estates belonging to leading plantation companies. Jerad and his only son Gayan now own a majority stake in a plantation company called Upcountry Estates (Pvt) Ltd (UEL). Jerad is the chairman and managing director of the company, whilst Gayan is the sales director. UEL owns tea and rubber estates in the Nuwara Eliya and Ratnapura districts. The company was acquired when the estates were privatised by the government.

Jerad invested in the company using the wealth he inherited from his father, which was passed on to him at the age of 35 when his father passed away. His father's dream was to see Jerad own and run his own estates, and he (i.e. the father) had a very good reputation in the estate community and was well respected not only by his peers but also by the workers.

In 2019 Mahen Zoysa, a family friend and fellow chartered accountant who had just returned to Sri Lanka, was requested to purchase shares in UEL. He used to work in the US and had 30 years of experience in the financial industry.

Gayan was not as hands-on with the plantation work as his father, and was not held in high esteem by his subordinates. Jerad was concerned by Gayan's lack of enthusiasm to govern the business, and was planning on listing the company on the Diri Savi Board in the future.

2. Company overview

2.1 Shareholding structure (40,000,000 shares at Rs. 15 per share)

Shareholders	**Percentage holding as at 31 March 2019**
Jerad De Silva	40%
Gayan De Silva	20%
Mahen Zoysa	30%
Secretary to the Treasury	10%
Total	**100%**

2.2 Human Resources

The company has a total workforce of nearly 9,000. The management cadre comprises 70 staff. All the staff are generally well looked after, and approximately 40% of the management staff have been in the company for over 15 years. However, staff retention rates are low and most employees are not emotionally engaged according to the employee satisfaction survey carried out last year (refer Annexure 1 for profiles of the directors and key management personnel, and Annexure 2 for the organisational structure).

Demanding higher wages is a common issue in the estate sector. A collective agreement was signed with the trade union in the second half of 2018 to increase the wages of workers. The new wage increase will approximately be a 7% annual increase in the total wage. The estate sector faces severe shortages of workers, both skilled and unskilled, as these workers are now looking to move away from plantation life.

2.3 Crop

Rubber

During the financial year 2018/19 UEL produced nearly 2.71 million kg of rubber compared to 3.15 million kg the previous year. This was a decline of approximately 14%, and it was mainly due to lower worker outturn, worker strikes and adverse weather.

The Colombo market prices of Ribbed Smoked Sheets (RSS) declined by approximately 15% compared to the previous year. UEL was able to achieve a net sales average (NSA) of approximately Rs. 285 per kg during FY 2018/19 compared to Rs. 359 per kg in the previous year. This was mainly due to a decline in prices.

The cost of production (COP) per kilogram, increased by 6.67% from Rs. 300 in the previous year to Rs. 320 in FY 2018/19. This was mainly due to the decline in crop.

Tea

In FY 2018/19 the company's tea production was 7.15 million kg compared to 6.4 million kg the previous year. A growth of nearly 19% was seen in high grown tea and a decline of 14.95% was seen in low grown tea compared to the previous year. The NSA declined by approximately 2% for high grown tea and 5.9% for low grown tea.

The COP per kilogram stood at Rs. 412 against Rs. 417 in the previous year.
Details of the extent and capacity of tea and rubber are shown in Annexure 4.

2.4 Capital expenditure

UEL invested nearly Rs. 104 million in FY 2018/19 in fixed assets. The expenditure on new planting is around Rs. 280 million in FY 2018/19.

Information technology

The company plans to invest in an integrated ERP solution in FY 2019/20 covering all aspects of operations and finance. The chairman expressed his concern regarding the implementation of a new IT system, as the company does not have a proper IT governance framework or competent staff to manage such an important project.

2.5 Governance issues in a family business

As UEL is a family business the governance processes are not mature in terms of governing the organisation. The division between the owners and the management is not clear. The chairman is keen on getting the company listed and is therefore actively seeking to bring the governance-related processes in line with a listed company. Prior to listing, a family constitution is to be drawn up.

The existing governance-related policies and processes are informal. Written procedures do not exist and the management seems to resist change. Weaknesses in the governance system of this family business are most evident in internal controls and risk management. The internal controls have not kept pace with the growth of the company.

Some of the key concerns in governance are:

- Lack of experience at board level on risk management, including IT and treasury management, which lead to poor investment decisions.
- Lack of proper deliberations at board level on key decisions.
- No independent directors.
- Inordinate dependence on a few senior staff.
- Resistance to change hence not easy to introduce best practices.
- Lack of a succession plan.

Gayan has indicated that he may sell his shares in the future since his expertise is mainly in marketing. Therefore the chairman is actively seeking an investor to buy his son’s shares, and perhaps his own shares as well.

2.6 Ethical issues

Jerad recently made many statements regarding the need for a code of ethics to be introduced in the company.

Compliance with applicable sustainability codes (including quality compliance), ethical sourcing, welfare and health and safety standards, and mitigating the effects of climate change were all topics that were discussed at adhoc board meetings of the company held from time to time. The need to have a specific team to focus on ethical and social impacts of the company was highlighted many times, but there was no proper leadership and commitment from the management team for successful implementation. A few complaints were received by the legal counsel regarding kickbacks associated with sales staff from tea and rubber brokering firms. Since no proper action was taken against the wrong doers, honest and hardworking staff in the company felt demotivated.

3. Financial information

3.1 Income statements of UEL

	Rs. '000		
For the year ended 31 March	**2019 Unaudited**	**2018**	**2017**
Revenue	3,885,068	3,998,405	4,056,529
Cost of sales	(3,157,686)	(3,198,724)	(3,164,093)
Gross profit/(loss)	**727,382**	**799,681**	**892,436**
Fair value gain/(loss) on consumable biological assets	88,767	142,535	90,454
Other operating income	247,967	241,846	216,615
Administrative expenses	(386,546)	(366,543)	(349,348)
Net finance costs	(498,646)	(578,621)	(365,343)
Profit/(loss) before income tax	**178,924**	**238,898**	**484,814**
Income tax	(20,086)	(56,079)	(48,233)
Profit for the year	**158,838**	**182,819**	**436,581**
Other comprehensive income/(expense)			
Actuarial gain/(loss) on retirement benefit obligations	(213)	(42,320)	31,918
Tax effect on other comprehensive income	44	8,989	(5,069)
Other comprehensive income/(expense) for the year, net of tax	**(169)**	**(33,331)**	**26,849**
Total comprehensive income/(expense) for the year	**158,669**	**149,488**	**463,430**

3.2 Break-up of revenue

	Rs. '000	
For the year ended 31 March	**2019**	**2018**
Sale of produce		
- Tea	3,108,054	2,878,852
- Rubber	777,014	1,119,553
	3,885,068	**3,998,405**

3.3 Accounting and finance

UEL currently uses several accounting software packages from different vendors. However in certain estates accounts are prepared on Excel. Mahen, the finance director of the company, continuously told the board about the poor quality of financial information presented to them. He also had serious concerns regarding the internal controls surrounding the preparation of financial statements.

The finance manager prepares the consolidated accounts of all the estates, and the accounts executives at each estate submit their financials to the head office on a monthly basis. High staff turnover of accounting staff was recently seen in three estates in a particular district headed by an assistant general manager. The lack of an accounting software package in certain estates, and the inability to prepare consolidated financial statements through the use of integrated software was a serious deficiency resulting in many errors in the financial statements.

The competence of staff in the accounting department at the head office was not sufficient to meet the current demands by the directors in terms of reports for decision-making. The finance director stated that he wants to change the current annual report format to an integrated reporting format. For this purpose staff with the required qualifications may need to be recruited.

A few concerns were raised by the finance manager on the assistance given by the current auditor on the implementation of SLFRS 15 and SLFRS 16. The current auditor is Messrs. Pedris & Co. Its senior partner is 75 years old and there seems to be constant delays in finalising the audits.

The internal audit department was set-up recently by transferring a senior officer to the post. He had worked at UEL for 20 years in operations prior to being appointed to the current role of internal auditor. It was noted that stock variances identified during periodical stock counts were not properly inquired into and adjusted in the general ledger.

3.4 Statements of financial position of UEL

	Rs. '000		
As at 31 March	**2019 Unaudited**	**2018**	**2017**
Assets			
Non-current assets			
Leasehold right to bare land of JEDB/SLSPC estates	195,000	200,500	210,000
Immovable leased assets of JEDB/SLSPC estates (other than bare land)	125,000	139,000	160,000
Tangible assets (other than mature/immature plantations)	919,000	935,000	899,500
Intangible assets	414,000	410,000	455,000
Investment property	125,000	105,000	92,500
Biological assets	3,857,575	3,600,545	3,500,000
Investments in subsidiaries	1,500,000	1,500,000	1,500,000
Financial assets at Amortised Cost	680,691	724,142	784,835
Total non-current assets	**7,816,266**	**7,614,187**	**7,601,835**
Current assets			
Inventory	445,000	440,500	400,500
Trade and other receivables	270,898	220,554	200,500
Amounts due from related parties	950,000	1,500,450	1,300,000
Cash and cash equivalents	374,873	495,363	750,005
Total current assets	**2,040,771**	**2,656,867**	**2,651,005**
Total assets	**9,857,037**	**10,271,054**	**10,252,840**
Equity and liabilities			
Capital and reserves			
Stated capital	600,000	600,000	300,000
General reserve	250,000	250,000	250,000
Retained earnings	2,848,100	2,689,431	2,539,943
Total equity	**3,698,100**	**3,539,431**	**3,089,943**
Non-current liabilities			
Interest bearing borrowings	2,200,303	1,495,676	1,850,555
Retirement benefit obligations	760,565	690,888	610,857
Grants and subsidies	345,000	320,565	310,000

Net obligation to lessor of JEDB/SLSPC	333,352	340,146	344,445
Deferred tax liability	270,565	405,676	360,656
Total non-current liabilities	**3,909,785**	**3,252,951**	**3,476,513**
Current liabilities			
Interest bearing borrowings	925,433	1,157,310	2,041,277
Net obligation to lessor of JEDB/SLSPC	52,345	55,454	60,555
Trade and other payables	694,243	1,205,010	672,563
Amounts due to related parties	121,456	265,444	15,434
Bank overdraft	455,675	795,454	896,555
Total current liabilities	**2,249,152**	**3,478,672**	**3,686,384**
Total liabilities	**6,158,937**	**6,731,623**	**7,162,897**
Total equity and liabilities	**9,857,037**	**10,271,054**	**10,252,840**

The company's interest bearing liabilities include debentures, term loans and finance leases. The debentures are of 4 to 7 year tenures with annual interest rates ranging from 14.25% to 15%. The term loans are from state banks at AWPLR + 4%. The majority of term loans are floating rate instruments. A distress loan for 3 years was also obtained at 5% from the Tea Board. The annual interest rates for the finance leases ranged from 22% to 26%. The interest cost in relation to overdrafts was high.

Interest bearing borrowings	**Rs. '000**
	2019
Debentures	1,420,000
Term loans	1,250,000
Distress loan	200,000
Leases	255,736
Total	**3,125,736**

The chairman of UEL has obtained funds from the company from time to time in addition to his salary, and has not returned them. These funds are recorded in the financial statements as amounts due from related parties.

4. 5 year forecast (forecasted sales)

	Rs. '000				
	2019/20	**2020/21**	**2021/22**	**2022/23**	**2023/24**
Revenue	4,273,574	4,700,931	5,171,025	5,688,127	6,256,940
Cost of sales	(3,418,859)	(3,713,736)	(4,085,109)	(4,493,620)	(4,942,982)
Gross profit/(loss)	**854,715**	**987,195**	**1,085,916**	**1,194,507**	**1,313,958**
Fair value gain/(loss) on biological assets	(15,333)	(8,500)	(5,500)	(4,500)	(2,000)
Other operating income	275,000	205,900	214,500	223,456	235,500
Administrative expenses	(447,311)	(469,500)	(492,646)	(517,458)	(543,767)
Net finance costs	(565,500)	(610,000)	(595,565)	(570,765)	(450,676)
Profit/(loss) before income tax	**101,571**	**105,095**	**206,705**	**325,240**	**553,015**

5. Hydropower projects

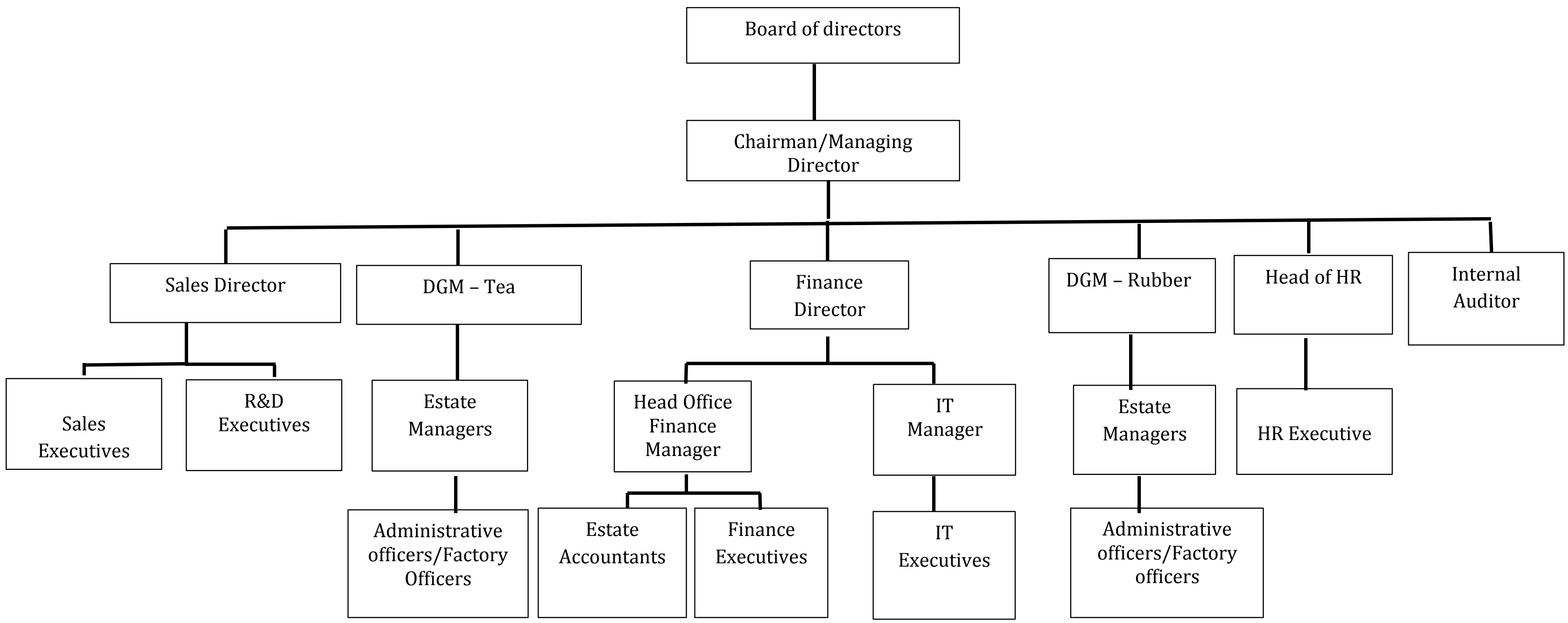
UEL is in the process of evaluating a few hydropower projects. Financial benchmark figures of a similar listed company, TT PLC, which is listed on the Colombo Stock Exchange, are given below. These figures may be of use for a valuation of the shares of UEL.

- Dividend payout ratio: 7.5%
- Earnings per share (EPS): Rs. 14.50 (issued at Rs. 15 per share)
- The company was funded with a debt-to-equity ratio of 65:35
- Market share price: Rs. 18
- Beta (based on ASPI): 0.55
- Current treasury bill rate: 9.5% per annum
- Market risk premium: 7.0%
- Market rate of return: 16.5% per annum

Annexure 1: Profiles of directors and key management personnel as at 31 March 2019

Name	Designation	Age	Qualifications	Industry experience (years)
Jerad De Silva	Chairman/Managing director	59	BSc (Sales), Diploma in Plantation Management	33
Gayan De Silva	Sales director	29	BSc (Hons), MSc (Marketing)	3
Mahen Zoyza	Finance director	55	BSc, FCA, FCMA (UK), CGMA	30
Ranmalie De Zoysa	Head of HR	55	Diploma in HR from IPM	27
Kasun Pathiraja	Finance manager	32	ACMA – SL	8
Methnuwan Ranasinghe	IT manager	27	Diploma in IT	4
Dudley Fernando	DGM – Rubber	52	BSc (General)	27
Prasanna Jayawardena	DGM – Tea	55	MBA (UK)	30
Saliya Kapuwatte	Internal auditor	61	Diploma in Plantation Management	28

Annexure 2: Organisational structure



Annexure 3: Overview of the tea industry's performance in 2018 and prospects for 2019

2018 began with a lot of optimism in the backdrop of an excellent year (2017) that was witnessed in terms of tea prices. The first quarter commenced on a high, with the quarterly auction average price being recorded as the highest ever. However, as the year progressed, the Sri Lankan tea industry faced numerous obstacles.

Subsequent to the banning of glyphosate by the Government of Sri Lanka, tea growers and large plantations in particular, were forced to use alternative products to control weed growth. This resulted in MCPA (2-Methyl-4-Chlorophenoxyacetic Acid) levels being higher than that permitted for exports to Japan. As the year unfolded, purchases from Japan declined due to purchases/shipments being made only following prior testing for chemical residue levels.

Around May, the US imposed sanctions on Iran, which had a cascading impact on auction prices in Colombo, particularly for the low grown (Tippy) teas. However, there was some optimism for tea prices to turn around towards June/July following the strengthening of oil prices and the weakening of the Sri Lankan rupee. However, this did not work out to be a reality following the weak economies in most of the Middle Eastern countries and Russia, which resulted in the currencies in the importer countries also depreciating against the US dollar.

During the second half of 2018, there was ample evidence of global production increasing significantly, primarily due to increased production in the African region. These increases did not adversely impact Colombo auction prices too much, as most of it comprised CTC teas.

After much deliberation, stakeholders were successful in negotiating with the Government of Sri Lanka to remove the glyphosate ban through a special gazette dated 11 July 2018; a welcome relief to the industry. However, it has taken a considerable period of time for the shipments to be available to the plantations on a regulated basis.

Starting around September, the Sri Lankan rupee began to show a significant devaluation against the US dollar, which possibly to some extent made Sri Lankan tea prices attractive to importers. Since then we saw a reasonable momentum although the 2018 auction price levels were below the corresponding sales of the previous year by approximately Rs. 50 or US$0.27 per kg.

A synopsis of the tea industry's performance during 2018 is set out below.

The first quarter commenced with auction volumes maintaining 6 – 7 Million/kg [M/kg], and as customary with the onset of the dry weather (end-February) auction volumes declined to 6 M/kg and below. During the period under review, total tea production was 73.8 M/kg compared to 66.8 M/kg in 2017; an increase of 7 M/kg (10%). All elevations recorded a gain, with the high and medium growns gaining more significantly.

Auction averages in the months of January and February continued to show improvement compared to the corresponding period in 2017. However, commencing from March 2018, auction averages in all elevations began to record significant negative variances compared to the corresponding period in 2017. Buoyant prices that were maintained in the first two months helped the quarterly total auction average price to show a gain of Rs. 21.74 over the corresponding period in 2017. Earnings from tea exports remained more or less static compared to the corresponding period in 2017 (Rs. 68.8 million in 2018 vis-à-vis Rs. 68.4 million in 2017).

The second quarter commenced with auction volumes maintaining at 6 M/kg and increasing to 7.5 – 8 M/kg by mid-May. During the second quarter, tea production declined 6.1 M/kg (6.8%) in comparison to the corresponding period in 2017. Interestingly, April and June showed a significant negative variance, whilst May recorded a 10% increase compared to May 2017. Average auction price continued to decline with medium growns in particular recording the sharpest drop (quarter-on-quarter with a negative variance of Rs. 44.38). Consequently, the cumulative position eroded to a negative variance of Rs. 11.78 by the end of June.

Earnings from tea during the period were recorded at Rs. 56.8 billion, marginally below the Rs. 57.7 billion recorded in the corresponding period in 2017. The third quarter commenced with auction volumes around 7 M/kg, which declined gradually and dropped to a low of 5.5 M/kg by end-September sales. Tea production, which totalled 64.5 M/kg vis-à-vis 76.3 M/kg in the corresponding period in 2017, recorded a 11.7 M/kg negative variance (15%). Tea prices continued to weaken further with the total auction average price declining to Rs. 536.69 vis-à-vis Rs. 610.28 during the corresponding period in 2017 (a 11% drop).

Exports totalled Rs. 58.7 billion compared to Rs. 63 billion in 2017; a negative variance of Rs. 4.3 billion (7%). Interestingly, cumulative earnings up to end-October totalled Rs. 192.4 billion vis-à-vis Rs. 194.3 billion in 2017; a negative variance of Rs. 1.9 billion (1%).

Due to a production deficit at the end of September, auction offerings during the fourth quarter of 2018 ranged between 5 – 5.5 M/kg in the early part and 6.5 – 7 M/kg in the latter part. Tea production statistics available for the month of October 2018 totaled 29.6 M/kg versus 25.7 M/kg in 2017 (an increase of 3.8 M/kg or 14%).

Considering that production up to October totaled 251 M/kg and assuming that production in November and December remain static around the 2017 figures (notwithstanding the labour unrest on plantations in the month of December and the curtailment of tea production), Sri Lanka is likely to achieve the 300 M/kg mark. This is a reasonable recovery from the disastrous second and third quarters.

Comparison of auction averages continued to reflect significant negative variances vis-à-vis the corresponding periods in 2017. Interestingly, auction averages during the fourth quarter up to the penultimate sale of the year showed fair improvement on third quarter achievements.

Sri Lankan tea production in 2019, consequent to the Government's decision to lift the ban on the use of glyphosate (weedicide), is likely to give much relief to producers, and in particular to the large-scale plantations that would be able to carry out the required agricultural practices to achieve their full potential. Further the government's decision to allow a more liberal policy on fertiliser – should contribute favorably (needless to say subject to extreme weather conditions not being a reality). However, ageing tea bushes and low productivity levels would be a downside.

Similarly, India with its aged plantations is unlikely to show any significant improvement in its output. On the other hand Kenya with its steady growth in production in the past several years is poised to achieve a 500 M/kg in 2018 and is likely to play a significant role in assessing the total global supply situation.

Demand growth in China and India, considering the magnitude of these two markets, is likely to influence prices. Consumption in these two countries is expected to outstrip production. The US too could be singled out as a fast-growing market, particularly for the instant tea and iced tea segments. Imports from Sri Lanka to the US have showed quite a significant growth in 2018.

Other factors likely to impact Sri Lankan tea prices

As highlighted earlier, Colombo auction prices showed a significant appreciation in the fourth quarter of 2018 compared to the third quarter. This was particularly in the case of leafy orthodox teas.

Further, the first quarter is traditionally a low crop period with enhanced product quality from most producer countries. This scenario will augur well for small leaf liquoring varieties that would be on offer.

Another important factor that might influence tea prices is the variation in exchange rates. The Sri Lankan rupee, which was under severe pressure at the commencement of the fourth quarter of 2018, stabilised somewhat towards mid-December. If this trend is reversed and the previous depreciation pattern that was seen a couple of months ago becomes a reality, this too would help Colombo auction prices in rupee terms.

(Source: Forbes & Walker Report/CBSL)

Annexure 4: Extent and capacity

Estate	Crop	Planting district	Area – Tea (Ha)		Others (Ha)	Roads etc. (Ha)	Factory capacity (kg)	No. of workers
			Mature	Immature	Immature			
Estate 1	Tea	Nuwara Eliya	250.00	1.00	125.00	70.00	18,300	545
Estate 2	Tea	Nuwara Eliya	470.00	6.00	110.00	130.00	35,000	1,100
Estate 3	Tea	Nuwara Eliya	365.00	4.70	255.00	62.00	25,000	1,025
Estate 4	Tea	Nuwara Eliya	675.00	35.00	400.00	140.00	43,400	1,675
Estate 5	Tea	Nuwara Eliya	535.00	1.75	262.00	160.00	16,772	1,162
Regional total			**2,295.00**	**48.45**	**1,152.00**	**562.00**		**5,507**

Estate	Crop	Planting district	Area – Tea (Ha)		Area – Rubber (Ha)		Others (Ha)	Roads etc. (Ha)	Factory capacity (kg)	No. of workers
			Mature	Immature	Mature	Immature	Immature			
Estate 6	Tea/rubber	Ratnapura	30.96	8.56	431.00	85.00	66.00	156.69	-	350
Estate 7	Tea/rubber	Ratnapura	184.00	40.00	798.00	272.00	63.00	341.26	6,850	946
Estate 8	Rubber	Ratnapura	-	-	825.00	256.00	131.00	805.00	7,500	800
Estate 9	Rubber	Ratnapura	-	-	1,152.00	274.00	106.00	520.00	10,900	1,013
Regional total			**214.96**	**48.56**	**3206.00**	**887.00**	**366.00**	**1,822.95**		**3,109**
Company total			**2,509.96**	**97.01**			**1,518.00**	**2,384.95**		**8,616**