AGRICULTURAL POLICY ANALYSIS PROJECT, PHASE III

Sponsored by the

U.S. Agency for International Development

Assisting USAID Bureaus, Missions and Developing Country Governments to Improve Food & Agricultural Policies and Make Markets Work Better

Prime Contractor	**Abt Associates Inc**
Subcontractors	**Development Alternatives Inc**
	Food Research Institute, Stanford University
	Harvard Institute for International Development, Harvard University
	International Science and Technology Institute
	Purdue University
	Training Resources Group
Affiliates	**Associates for International Resources and Development**
	International Food Policy Research Institute
	University of Arizona

Project Office 4800 Montgomery Lane, Suite 600 Bethesda, MD 20814 Telephone (301) 913 0500
Fax (301) 652-3839 Internet apap3@abtassoc com USAID Contract No LAG 4201 C 00-3052 00

A

SMALLHOLDER TEA AUTHORITY

December 1996

APAP III
Research Report
No 1033

Prepared for

Agricultural Policy Analysis Project, Phase III, (APAP III)

USAID Contract No LAG-4201-Q-00-3061-00

Author **J M O'Neill**
Imani Development Ltd

B

TABLE OF CONTENTS

1	**INTRODUCTION**	1
	1 1 Terms of Reference	1
2	**BACKGROUND TO STA**	3
3	**FUNCTIONS PERFORMED BY SMALLHOLDER TEA AUTHORITY**	5
	3 1 Marketing of Green Leaf	5
	3 2 Transport of Green Leaf	7
	3 3 Extension Services	9
	3 4 Maintenance of Infrastructure	11
	3 5 Input Procurement	12
	3 6 Provision of Credit	12
	3 7 Manufacture of Tea - Mateco	14
	3 8 Forestry	15
4	**FINANCIAL STATUS OF STA**	17
	4 1 Operating Results	17
	4 2 STA Assets and Liabilities	19
5	**OPTIONS FOR THE FUTURE OF STA**	21
	5 1 Objectives of STA	21
	5 2 Future of STA	22
	5 3 Future of Mateco	23
6	**HUMAN RESOURCES**	26
7	**ACTION PLAN**	28

C

1 INTRODUCTION

1 1 Terms of Reference

The Government of Malawi, through the Department of Statutory Corporations, have commissioned Mr J M O'Neill of Imani Development Limited to conduct a study of the Smallholder Tea Authority (STA) The main objectives of the study are

- to define an alternative form or a new vision for STA that would reduce and/or end any financial and administrative relationship with the Government
- to review the original mission statement and objectives and redefine them commensurate with the proposed new organization
- to identify or map out steps or an action plan to transform STA into a new organization

The terms of reference for the study were defined as follows

(a) Determine the form the Authority should be transformed into in order to make it more or completely financially and administratively self sustaining A minimum of three options should be investigated and the best possible one recommended

(b) Review the original statement and objectives and redefine them to suit the proposed new organization

(c) Assess the suitability of the existing organizational structure and human resources to the new organization, proposing, if need be, any changes If retrenchment is envisaged, propose a suitable compensation package

(d) Propose an appropriate management system to run the new organization

(e) Assess the Authority's current financial status and propose a proper financial structure for the new organization

(f) Take an inventory of the Authority's assets and propose how best they can be used or disposed of based on the recommendation in (a) above

(g) Develop steps or an action plan for transforming STA into the proposed new organization This should clearly outline what actions are to be taken, when they are to be taken and by whom

In accordance with the terms of reference, a draft report was submitted to a Review Committee comprising Government officials, management of the Authority, and growers representatives Comments from the Review Committee have been incorporated into this final report

2 BACKGROUND TO STA

STA was established by the Smallholder Tea Authority Order issued by the Minister of Agriculture under the authority of the Special Crops Act (Cap 65 01 of the Laws of Malawi) The objectives of the authority are set out in Section 3 of the order which states "There is hereby established an Authority, to be known as the Smallholder Tea Authority, for promoting and fostering the development of tea by smallholders in the areas of Mulanje, Thyolo and Nkhata Bay districts "

Both the Special Crops Act and the Smallholder Tea Authority Order are open to rather wide interpretation as regards the exact purpose of STA Whilst referring to the promoting and fostering of the development of the crop by smallholders, the intended beneficiary of this development is unclear Is it to be the smallholders themselves, the Government, the economy at large, or some combination thereof?

In 1965, the Tea Authority commenced operations with a total hectarage of 55 hectares of smallholder tea (3 5 ha in Thyolo and 51 5 ha in Mulanje district) Since that time impressive growth has been recorded As at 31st March 1996 the total area planted to smallholder tea was 2685 hectares of which 1928 hectares were in Mulanje district and 757 hectares in Thyolo However, production of green leaf appears to be declining from 15 3 million kilogrammes in 1993/94 to 14 3 million kilogrammes in 1994/95 and a further drop to 13 million kgs is forecast for 1995/96 Demand exists for introduction of tea on certain further areas of customary land but the Authority are not in a position to finance further development

At present, there are approximately 6,000 registered growers with a wide range of relative earnings ranging from virtually zero to as high as K75,000 per annum Mean annual earnings per smallholder for the 1995/96 season is approximately K3,500

Smallholder tea is not grown in Nkhata Bay district The public land originally designated for smallholders was given to Spearhead Enterprises Limited, the commercial arm of the now defunct Malawi Young Pioneers Admarc took over this land, Kawalazi Estate, when Spearhead went into receivership Subsequently, Commonwealth Development Corporation purchased the estate during the course of an Admarc divestiture programme

Initially, all green leaf grown was offered for sale to privately owned tea factories for a consideration calculated in accordance with a negotiated agreement In 1973, a limited liability company, Malawi Tea Factory Company Limited (MATECO) owned 60% by STA and 40% by Admarc, constructed a tea factory in Mulanje From modest initial production of 180 tonnes of made tea in 1974, factory production has increased annually reaching approximately 3,000 tonnes in the 1994/95 season All green leaf produced by smallholders is now processed into made tea at the MATECO factory

The Government of Malawi, in terms of an accepted fiscal restructuring and deregulation programme, has agreed in principle to remove any legislative obstacles to participation in the production and marketing of special crops To this end, the schedule of special crops (including tea) was removed by Government Gazette of 19th January 1996 The Special Crops Act remains in place solely to maintain the legal status of crop authorities established under the Act until such time as an alternative appropriate legal form for these authorities is determined

3 FUNCTIONS PERFORMED BY SMALLHOLDER TEA AUTHORITY

The functions performed by STA can be broadly categorized as follows

- the marketing of green leaf grown by smallholders
- the transport of green leaf from smallholder plots to factory
- the provision of extension services to smallholders
- the maintenance of infrastructure to support smallholder tea growing
- the procurement of inputs for smallholders
- the provision of credit to smallholders
- the manufacture of tea, through its subsidiary Malawi Tea Factory Company Limited (Mateco)
- the development and maintenance of eucalyptus plantations

Each of these functional activities are discussed below, together with alternative options for the continued performance of these activities

3 1 Marketing of Green Leaf

All green leaf grown by smallholders is purchased by STA Historically, the price paid consisted of an initial payment (currently 120 tambala per kg) and a second payment dependent on Mateco profitability and is the same for all smallholders, irrespective of quality of leaf plucked or distance from the smallholder plot to the processing factory All green leaf is now sold to Mateco, though in the past the leaf grown in Thyolo district was sold to independent commercial factories situated in Thyolo This marketing arrangement suffered from a number of fundamental drawbacks

- There is no certainty that there will be a second payment to smallholders and no transparency in the calculations of the quantum of the second payment Smallholders, rightly or wrongly, feel aggrieved that they have no control over the level of overheads of the Authority and the tea factory which directly affects the amount available for second payment

- The absence of quality plucking incentives encourages growers to pluck heavier coarse leaf rather than soft leaf which would result in better factory productivity

- Paying a pan-territorial ex-plot price entails cross-subsidization of distant smallholders by those situated closer to the Factory

- Losses between plot and factory are borne by the Authority rather than the grower

OPTIONS

Since tea is no longer classified as a special crop, smallholders are free to sell their green leaf to any potential buyer It is, however, unlikely that existing privately owned tea factories would be interested in replacing Mateco as a buyer of smallholder leaf It is noted that the Government have recently facilitated the purchase of Chitikali Estate by Malawi citizens and there is also a possibility, subject to funds being available, of acquiring privately owned estates in Thyolo district If these estates are to be managed by Mateco, they may provide a further market outlet for smallholder leaf

The supply pattern of smallholder leaf is erratic and the peak plucking season for smallholders coincides with that of the estate sector when private factories are already operating at capacity Nevertheless, smallholders should be permitted to contract to supply leaf to private factories either directly or through intermediate buyers or through cooperatives or clubs of growers ,

It is questionable that STA has a role to play in the future marketing of smallholder leaf At present there is only one buyer, Mateco, and smallholders could contract directly with them either individually or as clubs or cooperatives STA's present involvement in the green leaf marketing process is largely necessitated by their involvement in leaf transport and provision of credit to smallholders Once these activities are taken outside the ambit of STA (see 3 2 and 3 6 below) there is no requirement for further STA involvement

The key issue will be the negotiation of a transparent and equitable basis for determining the price payable for green leaf Ideally the price should be a 'delivered factory' price and, if possible, should differentiate the quality of leaf delivered Even if smallholder tea growers become owners of the tea factory, it will be necessary for the leaf price to be linked to factory profitability, as shareholding percentages will not correspond to quantities of leaf supplied by individual growers Hence growers should be given an incentive for contributing to factory throughput

Steps have been taken to modify the basis of determining the price paid for green leaf From August 1996 growers will be paid a price equivalent to 55% of the average gross price achieved for made tea (with an assumed made tea out-turn of 20% of green leaf throughput) No second payment accrues to growers under the new arrangement

3 2 Transport of Green Leaf

At present, STA take responsibility for transportation of smallholder leaf from geographically dispersed plots throughout Thyolo and Mulanje to the Mateco Factory premises in Mulanje A fleet of more than 100 vehicles comprising tractors, trailers, and lorries is involved, though a significant number of these vehicles are no longer in running order The cost of this activity is expected to be in the region of K2 5 million for the 1995/96 financial year

The characteristics of the tea crop cycle are that weights plucked vary from little more than 100,000 kgs per month in July and August increasing to in excess of 2 million kgs per month in the period December through to April This leads to inefficiencies in the transport operation as the fleet capacity is tailored towards the peak months and during the off season, capacity is greatly underutilized Some of the spare capacity is used to transport firewood In addition, vehicles often carry much less than full loads during the off season

OPTIONS

It must be recognized that once green leaf is plucked, it must be delivered to the factory on the same day, otherwise it is not suitable for processing into made tea The future viability of both smallholder tea growing and Mateco is therefore critically dependent on a continuing effective leaf transport service

Numerous options exist whereby the transport operation could be run independently of STA For instance, the fleet might be sold off to growers or clubs of growers and responsibility for delivery of leaf to the factory left with the growers themselves The fleet could be sold to Mateco who would then take over the leaf collection function Alternatively, the transport fleet might be sold to a private entrepreneur not necessarily involved in the tea industry If this latter option were chosen, it would be of utmost importance to ensure that a contract ensuring due performance by the fleet owner was drawn up

Whichever option is chosen, it should be possible to achieve economies on transport costs as the excess fleet capacity during the off season would presumably be contracted out to transport other crops

Two questions arise from the present arrangement whereby significant transport costs are incurred in bringing leaf produced in Thyolo to the factory situated in Mulanje Firstly, does the Thyolo leaf make any contribution to profitability of Mateco or does the increased transport cost result in losses being incurred on this leaf Secondly, discussions have been underway for some time with a view to establishing an intermediate withering shed at Thyolo Construction of a basic structure has commenced at Malamulo in Thyolo area close to an Escom electricity transformer Management estimate a total capital cost of K750,000 to complete the building and install the necessary withering troughs and fans

Table 3A calculates existing leaf transport costs based on the 1996 audited accounts of STA Table 3B looks at the contribution per kilogramme of leaf throughput at Mateco factory to fixed costs and profits

TABLE 3A - CALCULATION OF LEAF TRANSPORT COSTS

	THYOLO	MULANJE	TOTAL
	K'000	K'000	K'000
Vehicle Running Costs	1105	1156	2261
Other Collection Costs	365	501	866
Total Transport Costs	**1470**	**1657**	**3127**
Weight collected (Kg'000)	2652	10697	13349
Transport Cost /Kg	55 4 tambala	15 5 tambala	23 4 tambala

TABLE 3B - CALCULATION OF CONTRIBUTION PER KG LEAF THROUGHPUT

	TAMBALA
Gross price per kilogramme tea	1054
- Selling expenses	(60)
- Paid to smallholder	(580)
- Other variable costs	(121)
Contribution per kg made tea	293
Contribution per kg leaf	59

Notes

Based on 1996 audited accounts, using a presumed out-term of 20%
Payment to smallholders assumed at 55% of gross realizations under new marketing arrangement

Conclusions

The transport cost per kilogramme of leaf from Thyolo is 55 4 tambala With a contribution of 59 tambala, it is just worthwhile transporting Thyolo leaf to the factory However, the margin is slight and a minor reduction in average tea price realized or a minor increase in transport costs may result in marginal losses being incurred on Thyolo leaf

The green leaf is 80% by volume water which reduces to 54% by volume water after withering which effectively translates into a reduction by more than half in leaf weight and volume as a result of the withering process The differential in transport costs between Thyolo and Mulanje is approximately 40 tambala/kg (see Table 3A) A 50% reduction in transport costs would yield a saving of 20 tambala per kg, which based on 1996 leaf purchases of 2,652,000 kgs results in a saving in transport cost of k663,000 This is, however, a rather simplistic view as the seasonality of the tea crop will continue to lead to unavoidable inefficiencies such as less than full loads Nevertheless, it does seem to make economic sense to complete the Thyolo withering shed as a 10 tambala/kg leaf saving in transport costs (i e 25% efficiency increase versus a possible 50%) will reduce annual costs by some K265,000, a three year payback for a K750,000 investment

3 3 Extension Services

In the past, STA provided extension services to growers using seconded staff from the Ministry of Agriculture paid for by STA However, these services are no longer provided as growers viewed the cost of extension officers as an unnecessary overhead which reduced the return to growers Extension services are now extremely limited There are three demonstration plots but the cost of transporting growers to the demonstration plots is prohibitive - ideally, there should probably be one demonstration plot for each of the 43 blocks of approximately 200 growers each

Other services to growers have included soil analysis by Tea Research Foundation (TRF) to recommend appropriate fertilizers and provision by STA of plants for in filling after periods of drought The tea bushes used for infilling are purchased from TRF

In terms of a draft memorandum of understanding (not yet agreed to by STA management or Board of Directors), K3 3 million of EU Stabex Funds are to be committed over the remainder of 1996 to provide infilling materials to smallholders (K1 6 million) and to fund extension services provided by TRF to smallholder growers (K1 7 million)

OPTIONS

It is understood that smallholder tea growers are not opposed to extension services but do not consider that they should pay for these services There may be merit in this argument as the Ministry of Agriculture provide extension services without charge to growers of other smallholder crops Smallholder tea growers make a significant contribution to government revenues both through income tax levied on their profits and the recently introduced excise duty on manufactured tea Forecast excise duty payable by Mateco in 1996/97 is almost K2 million equivalent to 13 tambala per kilogramme of green leaf, i e an indirect tax at the rate of 10% on proceeds payable to smallholders

TRF is funded by grants and a cess levied on all tea manufactured in Malawi Smallholders will contribute through the cess levied on Mateco to TRF funding It is therefore not unreasonable to expect TRF to play a role in the provision of extension services to smallholders To this end one might have expected to see smallholder representation on the TRF board of directors

The extension services requirements of growers appears to be divisible into three areas, with different entities being best suited to providing the various types of extension assistance

- TRF should continue to assist with soil analysis and input recommendations and also should conduct research into the development of tea bushes suitable for the requirements of smallholder growers which may not necessarily be identical to those of large commercial estates

- The Ministry of Agriculture can provide valuable assistance in training growers in appropriate technology soil and water conservation techniques They are also well placed to assist in the development of growers clubs and the provision of leadership training to club leaders

- Mateco should expand the number of demonstration plots to one per block of growers, perhaps modelling their approach on National Seed Company (NSCM) whose maize demonstration plots have worked to the mutual benefit of growers and NSCM Additionally, there is need to train growers in plucking techniques

Improved techniques will increase Mateco profitability and growers returns through both higher quality leaf plucked and a more coordinate inflow of leaf to the factory

3 4 Maintenance of Infrastructure

Using government subventions and EU Stabex funds, STA have until recently maintained the roads and bridges around the smallholder plots to facilitate transport of green leaf to the factory In recent years no government subvention has been received for this purpose and until 1994 infrastructure maintenance was funded through approved draw-downs on Stabex funds

Subsequently, the EU suspended draw-downs on stabex funds, apparently as a result of the use of these funds for unauthorized purposes by crop authorities other than STA STA currently hold some K13 million of stabex funds in interest bearing accounts of which a significant sum was originally designated to fund maintenance of roads and bridges However, EU and Government of Malawi have re-negotiated the approved purposes for which the 'suspended' stabex funds may be used As a result STA have been requested to refund to the main EU stabex account all funds held apart from that required to carry out the infilling programme and extension programme referred to in 3 3 above

OPTIONS

It is beyond the scope of this study to comment on the most appropriate use for Stabex funds However, if funding is not available from this source, the road and bridge maintenance programme will certainly not continue It is assumed that Government would not wish to resume subventing the Authority to carry out this activity

Logically, the maintenance of these roads and bridges should be the responsibility of the Ministry of Works Maintenance should be carried out as part of the national infrastructure maintenance plan which presumably prioritizes projects in accordance with their economic and social importance It is also possible that individual projects, carried out on a self-help basis, would qualify for funding by the Malawi Social Action Fund (MASAF)

As the Authority evolves into a more commercially orientated entity, it is likely that some prevailing practices may change For example, the number of leaf collection points may be reduced, with the onus on growers to bring their leaf to central collection points Suggestion is that part of the proceeds of any privatization of STA/Mateco be applied to rehabilitate the existing infrastructure Thereafter, it would become incumbent on growers and management of the Authority's successor body to decide on wholly commercial grounds, the level of future infrastructure maintenance and which parties should bear the cost

3 5 Input Procurement

STA procures the input requirements of smallholder tea growers, which are subsequently supplied on credit to the growers For the purposes of this report the provision of credit is viewed as a separate function and discussed in 3 6 below

The major input is fertilizer - estimate 1996/97 requirement is some 900 tonnes of urea to be purchased from Hardware and General Dealers Limited Suppliers vary from year to year, in 1995/96 Compound T fertilizer was purchased from the Press Agriculture blending plant

Other inputs supplied are limited to leaf collection bags (polypropelene sacks), approximately 500 pruning knives per annum, and very small quantities of pesticides

There is some suggestion that part of the fertilizer supplied is diverted from tea to other smallholder crops such as maize

OPTIONS

Growers should be free to source the input requirements from whatever supplier they choose STA's continued involvement in the provision of farm inputs (particularly when credit is also provided on non-commercial terms) is inhibiting private sector development in this area

3 6 Provision of Credit

In the background section of the terms of reference for this study it is stated that "STA's main function is to provide long term credit on planting materials and inputs during the first five years of field establishment It also provides seasonal credit in kind to growers with good repayment records"

However, the provision of long-term credit is becoming rather less important As would be expected, with no expansion in tea areas, no new loans are being forecast for 1995/96 or 1996/97 Management now place a stricter interpretation on new growers and those growers registering after acquiring existing tea gardens no longer qualify for long term loans Additionally, loan repayment periods have been shortened considerably through increasing the amounts withheld from leaf proceeds (known as capital cess) from 2% of proceeds to 15% of proceeds Indeed, management forecast that long term loans which stood at K1 9 million at 30 June 1995 will reduce to K1 3 million at 30 June 1996 and a mere K30,000 at 30 June 1997

Seasonal credit is also more closely monitored As stated, only growers with good repayment records receive credit The rate of recovery of seasonal loans has also been increased from 40% of leaf proceeds to 50% of leaf proceeds

Although loans are, prima facie, provided interest free, growers effectively bear a full commercial rate of interest In essence, the profits of the combined STA/Mateco operation are distributed to growers by way of first and second payment for leaf Any interest costs incurred by STA through borrowing to fund credit to growers depresses profitability and is directly reflected in the leaf payments to growers (similarly interest income is foregone where STA do not have to resort to borrowing) In the circumstances of STA, the provision of interest free credit is inequitable amongst growers as the cost thereof is reflected in a lower per kilogramme leaf price meaning that growers 'interest' increases in proportion to weight of leaf produced by him rather than by reference to the quantum of his borrowing

OPTIONS

It is assumed that long-term credit will disappear in the course of the next twelve months, through accelerated repayments and that no fresh long term credit will be granted

As explained above, growers as a body are effectively already paying a commercial rate of interest on seasonal borrowings but there is need to relate the 'interest' suffered by individual borrowers to the amount of individual borrowings Mateco have already arranged a facility with FINCOM to fund 1996/97 seasonal input requirements of growers The interest suffered on this facility should be passed on to growers by charging them interest on their seasonal loans at a modest premium above the FINCOM interest rate to cover administration costs and bad debt risk

It could be argued that STA should withdraw from providing seasonal credit Growers should fund their input requirements either from their own resources or through borrowing from a financial institution such as Malawi Rural Finance Company Limited There are two factors inhibiting growers ability to borrow from an independent financial institution Firstly, the financial institution will require some form of extension service to ensure that funds borrowed are applied for the agreed purpose and that proper crop husbandry techniques are employed Secondly, growers have no collateral to offer for their borrowing beyond some form of stop order over green leaf sales to Mateco Tea is grown on customary land which cannot be used as collateral for the purposes of raising finance Were the nature of smallholders title to their lands to be changed to long leasehold, the individual smallholders would be able to offer land as security for borrowings

Because Mateco is an exporter earning foreign currency from tea sales, it can enter into foreign currency denominated borrowing at very advantageous interest rates (approximately 15% per annum versus almost 30% per annum for kwacha denominated borrowings) Growers as individuals are not exporters and could not avail of this facility A significant economic benefit accrues to growers as a result of borrowing 'through' Mateco Despite the administrative burden involved it is suggested that the best option for the smallholder is for Mateco to continue to source their seasonal credit requirements As stated earlier, interest should be passed on to growers and there may also be need to incorporate provisions into the seasonal credit terms to protect Mateco from exchange risk It is also important to closely monitor the situation, as local borrowing rates are declining rapidly and the relative advantage of foreign currency borrowing may be eliminated

3 7 Manufacture of Tea - Mateco

Smallholder leaf is now exclusively processed into manufactured tea at the Mateco factory Mateco is a private limited company owned 60% by STA and 40% by Admarc It operates a relatively modern tea factory achieving acceptable out turn rates of made tea from green leaf processed (around 21%) Manufactured tea is sold by direct negotiation with overseas buyers and through the Limbe, London and Mombasa tea auction floors Prices achieved for tea sold are consistently above the Malawi average price A small added value operation has recently been introduced, packaging made tea which is offered on the local retail market under the brand name Mateco Mount

Mateco has operated, throughout the years, for the financial benefit of the smallholder grower, rather than its shareholders The profits of Mateco are passed onto STA by way of a second or bonus payment for green leaf delivered STA, in turn, distribute all of their profits through a second payment to growers

OPTIONS

Obviously, Mateco must continue to offer a market for green leaf grown by smallholders The first issue that remains to be addressed is, whether Mateco should contract for leaf supplied with STA who in turn contract with individual growers or whether Mateco should contract directly with growers On the presumption that either Mateco or a contracted private transporter take over responsibility for transport of green leaf to the factory, there appears to be no need for STA involvement in green leaf marketing It will be necessary, however, if Mateco contracts directly with growers to have a leaf purchase agreement which includes a transparent price fixing arrangement acceptable to both Mateco and the growers

The second issue is whether STA and Admarc should continue as shareholders in Mateco In line with the ongoing privatisation programme, the STA and Admarc shareholdings should be transferred to private ownership The objective of achieving wide public participation is probably best served by allowing registered smallholder tea growers to purchase the shares presently held by STA and Admarc To enable this to happen it will first be necessary to alter the memorandum and articles of association of Mateco to those of a public company and to increase the present issued share capital of Mateco through, say, a bonus issue of shares

It is highly unlikely that registered growers will have sufficient funds to acquire Mateco shares for cash It will be necessary to establish an intermediate holding vehicle for the shares, such as a trust, from which growers could acquire the shares in piece meal fashion The trust may also have a long term purpose if eligible shareholders are limited to registered smallholder growers, a vehicle will be required to buy shares from growers leaving the scheme and to sell shares to growers entering the scheme It might also be desirable to have a 'golden share' held by the trust to give the trustees power to arbitrate the likely conflicts of interest between return to growers as shareholders and return to growers as suppliers of leaf Shareholdings will not correspond to quantities of leaf delivered and therefore some growers would want a higher dividend whereas others would want a higher leaf payment and lower dividend

3 8 Forestry

STA have established approximately 350 hectares of eucalyptus plantations on public land at various locations throughout the Thyolo and Mulanje districts The firewood from these plantations is sold to Mateco, where it is used for fuel in the tea manufacturing process

OPTIONS

Although STA make a book profit from the sale of firewood, the plantations are being maintained for the long-term benefit of Mateco, as they provide a secure supply of an increasingly scarce fuel resource

Logically, Mateco should purchase these plantations from STA However, it would first be necessary to provide secure title to the plantation lands by converting them from public lands to long leasehold

The plantations are situated at diverse geographical locations It is possible that Mateco management might consider that the cost of transporting firewood from sites remote from the factory would be prohibitive and they may decline to purchase these plantations The initial reaction of Mateco management is that they would wish to take over all the forestry areas with the exceptıon of Zoa forest In thıs event, two optıons exıst Eıther the Department of Forestry take over the runnıng of these plantatıons and pay STA an approprıate level of compensatıon for establıshment costs ıncurred or the plantatıons are sold by publıc auctıon The latter optıon would be more ın lıne wıth the objectıves of the on goıng prıvatızatıon of publıc enterprıses

4 FINANCIAL STATUS OF STA

4 1 Operating Results

The operating results for 1994 and 1995 of STA and its subsidiary company Mateco are summarized in Tables 4A and 4B below and on the next page

Table 4A STA - Summarized Profit and Loss Account 1994 and 1995

	1994	1995
	K'000	K'000
Leaf sales	12999	27542
Sundry income	377	1452
Total income	13,376	28,994
Leaf purchases	18411	20719
Leaf collection & workshops	747	1760
Estate expenses	161	378
Administration	1197	2545
Interest payable	670	682
Other costs	43	59
Total expenditure	21,229	26,143
Profit / (loss) before subvention	(7853)	2851
Government subvention	7091	—
Kgs leaf purchased	15,336,695	14,284,907
Total leaf price paid	120t/kg	145t/kg

Source 1994 and 1995 audited accounts

Table 4B Mateco - Summarized Profit and Loss Accounts 1994 and 1995

	1994	1995
	K'000	K'000
Net sales	13970	36971
Sundry income	97	973
Total income	14,067	37,944
Leaf purchases	10835	26876
Other manufacturing costs	2694	4644
Administration charges	833	1607
Finance charges	9	3
Total expenditure	14371	33130
Profit / (loss) before taxation	(304)	4814
Kg leaf purchased	11,783,923	13,451,878

Source 1994 and 1995 audited accounts

The 1994/95 season saw a recovery from the disastrous operating results of 1993/94, in which a government subvention of K7 million was required in order to secure the survival of the Authority The 1993/94 results were exceptionally poor because of a dramatic increase in initial leaf price paid to smallholders (from 25t/kg to 105t/kg) which did not come about because of any change in the world tea market but was perhaps influenced by political considerations Perversely, the dramatic fall in the value of the kwacha over the period June to September 1994 resulted in a similar dramatic increase in the kwacha proceeds of tea sales whose value was denominated in foreign currency The revised leaf price became sustainable in 1994/95 enabling STA and Mateco to generate combined profits before taxation in excess of K7 million even after increasing the leaf price (including bonus) to growers from 120t/kg to 145t/kg

Reliable figures for the 1995/96 season are not yet available but early indications are that the combined STA/Mateco operation will revert to a loss making position, due to a weakening in per kilogramme realizations for tea and a drop in throughput increasing per kilogramme processing costs In common with the tea industry in general the 'temporary' export levy on tea exports (imposed at 10% in the 1995 budget and renewed at the rate of 8% in the 1996 budget) has severely impacted profitability Also, the stability of the kwacha exchange rate against the US dollar has ment that the prices for tea have not appreciated in kwacha terms in a period when local inflation has approached 100% per annum

4 2 STA Assets and Liabilities

Accounts as at 30th June 1996 are not yet available but the latest estimates prepared by the company management can be used as a guide to the present financial status of STA

Excluding stabex funds to be refunded to EU or applied on designated projects and without providing for any bonus payments from Mateco or to growers in respect of the 1995/96 season, the estimated present financial status of STA on 30th June 1996 is summarized in Table 4C below

Table 4C STA Financial Status at 30 June 1996

	Estimated book value	Estimated market value	Notes
	K'000	K'000	
Fixed Assets	1194	9000	1
Plantations	1138	7000	2
Growers loans	1340	1000	3
Shares in Mateco	6	6000	4
Stores	2465	500	5
Debtors and prepayments	3400	3400	6
Cash and bank deposits	3256	3200	6
Total assets	12,799	30100	
Less creditors	3470	3500	6
Net worth	9329	26600	

1 Fixed assets comprise land and buildings, vehicles, and sundry plant and equipment

The land and buildings were valued over the period October 1995 to January 1996 by the National Property Advisory Service They include the head office complex consisting of offices, workshops and storerooms, a warehouse, some fifty staff houses situated at the head office and nearby at Pumula, some forty houses situated within the tea blocks and a number of sheds and offices also situated within the various tea blocks The total value given was K5,823,000 of which K2 million approximately by value are dwelling houses

The book value of the vehicles, plant, and equipment is approximately K500,000 The most significant value attaches to the vehicle fleet An independent valuation has not been carried out but even if only 50% of the 100 strong fleet are in running order, a conservative value of K3 million can be given for illustrative purposes

2 The Authority has 350 hectares of eucalyptus plantations Although no evidence was obtained of recent transactions involving the sale of plantations, the future economic benefit of this scarce resource is, based on discussions with agriculturalists, conservatively put at K20,000 per hectare

3 With the increase in the rate of loan recovery, management estimate these loans to be recovered in full by 30 June 1997 Discounting the gross value of the loans for the period to recovery would place a present value on the loans in the region of K1 million

4 An early draft of the June 1996 Mateco management accounts indicates a net asset value for the company in the region of K30 million This net asset value is essentially represented by the value of the factory, plant, and equipment based on valuations carried out during the year by independent valuers However, given that a 600 hectare tea estate complete with factory and related infrastructure was recently purchased for K15 million, the validity of a K30 million valuation for a factory alone is brought into question For illustrative purposes, a more conservative valuation of K10 million is placed on the factory which values STA's 60% shareholding in Mateco at K6 million

5 Stores are mainly vehicle spares of which the majority are slow moving or obsolete It is likely that the value of these spares would be heavily discounted in the event they were offered for sale on the open market

6 Monetary assets and liabilities are expected to realize their book value

5 OPTIONS FOR THE FUTURE OF STA

5 1 Objectives of STA

In Section 2 of this report the objectives for which the Smallholder Tea Authority was established are set out i e "to promote and foster the development of tea by smallholders in the areas of Mulanje, Thyolo and Nkhata bay districts "

There is no longer scope for promotion of smallholder tea growing in Nkhata Bay district as the land originally designated for smallholders is now owned by a private limited company STA would appear to have achieved its objective of developing smallholder tea growing in the Thyolo and Mulanje districts as evidenced by the impressive growth in the areas of smallholder tea under cultivation to its present level of 2685 hectares

Despite the acute pressure on the land resource in Thyolo and Mulanje district, there is still potential for increasing the area under cultivation of smallholder tea Occupants of customary land in the Thyolo highlands and on the eastern slopes of Mount Mulanje have considerable interest in becoming smallholder tea growers It was originally intended that EU Stabex funds be used to provide planting materials for these potential farmers However, these funds are no longer available for this purpose and it is beyond the financial means of the Authority to provide medium to long term credit to enable farmers to establish tea gardens

There does appear to be potential to increase the productivity of the existing smallholder tea plantations Present yields in the region of 5600 kgs of green leaf per hectare are less than half that achieved by the estate sector There are mitigating factors which affect smallholder yields The quality of land cultivated by smallholders is not as good as that of the estate sector and the small size and geographical dispersion of the smallholder plots inhibits the use of best farming techniques However, there are wide variations in productivity and hence income amongst the growers with annual leaf sales varying from virtually zero to in excess of K75,000

Customary land is subject to sub-division on inheritance resulting in smaller tea gardens, in some cases beyond the threshold at which it is economically viable to apply a full regime of recommended crop inputs Conversely, where growers have been able to acquire a number of plots, yields achieved and income generated has increased dramatically This points to a need to review the system of land tenure A change to leasehold offers two apparent advantages A land rent would be chargeable, creating a cost which encourage under-performing growers to consider whether it is worthwhile continuing to hold onto land As leasehold land would be readily marketable, successful growers would be afforded the opportunity to increase the size of their land holdings As a result overall productivity per hectare would increase

5 2 Future of STA

Section 3 of this report discusses the functions carried out by STA It appears that all the present functions of the Authority could be carried out at least as efficiently by some entity other than STA, either Mateco or an independent private entity in the case of commercial functions or directly by the Ministry of Agriculture in the case of developmental functions such as extension services

The suggestion is therefore, that the Smallholder Tea Authority be wound up The assets of the Authority fall into two categories, those which will be required by Mateco to carry on the functions presently performed by STA and those assets which will be surplus to requirements The ideal solution would be to wind up STA by selling for cash to Mateco those assets which they will require and selling surplus assets by public auction

There are, however, a number of factors which inhibit adoption of this 'theoretically ideal approach'

Mateco do not have funds to pay cash for assets acquired and even if long term finance could be identified to enable Mateco to buy the assets it is unlikely that Mateco's present level of profitability could sustain the debt service costs unless the level of payment to growers for green leaf was reduced

Furthermore, certain assets of STA, though not required for the long term efficient operation of Mateco, may be required in the short term For example, the entire STA headquarters complex could be surplus to requirements, but only if Mateco have expanded their office accommodation, workshops and stores at the Mulanje factory site

It is therefore suggested that the non-monetary assets of STA are transferred to Mateco at an independently determined fair market value and in exchange Mateco issue shares to STA There will be certain legal formalities to attend to prior to the transfer, notably increasing the authorized capital of Mateco and altering the status of the public land presently occupied by STA to permit it to be transferred to Mateco

The monetary assets of STA (cash and debtors) would be retained to settle STA liabilities, such as creditors and growers bonus payments accrued and any terminal benefits due Any net balance remaining would be paid into the Privatization Revenue Account

5 3 Future of Mateco

Mateco is presently owned indirectly by Government through STA and Admarc The proportionate STA and Admarc holdings may alter if STA assets are sold to Mateco in exchange for shares but Government will remain the ultimate 100% shareholder

In accordance with Government policy of withdrawing from ownership of public enterprises it is anticipated that Mateco will be privatized The objectives of the privatization programme as set out in the Public Enterprises (Privatization) Act of 1996 are as follows

- to foster increased efficiency in the economy,
- to increase competition and reduce monopoly in the economy,
- to promote participation by the Malawian public in enterprises,
- to raise revenue for the Government

There are inherent conflicts between some of these objectives e g there may be need to forego some revenue from the disposal of Mateco in order to achieve the broadest possible public participation

Several alternatives exist for the disposal of Governments interests in Mateco including

- offer for sale of the entire shareholding or assets of Mateco to interested private entrepreneurs

- offer for sale of part of the shareholding to a suitable technical partner with the balance of the shareholding being offered to growers or the public at large

- public offering of the entire shareholding

- sale of the shares to registered growers and employees of the company

Sale to a private entrepreneur would not achieve the objective of broad public participation It may result in increased efficiency but with a virtual monopsony over the purchase of smallholder leaf, there would be need to create a mechanism to regulate the basis of fixing the green leaf purchase price

There does not appear to be a need to introduce a technical partner Present management of Mateco appear competent and factory performance and prices achieved for tea equal or exceed industry norms There may be merit in introducing a technical partner into the value added operation If this is considered necessary in the future, the value added operation could be hived off into a separate company with Mateco becoming a shareholder in that company There is, however, no need to take this step prior to privatization

Mateco is not, at present, suitable for an offering to the public at large There is no history of profits or dividends Furthermore, there would undoubtedly be a risk of conflict arising between the interest of growers and that of independent shareholders

The most appropriate method of privatizing Mateco would appear to be through offering the shares in the company to growers and employees These categories embrace in excess of 6000 potential shareholders

An innovative financing mechanism will be required to enable growers and employees to acquire shares Section 31 of the Public Enterprises (Privatization) Act prohibits the sale of shares on credit unless otherwise prescribed by regulations under the Act

The shares held by STA and Mateco could be transferred to an intermediate holding vehicle such as a trust which would hold the shares with a view to disposal to growers and employees over a period of time Part of future leaf proceeds and employee remuneration could be used to purchase shares from the trust with the proceeds of shares sold by the trust being deposited in the Privatization Revenue Account

The present net asset value of Mateco is in the region of K30 million Assuming that the non-monetary assets of STA are transferred to Mateco in exchange for shares, the net asset value would increase to in excess of K40 million However, this is not an indication of the fair market value of the company, particularly if one considered that Chitakali Estate comprising 600 hectares of tea, tea factory and associated infrastructure, vehicles and equipment was sold for K15 million

The consultants have not been asked to place a value on Mateco and, in any event, a decision as to the level of discount below fair market value to be granted to purchasers would need to be taken by the Privatization Commission

It is suggested that the trust should not be self liquidating but that a proportion of the Mateco shares should be retained by the trust to cater for new growers and employees Additionally the trust would offer a vehicle for buying back the shares of retiring growers and employees

It is felt that all growers should be given the opportunity to acquire an equal number of shares and be given a period of time in which to exercise this option After the option period has expired, shares not taken up would be offered to existing shareholders Although this may appear a rather lengthy process, it would ensure that the ownership of the company shares does not initially become concentrated in the hands of the wealthier growers

Section 21 of the Public Enterprises (Privatization) Act permits the Minister of Finance to acquire a share in a privatized enterprise conferring special rights to intervene in the operations of the enterprise In the case of Mateco, it may be necessary that such a share be held by the Minister or by the trust on his behalf The interests of shareholders and growers will directly conflict unless shareholding percentages directly correspond to percentages of leaf delivered by each shareholder (which is clearly impossible) Until such time as a competitive market for smallholder leaf develops, it may be necessary for Government to retain the right to intervene in the setting of the green leaf purchase price in the event that the company fixes an unfair price to the advantage of shareholders and disadvantage of growers as a whole

6 HUMAN RESOURCES

As discussed in Section 3 of this report, STA have reduced their involvement in a number of areas, particularly extension services and maintenance of infrastructure, with the result that the level of permanent staff at the Authority has been greatly reduced in recent years In particular extension service staff, seconded from the Ministry of Agriculture, but paid for by STA, are no longer on the STA payroll

In addition a number of senior positions on the existing organization chart are vacant, notably, General Manager, Chief Technical Manager and Financial Controller The General Manager's duties are being performed by the General Manager of Mateco and the Financial Accountant is presently acting as Financial Controller, though STA have recently advertised in the local press with a view to recruiting a Financial Controller

Excluding the General Manager of Mateco, who receives a modest monthly allowance for acting as STA General Manager, there are 17 staff on the senior staff payroll, 9 in the accounting department, 4 in the vehicle workshops, the chief security officer, the forestry manager, and 2 district managers, one each for Thyolo and Mulanje

STA also employ 43 drivers and 120 full time labourers (supplemented by temporary staff during peak plucking season) More than half of the full time labourers are employed either as watchmen or labourers in the Authority's plantations and apart from a few general labourers who look after the head office area the balance of the full time staff are either motor vehicle assistants or assistant mechanics

If, as suggested, the leaf transportation function and the eucalyptus plantations are transferred to Mateco it seems unlikely that any significant level of staff retrenchment would be required The Mateco accounting function is presently carried out by STA and therefore, if STA were wound up, Mateco would be obliged to take on accounting staff, preferably from amongst the existing STA accounting staff who are familiar with the business Excess staff members in the new organization would be modest, limited to a few relatively low paid individuals and the insignificant cost attached could be borne until the optimal staff complement is arrived at through a process of natural wastage

However, even if Mateco took on all STA permanent staff, there would remain a legal obligation for STA to pay retrenchment benefits to these individuals In the circumstances, where no hardship is likely to occur to the 'retrenched' individuals, there would appear to be no justification for paying beyond the legal minimum amount stipulated in the Authority's conditions of service Based on latest salaries, the redundancy pay entitlement of STA staff (calculated at one month's salary for each year worked) is approximately K800,000 In addition, pay in respect of any accumulated leave days would also fall due for payment

The suggested option for the future of Mateco envisages that company continuing as a going concern As such, there is no legal obligation to pay retrenchment benefits to Mateco employees However, it is likely that Mateco employees will lobby strongly to be afforded the same treatment as their counterparts in STA In the event that it proves necessary to pay retrenchment benefits to Mateco employees, their entitlement is calculated at K600,000 approximately plus any accumulated leave pay on the same basis as that for STA

7 ACTION PLAN

The Public Enterprises (Privatization)Act requires that the Privatization Commission approve any proposed restructuring or privatization of state owned enterprises It will therefore, be necessary that their approval be sought for any proposed course of action including the proposed pricing of shares to be sold to growers and staff Legally, the Privatization Commission have control over the disposition of the Admarc 40% minority shareholding in Mateco but, undoubtedly, the Commissioners would wish to consult Admarc senior management for their views on the proposals at least in so far as they affect Admarc's shareholding Accordingly, the initial step in the action plan will be to seek the approval of the Privatization Commission

On the assumption that the Privatization Commission approves the proposals, then all other steps in the process become the responsibility of the Privatization Commission or their agents should they wish to appoint independent agents to carry out the work on their behalf The various steps envisaged are set out below in approximate chronological order but many of the tasks can be performed contemporaneously

- Stamp duty implications to be resolved

  Discussions to be held with the Ministry of Finance to assess stamp duty implications of contemplated property and share transactions Where necessary, stamp duty exemptions to be sought

- Alteration of Mateco memorandum and articles and increase in authorized capital

  Extraordinary general meeting of Mateco shareholders (Admarc and STA) will be required to change status of Mateco to a public company and increase its authorized share capital

- Resolution of land issues

  Negotiate with Ministry of Lands for change in status of public lands presently occupied by STA to enable Mateco to occupy them on leasehold title

- Establish trust

  Lawyers to be instructed to prepare trust deed in order that trust can be formed Trustees to be determined in advance

- Transfer of Assets

  STA and Admarc shares in Mateco to be transferred to the trust
  STA non-monetary assets to be transferred to Mateco

- Offer for sale of shares

  An offer for sale document will be required to be circulated amongst the 6,000 approximate potential shareholders in Mateco giving information on financial status of the company and details of the terms of offer

  In order to achieve the widest ownership spread, growers and staff would be permitted to acquire shares in blocks of say K100 value over a period of time up to a maximum individual holding After this period had elapsed, shares not taken up would be re-offered to existing shareholders including those who had already reached their maximum limit After the re-offer any remaining shares not taken up could be offered to the public at large

- Winding up of STA

  After collection of all monetary amounts due to STA, and settlement of all liabilities, including retrenchment benefits any net cash balance remaining would be paid over to the Privatization Revenue Account and STA could be wound up

- Proceeds of shares

  The proceeds of shares would flow through the trust to the Privatization Revenue Account