Interview with Gottfried Thoma, Managing Director and Chief Executive Officer of Ceylon Tobacco Company Ltd.

Could you explain the reasons for the fall in sales in 1997?

Sales have fallen a bit more than 6% in the first nine months of the year compared with the same period last year. There are two reasons – one is the significant increase in smuggled products from abroad – international brands like Marlboro, Rothmans, Dunhill, Winston, Salem which you can find in stores in Colombo and even up in Kandy. So we're getting hit on the top end and we're getting hit on the low end which is basically the illegally manufactured cigarettes here in Sri Lanka which are selling at a very, very low price because they don't pay any taxes or defense levy or anything else. We see them in Colombo, Matara, Galle, Kandy. They are spreading wider and wider. It is a recent phenomenon. We heard about two or three cigarette making machines being imported, most likely from China. There are filter cigarettes selling for one rupee. We're charging Rs 4.50 for one stick. You have to keep in mind that we're paying more than Rs 3 already in excise taxes. So the government is losing much more than we're losing.

The anti-smoking lobby has said that part of the reason for the fall in sales is that people are moving away from smoking or that those who smoke are giving up smoking?

Personally I don't think so. I can say on behalf of the company our research indicates people enjoy smoking. It is the choice of adults. We believe the major negative impact for the sales drop has come from the increase in smuggled international cigarettes and the recent phenomena of legally manufactured local cigarettes. We don't believe hat people are moving away from cigarette smoking beause of the so-called dangers of smoking. There is the hird issue of product affordability – cigarettes simply have become a bit too expensive.

How will it help if the government cuts taxes on cigarettes?

It will help tremendously. I said earlier about product affordability – if you look at especially people in the outstations- you have the husband, the wife, two or three kids. Your income has to feed the family, clothe your kids, before you have the luxury of let's say of going to the cinema or smoking a cigarette, or having a glass of beer. If the government reduces taxes people will enjoy to a much larger degree smoking cigarettes because it is a product which you use for enjoyment. Even in beer, when the price dropped, there was a tremendous upsurge in demand for beer. It becomes more affordable. We're the highest taxed cigarettes in the region and the second highest in the world. 82% of our revenue goes to the government in the form of various taxes. Out of every Rs100, Rs 82 goes to the government by way of taxes. When we talk about smuggled cigarettes and illegally made cigarettes…of course it hurts us. It hurts our farmers, it hurts our distributors, but mostly it hurts the government. Our preliminary estimates indicates Rs 1.5 billion is lost by the government because they lose on the excise tax the smugglers don't pay that, the illegal manufacturers don't pay that or the defense levy, BTT, income tax.

Why not do something about it and get that money in the government coffers. We're hopeful that something will happen. Up to now there have been lots of good intensions but no implementation.

Why can't you cut your prices? Won't that increase sales?

If we cut the price – keep in mind 82% goes to the government we can cut our price and say 'Look no more profits for the company' so we do it for nothing, we sell for nothing and we still pay 82% to the government. So the impact we can make is very little. It is only out of the remaining 18% out of Rs 100 that we have to pay retailers, distributors, the leaf cost more than Rs 500 million goes to the outstations for the purchase of leaf- we have to pay our cost of production, we have to pay our people, plus we want to make a reasonable profit. And we have to also invest for the future. in new technology. Cigarette machines are extremely expensive. In 1996 we invested over Rs 400, in 1997 Rs 500 million, in 1998 we plan to spend over Rs 300 million on machinery in addition to training people to make world class products which comply to world class standards.

By how much should the government cut taxes?

It is a balanced approach you have to take. You have keep in mind that most likely CTC is the highest tax payer in the country- nearly 10% of total government revenue comes from CTC. The government is also a major stakeholder in our

business. If they cut taxes significantly cigarette consumption would increase but if they cut it by much at the beginning they might lose revenue. So what about all the social welfare programmes. I would dare to say if we reduce our price, let's say a Goldleaf down to Rs 3, Bristol down to Rs 2-I would dare to say that in five years the total market size will double. By doing that we could eradicate all the smuggled cigarettes because those guys would no longer make a profit. Those cigarettes would go out because the quality of our cigarettes is better.

Despite the drop in sales your turnover and after-tax profits have increased. Some analysts have said that this is because you're marketing of high-margin, up- market brands and because of staff cuts?

It is not because of high-margin brands. Both Bristol and Goldleaf are what you call high-priced brands but not premium brands. Benson & Hedges, for example, is a premium brand but it is sold only in small quantities. Now how did we achieve an increase in after-tax profits despite a 6% sales drop? Point one – turnover increased due to price increases. Again the major beneficiary was the government. Point two – our company is going through a major re-engineering process. If we are faced with smuggled and illegally made cigarettes we have to contain our costs. So we're getting a company which is very, very lean in terms of staff. Along with staff reductions we're introducing modern technology very gently. We're paying a huge amount of money to make sure people leaving the company are all taken care of under our highly incentivized voluntary separation scheme that works hand in hand with the unions at CTC without any industrial unrest. That is the reason why profits have gone up… profits after-tax and not profit before tax. About 91 people have left. Others have expressed a desire to leave. We have a staff of about 1,100, including those at CTC Foliage. The minister of labor said to me recently that CTC is really an example for Sri Lanka the way industrial relationships should be. open dialogue, no hidden agenda, taking well care of our people – sensible staff cuts in co-operation with the workers and the unions.

Keep in mind also that due to our very high investment we're entitled to incentives which have been given by the government to industrialists. So our profit after-tax increased because of those incentives. Profit after-tax has come up because of those tax incentives. But if you look at profit before taxation – last year Rs 569.7 million, this year Rs 567 million. So although profit before tax has come down, sales have come down, it is only because CTC is investing so much for the future and we're getting those tax incentives that profit after-tax has come up. But it is a very unsatisfactory situation. We're spending hundreds of millions of rupees in investing

for the future and you know that your sales are coming down, profit before tax is coming down. The profit after-tax is up only because of tax incentives just because of those bloody products.

Also we have to look for export markets. Our exports are about 15%. We want to increase exports to more than 25%. That’s one way for us to make sure we continue to be a very viable operation in Sri Lanka. Because if this trend continues that’s what we’re extremely worried about – our domestic volume will shrink because of smuggled and illegally made cigarettes.