

Capstone 1

Kingsdale Tea Inc. — Case

Candidates are expected to use the case facts from the Capstone 1 case to complete their analysis. It is not expected that candidates consider the impact of emerging current events (such as the COVID-19 pandemic) in their response. However, candidates may choose to do so in a reasonable way. For instance, when conducting industry research, candidates may encounter and consider the implications of COVID-19 on the industry. However, the impacts of current events (including COVID-19) are not meant to be a significant part of candidates' analysis.

Capstone 1

Kingsdale Tea Inc. — Case

CPA Evaluation — 2023

It is April 28, 2023, and you are working as a CPA with F & W Consulting LLP (FWC). You have been assigned to develop a report for the board of directors (board) and management of Kingsdale Tea Inc. (KTI).

KTI has approached FWC with a request to assist them in strategic analysis and to set a new direction for the company. Based on past years' results, the board is concerned about the stagnant revenues and declining profits as well as reliance on existing customers. There are conflicting viewpoints among the three shareholders as to how the company should grow in the future, as well as many operational issues that they would like you to analyze and address.

You have been provided with the following information to review and analyze (all dollar values are in Canadian dollars unless specifically stated otherwise).

Kingsdale Tea Inc.

KTI, a privately held Canadian company, is a tea producer currently selling private-label products to four grocery retailers and three food service chains in Canada. KTI is 70% owned by Michael Galinsky and 15% each owned by his son Jason Galinsky and his daughter Sabrina McLean. Kathleen Galinsky, Michael's other daughter, works in the company but does not yet have any ownership.

An organizational chart is provided in Appendix I. KTI's most recent financial statements for the years ended December 31, 2020, 2021, and 2022 (prepared under IFRS) are provided in Appendix II. Industry benchmarks are provided in Appendix III.

Industry information

The coffee and tea production industry in Canada has total revenues of \$3.1 billion, of which tea represents \$1.27 billion.¹ The total industry is expected to grow at an annual rate of 4.7% until 2024, driven by increased exports and high profits.² A subcategory of this industry is tea production, which includes the processing and packaging of tea leaves for all categories of teas, as described in the next section. Excluded from this industry are companies that bottle or can ready-to-drink (RTD) teas and herbal tea producers.

¹ Eva Koronios, "Strong brew: The world price of coffee as fostered strong revenue growth," *IBISWorld Industry Report 31192CA: Coffee and Tea Production in Canada*, April 2019.

² Koronios, 2019.

Product differentiation

Tea products can be differentiated by both category of tea and packaging.

Categories of tea

- There are three main classifications of teas made from the *Camellia sinensis* plant:
 - Traditional tea: This includes black, green, white, and oolong teas.
 - Specialty teas: These are high-quality, premium versions of traditional tea, often grown on small tea estates and carefully processed to maintain their quality and enhance their taste. Organic teas are also included in this category.
 - Flavoured teas: These are traditional teas that have been blended with spices and fruit to produce unique flavours.
- Herbal teas are made from herbs and not from the *Camellia sinensis* plant. They can also be flavoured with spices and additives.

Black tea is by far the most popular traditional tea, and will likely continue to be so in the future due to its health benefits from antioxidants and polyphenols.³ Green tea is expected to have the highest year-over-year growth rate, both because of its related health benefits and because tea drinkers are becoming more educated about the benefits of different types of teas.⁴ Herbal teas are often consumed in the evening to relieve stress and help induce sleep, since they are caffeine-free.

Within all these product categories, quality can also differ. High-quality loose-leaf tea can be identified by its looks, touch, aroma, and taste. The following characteristics distinguish high-quality tea:⁵

- It looks like dried tea leaves and is not crumbly or dust-like, and does not include stem fragments.
- It feels smooth and whole and does not feel overdried or disintegrate when handled.
- It has a distinct aroma that can be easily detected, no matter what type it is.
- It has a strong, pleasant, and recognizable taste.

³ Sumesh Kumar and Roshan Deshmukh, "Tea Market by Type (Green Tea, Black Tea, Oolong Tea, Fruit/Herbal Tea, and Others), Packaging (Plastic Containers, Loose Tea, Paperboards, Aluminum Tins, and Tea Bags), Distribution Channel (Supermarkets/Hypermarkets, Specialty Stores, Convenience Stores, Online Stores, And Others) and Application (Residential and Commercial)," Allied Market Research, June 2020, <https://www.alliedmarketresearch.com/tea-market>.

⁴ Kumar and Deshmukh, 2020.

⁵ "How to Identify Quality Tea," Pure Leaf, accessed January 22, 2021, <https://www.pureleaf.com/us/how-to-identify-quality-tea>.

Low-quality teas will lack some or all of these characteristics. The quality of the tea depends on the size of leaf, its placement on the plant, and how it is picked and processed.

Consumers who are concerned about ethical sourcing will purchase tea that has been certified as organic and/or Fairtrade. The demand for specialty tea is expected to increase for the foreseeable future, requiring producers to spend more on research and development.⁶

Packaging

Tea can be packaged, in order of popularity, in tea bags, as loose tea (sold in tins or cardboard packaging), or as individual serving pods. Tea bags are the least expensive and are the most easily disposed of. Loose tea is perceived to be of the highest quality and to steep the best tasting tea. Pods are used for convenience and for entertaining guests with single servings.⁷

Niche players are developing different kinds of bags that are more environmentally friendly or differently shaped to produce better steeped tea. Consumers are looking for environmentally friendly packaging made from sustainable materials that are recyclable on disposal. Eco-friendly packaging means there is little impact on the environment during the production, use, or disposal of the packaging.

Tea production industry value chain

The following are the steps in the value chain for the tea production industry for traditional, specialty, and flavoured teas (not herbal, and excluding further downstream tea products):⁸

1. Harvesting: Tea farmers grow and harvest (pick) the tea leaves.
2. Processing: Tea processing includes four stages:
 - i. Withering: The tea leaves change physically and chemically.
 - ii. Rolling: The tea leaves are crushed to allow their enzymes to mix.
 - iii. Fermentation: The tea leaves are oxidized. White, green, and black tea all come from the same plant and differ based on the amount of oxidation. White tea is the least oxidized, green tea is next, and black tea undergoes the most oxidation. Oolong tea falls between green and black tea in terms of oxidation, but its twisted shape makes it unique.
 - iv. Drying and sorting: Tea leaves are dried and sorted by grade. Tea grading generally depends on the size of the leaf and its location on the plant. However,

⁶ Qing Zheng, “Freshly brewed: A growing emphasis on healthy living will drive industry revenue growth,” *IBISWorld Industry Report 31192B: Tea Production in the United States*, December 2019.

⁷ Louise Roberge, “Canadian Tea Market Overview,” Tea Association of Canada, accessed April 14, 2020, <http://www.o-cha.net/english/association/information/documents/Louise.pdf>.

⁸ Koronios, 2019.

this grading is not standardized nor is it an indication of quality, which is more influenced by the plant's origin, soil, rainfall, and elevation.⁹

Depending on the level of technology, these stages can be completed using equipment or by hand.

3. Production: Tea producers (such as KTI) take the processed tea leaves and may blend them with other teas or flavours, including fruit and spices. The tea leaves are then packaged and sold under a private label and/or the producers' own brand.

While some producers are also involved in processing the tea, most Canadian tea producers are not; they simply produce and package the tea for sale to distributors or directly to end consumers.

Further downstream in the value chain are the value-added products that incorporate the tea as a raw material. This includes drinks that are bottled and ready to drink, food items into which the tea is baked, and cosmetic products that use extracts from the tea leaves. These products can be manufactured either by the tea producer itself or, more commonly, by another manufacturer. The tea used in the manufacturing of other tea products is purchased directly from the harvesters and processors, rather than from tea producers.

*Tea growers*¹⁰

There are two varieties of the tea plant, *Camellia sinensis*: the small-leaf variety that grows in the high mountain regions in a cooler climate and the large-leaf variety that grows in moist tropical climates.¹¹

Tea leaves are purchased mainly from India, Sri Lanka, Taiwan, Indonesia, China, and Japan, and Canadian producers rely on farms in these countries to provide the raw materials.¹²

Tea is cultivated primarily on large plantations, but also by small individual farmers. Smaller farmers often sell their harvested tea to the large plantations for processing and are paid low prices in comparison to what the large plantations will ultimately sell the processed tea for. However, there are other individual farms that will pay for processing or process the tea themselves. Globally, about 70% of processed tea is sold at auction centres, because there is no futures market for tea.¹³ Large buyers can influence the demand and price of different types of tea sold at these auctions. To be successful, tea

⁹ "Tea Grading," Imperial Tea Gardens, accessed January 21, 2021, <https://www.imperialteagarden.com/pages/tea-grading>.

¹⁰ "Tea," Fairtrade International, accessed June 15, 2022, <https://www.fairtrade.net/product/tea>.

¹¹ "Tea Plant Varieties," Tea Source, accessed May 25, 2022, <https://www.teasource.com/blogs/beyond-the-leaf/tea-plant-varieties>.

¹² Koronios, 2019.

¹³ "Certifying Fairtrade," Fairtrade Canada, accessed February 28, 2023, <https://web.archive.org/web/20221214091519/https://fairtrade.ca/for-business/getting-fairtrade-certified/>.

producers need long-term, reliable supply contracts with overseas suppliers of tea that, ideally, have guaranteed supplies.¹⁴

There are three main auctions for tea: Colombo for Sri Lankan teas, Mombasa for African teas, and Kolkata for Indian teas. Chinese teas are not auctioned. Historically, tea prices have ranged from just over US\$2.00 per kilogram for lowland teas to over US\$4.00 per kilogram for high mountain teas.¹⁵ Prices depend on supply and demand, growth region, and quality.

The larger plantations not only grow the tea but also have factories to process the tea. Workers are hired to work in the fields and the factories, and although they are paid local minimum wage rates, the compensation is often not enough to feed their families. These employees work under harsh conditions and are not usually protected against job loss or discrimination. Buyers can help ensure that workers are treated fairly by stipulating that Fairtrade standards, or some other general standards, are adhered to in their purchase contracts for processed tea.

Customer segments

Canadian coffee and tea producers' revenue by type of customer is as follows:¹⁶

Customer segment	Percentage of revenue
Food service	56.8%
Exports (currently, 97.2% to the United States)	22.9%
Groceries and retail outlets	16.6%
Offices and other (drug stores, hotels convenience stores)	3.7%
	100%

Food service¹⁷

Food service includes quick-service restaurants (such as McDonalds), cafés (such as Starbucks), tearooms, and restaurants. This segment represents the highest proportion of revenues, because Canadians often stop at these establishments for their coffee or tea daily. Food service outlets, especially cafés, are increasing their selection of tea beverages in order to meet consumer preferences for traditional, specialty, and flavoured tea drinks.

¹⁴ Koronios, 2019.

¹⁵ Dan Bolton, "World Bank Predicts Recovery of Tea Prices in 2020," World Tea News, November 18, 2019, <https://www.worldteanews.com/Insights/world-bank-predicts-recovery-tea-prices-2020>.

¹⁶ Koronios, 2019.

¹⁷ Koronios, 2019.

Exports

The amount of sales exported depends on the relative value of the Canadian dollar to the U.S. dollar, as 97% of exports are to the United States.¹⁸ As the Canadian dollar depreciates, exports increase, and vice versa.

Groceries and retail outlets

As the end consumer begins to shift to making tea at home, sales to the grocery and other retail outlets are increasing. For this market, particularly for the mass merchandisers (such as Costco), the budget-minded consumer will purchase low-cost traditional black tea in bulk. This allows retailers to enter into low-cost supply contracts with tea producers. These bulk sales are usually for lower-quality teas that have lower processing and production costs and thus a lower selling price. Because of the bulk purchases and the lower cost of this type of tea, the selling prices for this segment are significantly lower per weight. The consolidation of major grocery retailers has intensified competition between producers to access retail premium shelf space, which is important for tea producers to be successful.¹⁹

Both the grocery and food service retailers continue to expand their mix of private-label products, reducing the demand for the tea producers' own brands.²⁰ These private-label brands are lower priced than comparable tea producers' brands.

Offices and other²¹

For the office segment, customers enter into long-term supply contracts with primarily coffee production companies. These coffee companies are contracted to deliver coffee and tea, as well as the equipment to make these hot beverages on site. Additional services such as restocking, machine repair, and catering are also provided, resulting in higher revenues (and margins) for producers. Tea producers can partner with these coffee producers to provide the required tea products.

Pricing

The selling price charged to the various customer segments depends on the quality of the tea sold, the volumes sold to each customer, and whether the tea is a private label for the customer or the tea producers' own brand. The lowest selling price is for tea that is packaged in bulk, is low quality, and is private label. Chain grocery retailers and chain food services companies (such as Starbucks and Tim Hortons) fall into this category. These customers have the buying power to set the tea producers' selling prices due to the high volume of tea purchased.²² In addition, these chain customers have a loyal

¹⁸ Koronios, 2019.

¹⁹ Koronios, 2019.

²⁰ Koronios, 2019.

²¹ Koronios, 2019.

²² Koronios, 2019.

consumer base that will buy their branded products. Grocery retailers also have the power to decide whether the tea product is placed in a coveted spot on the shelves.

In contrast, sales to other customers will be at higher selling prices, as the product is not sold in large volumes, is usually of higher quality, and the tea producers are selling their own brands (as opposed to private-label brands).

Profit margins across the industry have increased to 10.6% because of greater demand and stable input prices.²³ Although selling prices can fluctuate with the cost of tea leaves, there is strong price-based competition in the market that can keep these prices in line.²⁴ Specialty teas and fruit and spice blends typically result in higher margins than the low-cost, bulk teas.

Online sales

Tea has been sold online for many years, by grocery food retailers, food services outlets selling their own brands, or directly by tea producers. Many tea producers have an online presence to promote their brand, build brand loyalty, and sell directly to end consumers. These companies can provide a wide offering of products, educate consumers on how their tea is produced, and obtain data analytics on consumer preferences.²⁵

Competition

The four largest coffee and tea producers make up 46.5% of the total coffee and tea production industry in Canada: Restaurant Brands International Inc. (Tim Hortons) has 17.8% market share, Keurig Dr. Pepper has 11.1%, Club Coffee LP has 9.5%, and Mother Parker has 8%.²⁶ There are currently 309 producers, a number that is expected to grow with the entrance of smaller, niche competitors.²⁷ The large competitors with substantial resources are expected to continue to gain market share due to their continued product innovation, strong brand loyalty, marketing programs, and joint ventures with other key players.²⁸

These joint ventures are with farmers, downstream manufacturers to produce tea-based products, or companies that distribute beverages within the same distribution channels. These large competitors use their significant purchasing power to reduce the raw material costs paid to the tea farmers. They can also obtain premium shelf space in stores because of their large size and brand recognition. To further achieve economies of scale, these companies invest significant amounts in technology, such as information systems and software, to make blending teas and flavours in the production process

²³ Koronios, 2019.

²⁴ Koronios, 2019.

²⁵ Dan Bolton, "Follow the Leaders: Online Tea Stores," World Tea News, April 10, 2018, <https://worldteanews.com/tea-business-resources/follow-the-leaders-online-tea-stores>.

²⁶ Koronios, 2019.

²⁷ Koronios, 2019.

²⁸ Koronios, 2019.

more efficient.²⁹ For tea producers selling their own brands, strong brand recognition is important for success. This can be achieved by spending significantly on marketing and by having a reputation for delivering an exceptional consumer experience.

To be successful, tea producers need to be able to adapt their product to changes in consumer preferences, have a differentiated product to maintain market share, and have economies of scale and scope to keep per-unit costs low.³⁰ The higher the world price of tea leaves, the lower the profit margins, given the strong price competition in the industry. Producers need to be able to pass on any increases in raw material input costs to their customers. This may be difficult to do when they have long-term revenue contracts in place.

Large competitors use one of the following strategies:³¹

- Manufacture mid-to-low value, high-volume branded products.
- Manufacture high-value products with shorter production runs and lower volumes.

The smaller tea producers use a variety of strategies. Some are niche players that sell only specialty, premium tea to high-end tea and coffee shops. They may also specialize in organic and/or Fairtrade products (Fairtrade is discussed in more detail below). Tea producers are increasingly creating and marketing their own brands or securing large contracts with retailers to be their brand of choice. Smaller tea producers must differentiate by having innovative product offerings and packaging and by spending more on marketing.³²

Consumers are price sensitive within a product category and will switch to a lower-priced alternative if they do not taste any difference, as is often the case for private-label products. Perceived quality, brand recognition, and loyalty will impact the price consumers are willing to pay.³³

There is also competition for the best retail shelf space in stores. To ensure success, tea producers must establish good relationships with grocery retailers to receive premium retail shelf space in the store and be part of the in-store advertising. Increasingly, the smaller producers are expanding to non-traditional customers such as drug and discount stores, shopping mall kiosks, and other areas with high pedestrian foot traffic.³⁴

If the Canadian dollar appreciates, the percentage of imports of teas will increase, increasing competition in Canada. As long as the Canadian dollar is low in comparison

²⁹ Koronios, 2019.

³⁰ Koronios, 2019.

³¹ Koronios, 2019.

³² Koronios, 2019.

³³ Koronios, 2019.

³⁴ Koronios, 2019.

to the U.S. dollar, exports to the United States will outweigh imports of tea products into the Canadian market.

Additional value-added products that use tea

Tea can be further manufactured into the following types of products:

- bottled RTD tea
- matcha powder
- cosmetic ingredients and dietary supplements

Bottled RTD teas have been increasing their market share in the convenience drink category as soda, bottled water, sports drinks, and juice decline in popularity.³⁵ Packaging the tea as RTD is seen as a downstream product to further boost revenues and margins. RTD teas include cold-brewed teas (which are touted to taste less bitter and retain more health benefits) and sparkling teas that are seen as a healthier alternative to sodas.

Matcha is a Japanese green tea whose leaves are crushed and then sold in powder form. Rather than steeping whole tea leaves and then removing them as with other teas, the matcha powder is dissolved into boiled water so that the entire leaf itself is consumed. As a result, matcha is more potent and its health benefits are enhanced.³⁶ Matcha can be used in baked goods, providing an alternative to drinking the tea.

In addition, the tea plant is a source of bioactive ingredients that can be extracted and used in making cosmetic products and dietary supplements.³⁷ As consumers demand more natural skin care products, extracts from green, black, and white teas have become important ingredients for the treatment of various skin conditions because of their positive effect on skin. Tea extracts are also used in a variety of dietary supplements that purport to boost energy and the immune system.

Ethical practices

Ethical practices in tea harvesting include social responsibility for the workers and environmental responsibility in farming the land.³⁸ For the workers, companies that practice social responsibility implement policies ensuring health and safety practices are followed, child labour is forbidden, fair and living wages are paid, working hours are

³⁵ Dan Bolton, "Market Research Reflects and Predicts Growth," World Tea News, January 15, 2019, <https://www.worldteanews.com/Insights/market-research-reflects-and-predicts-growth>.

³⁶ Carol Neshevich, "Matcha, matcha everywhere," Food in Canada, December 8, 2015, <https://www.foodincanada.com/features/matcha-matcha-everywhere/>.

³⁷ W. Koch, J. Zagorska, Z. Marzec, and W. Kukula-Koch, "Applications of Tea (*Camellia sinensis*) and Its Active Constituents in Cosmetics," *Molecules*, December 2019, <https://www.ncbi.nlm.nih.gov/pmc/articles/PMC6930595/>.

³⁸ Sarah Roberts, "Working Collaboratively to Improve the Sustainability of the Tea Sector," Ethical Tea Partnership, September 8, 2016, <https://www.ethicalteapartnership.org/working-collaboratively-improve-sustainability-tea-sector/>.

reasonable, there is no discrimination (particularly toward women), and benefits are provided.

To demonstrate environmental responsibility, companies ensure that the farmers they work with follow practices to improve soil and crop quality, plant to create biodiversity, reduce the use of pesticides, and employ reforestation to reduce water shortages and droughts.³⁹

Tea producers can require the implementation of these standards at the farmers' level by including these practices in their purchase contracts and visiting the farms to ensure the standards are being followed.

Many tea producers enter into collaborative arrangements with government agencies in the countries where their tea is grown. In these cases, government agencies provide programs to educate the tea farmers in best agricultural practices.

Climate change is a threat in tea-growing countries, and forward-thinking companies are incorporating the impact of climate change into their short- and long-term supply plans.⁴⁰ One initiative to combat the impact of climate change is to breed different varieties of tea plants that will be more resilient to climate changes.⁴¹

At all points in the value chain, tea producers that implement sustainable practices aim to reduce their water and energy usage, increase their use of renewable energy, incorporate recyclable materials into their products, and measure and report their greenhouse gas (GHG) emissions and water usage.⁴² Key metrics for GHG emissions and water usage include calculating footprints by product for raw materials and packaging, for distribution, for use of the product (such as boiling water), and for final disposal after the product has been used.⁴³

Producers that are serious about using and promoting eco-friendly packaging will disclose the exact proportion of the material that is made from recycled content. Additionally, these manufacturers will be able to trace the material back to its origins so that the content can be verified.⁴⁴ Using recycled materials in a product can increase production costs due to higher prices for the raw materials, changes required to the production processes, and specialized equipment needed to work with these recycled materials.

³⁹ "Sustainable tea farming around the world," Unilever, accessed May 15, 2022, <https://www.unilever.ca/news/2017/sustainable-tea-farming-around-the-world/>.

⁴⁰ "The Hain Celestial Group Climate Change Statement," The Hain Celestial Group, March 2016, <https://web.archive.org/web/20220120013605/https://www.hain.com/wp-content/uploads/2016/02/Climate-Change-HAIN-Statement-2016-2.pdf>.

⁴¹ "Sustainable tea," Unilever.

⁴² "The Hain Celestial Group Climate Change Statement."

⁴³ "The Hain Celestial Group Climate Change Statement."

⁴⁴ "Sustainability and pricing," EcoEnclose, accessed April 25, 2020, <https://www.ecoenclose.com/Sustainability-and-Pricing/>.

Regulations

Health Canada, under the Food and Drugs Act, regulates the concentration of water-soluble extractives in tea and the level of caffeine in decaffeinated tea (where caffeine levels cannot exceed 0.4%). Packaging and nutrition labelling are also regulated. The Pest Control Products Act tests for the level of pesticides in tea products.⁴⁵

Organic

In order to label their food as “organic,” processors, producers, and manufacturers are legally required to be certified in line with the Canadian Organic Standards.⁴⁶ The Canadian Food Inspection Agency appoints third-party auditors to examine all the processes from the farm to the sale of the product to ensure that producers have not used any prohibited substances. It can take up to three years to become initially certified, as producers must prove that prohibited substances have not been used in the last three years.

Fairtrade

For Fairtrade certification, Canada uses FLOCERT, which is based in Germany. FLOCERT is the largest Fairtrade certifier, certifying producers, traders, and licensees. It follows the requirements of ISO 17065. Auditors are used to ensure compliance with the internationally agreed Fairtrade standards.

Harvesters, processors, and producers must be audited before they can sell Fairtrade certified products. The auditor visits the fields and facilities and completes a physical audit. A report is prepared that identifies any non-conformities. The decision to certify is made by FLOCERT once any irregularities have been resolved. Once certified, producers are audited at least twice in a three-year cycle, along with additional unannounced audits.⁴⁷

To be successful, it is important for tea producers to comply with government regulations for food production and, if applicable, with regulations for organic and Fairtrade certifications.

The tea consumer

The following are some significant statistics regarding the profile of an average Canadian tea consumer⁴⁸ (note that these statistics are for all types of tea):

- 55% are female.
- 35% live in three- to four-person households and 33% in two-person households.

⁴⁵ Koronios, 2019.

⁴⁶ “Organic Certification,” Canada Organic Trade Association, accessed April 14, 2020, <https://www.canada-organic.ca/en/what-we-do/organic-101/organic-certification>.

⁴⁷ “Certifying Fairtrade.”

⁴⁸ Roberge.

- 35% are heavy tea drinkers (consuming 14.1 cups per week), 41% are medium drinkers (average of five cups per week), and 24% are light drinkers (1.4 cups per week).
- 64% of the surveyed 18- to 33-year-old age group indicated they were tea drinkers, preferring flavoured teas and specialty teas.
- Tea drinkers over 65 years old prefer black tea.

The following survey responses highlight why people drink tea:⁴⁹

- I like the taste: 53%
- To relax: 40%
- For pleasure: 38%
- To warm myself up: 27%
- It makes me happy: 22%
- For health reasons: 21%
- Try new flavours: 15%
- After a meal / for digestion: 12%
- Out of habit: 10%
- To wake me up: 9%
- When in company: 9%

Studies indicate that in purchasing tea, consumers first look for the type, then they select taste, and finally they consider brand and price.⁵⁰ Even though price appears to be the last attribute considered, consumers are still looking for the best value for their tea. Consequently, many individuals like to sample the tea before purchasing it. People also often drink tea outside the home, in cafés, tea shops, or tearooms.⁵¹ The café or tearoom becomes part of the experience of relaxing and enjoying a high-quality cup of tea. Tea is seen as a beverage to have with any meal or with a snack, and it is used as a base in some cocktails or mocktails (non-alcoholic beverages).⁵² Food service companies may expand or change their tea offerings to meet consumers' changing preferences.

⁴⁹ Jan Conway, "Why do you usually drink tea?" Statista, March 21, 2019, <https://www.statista.com/statistics/679635/reasons-for-drinking-tea-among-us-consumers/>.

⁵⁰ Roberge.

⁵¹ Roberge.

⁵² Bolton, "Market Research."

*Demand drivers*⁵³

- The higher the per capita disposable income, the higher the demand for specialty tea, flavoured products, and single-serving pods, which are more expensive.
- Because of the touted health benefits of tea, the demand for tea will remain high, as many consumers believe that tea can help with weight loss, reduce the risk of heart attacks and stroke, and boost the immune system.⁵⁴ Consumers are moving away from sugary soda drinks and are instead looking for healthier alternatives.
- Although food services is the most significant customer segment, consumers continue to purchase tea for home preparation, and demand for tea products by grocery retailers is expected to grow.
- The cultural shift to relaxing and socializing in cafés and tearooms has increased the demand for teas and specialty blends.
- Younger consumers (under 30 years old) have been exposed to marketing campaigns promoting the health benefits of tea and have increased their demand for tea. This sector is attracted to tearooms, which have become more visible and are seen as a popular trend.⁵⁵
- The cost of substitutes, particularly coffee (including RTD coffee beverages) and energy drinks, may cause the demand for more expensive tea and tea-based products to decline, especially if the per capita disposable income declines.

Trends within the industry

- Spiced teas are growing in popularity due to changing consumer demographics, particularly for the 18- to 35-year-old segment of the consumer market.⁵⁶
- There is an increasing demand for cafés and specialty tearooms as consumers look for ways to relax outside their homes.
- There is increasing demand for convenience in preparing tea and coffee, including the new coffee and tea makers that can make a single serving using specially designed pods. There is thus an increasing demand for instant single-serving pods/capsules for different types of teas.⁵⁷
- As consumers become more educated about the treatment of tea farmers, there is an increasing demand for ethically sourced (Fairtrade) and organic teas.⁵⁸
- Consumers' demand for specialty and gourmet teas will continue to increase. Due to the care that is taken in the processing of these premium-priced teas, there are

⁵³ Koronios, 2019.

⁵⁴ Zheng, 2019.

⁵⁵ Zheng, 2019.

⁵⁶ Koronios, 2019.

⁵⁷ Bolton, "Market Research."

⁵⁸ Koronios, 2019.

reportedly higher health benefits related to antioxidant properties that reduce cholesterol and increase metabolic rates.

- Producers are adding healthy ingredients into their teas that are designed to help people with diabetes, obesity, and heart conditions.⁵⁹
- Demand is increasing for matcha tea-based baked goods due to the potential health benefits. Given its ability to be pulverized, the fine matcha powder can be used in products other than tea, such as cakes, cookies, muffins, and biscotti.⁶⁰
- Producers are expanding their products beyond tea leaves and creating unique RTD tea products by partnering with energy drink manufacturers⁶¹ or infusing their drink with cannabis to appeal to 18- to 35-year-olds.⁶²
- A growing trend is the demand for artisanal tea — a tea crafted by a tea artisan and made almost entirely by hand (although a small amount of machinery may be used). The demand for artisanal tea is driven by several factors: consumers wanting farm-to-table foods; a sober lifestyle trend away from bars and toward teahouses; certain demographics consuming as much tea as coffee; and gamers, who are high-end buyers, using tea as a natural stimulant to keep them awake and focused all night.⁶³
- There is also an increasing use of tea in other products, including beauty and cosmetic products,⁶⁴ to capitalize on tea's natural health benefits.
- Online distribution direct to the end consumer is expected to increase due to the rise in popularity of online apps and easy product delivery.⁶⁵

General risks in the industry

- Raw material risk: There could be a shortage of supply of tea leaves or a reduction of quality due to the impact of weather conditions, crop disease, or pests.

⁵⁹ “Tea Market Size, Share & Trends Analysis Report By Product (Black, Green, Oolong, Herbal), By Distribution Channel (Supermarkets & Hypermarkets, Specialty Stores, Online), By Region, And Segment Forecasts, 2019 – 2025,” Grand View Research, August 2019, <https://www.grandviewresearch.com/industry-analysis/tea-market>.

⁶⁰ “Enrichment of Biscuits with Matcha Green Tea Powder: Its Impact on Consumer Acceptability and Acute Metabolic Response,” National Library of Medicine, February 1, 2018, <https://www.ncbi.nlm.nih.gov/pmc/articles/PMC5848121/>.

⁶¹ “RTD Tea and Coffee Market Size Worth \$116.13 Billion by 2024,” Grand View Research, April 2018, <https://www.grandviewresearch.com/press-release/global-ready-to-drink-tea-and-ready-to-drink-coffee-market>.

⁶² “2019 State of the Beverage Industry: Ready-to-drink tea, functionality drives demand in market,” Beverage Industry, July 15, 2019, <https://www.bevindustry.com/articles/92246-2019-state-of-the-beverage-industry-ready-to-drink-tea-functionality-drives-demand-in-market>.

⁶³ Kevin Alexander, “Artisanal Tea in America Is Having a Moment,” Thrillist, October 8, 2019, <https://www.thrillist.com/eat/nation/american-artisan-tea-culture>.

⁶⁴ “Tea Market Size.”

⁶⁵ “Tea Market Size.”

- Consumer risk: The demand for tea products is driven by consumer preferences for the taste, quality, and health benefits of tea.
- Regulatory compliance risk: Tea is a food product that must be produced and manufactured in compliance with strict health regulations. In addition, if the product is marketed as organic or Fairtrade, these certifications must be maintained.
- Exchange rate risk: Tea leaves are imported, and tea products are exported.
- Reputational risk: If a product must be recalled due to errors in production or contamination, this will negatively impact the reputation of the tea producer. In addition, if the tea producer works with a farm that contravenes human right standards, this will negatively impact its reputation.

Company background

Michael Galinsky started KTI in 2006. Before that, Michael worked as a buyer for a large national grocery retailer, Lakeside Food Inc. (Lakeside). He was heavily involved in sourcing new products and negotiating private-label supply contracts. At that time, Lakeside contracted with only the largest tea plantations. One of Michael's responsibilities at Lakeside was to visit the farms supplying the tea to the large plantations that processed and produced tea for Lakeside, primarily in Sri Lanka and Indonesia, to inspect where the tea came from and how it was harvested.

In discussions with the smaller farmers, Michael learned that these farms were forced to sell their crops to the large plantations at significantly below-market rates, leaving the farmers struggling to earn enough for their families. He felt there had to be fairer supply agreements that could be made with these smaller farmers, and this became the motivation for Michael to start KTI and become a tea producer. Michael's goal was for KTI to differentiate itself by being an ethical tea producer. He wanted to ensure that the tea farmers and their workers were treated and paid fairly, and sustainable and environmentally friendly growing practices were followed. KTI would use eco-friendly packaging and production processes that require less energy and water where possible.

Initially, KTI produced only black tea, and Michael was able to sign supply contracts with four farmers in Sri Lanka to provide the processed black tea leaves for KTI. He also convinced Lakeside to agree to purchase a higher-quality, specialty private-label black tea from KTI. During the next five years, Michael gained three more revenue contracts with various grocery retailers for private-label back teas and increased the number of farmers working with KTI to 10. Green tea was also added as a product to the customers' private-label contracts during this time period.

In 2011, two of his children, Jason Galinsky and Sabrina McLean, joined the company. Jason has a marketing degree and joined KTI as a marketing manager. Sabrina has a master's degree in food chemistry and convinced Michael to start a research and development (R&D) lab. She joined KTI as a research assistant working directly for the head of R&D.

Also in 2011, consumers' demand for organic and Fairtrade tea started to increase, and at Jason and Sabrina's suggestion, Michael decided to have KTI's product sold as organic and Fairtrade. Michael convinced the supply farmers he works with to become certified under both these standards, and certification was finalized in 2014. KTI's customers supported this transition, and KTI's teas became the first private-label organic and Fairtrade teas sold by these four customers.

The R&D division started the development of flavoured teas, infusing its existing teas with different spice combinations, and in 2015, KTI introduced a line of spiced teas. Michael and Jason decided that the spiced teas would be best sold by food service customers and approached three large food service chains about producing a private-label spiced tea. Initially, the customers purchased in small quantities to test the end-consumer acceptance for this product. By 2018, all three companies had agreed to long-term contractual arrangements with KTI to produce private-label spiced specialty teas.

In 2018, Michael's youngest daughter, Kathleen Galinsky, an attorney, joined the company as KTI's legal representation.

In 2021, Michael decided to transfer some ownership of the company to Jason and Sabrina, to help solidify their long-term commitment to the company. Michael gifted 15% of the shares in KTI to each of Jason and Sabrina, leaving him with 70% ownership. At that time, it was assumed that Kathleen would eventually also be given ownership, after having worked with the company for enough years.

Today, in 2023, KTI has maintained its private-label sales contracts with the four grocery retailers and three food service chains, but has not gained any new customers. As a result, over the past five years, sales growth has been minimal in both revenues and volumes. However, KTI has gained a reputation among its customers for its ethical sourcing and production of tea.

For the year ended December 31, 2022, the company had sales of \$43.2 million. Net earnings for the company were \$1.5 million. Five years ago, the company's net earnings had been as high as \$3.5 million.

Company overview

KTI has two divisions: a manufacturing division and an R&D division. The manufacturing division has a single production facility in Ontario that produces the private-label tea for its customers. KTI spends very little on marketing, since it does not have its own brand. Any marketing dollars are spent solely on managing the private-label customers. Michael is the only person who communicates with these customers and negotiates the contracts. Michael is well respected in the industry and is known for his honesty and fairness. These customers continue to contract with KTI because of their long-term relationship with Michael and because KTI always meets its commitments for quality, quantities, and timing of delivery, while also following ethical practices.

KTI works with its customers to design packaging for their private-label products so that it is in line with KTI's sustainability standards while meeting customer specifications. All the tea currently sold is packaged in tea bags that are made from compostable cotton. The tea bags are then packed in recyclable cardboard boxes. Any changes to packaging design or graphics requested by the customer have to be approved by Michael.

Jason manages the supply contracts with the farmers, having taken over this responsibility from Michael in 2015. Jason has also visited potential new farms, some that are growing a superior-quality premium tea that is processed using traditional methods, mainly by hand.

KTI's R&D division researches and develops new tea products, including mixing different flavours (fruits, spices, and herbs), and packages for the tea. The R&D division has developed a variety of products over the years, but no new products have been introduced into the market since the spiced tea in 2015. At this point, KTI's existing customers are not interested in expanding into any new private-label specialty or flavoured teas because of their high price points, and Michael has stopped asking them.

KTI prides itself on ethical practices for sustainability and human rights. To comply with these ethical sourcing values, KTI has a set of standards that farmers agree to as part of the contractual arrangements. In addition, the packaging that is used for its private-label products must also comply with its standards regarding the amount of recyclable content. KTI monitors its use of energy and water in its production processes and is constantly looking for ways to reduce these inputs.

The company's sales and profits have been declining. As private-label contracts come up for renewal, the directors need to make decisions about the future direction of KTI. Michael wants to continue to focus only on private-label production. It has historically been a stable and profitable segment, and it is one that Michael has a lot of experience in. Additionally, Michael does not want to take any actions that might jeopardize KTI's long-term relationships with these customers.

Jason and Sabrina, however, want to create the company's own brand of specialty and flavoured teas to diversify KTI's customer base and reduce the company's reliance on its few existing customers. They both believe now is the time to capitalize on consumers' growing preference for high-quality premium teas and take control over any new products that are introduced.

Corporate vision and mission

KTI's vision and mission statements and core values, approved by the board in 2018, are:

Vision statement: We envision an environment where a high-quality tea is produced by fairly compensated farmers, our customers enjoy a pure, complex, and pleasant experience every time they drink a cup of our tea, and everyone involved in the process is treated with honesty, fairness, and respect.

Mission statement: *Do right by the farmers and our customers and far exceed consumer expectations daily. We produce our tea in an ethically responsible manner, and its distinctive taste and high quality inspire loyalty in our consumers. We strive to bring the health benefits of tea in all its forms to individuals.*

Corporate values

KTI has five core values:

1. Produce extraordinary organic, Fairtrade tea.
2. Build long-term relationships with farmers, suppliers, customers, and consumers.
3. Build a brand that is known to be ethical and respected.
4. Treat all employees with fairness, honesty, and respect.
5. Ensure ethical, sustainable, and environmental standards are adhered to and followed throughout all of our processes, from farm to table.

KTI also has a code of ethics and ethical standards that is incorporated into its contracts with farmers and customers.

Future plans and objectives

In early April 2023, the board met and set the following objectives:

- Increase the gross profit margin to 25% of revenues by 2026.
- Have 30% of revenues from non-private-label product sales by 2026.
- Have 50% of operating profits from non-private-label product sales by 2026.
- Promote the KTI brand and market it as a company that is known for its ethical standards at the consumer level.
- Increase control over its sources of tea leaves (raw materials) and diversify where the tea is grown.

Company structure

KTI has a board of directors that consists of Michael, Jason, Sabrina, and Kathleen. Each director has an equal vote on strategic and financial decisions. The board meets every month. At the meeting, the board discusses topics related to financial and budget reports, production issues, customer contracts, farmer contracts, new corporate policies, and election of the officers. However, Michael often makes daily operational decisions that are counter to the decisions made by the board.

There is one committee, the ethical standards committee. The committee is responsible for reviewing the existing standards employed by KTI, ensuring adherence to these standards at all levels in the company, and updating for changes as required. On this committee is Jason (the chair), Kathleen, Hans Meindl (the production manager), and Rashmi Gunapala (a tea farmer).

Management team

KTI's corporate management team is made up of the following individuals:

Michael Galinsky — chair of the board and chief executive officer (CEO)

Michael is 62 years old, has a business degree, and worked his way up to management in a large grocery retail chain before starting KTI. Michael's strengths are in customer relationships and understanding the needs of customers. This strength makes him a good contract negotiator and a problem solver. He works in partnership with the customers to exceed their expectations, and in return they have given KTI their loyalty since the first contracts were signed. His business philosophy is that by working together, any issue can be resolved. However, Michael prefers to make all of the daily operational decisions, and therefore the company has a very centralized structure. Having been in the business for many years, Michael has a lot of experience and an excellent reputation. Michael's primary responsibilities are in managing the current customer contracts and finding new customers. Michael has strong beliefs in sustainable and ethical practices, driving the company's focus in these areas, and he has passed along these beliefs to his children.

Michael wants KTI to remain focused on producing only private labels. He is convinced that this is a low-risk approach that has worked well in the past, and so there is no need to change. He believes that he can continue to negotiate the right price for KTI so that the level of profit seen in the past can be maintained. He believes that the decline in profit is simply a result of not yet renewing the terms of the existing contracts. He wants the company to look for new private-label customers to grow revenues and basically keep the current business model unchanged. He has fostered these customer relationships over a long period of time and does not want to do anything that will jeopardize this. He believes that KTI's existing customers must come first.

Jason Galinsky — VP marketing

Jason is 37 years old and has a business degree in marketing. Jason has worked in a marketing research company and also for a large, diversified food manufacturer that sold branded products in the coffee and snack food segments. In these companies, Jason designed and implemented marketing plans to promote existing and new products that were highly successful and innovative at the time. After joining KTI, Jason began managing the work involving the tea farmers and the supply of tea leaves. He is passionate about ensuring that the farmers KTI works with are treated fairly and working with the local governments to ensure they are planning for the impacts of climate change. As such, he has gained the respect of the farmers. As a tea connoisseur, he is constantly tasting competitors' products for quality comparisons. Jason is charismatic, highly creative, and a good listener. He considers himself a visionary capable of seeing what the future might look like and knowing the actions required to get there. However, he can also be stubborn and unrelenting in his ideas. These traits have caused Michael and Jason to have many arguments about corporate decisions.

Jason feels that Michael has stifled his creativity and innovation. Jason wants the company to create its own brand of products that will allow the company's name to become known. He thinks that the future of KTI lies in high-quality premium teas that have much higher margins than private-label products, and he believes that KTI has the people and resources to make this change. Jason wants to diversify away from private-label products, limiting the power of, and dependency on, these customers.

Sabrina McLean — VP research and development

Sabrina is 34 years old. After completing her university education, Sabrina worked for a government lab doing food research related to pesticide-free farming and crop yields. Since coming to KTI, Sabrina has worked only in the R&D department, which she now heads. Sabrina is a scientist at heart, always reading about new findings and keeping up with what competitors are doing with respect to product development. Her interests are in tea production yields, the health benefits of tea, how to enhance the taste of tea, and designing innovative products. She is very methodical and focused, and because of her experience in the industry, Sabrina has judged tea tasting events in the past.

Sabrina is frustrated because Michael refuses to introduce any of the new products the R&D department has developed over the past five years to his customers. Because the customers have not expressed any interest in new tea lines in the past, Michael has stopped introducing any new potential products to them in order to maintain his good relationships with them. Sabrina agrees with Jason that KTI now has the resources and expertise to create and market its own brand of premium quality tea. She believes that the talent in the R&D department is being wasted if the innovative products are not going to be embraced. Her R&D department has constantly been at the forefront of new product development, as it develops products about one year ahead of competitors' similar successful product introductions.

Kathleen Galinsky — VP legal and human resources

Kathleen is 32 years old. After graduating with her law degree, Kathleen worked for a small regional law firm specializing in corporate and contract law. She is now KTI's in-house lawyer and is involved in drafting the company's contractual agreements and ensuring compliance for organic and Fairtrade certifications. She is also responsible for the human resources department and all issues relating to employees. She is responsible for writing and updating the ethical standard protocols and the human resources policies.

Kathleen's main concern is compliance with laws and regulations, and also ensuring that profits are maintained and that the company continues to grow. As a lawyer, she can see both sides of any arguments put forth by Michael, Jason, or Sabrina. Her focus is more on the numbers rather than on strategy and its implementation.

Hans Meindl — VP production

Hans is 58 years old and has been with KTI since 2007. Before that, he oversaw manufacturing in a small cereal and bread company. Hans is very hands-on and is

constantly on the production floor, overseeing the production processes and interacting with employees. He is adamant about quality control, meeting production timelines, and keeping costs down. It is because of his diligence that KTI is known for meeting its commitments to quality, quantities, and timely delivery.

Rashmi Gunapala — tea farmer

Rashmi is 45 years old and is now head of her family's tea farm in Sri Lanka. Rashmi's family farm was one of the first contracted by KTI. She now represents the tea farmers at KTI when needed. She is not an employee of KTI but is compensated as a committee member when she attends meetings. Rashmi wants to ensure that tea production remains sustainable and is concerned about land management and climate change.

Andrew Li — chief financial officer (CFO)

Andrew is 36 years old, has a master's degree in business administration, and has worked at KTI since 2015. He started in the accounting office and progressed his way to CFO in 2019. Before joining KTI, Andrew worked in the accounting department of a national food manufacturer. Andrew is responsible for all the accounting personnel and preparation of external and internal financial reports and flexible budgets. He reports directly to Michael, who reviews the monthly reports before they go to the other directors.

Human resources

The breakdown of employees is as follows:

Senior management — shareholders (paid \$150,000 annually)	3
Other senior management	3
Production	46
R&D	5
Administration, marketing, IT, and head office	20
Total employees	77

Company operations

Revenue

KTI has contracts with seven customers to manufacture private-label products. It has four national grocery retailers that contract for organic and Fairtrade black and green teas, and three food service companies that contract for spiced organic and Fairtrade black and green teas. Two customers represent 35% of the company's total annual sales. For all the customers, the tea leaves are packaged in bags and then boxed in different quantities. There have been no new customers for the past five years, and volumes of sales from the existing customer base have grown very little during that period.

The revenue contracts are for three to five years in length. KTI has control and ownership of the product and its formulations under these contracts, but any major changes in the product related to quality and taste must be approved by the customer. Although the specifications for packaging and labelling of the product are provided by the customer, KTI purchases the packaging from its own suppliers. KTI has its name and address in small print on the label to identify the company that produced the product.

Under the terms of the customer contract, KTI is liable for any nonconformity in quality or appearance. Minimum orders each year are guaranteed by the customers. Selling prices are fixed for the contract period, increasing annually only for inflation rate changes. The grocery retail customers have agreed to give KTI premium shelf space, since sales of private-label products result in higher margins for the retailer. Customers are permitted to visit and inspect the plant at least annually, or more often upon request. When contract renewals are negotiated, KTI is under pressure to reduce or maintain its selling prices, and therefore it has to manage its input costs accordingly. There are no contractual terms allowing KTI to pass on increases in input costs to its customers.

Generally, KTI has at least 30 days of inventory on hand for each customer, and speedy delivery is one advantage for customers. In addition, since the quality and taste of the tea starts to deteriorate with age, it is critical that the number of days in inventory stays short. KTI is responsible for shipping to the locations identified by the customers at the time of order. Terms for payment of accounts receivable vary from 30 to 45 days, with the larger customers being allowed the longer credit periods.

Michael constantly communicates with the seven customers to ensure that KTI is delivering excellent customer service and products.

Farmers (the owners of the farms)

KTI has supply contracts with farmers in the highlands of Sri Lanka. The contracts vary in length from two to four years and require KTI to purchase the farmers' annual yield of tea leaves after they have been processed. The purchase price is in Indian rupees (INR, ₹), which is KTI's preferred currency, and is set annually by auction. The average exchange rate during 2022 was C\$1 = ₹54.503, and the current exchange rate is C\$1 = ₹52.6366. These contracts cannot be terminated early without significant penalties. Currently, KTI does not hedge these foreign currency payments.

During the past three years, the price of the tea leaves has remained stable. However, the price can be severely impacted if yields are low due to drought, pests, disease, or poor land and soil management. If the auction price is not seen to be sufficient in any year for the farmers, KTI will pay a premium (to be determined annually) to allow the farmers to earn an adequate return. In addition, in years when the premium may not be enough because the crop has been ruined by drought or disease, KTI has provided additional monetary support for the farmers it works with on a short-term lending basis

⁶⁶ Due to timing of authoring of the Capstone 1 case, the exchange rates here do not reflect actual exchange rates. Candidates should use the case facts as presented.

that is repaid in the following year. This support is in the form of a non-interest-bearing loan, but it has not been required during the past seven years.

The tea purchased by KTI comes from farms in Sri Lanka and is high-quality specialty tea grown on mountain slopes. High-quality tea produces a preferred taste that is not bitter, and consumers are willing to pay a premium for it. All the farms have been certified as organic and Fairtrade and are audited as required to maintain these certifications. Under the contracts, KTI is required to pay the farmers prior to shipment. As stipulated in their contracts, farmers agree to follow standards ensuring workers are treated fairly. Farmers are also required to follow standards related to land management and to maintain their organic and Fairtrade certifications.

KTI has a good relationship with the farmers, many of whom have worked with the company since it began and are very loyal to the company. Jason visits the farmers twice a year to ensure that KTI's standards for growing and processing, as well as standards for treatment of workers on the farms, are being adhered to, and also to listen to the farmers' concerns.

Currently, KTI uses all of the processed tea leaves that it purchases from the farmers, meaning that it is at production capacity given the current supply of raw materials. If KTI increases its volume of sales, new farmers will have to be contracted. Jason has been in discussions with some Sri Lankan farmers who might be interested in contracting with KTI if production volumes increase. These potential suppliers are already organic and Fairtrade certified. However, the additional supply from these farmers may not be sufficient to meet all the future demand. Since the quality of the product made by KTI is highly dependent on the quality of the tea leaves used, Jason is very selective about the farms chosen to supply KTI's raw material. This means that there might not be enough farms immediately available to meet all the supply needs if volumes of production increase significantly. It can take up to two years for Jason to find and approve farms that will meet KTI's stringent standards and also be organic and Fairtrade certified.

Cost of goods sold

Included in the cost of goods sold are purchase costs for the tea leaves, flavourings, packaging, all other production supplies and production wages, and other related production costs, including depreciation. Also, like industry practices, warehousing costs and shipping are included in the cost of goods sold. KTI uses eco-friendly packaging, which means that minimal harm is done to the environment in the production, use, or disposal of the packaging. KTI uses packaging materials that are at least 90% recycled content. KTI also uses suppliers whose products are traceable and verifiable. For the past three years, the input cost of this type of packaging has been more expensive than if new materials were used, resulting in higher unit costs.

In the production method itself, KTI has historically employed methods that reduce the use of energy and water. However, as the company has reduced its investment in equipment and technology, there has been no reduction in energy and water usage for the past three years.

Property, plant, and equipment

Asset	(in \$'000s)	Depreciation policy
Land	250	
Buildings	1,930	Declining balance 4%
Manufacturing machinery and equipment	3,993	Declining balance ranging from 10% to 20%
Furniture, fixtures, and computers	1,109	Declining balance ranging from 20% to 25%
Total net book value	7,282	

KTI owns a single property that includes the manufacturing plant, the head office, and the R&D facilities. It leases three vehicles. On a square footage basis, 70% of the building is used for manufacturing purposes. There have been no additions or improvements to the building for the past five years. In 2020, the company spent \$1.45 million on upgrades to the manufacturing machinery and equipment and to furniture, fixtures, and computers. During 2021 and 2022, KTI underspent on its upgrades and additions. Michael has been reluctant to spend any additional funds because he believes everything is working fine. He wants to conserve the cash or have it available to pay as dividends. Jason and Sabrina disagree with this and think that the company is currently underinvesting in its plant and equipment. Based on estimates, Jason believes that KTI should be spending at least \$3 million annually for the foreseeable future to make up for years that were underfunded and to sustain its current capital assets.

Currently the manufacturing equipment is operating at 80% of normal capacity using two shifts a day. There is some excess space that is not being used.

Marketing and advertising

KTI's customers all do their own marketing for their private-label products. The only marketing costs are those incurred by Michael relating to promotional and marketing activities for the existing customer base (including travel).

KTI currently has no website or online presence. Because the existing customers have been with the company for many years and new customers are typically attracted in person, Michael does not see the need to spend any funds on a website.

R&D

The R&D department, made up of food scientists and assistants, analyzes and experiments with adding different fruits, spices, herbs, and other ingredients to change the flavour of the tea and to enhance its health benefits. The scientists also look at different ways to package the tea to retain its quality and improve its taste.

New products that the R&D department has been working on include a range of teas infused with botanicals that aid in digestion and more flavour-enhanced teas, including RTD products. The scientists keep up to date on industry research to ensure they are at

the forefront of what competitors are doing and to keep abreast of the changes in consumer preferences. Even though the R&D department continues to successfully develop new products, often ahead of competitors, these products are not being embraced by the customers.

Data analytics

KTI has no consumer contact and therefore has no primary data on consumer preferences.

Financial reporting and budgeting

KTI prepares its financial statements using IFRS. To comply with its revenue contract with its largest customer, KTI is required to provide the customer with a copy of its audited annual financial statements. KTI has had the same auditors, Thorne & Ritter, LLP, since inception. Annual audited financial statements are also submitted to KTI's bank, H&Y Bank. The audit for 2022 was completed in March 2023.

KTI usually pays dividends, but not every year. Dividends were declared and paid in 2021 and 2022 because Michael is concerned about his retirement and wants to withdraw funds while there is excess cash available. Jason and Sabrina would have preferred to keep the funds in the company for growth opportunities.

Banking and financing

KTI has the following line of credit and a long-term debt outstanding:

1. Line of credit — H&Y Bank: Maximum limit of \$2,500,000, bearing interest at prime plus 1.5% (prime is currently 2.0%). The line of credit is secured by the accounts receivable and inventories and is renewed annually in September. The line of credit has one covenant: the current ratio must be greater than 2.0.
2. Term loan — Keiser Investments Inc: The 6% term loan is secured by a general security agreement, subordinated to the line of credit. It is repayable in annual principal payments of \$400,000 on November 1 and matures on October 31, 2040.

The company has found two alternative sources of funds for any new long-term investments. The terms and conditions proposed for each alternative are provided in Appendix IV.

Board meeting dialogue

The board met on April 25, 2023. Prior to the meeting, a briefing was distributed to the board members on the four new projects that had been discussed at earlier meetings:

- contract with Home Taste Koffee Inc. (Appendix V)
- produce a KTI branded tea (Appendix VI)

- pursue an investment in the Sleeping Hills Tea Estate (SHTE) tea farm (Appendix VII)
- manufacture RTD tea-based products (Appendix VIII)

The meeting's agenda was announced as follows:

1. Consider the four proposed strategic alternatives.
2. Discuss any other business.

Excerpts from the discussions that took place are detailed below.

Michael: Thank you all for coming. I wanted to mention that recently, one of our customers has been hinting that they may not renew their contract, which expires in October, unless their purchase price can be reduced. I am not sure how our negotiations will go, so I have been searching for a new customer, and have been in discussions with Frank Fullerton, the sole owner of Home Taste Koffee Inc. (HTK). As you know, HTK is the inventor and manufacturer of the new Cofte maker, which uses pods to make great-tasting tea and coffee. The Cofte maker is very popular and has been steadily gaining market share from other competitors, given its proprietary design that allows it to brew single, double, and triple servings using pods of different sizes.

Jason: I am familiar with the Cofte makers and have seen many news articles focused on the fact that the Cofte pods have only a small amount of recycled material — I think it is around 55%.

Michael: The pods are uniquely designed and patented to produce higher-quality premium tea and coffee than other comparable systems in the market. The pods are sold at a premium price, targeting the more discerning coffee and tea drinkers, who drink these hot beverages not only for the great taste but also for the experience. HTK produces its own coffee but is looking to contract with a tea producer that will supply a variety of teas in all three sizes of pods for its machines. The tea will be distributed by HTK primarily to hotels and offices. This will be a great way for KTI to diversify its products and customer base in a low-risk manner.

Sabrina: I have reviewed the proposal, and it looks like HTK wants eight different types of teas. What specifically are they looking for?

Michael: That can all be worked out later between Frank and me. I will continue to be the face of KTI in negotiations with Frank and ongoing relationships with HTK. For now, I think if we can come up with eight flavours using fruits and spices, that should be acceptable. Eventually, they want to have one or two herbal teas to include in the mix, alongside the current minimum of one milk-based product.

Sabrina: I have some issues with this. We have never worked with pods and have no idea how our tea will taste when made in these tea pods in a Cofte maker. We will need to do extensive R&D work to ensure that the product is up to our standards, which we may not be able to complete in time to meet the production schedule. We do not

currently produce any herbal teas or milk-based teas and only one line of flavoured tea, so this will require a significant change in our operations and product development, if and when we have to produce these products.

Kathleen: As well, the contract is only for a year, but we are going to have to make a major investment in equipment. And where do we find the equipment supplier and the packaging supplier?

Michael: Frank assured me that the contract would be renewed as long as things went well. It is just that his practice has always been to start with a shorter contract initially and then increase at the time of renewal. HTK will let us know exactly which suppliers to use for everything — equipment, packaging, and so on.

Jason: It looks like we will have to find new farmers to get the amount of raw materials we require, since we are currently producing all of the processed tea that we receive. This new supply contract will have to be longer than one year to be consistent with our normal practices. Although there is no requirement for Fairtrade certification, I will want to ensure that any new farmers are certified, since we may need to use their tea leaves in other products in the future. Therefore, the costs of raw material inputs may be higher than forecasted.

Sabrina: We don't have any expertise running this equipment or any employees familiar with this process.

Michael: I asked Frank about that, and he said that we will be required to hire his approved production manager to run this new line, and this manager will hire his own employees.

Sabrina: But does this manager have any tea production experience?

Michael: Yes. Apparently HTK has attempted to partner with two other tea producers in the past, but they were not satisfied with the quality and so they are coming to us.

Jason: The rumours are that Frank can be very demanding and unreasonable and that his production manager is disrespectful and discriminatory.

Kathleen: Well, I do like the high profit margins this contract generates, and I think we should give it a try. Currently, for coffee, HTK is well recognized as having a premium brand. We can always terminate if we are not happy.

Michael: Your opinions are all noted. Let's move to the next item. Jason, can you expand on your idea?

Jason: As you know, I believe that the future of KTI lies in us producing our own brand of tea, to be called Kingsdale Teas. To do so, a product mix that includes teas grown in Sri Lanka and in Kenya is required. Kenya has become a leader in growing single-origin artisan teas, and I think KTI can capitalize on this. I have met several times with a group of tea farmers in Kenya who currently grow and process artisanal teas that are certified

organic and Fairtrade. I have been in discussions with Dennis Mwangi, a farmer and representative of these farmers, and they are extremely interested in selling to KTI.

I have also been researching the market for high-quality, artisanal teas and have determined that tearooms and tea shops should be the target customer segment. Over the past year, I have met with many tearoom and tea shop owners across Canada, bringing them samples of some new products developed by Sabrina and some of the Kenyan artisanal tea. These owners are all excited about the products they have sampled, and there are at least 30 customers expressing an interest in buying these teas. A vital component of the plan is for the Kingsdale Teas to be exported to the United States. I have already been in discussions with a long-time friend, Alwynn Blackstone, who lives in the United States and currently works for a tea producer there. She is familiar with the U.S. tea market and will act as KTI's agent in the United States. Alwynn will be given responsibility for the entire U.S. market.

Kathleen: Why limit the sales to only tearooms and tea shops? Why not try to sell this brand everywhere?

Jason: This is a premium-priced, speciality tea. The tearooms and tea shops are very discriminating in the type of tea they carry, since that is what they focus on selling, and they are willing to pay the premium price. If we sell it everywhere, then the product really is not differentiated in any way. Also, being sampled and enjoyed in tearooms and tea shops is the best way to sell our tea, because the tea is brewed to perfection, the taste is phenomenal, and customers will have a pleasant experience.

Michael: But what about our private-label customers? One reason they have stayed with us for so long is that we do not make any competing products, except for other private-label products. I do not want to develop and produce the Kingsdale brand by sacrificing the private-label customers.

Jason: We can slowly move away from private labels, since I think we will be able to sell everything that we produce under our own brand. The margins are better for our own brand compared to private labels, and we are not subject to the constant pressure to reduce prices. To meet production demands, we can initially put on a third shift for the production equipment, and then later we could add another machine, since we have the space.

Michael: I do not like the idea. There are no guaranteed sales at fixed prices, since there are no long-term contracts. Producing private-label tea has allowed our revenues to be stable.

Jason: One of the reasons I chose this segment is that these customers do not purchase based on price, but instead choose based on the type, quality, and taste of the tea. They represent a small niche segment that I think we can appeal to based on our passion and commitment to making extraordinary teas. KTI will not be competing directly on price, and we can generate higher margins.

Sabrina: Well, I love this idea. I also think the timing is right. The R&D department has developed many different tea blends that we have not been able to produce for the private-label customers. With the addition of artisanal teas, we will have a nice broad selection of teas that will appeal to these tearoom and tea shop customers. Finally, we will have control over the type of product that we sell. I have tasted this new artisanal tea from Kenya, and it is some of the best I have ever had. Congratulations to Jason for securing the tea source.

Michael: I am concerned about selling to the United States. Have you done any market analysis specific to the United States? I know that the cultural trends can be quite different, and tearooms may not be trending upwards as they are here.

Jason: I have done limited research, but I have discussed it with Alwynn, who has extensive experience in that market. We both believe this proposal will be successful and that now is the opportune time to make this move.

Kathleen: The marketing spending is too significant and the proposal seems too aggressive. This isn't the best use of our limited resources.

Jason: I disagree. In addition to analyzing the proposal itself, I think we should have FWC complete some additional industry research into tearooms for us and provide us with a bit more background on this type of customer, to help us make this decision. I have provided a list of websites (Appendix VI) that might be helpful as part of this analysis.

Michael: Kathleen, I believe you also have a proposal you have been working on.

Kathleen: Yes. Amasha Bandars, who you all know, has been one of our largest contract suppliers for at least 10 years. Amasha owns SHTE along with her brother, who has been a silent partner for many years. Her brother now wants to sell his share of the farm. SHTE processes high-quality, premium tea. Amasha's brother wants to sell 45% of the farm to KTI, and Amasha has proposed that KTI and Amasha invest in a new company, S&K Inc. (S&K), to be incorporated in Sri Lanka. Having worked with Amasha, I know she is very trustworthy and extremely dedicated to her farm. She is risk averse, like me, so I think we should seriously consider this proposal. I have a lot of faith in Amasha, and this investment will give us control over the quality of the tea we purchase.

Jason: I like the idea. I have been to Amasha's farm many times over the years, and it is very well run. I think it would be great for us to be able to learn first-hand what it takes to run a tea farm, and this will give us better knowledge to negotiate our contracts with the other farmers we work with. As well, we might want to consider owning more tea farms in the future, and this opportunity will allow us to try it and see if it works with only a small investment.

Michael: I am not so sure about making this investment. We have never even acquired another company in Canada before, let alone in a foreign country. I think there is too much that can go wrong, especially when it is far away.

Sabrina: I am also not convinced this is the best use of our money. We already have a long-term supply contract with her, so I don't see why we have to buy into her farm.

Kathleen: This investment gives us a guaranteed supply with more control over cost and overall lower input costs when netted with the profits earned. We will be hedging our risk of the volatile auction prices by sharing in the profits. Keep in mind that at any time, the farmers may decide not to renew our supply contracts. Having an ownership in a farm guarantees us this supply.

Jason: I think owning a tea farm will give confidence to the farmers we currently work with that we know what we are talking about. I also think this experience will help to attract and select future farmers we want to contract with, as I will have a better idea of what to look for when I visit their farms and be able to discuss issues with them from their viewpoint.

Kathleen: Amasha is using up-to-date technology on her farm, and that is why her profits are acceptable. Again, it is good for us to understand what works and what doesn't so that we can have knowledgeable discussions with the farmers. The farm has been in Amasha's family for generations, and there are many relatives working in the business, which means a wealth of experience to utilize. Now, let's move on to discuss Sabrina's proposal.

Sabrina: I am really excited about this new RTD tea-based product. As you know, the R&D department has been experimenting with cold-brewed teas and blending flavours. We believe that we have some very innovative products compared to what is available in the market today. I have been talking to Conrad Bolton, our good friend, and he is interested in being involved in this new product. Conrad owns a bottling company, Bolton Drinks Corp. (BDC), located next to KTI's facilities. He recently approached me with the idea of KTI using BDC's plant and facilities to produce and warehouse a variety of RTD tea-based drinks, with KTI entering into a 10-year lease with BDC for the use of its bottling facilities and equipment. Conrad has a lot of experience in this sector, was successful in the industry for many years, and is now looking for something new and exciting. We all know that he has always been well respected locally and known to treat his employees fairly.

Michael: I don't know. I really like Conrad, but he is my age and was supposed to retire. How can we commit to a 10-year lease agreement with him, not knowing if he will still be interested in 10 years? I think we will be taking a large risk, since we will be relying heavily on him.

Jason: I think Sabrina and I can learn quickly about this segment from Conrad's experience in the industry. We can save time by initially using Conrad's contacts to get us started, and we can begin producing and selling a lot sooner than without him.

Kathleen: I think there are different regulatory requirements that we will have to follow, and so we will be relying on Conrad to comply with these.

Michael: This RTD market is incredibly competitive, not only from tea producers but also from substitutes. I have always stayed away from any branded products in the past, since it takes significant resources to build up the brand and tastes rapidly change in this market. I don't think we have the resources to keep up with changing tastes and competitors' new product introductions in this segment.

Jason: The RTD market is growing and there is demand for a premium-priced product, which I think we can deliver on. We should move forward with this proposal and act now while the demand is increasing and before the market is saturated.

Kathleen: Introducing this product will take time and resources that we cannot afford to waste. In the meantime, I think we should have the break-even volumes in 2024 to assess our risk of loss.

Michael: I am not convinced that you have produced a unique product that will be able to compete. It is a green tea that is infused with different flavours. How is this different from what has been sold for a few years now? Competitors are becoming more innovative than that.

Sabrina: This product is different in that there are not many organic and Fairtrade RTDs being sold. And the fruit flavours, spices, and herbs that we are adding have also not been used in combination. Believe me, I have tasted a lot of them. I really do think we have something unique and if marketed properly, it will sell.

Jason: I have done some market research and totally support Sabrina's proposal. I want KTI to develop its own brand, which this will do. However, I think we should also ask FWC to perform some additional research on the RTD segment of the industry and provide us with key information on this area.

Michael: We have been successful to date, and I really cannot see why we would want to change. We are known and well respected in the industry.

Jason: No, our name is not known in the industry. It is known only to customers who require tea to be produced under their own label. The end consumer has no idea who we are.

Michael: I am nearing retirement, and the last thing I want to do is hand over a company to all of you that is losing money. I need cash flow for my retirement, and I am not willing to take any risk that the cash flow might not be there. You will just have to wait and do this when I am retired.

Sabrina: In the meantime, there is a risk that we will start losing our existing customers and we will have no plans to replace them. Both the Kingsdale Teas and the RTD products will take time to implement, and we will need the cash generated by the private label to do so. Besides, we have to grow the company if Jason, Kathleen, and I have to be able to buy you out, plus earn a good salary.

Michael: All good points. Now that all the ideas have been discussed, we need to decide how we will finance any of our strategic decisions.

Kathleen: Yes, I have been working on that and I have two options (Appendix IV). Conrad has offered to invest in the company, since he is looking for something new to do. I think we should have FWC assess these proposals. We should also have FWC provide a discussion of any accounting or tax implications related to any of the strategic initiatives we are asking them to assess. As well, I know that FWC are not our auditors, but I think they can comment on what type of report Conrad is asking for under the RTD proposal.

Michael: Agreed. Anything else we want FWC to discuss for us?

Sabrina: Yes. As you know, KTI has no consumer contact and therefore is not able to collect data on consumer preferences directly. However, there are market research studies available that collect this data. Data analysis can be used to reveal consumer desires for new flavours and new products and give insight into pricing and market communication opportunities. To help determine the future direction of the company — both strategically and from a product development perspective — KTI has purchased a subset of responses to a survey from the Hot Beverage Institute of America (HBIA), found in the accompanying “DataSet.xlsx” file. I have prepared some background on HBIA and the surveys (Appendix IX), and we should have FWC analyze these results for us.

Michael: Yes, good idea.

Jason: Agreed. I also have an additional concern to discuss. I know that our centralized structure has worked well in the past. But there are now many capable managers in the company with lots of experience, and as we move forward and grow, I would like us to consider a decentralized structure to relieve Dad from making all the decisions. I think we should have FWC provide us with the pros and cons of a centralized versus a decentralized structure.

Sabrina: Good idea. As well, with all these potential changes, we really need to ensure our performance management system is robust enough. Let’s ask FWC for advice on how to improve our performance measurement tools. We can ask them to provide a framework to use for performance management and the key metrics that should be tracked.

Jason: While we are on this topic, let’s ask their advice on succession planning and how it can work for our organization, ignoring any tax implications. Dad, we need to start planning for this, so that all is in place once you do decide to retire.

Michael: I know. But I don’t want to think about retiring just yet.

Kathleen: Dad, you know it is the sensible thing to protect the value of the company that you have built. It doesn’t mean it has to happen tomorrow, but it is always good to prepare and have a plan in place.

Michael: Well, I guess since we all are being open about our opinions, I should bring you up to date on an issue that has become more serious over the past few weeks. A few months ago, one of our employees came to Hans and complained that he had started having respiratory issues and his doctor felt that it was work related. He said that he had started having coughing fits regularly in the plant, which seemed to get better when he got home. Hans took the first complaint and came to me with it in early February. We decided to ignore it at the time and wait and see what happened, since this employee has been a chronic complainer in the past. In February, the employee came in again and said that he had gotten worse and his doctor felt that it might have to do with dust particles in the air. I walked around the plant with Hans and couldn't see anything, so again we decided to ignore it.

Jason: This sounds serious.

Michael: In March, the employee came in again and threatened to refuse to work if something wasn't done. Hans again came to me with this, and we decided to test for dust particles in the air one evening when there was no one around. We found that the concentration of dust was within acceptable guidelines, but at the highest end of the range, so I asked Hans to investigate what might be causing it. Hans determined the cause a few weeks later and said that it was due to the way the machine was designed and operating. He said we could fix it at a cost of \$1,000,000 by replacing the parts and improving the ventilation system. Since we had only had the one complaint and we were still within an acceptable range, I said we would put off the expenditure until we got another complaint. We didn't think we needed to spend the money right now, since it would increase our unit costs.

Jason: This does not sound good. What are the implications for us, you think?

Kathleen: If this gets out to our employees, suppliers, or customers, our reputation — which is based on ethical practices — may be jeopardized. I think we need some guidance on what we should do about this and, hopefully, FWC can help us.

Michael: All right, that might be best. If there is nothing else, we are adjourned.

Table of appendices

Appendix I Organizational chart 36

Appendix II KTI financial statements 37

Appendix III Industry benchmarks 40

Appendix IV Financing alternatives 41

Appendix V Contract with Home Taste Koffee Inc. 42

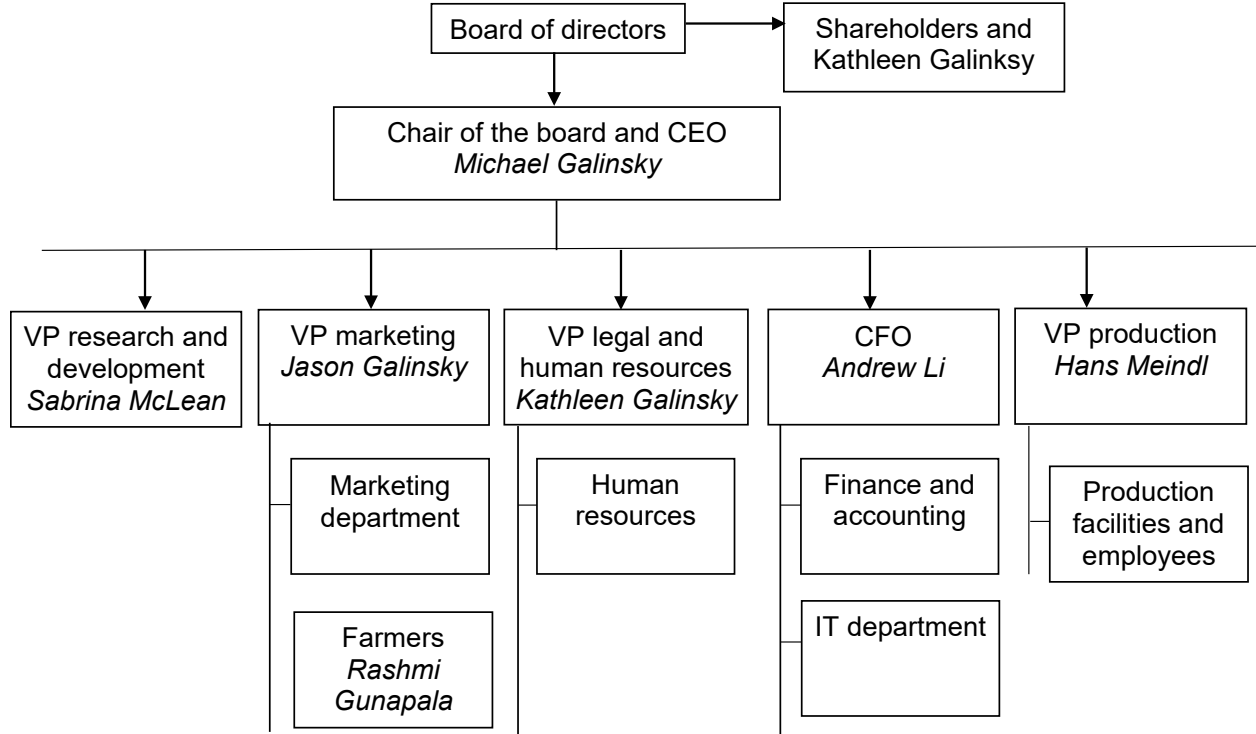
Appendix VI Develop branded tea — Kingsdale Teas 46

Appendix VII Ownership in tea farm — SHTE..... 48

Appendix VIII Ready-to-drink tea-based product..... 51

Appendix IX Consumer data 55

Appendix I
Organizational chart
Prepared by Kathleen Galinsky



Appendix II
KTI financial statements
Prepared by Andrew Li

Kingsdale Tea Inc.
Partial statement of profit or loss and comprehensive income
for the years ended December 31
(under IFRS)
(in C\$'000s)

	AUDITED 2022 \$	AUDITED 2021 \$	AUDITED 2020 \$
Revenue	43,200	42,180	40,854
Cost of sales	34,769	32,950	31,980
Gross profit	8,431	9,230	8,874
Expenses			
Research and development	775	770	730
Marketing	265	235	225
General and administrative	4,938	4,790	4,526
Total expenses	5,978	5,795	5,481
Operating income	2,453	3,435	3,393
Finance expense	473	496	518
Income before taxes	1,980	2,939	2,875
Income taxes	515	770	753
Profit and comprehensive income for the year	1,465	2,169	2,122

Kingsdale Tea Inc.
Partial statement of changes in equity
for the years ended December 31
(under IFRS)
(in C\$'000s)

	AUDITED 2022 \$	AUDITED 2021 \$	AUDITED 2020 \$
Retained earnings			
Balance — beginning of year	4,947	4,098	1,976
Comprehensive income	1,465	2,169	2,122
Dividends	(1,620)	(1,320)	-
Balance — end of year	4,792	4,947	4,098

Appendix II (continued)
KTI financial statements
 Prepared by Andrew Li

Kingsdale Tea Inc.
Statement of financial position
 as at December 31
 (under IFRS)
 (in C\$'000s)

	AUDITED 2022 \$	AUDITED 2021 \$	AUDITED 2020 \$
Assets			
Current assets			
Cash and cash equivalents	1,023	1,954	984
Accounts receivable	5,314	4,851	4,494
Inventories	3,094	2,768	2,718
Prepaid supplies and expenses	1,450	1,212	1,203
Total current assets	10,881	10,785	9,399
Property, plant, and equipment — net	7,282	7,540	7,671
Total assets	18,163	18,325	17,070
Liabilities			
Current liabilities			
Line of credit	650	570	545
Trade payables and accrued liabilities	3,853	3,408	3,010
Income taxes payable	164	331	64
Current portion — term loan	400	400	400
Total current liabilities	5,067	4,709	4,019
Long-term debt — term loan	6,800	7,200	7,600
Deferred income taxes	1,204	1,169	1,053
Total liabilities	13,071	13,078	12,672
Shareholders' equity			
Share capital — 300,000 common shares outstanding	300	300	300
Retained earnings	4,792	4,947	4,098
Total shareholders' equity	5,092	5,247	4,398
Total liabilities and shareholders' equity	18,163	18,325	17,070

Appendix II (continued)
KTI financial statements
 Prepared by Andrew Li

Kingsdale Tea Inc.
Statement of cash flows
 for the years ended December 31
 (under IFRS)
 (in C\$'000s)

	AUDITED	AUDITED
	2022	2021
	\$	\$
Operating activities		
Net profit	1,465	2,169
Depreciation	1,098	1,141
Interest expense	473	496
Interest paid	(473)	(496)
Income tax expense	515	770
Income taxes paid	(647)	(387)
Change in working capital balances		
Accounts receivable	(463)	(357)
Inventories	(326)	(50)
Prepaid supplies and expenses	(238)	(9)
Trade payables and accrued liabilities	445	398
Total cash flow from operating activities	<u>1,849</u>	<u>3,675</u>
Investing activities		
Investment in property, plant, and equipment	<u>(840)</u>	<u>(1,010)</u>
Financing activities		
Line of credit	80	25
Repayment mortgage payable	(400)	(400)
Dividends paid	(1,620)	(1,320)
Total cash flow from financing activities	<u>(1,940)</u>	<u>(1,695)</u>
Change in cash	(931)	970
Opening cash and cash equivalents	1,954	984
Closing cash and cash equivalents	<u><u>1,023</u></u>	<u><u>1,954</u></u>

Appendix III
Industry benchmarks
 Prepared by Andrew Li

Industry benchmarks	Industry average
Revenue growth	4.7%
Current ratio	2.5
Total debt-to-assets ratio	0.4
Return on assets (net return)	10.0%
Days in receivable	37.0
Days in inventory	45.0
Gross profit margin	24.0%
Operating margin	10.6%
Profit margin	7.0%
Marketing expenses as a percentage of revenue	2.6%
Research and development as a percentage of revenue	2.0%
General and administration as a percentage of revenue	14.0%

Appendix IV
Financing alternatives
Prepared by Kathleen Galinsky

Keiser Investments Inc. term loan

Keiser Investments Inc. has offered to lend a term loan in the amount of \$6,000,000, which would be subordinated to all other loans. The loan bears annual interest at 10%, with the interest payable monthly. In addition to the annual interest rate, KTI will pay bonus interest. The bonus interest will be payable in any year that KTI's EBITDA is greater than \$3.0 million. The bonus interest will be equal to 5% on the excess EBITDA above the base of \$3.0 million. KTI will be required to submit quarterly unaudited statements and annual audited statements. Dividends are limited to \$500,000 annually during the term of the loan, and salaries to shareholders are fixed at the current levels for the term of the loan. The principal is due three years after issue of the loan.

Preferred share investment by Conrad Bolton

Conrad Bolton has offered to purchase 80,000 preferred shares in KTI for \$8,000,000. These preferred shares are non-voting and fully participating, with a cumulative annual dividend of 5%. The shares are redeemable by the issuer at a price of \$100 per share any time after January 1, 2027. One requirement is that Conrad gets a seat on the board of directors and has some say over the operations of the company.

Appendix V
Contract with Home Taste Koffee Inc.
Prepared by Michael Galinsky

HTK has been in business for 10 years, starting as a coffee producer and then inventing and beginning to sell the Cofte maker four years ago.

HTK has contracts with major national hotel chains and many large office complexes, where it provides its Cofte makers at a significantly discounted price and sells its coffee and tea pods as required. It has multi-year contracts to supply these pods to its customers. HTK also has contracts with grocery retailers to sell its pods in bulk for home use. As part of its agreement with most of these retailers, HTK has negotiated premium shelf space.

The following is an excerpt from the proposed co-branding contract, provided by Frank. He is not interested in negotiating different terms, as this is the standard that he uses with all of his coffee and tea suppliers.

Terms and conditions:

- HTK and KTI agree in this contractual arrangement to co-brand tea pods that will be distributed by HTK.
- The initial contract will terminate in one year, on December 31, 2024, and, if agreed by both parties, will be renewed for another four years.

Production and shipments:

- HTK acknowledges that KTI will formulate and produce tea pods based on KTI's proprietary formulas, which will always be owned and controlled solely by KTI and remain the sole property of KTI.
- KTI will initially provide eight different flavours of tea, including one milk-based product, and the tea leaves used will be certified as organic. HTK will have the final say on the eight flavours to be produced as part of the arrangement.
- Annually, KTI must produce two new innovative flavours of tea pods, replacing two of the existing products.
- KTI will be responsible for ensuring that quality of the product is always maintained.
- KTI will be required to provide 10 samples of product for testing by HTK. HTK agrees to pay \$1,000 for these 10 samples in advance, before any production commences.
- KTI agrees to test for product quality, stability, and consistency on a regular basis.
- KTI will be responsible for ensuring that the product complies with all regulatory requirements.

Appendix V (continued)
Contract with Home Taste Koffee Inc.
Prepared by Michael Galinsky

- HTK agrees to provide all label and packaging specifications. The product will be co-branded by HTK and KTI, and KTI will have its name displayed prominently on the product's label as approved by HTK. KTI may also provide a descriptive phrase on the front of the package that will help to promote its product. HTK will approve this marketing phrase.
- If HTK, a customer, or a consumer should find KTI's product defective in any way, HTK will provide notice of the alleged nonconformity in writing within five days and KTI will be required to replace the defective product at its own cost.
- HTK will require KTI to hire a production manager of HTK's choice. This production manager will have the sole responsibility of running this production line, as well as hiring the employees to be part of this production team.

Payment and inventory:

- HTK agrees to pay in full, within 45 days of shipment, for all co-branded product produced under the agreement.
- KTI will be responsible for ordering the packaging and labels and for their payments, but must purchase the packaging only from an HTK approved supplier.
- KTI must maintain a finished goods inventory representing a minimum of 30 days of sales worth of product, ready for immediate shipping on notice.
- If in any year the volume of product shipped by KTI is 120% greater than the volumes forecasted, HTK will be entitled to a volume discount on all product purchased in that year of 12%.
- HTK maintains data on how often each product is sold, providing it with an indication of consumer preferences. HTK will share this information with KTI monthly.

Other items:

- HTK agrees to not disclose, provide, or otherwise make available to another third party any KTI confidential and proprietary information. Similarly, KTI agrees not to disclose any HTK confidential and proprietary information.
- The agreement may be terminated by HTK with 30 days' notice, for no cause. KTI may also terminate the contract giving 60 days' notice, with no cause.
- KTI agrees to purchase the required equipment to package the tea pods from a supplier approved by HTK. This equipment is state-of-the-art, incorporating robotics for blending and mixing, and requires minimal labour.
- KTI cannot produce and sell Cofte tea pods unless under contract with HTK or otherwise approved by HTK.

Appendix V (continued)
Contract with Home Taste Koffee Inc.
 Prepared by Michael Galinsky

- HTK agrees to pay the prices as detailed below. HTK agrees to purchase, at a minimum, 80% of the forecasted volumes detailed below.

Based on Frank's experience with previous tea producers, he has provided the following estimates for costs and sales. He believes that sales could start in January 2024.

	2024	2025	2026	2027	2028
Single-serving pod					
Volume of sales	6,500,000	6,800,000	6,900,000	6,900,000	6,900,000
Selling price per pod	\$0.425	\$0.425	\$0.425	\$0.425	\$0.425
Double-serving pod					
Volume of sales	6,100,000	6,300,000	6,500,000	6,500,000	6,500,000
Selling price per pod	\$0.755	\$0.755	\$0.755	\$0.755	\$0.755
Triple-serving pod					
Volume of sales	4,600,000	4,800,000	4,900,000	4,900,000	4,900,000
Selling price per pod	\$1.092	\$1.092	\$1.092	\$1.092	\$1.092

Frank also states that historically, the packaging costs have represented 3.2% of revenues. The cost of the new equipment will be \$6,500,000 and will be purchased near the end of 2023, with production started before the end of the year. For tax purposes, the equipment would be assigned to Class 53. At the time of disposal, at the end of five years, the equipment can be sold for \$1,350,000 and there will be other assets remaining in the class at this time.

Hans and I have prepared some estimates of additional costs (with input from Frank), as follows:

- There will be an addition required to the warehouse to increase the space. The cost of this addition will be \$900,000, and it will qualify for capital cost allowance (CCA) at 6% declining balance. At the end of five years, the salvage value of this addition will be nil but could be used by the company beyond five years, if the contract is extended.
- Direct labour will equal 4% of revenues.
- Tea leaves and other ingredients will equal 51% of revenues.
- KTI will invest and maintain a specific working capital equal to 16% of the next year's revenue.

Appendix V (continued)
Contract with Home Taste Koffee Inc.
Prepared by Michael Galinsky

Annual fixed costs for KTI's operations are estimated as follows, excluding depreciation:

- production costs: \$375,000
- warehousing costs: \$80,000
- marketing costs: \$50,000

It is estimated that there will be one research assistant required at an annual salary of \$75,000 including fringe benefits, plus additional supplies of \$25,000 annually. There will be no new administrative staff required, but I have determined that 10% of the existing general and administrative costs should be allocated to this new product line. Sabrina estimated that it would cost \$1,500 in materials to produce the test samples requested.

KTI's cost of capital for this project analysis is 18%, and the corporate tax rate to apply is 26.5%.

Appendix VI

Develop branded tea — Kingsdale Teas

Prepared by Jason Galinsky

I have approached Dennis about exporting their tea, and Dennis and his group are very interested in selling their artisanal and other black and green teas in Canada. If the proposal is accepted, the farmers' contracts will be initially for four years, with the price set annually by mutual agreement, which will vary based on annual yields. Since the artisanal teas are unique and hand processed, their price will be much higher than the auction prices for the non-artisanal teas.

My vision is that the Kingsdale brand will represent high-quality premium, organic, and Fairtrade teas in a variety of types and flavours. The teas will be known for being ethically sourced and will be sold as loose-leaf tea, not in bags. The tea will be sold only to tearooms and tea shops at a premium price and in small batches to retain the quality and freshness of the tea. No long-term customer contracts will be signed, but I expect to have monthly orders to ship product to these customers. The value proposition for the Kingsdale Teas brand is to have a product that is extraordinary, is unique, has distinctive flavours, and is available only in limited quantities to very discriminating tea drinkers. Sabrina and I will have total control selecting and developing the teas that will be sold under this brand.

To meet the projected customers' orders, the company will use tea from the Kenyan farmers and from the new Sri Lankan farmers, with whom I have already started discussions. If any current private-label contracts are not renewed, I suggest that any excess raw materials from the existing contracted farmers be used for the Kingsdale brand. I believe I can sell as much tea as can be produced. The current projections assume that 50% of the tea is sourced from Kenya.

I will continue to be responsible for the marketing and sales of Kingsdale Teas in Canada. The personal marketing approach is the most effective method for this type of product, and I will personally visit each customer's premises at least every six months.

Production equipment modifications will be required to be able to package the tea as loose leaf. New warehousing equipment will also be needed to improve the efficiency of shipping given the multiple daily shipments that will be required. The total cost of the modifications and new state-of-the-art equipment will be \$2,500,000. There will also be an addition to the warehouse required to increase the space that will cost \$1,200,000. For tax purposes, the equipment would be assigned to Class 53, and the warehouse addition will qualify for a CCA rate of 6% declining balance. There will also be an initial working capital investment of \$500,000.

Appendix VI (continued)
Develop branded tea — Kingsdale Teas
 Prepared by Jason Galinsky

Currently, the exchange rate is US\$1 = C\$1.35, but historically, the exchange rate has been as low as US\$1 = C\$0.98. Forecasts of sales in Canada and the United States are as follows:

	2023	2024	2025	2026
	(Oct to Dec)	(Jan to Dec)	(Jan to Dec)	(Jan to Dec)
Number of Canadian customers	30	75	100	125
Units sold per Canadian customer	300	1,200	1,250	1,300
Selling price per unit sold for Canadian customer	C\$110	C\$110	C\$110	C\$115
Number of U.S. customers	10	60	85	110
Units sold per U.S. customer	300	1,200	1,250	1,300
Selling price per unit sold for U.S. customer	US\$95	US\$95	US\$95	US\$100

The cost per unit sold is \$66.70. Shipping costs are 4% of Canadian sales and 6% of U.S. sales. The commission paid to the U.S. sales agent is 7% of U.S. sales.

Marketing costs in Canada will be \$725,000 for 2023 and \$1,450,000 for 2024 and onwards. In the United States, marketing costs will be C\$1,375,000 in 2023 and then C\$2,150,000 for 2024 and onwards.

Annual expenditures will be R&D \$550,000, warehousing costs \$800,000, and general and administration \$540,000.

KTI accepts projects of this size that pay back within three years.

To help understand how tearooms operate and how customers are served, I have found two sources that I suggest the other directors review:

- Melanie Luff, “How to Run a Tea Room: A short guide to the complex blend of written and unwritten rules in the refined realms of tea,” BusinessesForSale.com, <https://canada.businessesforsale.com/canadian/search/tea-rooms-for-sale/articles/everything-you-need-to-know-about-running-a-tea-room>.
- Tina Jesson, “10 Tips for Tearoom Success,” World Tea News, November 1, 2017, <https://worldteanews.com/tea-industry-news-and-features/10-tips-tearoom-success>.

Appendix VII

Ownership in tea farm — SHTE

Prepared by Kathleen Galinsky

Amasha would own 55% of S&K, and KTI would own 45%. (Sri Lanka laws do not allow companies with local ownership of less than 50% to buy property in Sri Lanka.) Amasha would contribute 55% of SHTE's assets and operations to S&K, and KTI would contribute cash of \$3,100,000, which would be used to buy 45% of SHTE's assets and operations from Amasha's brother.

In 2022, KTI purchased tea from SHTE totalling \$2,600,000, which is approximately 9% of KTI's total tea purchases in 2022, with none of it remaining in ending inventory. Amasha's contracts with KTI are currently for a four-year period. Excerpts from SHTE's last four years of operations is provided below. SHTE reports under IFRS and has no outstanding debt.

Since there have been no recent sales of comparative companies, it has been decided that the best approach to use to value SHTE is the capitalization of net profits. In discussions with experts, I have gathered the following current information related to cost of capital for tea farms in Sri Lanka:

- The target capital structure is a debt-to-asset ratio of 10%, with debt having a current cost before taxes of 5.2%.
- The current risk-free rate in Sri Lanka is 3%, and the beta for similar sized companies is 3.5. The market risk premium is 5%.
- The last four years of financial information should be weighted at the following percentages: 2023 at 40%, and each of the other years at 20%.

In discussions, Amasha provided the following additional information:

- Normally each year, a portion of the tea plants need to be replaced at a cost of ₹450,000. However, in 2022 and 2021, due to low revenues, this replanting was not done.
- Amasha has been paid a low salary from the business for each of the years provided. Based on the management work that she does, a comparable annual salary would have been higher by ₹2,000,000.
- There are some small amounts of personal expenses related to travel that have been included in each year, as follows: 2023 — ₹150,000; 2022 — ₹350,000; 2021 — ₹750,000, and 2020 — ₹650,000.

Appendix VII (continued)
Ownership in tea farm — SHTE
Prepared by Kathleen Galinsky

Amasha has proposed the following contractual arrangement, which she is not willing to negotiate at this point:

- S&K will be formed for the specific purpose of carrying on the business of growing, harvesting, and processing tea at SHTE.
- Amasha and KTI are each a party to this agreement.
- Assets will be owned by S&K, and liabilities will be the obligation of S&K.
- Amasha and KTI will have rights to the net assets of S&K.
- Any tea processed will first be sold to KTI in the quantities requested, and only after those sales will any remaining product be sold to outside parties.
- The board of directors will consist of four directors; Amasha will appoint two directors of her choice, and KTI will appoint two directors of its choice.
- All business decisions will be made unanimously, regardless of proportion of ownership.
- Annual profits of S&K will be allocated as follows: 55% to Amasha and 45% to KTI.
- Amasha will manage the operations on a daily basis and be paid a salary as mutually agreed by both parties for this work.
- KTI will continue to purchase processed tea as required under the current arrangement and will pay the prevailing market (auction) prices to S&K.
- In any year where losses occur and a cash deficit results, each party will be required to contribute sufficient cash to cover the losses, in proportion to their ownership.
- The anniversary date will be the date on which the agreement is signed and becomes enforceable.
- Each party has the right to terminate this agreement. After the initial year, the agreement will automatically renew annually on its anniversary date, unless written notice is provided to the other party of the desire to terminate the arrangement. This written notice must be provided 30 days prior to anniversary date. Only by mutual agreement can this agreement be terminated any time other than the anniversary date.

Please note that I have validated the Sri Lankan financial and tax information included in this proposal, and FWC should not perform additional research on this topic at this time.

Appendix VII (continued)
Ownership in tea farm — SHTE
 Prepared by Kathleen Galinsky

Sleeping Hills Tea Estate
Statement of profit or loss
 For the years ended March 31, 2020, 2021, 2022, and 2023
 (under IFRS)
 (unaudited)

	2023	2022	2021	2020
	₹	₹	₹	₹
Revenue	193,108,600	180,560,700	170,564,120	198,041,200
Costs				
Fertilizer	25,557,600	26,557,600	28,996,540	26,996,540
Harvest and processing	62,810,000	54,810,000	65,743,000	54,743,000
Other	25,000,000	22,300,000	22,300,001	26,781,020
	<u>113,367,600</u>	<u>103,667,600</u>	<u>117,039,541</u>	<u>108,520,560</u>
Operating profit	79,741,000	76,893,100	53,524,579	89,520,640
Income taxes at 14%	11,163,740	10,765,034	7,493,441	12,532,890
Net profit or loss	<u>68,577,260</u>	<u>66,128,066</u>	<u>46,031,138</u>	<u>76,987,750</u>

Appendix VIII
RTD tea-based product
Prepared by Sabrina McLean

Bolton Drinks Corp. (BDC) is located next to KTI's manufacturing facilities, and has been for many years. BDC bottled fruit juices and had customer contracts with convenience stores, gas stations, vending machine companies, and small independent grocery stores. After being in business for 30 years, Conrad decided it might be time to retire and slowly wound down his business. However, he has now changed his mind and decided he is not ready for retirement.

BDC has an automated production line that can package product in a variety of container and bottle sizes. For now, this line is not used. The equipment is about five years old. KTI would pay BDC rent for sole use of the facility and equipment and a management fee to manage the production line and warehouse. KTI would be responsible for all other costs.

Conrad would provide his experience and supply the names of customer and supplier contacts. He would also set up initial meetings with his previous customers to make the introductions and start the discussions. In the past, Conrad had one-year supply contracts with these customers. I plan for Jason to be involved in the sales and marketing of the new product. Conrad also has supplier contacts for bottles that he is happy to share with KTI. I have asked Conrad to be responsible for the purchase of packaging and labelling, but with input from Jason and me.

I want these new RTD products to be premium high-quality green tea drinks, certified organic and Fairtrade, and packaged in recyclable bottles. They will be premium priced and targeted to 18- to 35-year-olds. My R&D department has been researching various cold tea drinks and experimenting with unique fruit, herb, and spice blends to create bold new flavours. I believe that by late November 2023 we should have at least four different varieties ready to produce and sell. In the meantime, I can work with Conrad to prepare sample products to make sure that after bottling, the taste is still of high quality.

KTI would enter a 10-year lease with BDC at a monthly rate of \$77,714, payable at the beginning of each month, starting January 1, 2024. The annual rate implicit in the lease is 6%, compounded monthly. The economic life is 10 years for the equipment and 15 years for the facilities. (The equipment and facilities have a combined fair market value of \$12 million.) BDC will be responsible for upgrading the equipment to handle the packaging specifications, once selected, and maintaining the equipment in working condition.

Appendix VIII (continued)
RTD tea-based product
 Prepared by Sabrina McLean

KTI also agrees to pay BDC an annual management fee of \$250,000, payable monthly, starting July 1, 2023. In addition, KTI will pay BDC an annual bonus equal to 2% of all RTD product sales. Assuming production starts January 1, 2024, the 2% bonus will be based on total sales from January 1 to December 31 and be payable by January 21 of the following year. Conrad will require an annual audited report on the total sales and the amount of bonus paid to be provided no later than February 15 of the following year.

From discussions with Conrad, I have decided that there will be two sizes sold: single bottles and six-bottle packs. The products will be marketed under a new brand name still to be determined. For this tea product, I suggest using tea grown in the lowlands of Sri Lanka. Jason will therefore have to contract with new farmers to meet the increased supply requirements.

Conrad and I have prepared forecast assumptions below:

Sales: selling price per single bottle: \$2.75; selling price per six-pack \$12.90

	2024	2025	2026
Volume of singles sold	1,200,000	1,300,000	2,100,000
Volume of six-packs sold	650,000	800,000	950,000

Variable costs per unit

	Single bottles	Six-pack
Direct materials	\$0.40	\$2.50
Direct labour	\$0.25	\$0.90
Other production costs	\$1.10	\$5.35
Shipping and distribution	\$0.21	\$1.03

Additional annual costs:

- wages for additional office staff: \$210,000
- marketing costs: \$600,000
- general and administrative costs: \$85,000 fixed, plus \$0.16 per item sold
- warehousing costs: \$350,000

Appendix VIII (continued)
RTD tea-based product
Prepared by Sabrina McLean

I have also done some preliminary research into the RTD industry and have provided a summary of my research below⁶⁷ (although it's from the United States, there are assumed to be similarities with the Canadian industry):

- The RTD tea-based industry is growing as consumers turn toward healthier choices than sweetened soda and fruit juices.
- Demand is driven by consumers' health concerns and product innovation.
- Consumers are looking for a variety of flavours and differentiated tea offerings with unique blends that can be sold at premium prices.
- Distribution of sales by major markets is as follows: gas stations and convenience stores 15%; vending machines 5%, warehouse clubs and big-box stores 21.7%, grocery stores 45.5%, and exports 12.8%. A significant proportion is sold in non-traditional distribution channels. Vending machines, gas stations, and convenience stores are expected to increase their market share, and grocery stores are increasing their retail space for these types of beverages, while the share sold through warehouses and superstores is shrinking.
- Key success factors are strong distribution networks to gain access to premium shelf space, economies of scale, control of distribution arrangements to minimize logistical costs, production of goods favoured by the market based on consumers' shifting preferences, brand name recognition, and aggressive marketing.
- Competition is high and based on price, branding, and quality. The large operators have economies of scale and power to negotiate lower prices with suppliers. Smaller operators can be successful if they are selling a premium-priced RTD.
- The barriers to entry are medium, but new smaller entrants can be successful by entering a niche market and selling a unique product. These niche markets are less price sensitive.
- Automated equipment is used, and the trend is toward packaging in glass bottles, which are better for the environment and also better preserve the flavour. Other packaging is in cans and polyethylene terephthalate (PET) bottles. In addition, companies continuously invest in new capital equipment to optimize production and lower costs.

⁶⁷ Anna Amir, "Strong tea: Health-conscious consumers and product development will drive industry demand," *IBISWorld Industry Report OD4297: RTD Tea Production in the US*, December 2018.

Appendix VIII (continued)
RTD tea-based product
Prepared by Sabrina McLean

I have also found the following three other good sources of industry information:

- “RTD Tea and Coffee Market Size Worth \$116.13 Billion By 2024,” Grand View Research, April 2018, <https://www.grandviewresearch.com/press-release/global-ready-to-drink-tea-and-ready-to-drink-coffee-market>.
- “2019 State of the Beverage Industry: Ready-to-drink tea, functionality drives demand in market,” Beverage Industry, July 15, 2019, <https://www.bevindustry.com/articles/92246-2019-state-of-the-beverage-industry-ready-to-drink-tea-functionality-drives-demand-in-market>.
- “Tea Trouble: How Formulations Meet Packaging Needs, Not Consumers’,” Nosh, October 16, 2014, <https://www.nosh.com/news/2014/tea-trouble-how-formulations-meet-packaging-needs-not-consumers>.

Appendix IX Consumer data

Prepared by Sabrina McLean

Hot Beverage Institute of America (HBIA) is a marketing and lobby group for tea and coffee producers. It uses various methods to engage with the public, including contests, social media promotions, and consumer quizzes. In exchange for entries into these engagement activities, HBIA collects some personal information from participants, including name and email address. HBIA then uses this information to distribute its bi-annual online market survey, a portion of which KTI has purchased.

The survey is sent to all users in HBIA's public engagement database and includes anyone who has identified as having an interest in tea or coffee in Canada and the United States. The survey, which is voluntary, has an 8% response rate.

KTI purchased the responses of Canadian participants. The responses are included in the DataSet.xlsx file.

The following personal information is collected from respondents (though not all of it has been included in the information purchased by KTI):

- First Name (not included)
- Last Name (included)
- Street Address (not included)
- City (included)
- Email Address (included)
- Gender (included)
- Age (included)
- Annual income (included)

Respondents are then asked a series of questions about their hot beverage habits. The following questions were included as part of the 2021 survey:

- What is your preferred beverage?
- How much of your preferred beverage did you drink daily five years ago?
- How much of your preferred beverage did you drink daily one year ago?
- How much of your preferred beverage do you currently drink daily?
- What is your favourite variety?
- What is the country of origin of your favourite variety?
- Where do you most frequently purchase your preferred beverage?
- What is the average price that you pay for your preferred beverage?

Appendix IX (continued)
Consumer data
Prepared by Sabrina McLean

Consumers were also asked to rank on a scale of 1 to 5 how important the following factors are in their buying decision, where 1 is “not important” and 5 is “very important”:

- the health benefits of their preferred beverage
- the use of organic ingredients in their preferred beverage
- the use of sustainably sources ingredients
- the use of Fairtrade practices by the producer
- the producer being Canadian

The other board members and I would like to have the information analyzed and presented visually at the next board meeting. We want to gain a better understanding of the “end-user” in KTI’s market. Some of the things we are most interested in are:

- consumption patterns
- consumer demographics
- buying considerations

As well, I have been doing a lot of reading about data acquisition recently, and I would also like FWC to evaluate the quality of the data received, the method used to collect it, and identify any biases that it may contain.

Finally, I would like to begin storing consumer data onsite at KTI. Eventually I believe that it would be beneficial to begin collecting data directly. Please provide us with some guidelines on collecting and storing personal data.