



Rest allows us to go the long haul;
The Puerh market enters an era of price correction

By Chen Chih Tung



After a spring of soaring prices and an explosive rise in raw material costs, the heat of summer failed to bring the tea market to a boil. Instead, following a large scale price drop of Menghai Tea Factory's teas, the market saw a cooling off. This caused many tea collectors and speculators to take notice. With Chinese language media outlets competing to deliver dire reports, people are coming to the harsh realization that Puerh is not just a financial stock, but rather a type of tea. No matter how good the tea, it cannot support limitless price increases. Although quality affects the experience of drinking tea, money for tea is not unlimited.

The current market price correction is the result of basic economic principles. There are essentially two kinds of limits on economic growth: the first is the maximum price the market is willing to accept; the second is caused by limited raw materials and/or resources.

A combination of natural and man-made disasters this year has caused both factors to come into play. Also impacting the current situation is the media's coverage of Puerh tea speculation, which, all in all, has been quite balanced. Existing tea stock is, however, existing stock. Prices have risen by several orders of magnitude in a short period of time, but quality cannot possibly improve at such a rate. As a result, recent price increases are hard to justify logically.

In the past year, Menghai teas reached prices of 20,000RMB/case. This scale of increase is extremely alarming. Many people believe the recent sell-off is the result of media coverage. I would say, though, the real cause is unreasonably high prices. When prices rise too high, people sell. A large price-drop leads to buying. As is the case with any product whose price is peaking, negative news or opinions are hard to find. When the



market bottoms out, the opposite occurs and it becomes difficult to find positive news or active trading. Prices generally peak in an environment of heavy buying and slowly bottom out in an environment in which people are selling and buyers are few and far between.

In this atmosphere of panic and sell-off, is this the end of Puerh tea? Is Menghai tea no longer Menghai tea? As I've just said, new stock cannot dramatically increase in quality within a short time period. As a result, explosively rising prices are left without any real rationale. The tea simply becomes an accumulation of capital. The flipside of this is that rapidly falling prices don't change the nature of existing products. This is similar to the stock situation of the Industrial and Commercial Bank of China (ICBC). Even though the stock value has halved, ICBC is still ICBC and still operates as usual. This is just a normal fluctuation in a maturing market and a momentary psychological reaction. As long as the business remains solid, long-term investment will eventually get back on track. By the same principle, when Menghai teas were selling for 20,000RMB, trucks loaded with raw materials lined up to get into the factory. Now that prices have fallen to around 10,000RMB, the trucks are still lined up. The market fluctuation has only changed prices and the mentality of speculators but has not affected the way tea factories do business. Intense short-term price fluctuations clearly lead to customer backlash, but this year's rise in raw material costs is undeniable. Consequently, a rise in tea prices is unavoidable. The question is how much of the rise is justified? I feel this is something worth looking into.

We can employ a simple formula to understand Puerh tea pricing. The price of Puerh is decided by the raw material cost plus cost of raw material waste, adding the processing cost and the gross profit taken in processing the tea. The final price, though, is determined by the trademarks cost of the brand name. Of course this cost is a factor of the relative status of the brand in the eyes



The original Menghai Tea Factory.

of consumers. In general, it's quite easy to estimate a reasonable value for a given tea based on the raw material cost. Assuming a base price of 50RMB/kilogram for unprocessed tea leaves and that the leaves are pressed into 400 gram cakes, our calculation is:

$$[(50 \times 1.15) + 15] \times 1.2 \times 400 = 34800, 34800 / 1000 = 34.8.$$

This is the cost per cake and does not include any additional brand name cost. Even here using the most average quality Yunnan tea, a package (84 cakes) is nearly 3000RMB. We also haven't considered the factory's operating and transport costs or the costs associated with selling the tea. Assuming all of these additional costs, the initial price is likely somewhere around 4000RMB. This is the lowest gross price. That is to say, mass produced Puerh using the cheapest available unprocessed tea leaves will have about this initial price. Using raw materials from the Menghai area, the price will be even

higher. Considering the value of the product name, does 10,000RMB/case for Menghai factory teas still seem so expensive?

During a market decline there is a notion that merits fresh consideration. That is replacement cost. For example, many IC manufacturers during the semiconductor collapse suffered stock falls below nominal value. Of course this is not a good situation for conducting business. More importantly if using this stock price to calculate the total worth of the company is below even the cost of starting a new semiconductor manufacturing company, then the stock value is said to possess replacement cost value. That is to say, the buying of the semiconductor manufacturer at this price is actually below the cost to start a new semiconductor factory from scratch. Puerh tea obeys the same principle. When the price falls to a certain level, it's necessary to consider just how much actual profit tea factories and dealers can realize. If profit falls below 10 - 15%, I would say this price level and the replacement cost situation just mentioned are comparable. The rise in raw material price costs over the past year is an unavoidable fact. Even if prices for this year's tea were to remain at much higher levels than last year's, one cannot evaluate this year's prices based on last year's.

The biggest bottleneck in this year's tea market has not only been the rise in raw material prices, but also the resulting profit taken by speculators who have built up reserves of tea over the past several years. This resulted in a rejection of new teas and has illuminated the problem of financial manipulation in the market. Last year I repeatedly emphasized the situation with Menghai list prices which saw 701 and 601 prices being equal. This is not a normal situation. The fact that 701 and 601 prices were the same indicates that the flow of money in the market is obeying a single principle: whichever batch of stock the money flows into will rise in price. If the market experiences a disturbance and funds cannot be



moved around at will, this can lead to a price fall. Many people are asking what should be used as a price index in today's market. I believe that the Chinese market, and in particular the spot market, should consult Menghai 701 as a price indicator. If the market value of 701 is unable to maintain the level of 10,000RMB per case, people's faith in the market could suffer a serious blow. If even the leading tea label is unable to sustain solid trading, then other brands will have even more difficulty supporting a strong price. When Menghai teas earlier this year broke the 20,000RMB mark, this caused a very precarious situation. With a price too high for most consumers, it's always difficult to sustain a healthy volume of business. However, following the price drop, Menghai teas have had a huge impact on other prices in the market. Menghai 702 and later stock are all less than 10,000RMB per case, and such prices leave other tea factories without any room for movement. Add in the rejection of this year's stock caused by all of these factories' older teas already in the market, and the already difficult position faced by these tea producers becomes



worse. The situation this year is grim and amounts to a restructuring of the market.

The rise in raw material prices is undeniable, but current market conditions prevent prices from rising and mitigating the situation. This is causing a continuous slide in profit margins for tea factories and their agents. Just consider the situation of first-tier Menghai agents. This year's factory prices exceed last year's not by a percentage but by countless multiples. In a situation in which the sale price cannot rise, manufacturers and their agents are forced to confront a limited profit margin and undertake restructuring and redistribution. The risk assumed by agents is greatly increased. I would guess that during this period of fluctuation many agents will bail out. Of course this situation is not exclusive to Menghai Tea Factory, but is affecting all major Yunnan tea producers. Since late 2005, a continuous stream of outside investors have poured money into the Puerh tea market. These people represent not a technological improvement, but rather an increase in capital. Last year I repeatedly raised the point that outside investors are primarily concerned with profit. If the profit level on the investment falls, the proportion that is cost rises. When compared with other forms of investment, Puerh lacks liquidity. Perhaps during the fiery market of last year, many people failed to consider this fact. The importance of a product's fluidity, after all, is relative and not absolute.

Whenever a new investment opportunity arises with bigger and better profits, funds will naturally move toward that new investment. This is not to say that the current investment is a poor earner, but rather that the newer investment has even better performance. This is just the way investment works. Many industry investors and newer agents, though, are currently experiencing the torment caused by a shrinking pool of buyers and the trap imposed by a lack of fluidity. The situation resembles what happens in a market with an extremely

low volume stock. Even if the market price is 200RMB per share, a large stockholder wishing to quickly unload his stock may be forced to settle for half this. This is the pitfall caused by lack of liquidity in today's market, and the shock is unprecedented.

The Puerh market previously experienced a price fall during the "Pigpen Puerh Incident" of 2005, but today's tea market volume exceeds 2005's by many times. Pressure on investors in today's market also vastly exceeds 2005's. After all, transactions in 2005 involved much smaller sums of money. The fall in 2005 was the result of a developing market that had not yet found a source of strong or sustained buying, and led to a reordering correction. Today's fall, however, occurs in a market that is gradually moving toward maturity. The current price tumble is comprehensive and carries a definite destructive force. The high level of trade volume combined with the quantity of teas stored between 2005 and today has led to an extremely chaotic market situation. Consumers saw new teas substantially rising in price, but 2005 and 2006 teas without a corresponding rise. This set up price disparity, causing investment to flow into 2005 and 2006 teas. Tea factories are unable to differentiate new teas from teas produced within the past two years, so it's understandable that new teas face pressure from older products.

In terms of outside investment, this year's level and volume of investment is unprecedented. The moment profit fails to equal expectations, the resulting disappointment and pressure to sell is correspondingly unprecedented. If Menghai 701 can maintain strength in the eyes of investors, this will have a benefit over the next several months in investor confidence, market volume, and organization. For this reason, Menghai's new teas are a good measure of the future market. In the short term, though, I don't see any way these teas will again rise to their recent sky-high prices. Instead, they must develop effective trading at new price levels. Even



after the price fall, 10,000RMB for 701 is still several times more expensive than last year's 601. My view is that after prices fall to a certain level, the tea must be significantly traded at the new prices. If no one actually buys at these prices, then they can't be said to be real. If enough trading develops to sustain today's price levels, then the market as a whole will have grown significantly over last year.

Overall, I would say the current market situation is a problem of confidence, and not a lack of funds. With investors learning that Puerh is after all just tea, and in addition to rising in price can also fall, the market is entering a restructuring phase. In the long-term, recent unhealthy levels of short-term speculation can only hurt the market. From the perspective of long term collectors in the market, this is a pursuit of fast profit and has nothing to do with the flavor of aged Puerh tea. There were even people this year rushing to buy up

tea products who have never drank Puerh. This situation can only give people the negative impression that Puerh is just about speculation, causing damage to the future growth of the market. I'm sure many long-time tea drinkers have watched these developments with a combination of distress and helplessness. In light of all of this, the withdrawal of capital from the market this year was both inevitable and necessary. The overall trade of Puerh must return to a consideration of core values, as opposed to just a consideration of profitability. This is the only way to maintain continued positive development.

Given that commodity, labor, and overall costs are continuously rising in Yunnan, it would be unrealistic to hope for Puerh price's to return to 2005 levels. Also given current worldwide inflationary trends among many agricultural products, it seems unlikely Puerh will



Old-growth *maocha* drying in the sun.

experience a weakening of pressure. Although summer tea prices have fallen, summer teas have historically only commanded half the price of spring teas. This year's summer teas are still much higher than last years, so the current market's attitude toward Puerh is one of confusion. The overall rise in Puerh prices is, indeed, alarming. However, I would suggest that these higher price levels are reasonable given the needs of the market and recent increases in raw material prices. As for the overall structure of the Yunnan tea industry, though, I believe we will see more and more elimination from the market. Yunnan tea producers possess huge factories but completely lack a sense of the risk in controlling raw materials. Any rise in the price of raw materials is a blow to producers. They possess the ability for huge output, but factory utilization levels this year are not even half of last year. Profit margins have fallen but risk levels have risen dramatically. This all points to the fact that producers who do not possess a base of tea production are at a major disadvantage over raw material sellers, both in terms of today's market and of growth potential. Moreover, in the current short-term situation of gradual investment pull-out, future investment can no longer af-

ford to entirely focus on a single factory's products. This kind of large scale investment into one given product is relatively higher risk in the current environment, but future investment is still likely to be concentrated on the three largest labels. This is not a consideration of profit potential but, rather, of fluidity. I believe, though, that if there is to be future investment in the Puerh tea market, it should not focus on tea products by factory. Instead, it should focus on the raw materials market. Controlling raw materials may allow more fluidity than controlling factory merchandise. In light of this, it seems likely that factories will increasingly vie for control of tea production.

Future development of the market will further consolidate power into the hand of the big producers. Smaller operations will be relegated to the status of contract factories or will gradually decline. By "big" here I'm not referring to volume but rather to brand name. The only teas that will be able to stand independent of plantation teas are wild arbor teas (*Ye Sheng Jiao Mu*). That means if you want to collect plantation teas, you should focus on known and in-demand names. If you want to store teas for their intrinsic value, you should focus on wild arbor products. Wild arbor teas are a small portion of the overall market, and their prices are not supported in the same way—wild arbor prices are directly related to raw material prices. Also, there is a distinct division between the wild arbor tea market and the plantation tea market, which ensures wild arbor teas' growth potential. As long as raw material prices rise, Puerh tea prices will also rise, leading to a certain level of brand weakening. In addition, this current market restructuring is changing the way the market looks at tea collection. In the future, storing Puerh tea will be a true collector's market, with only quality tea products able to stand out.

In the current environment in which high-end food products repeatedly and greatly increase in price, and given that wild arbor tea can be considered high-

end Puerh, it seems likely that wild arbor Puerh will continue to enjoy very good growth in the future. Plantation tea producers, on the other hand, will continue to see their profit margins decline (other than the top three brands).

In the current tea market, sales of plantation teas have almost completely stopped. Wild teas, though, continue to sell in foreign markets as well as in Beijing and Shanghai. This would seem to indicate that speculators have pulled out of the market while tea drinkers continue to buy. It also shows the growth potential for wild arbor teas. I believe that after experiencing the current market correction, large tea factories are likely to reduce production. Moreover, it also seems likely that many less-determined agents will be eliminated from the market.

In the end, though, after a period of rest and reorganization, the market will likely once again begin

to heat up. I believe this will be a return to higher levels of trade rather than increasing prices. The era of exploding profits for factory teas will likely transform into an era of stability, with a gradual return to rationality and quality rather than just considering the accumulation of capital. For many tea lovers this is not a negative situation but rather very good news. It either leads to a future tea market even more dominated by large factories or to a market increasingly focused on quality. This is the gist of the "Fifteen Major Issues" I formulated at the beginning of this year. Finally, let me say that drinking Puerh is a pursuit of the best flavor, not the highest price. If we reduce the extremely rich tea drinking culture and all of the energy that goes into its production to a simple calculation of price, isn't that a rather bleak future for Puerh? This is something that merits pondering. I present this with best wishes for all tea lovers.

The Leaf

