SURYA NEPAL PRIVATE LIMITED

## DIRECTORS REPORT

# Your Directors are pleased to submit their Report and the Audited Accounts of your Company for the year ended 320d Asadh, 2075 (16" July, 2018). SOCIO ECONOMIC AND REGULATORY ENVIRONMENT

The year witnessed Nepal's transition to federalism with the successful formation of governments at the federal, provincial and local level. Such an empowered structure of governance is expected to lend political stability and augurs well for the development of the country. Reforms and policies that enhance the ease of doing business and attract both domestic and foreign investment will be critical to bolstering economic growth going forward.

Towards this, the new federal government and the sub-national governments have promised to promote the country as an attractive investment location. The new Government continues to focus on policies & programs towards attaining the stability, development and prosperity in line with its motto of creating "Prosperous Nepal, Happy Nepalis." The Government has set an ambitious real GDP growth target of 8% per annum along with a target to double per capita income in five years and to transform Nepal to the status of a middle-income country by 2030.

The economy of Nepal grew at a healthy pace during the year under review. Real GDP growth for the year under review is estimated at 5.9% against an average growth of 4.3% during the last decade (2065-2075). The annual average inflation during the year was contained at 4.2% (4.5% in the previous year). However, increasing fuel prices, higher taxes and increased cost of imports due to the recent strengthening of the US Dollar are expected to exert inflationary pressures going forward.

On the external front, merchandise imports increased sharply during the year to 41.3% of GDP as against 37.5% of GDP in the previous year on the back of increase in imports of petroleum products, vehicles and spare parts etc. While workers' remittances grew faster at 8.6% during the year against 4.6% in the previous year, the same declined to 25.1% of GDP compared to 26.3% in the previous year. Consequently, the Current Account Deficit increased significantly to 8.2% of GDP versus 0.4% in the previous fiscal. The successful implementation of recent measures announced by the Government to increase Foreign Direct Investment (FDI) flows into the country and promote industries contributing to exports and import substitution is expected to go a long way in containing the rising pressures on the external account and ensuring the macroeconomic stability of the country.

During the year, the governments at all levels initiated the process of formulating new laws as per the Constitution. Various regulations such as the Consumer Protection Act, Industrial Enterprises Rules and Contribution based Social Security Rules etc. are in the process of being notified. The National Intellectual Property Policy, 2017 was also announced towards ensuring protection and promotion of intellectual property rights in the country. Revamping the current law on intellectual property rights in line with the new Policy as aforementioned will be critical in realising the government's stated objectives. Further reforms towards promotion and protection of investments in the country would be crucial to spur private investments, both domestic and foreign.

Unlike most countries where tobacco and cigarettes are synonymous, the larger share of tobacco consumption in Nepal is in the form of Smokeless Tobacco (SLT) products like khaini, gutka, snuff and betel-quid with tobacco ("Paan"). Despite its low share in total tobacco consumption, the legal cigarette industry occupies an important place in Nepal's economy. The legal cigarette industry:

· provides direct/indirect employment to an estimated 1 lakh people and supports the livelihoods of more than 4 lakh farmers, farm workers, retailers and others engaged in cultivation and trade of tobacco products.

. contributes around 10% of the total excise duty collection of the Government and around 839% of the excise duty collection from the tobacco sector.

. is amongst only a handful of industries in which Nepal has sufficient domestic manufacturing capacity and contributes significantly towards building country's manufacturing competitiveness and industrial productivity.

. is one of the major contributors to the manufacturing sector GDP of the country.

However, a skewed focus on cigarettes has resulted in a punitive and discriminatory taxation policy. The Health Risk Tax, introduced with effect from mid-jestha, 2075, is a case in point. It is pertinent to note that the Health Risk Tax on cigarettes is 14 times higher as compared to smokeless tobacco products (on a per Kg of tobacco basis). The introduction of Health Risk Tax, coupled with increase in excise duty announced in the Budget for 2075-76, has resulted in an unprecedented increase in tax incidence on cigarettes of upto 87%. The tax burden on cigarettes has been exacerbated by the increase in customs duty announced during the

year on import of certain raw materials for the tobacco industry. This has further increased the operating pressure on the legal cigarette industry.

The consumption of cigarettes is highly price elastic. With a large number of cigarette consumers also consuming relatively lower priced Smokeless Tobacco Products like Khaini, Cutkha etc., the steep increase in tax incidence on cigarettes as aforementioned will encourage the shift to cheaper/ revenue inefficient and largely tax evaded tobacco products. The risk of such shift in consumption has also been identified in the WHO Study on Economics of Tobacco in Nepal. The report states that "With increased pricing an Cigarettes, people may switch to smokeless tobacco products. in order to prevent this switching. . it is necessary to increase taxes on these products."

An analysis of the WHO Report on Global Tobacco Epidemic, 2017 reveals that cigarette taxes in Nepal are amongst the highest in world (as a % of per capita GDP required to purchase 2000 cigarettes of most popular brand). Excessively high rates of taxes levied in cigarettes create a lucrative arbitrage for counterfeiters and smugglers. The Interpol, in its Trafficking and Counterfeiting Casebook, states that "It would be hard to find a more ideal candidate for counterfeiting and illicit trade than cigarettes. The product is smoll, lightweight ond profitable for ilicit trade because the sale price is many times the cost of manufacture, mostly due to high levels of local tax in most countries". It may be noted that illegal trade taken as a whole ranks as the fourth biggest tobacco "company" in the world.

Steep increase in duties on cigarettes, which are already subject to punitive and discriminatory taxation; will not only severely impact the legal cigarette industry and provide fillip to the illicit trade but also sub- optimise the revenue potential of the tobacco sector. The most effective ways to check the menace of illicit trade of cigarettes while pursuing health and revenue objectives are non-discriminatory & equitable taxation across tobacco products and moderation in cigarette taxation.

In addition to the punitive and discriminatory taxation regime, the legal cigarette industry is also subject to a harsh regulatory framework in Nepal. The provisions of the Tobacco Products Control and Regulation Act (TOPCA) require cigarette packages to carry Graphic Health Warnings (GHW) covering at least 75% of the total surface area of the packet. Unlike the global trend of regulatory requirement of printing the health warning on the principal display area (front and back of the package), regulations in Nepal require printing of health warnings covering 75% of the entire surface area of the package.

In this context, it is pertinent to note that the global average size of pictorial warnings is only about 30% coverage of the principal display area. In fact, the three countries that account for about $1% of the world's cigarette consumption, viz. USA, Japan and China have not adopted pictorial/graphical health warnings and have prescribed only text-based warnings on cigarette packages.

Despite this, the Ministry of Health issued two new Directives in Kartik'71 (November 2014) and Poush'71 (January 2015) which, inter alia, require manufacturers to print multiple pictorial wamings and warning messages on at least 90% of the total surface area of the cigarette packet- the largest in the world. The pictures and warning messages, provided in the proposed Directive are even more egregious, gruesome and exaggerated than the existing GHW and seem to be designed to shock, as opposed to factually inform, the consumer.

The existing 75% GHW already impedes the legal cigarette industry from providing comprehensive brand information on the cigarette packet, thereby preventing cigarette consumers from making fully informed choices across brands. It is apprehended that a further increase in size of GHW to 90% will have the following unintended consequences:

. commoditization of the product due to practically no space being available on the cigarette packet for providing brand information. As a result of this, price will become the most significant determinant for consumer choice.

. further filip to growth of smuggled international brands that do not carry statutory GHW as well as spawning of manufacture of counterfeit look-alike products of dubious quality. These duty evaded cigarettes can be offered to consumers at prices far lower to duty paid cigarettes. The growth of illicit cigarettes will also depress the demand for domestic tobacco thereby adversely impacting the earnings of Nepali tobacco farmers and farm workers as well as lakhs of people who are dependent directly/indirectly on the legal cigarette industry for their livelihood.

. substantially lower tax revenue to the exchequer.

It has been experienced internationally that extreme regulations do not reduce demand for tobacco, but merely shift it from the legal to illegal tobacco products of suspect quality, thereby undermining public health objectives.

As stated in previous years, your Company, along with other stakeholders like farmers, retailers etc. has made recommendations to the Ministry

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